LPL RESEARCH
GLOBAL PORTFOLIO STRATEGY

January 2021

STOCKS FAVORED OVER BONDS IN 2021

LPL Research's Monthly Market Outlook

We see an S&P 500 Index fair value target range of 3,850–3,900 at year-end 2021 with potential for upside if there's better-than-expected progress on vaccine distribution. A strong earnings rebound may enable stocks to grow into somewhat elevated valuations. Our S&P 500 target is based on a price-to-earnings (PE) multiple of 20 and our preliminary 2022 earnings forecast of $190. We see the 10-year yield finishing 2021 in a range of 1.25–1.75%. Inflation is likely to rise temporarily but then normalize, and the Federal Reserve (Fed) is expected to keep rates low. At the same time, an improving economy and even normalizing inflation could put upward pressure on rates, limiting return potential for high-quality bonds.

KEY CHANGES FROM DECEMBER'S REPORT:

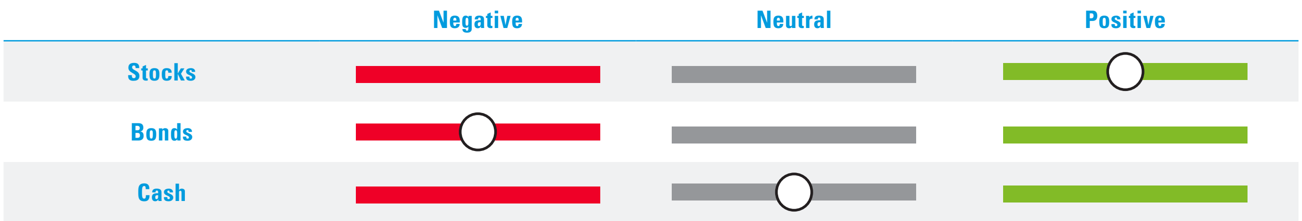
- Upgraded financials and crude oil views to neutral
- Downgraded communication services view to neutral

INVESTMENT TAKEAWAYS

- Our equities recommendation remains overweight. We continue to favor stocks over bonds based on our expectation for a strong economic and earnings recovery in 2021, supported by additional fiscal stimulus—with potentially more coming soon based on the outcome of the Georgia Senate races— continued progress in combating COVID-19, and the likely continuation of the low-rate environment.
- Key near-term risks include containing the latest wave of COVID-19 while awaiting vaccines and concerns about potential tax increases and tougher regulations under a Democratic-controlled Congress.
- We maintain a slight preference for growth stocks as 2021 begins, bolstered by strong earnings trends and favorable positioning for the pandemic.
- As the economic recovery progresses in 2021, we would expect cyclical value stocks to get a boost. We have taken one step closer to a balanced growth-value view with this month's financials upgrade.
- We expect solid economic growth across Asia to support continued outperformance by stocks in emerging markets (EM). EM may garner additional support from potential easing of US-China trade tensions, although ongoing geopolitical and regulatory threats may lead to bouts of volatility.
- Our fixed income view remains underweight. While Fed policy and modest inflationary pressure for now may limit the risk of a large rate move, rising rates may still put some pressure on bond returns going out a full year.
- We favor a blend of high-quality intermediate bonds that is underweight US Treasuries with an emphasis on short-to-intermediate maturities with sector weightings tilted toward mortgage-backed securities (MBS).

BROAD ASSET CLASS VIEWS

LPL Research's Views on Stocks, Bonds, and Cash



OUR ASSET CLASS & SECTOR CHOICES

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
▪ Emerging Markets Equities ▪ Growth Equities	▪ Healthcare ▪ Materials ▪ Technology	▪ Mortgage-Backed Securities	▪ Event Driven

2021 MARKET FORECASTS

Expect Solid Gains for Stocks in 2021 as COVID-19 Progress Continues

	2021
10-Year US Treasury Yield	1.25–1.75%
S&P 500 Earnings per Share	$165
S&P 500 Fair Value	3,850–3,900*

Source: LPL Research, FactSet, Bloomberg

All indexes are unmanaged and cannot be invested into directly. The economic forecasts may not develop as predicted.

*As noted in our *Outlook 2021: Powering Forward* dated 12/08/2020, our year-end 2021 fair-value target range for the S&P 500 of 3,850–3,900 is based on a PE of 20 and our preliminary 2022 S&P 500 EPS forecast of $190 in 2022.

2021 ECONOMIC FORECASTS

End of Pandemic to Usher in Strong Global Economic Recovery in 2021

	2021
United States	4 to 4.5%
Developed ex-US	3.75% to 4.25%
Emerging Markets	5% to 5.5%
Global	4.5% to 5%

Source: LPL Research, Bloomberg

The economic forecasts may not develop as predicted.

All data, views, and forecasts herein are as of 1/05/21.

EQUITY ASSET CLASSES

Sticking with Growth as 2021 Begins

We favor stocks over bonds in 2021 based on our expectation for a strong economic and earnings recovery, supported by additional fiscal stimulus, continued progress combating COVID-19, and still-low interest rates. We maintain a slight preference for growth stocks, but as the economic recovery progresses, cyclical value stocks may get a boost. We expect solid economic growth across Asia to support continued outperformance by stocks in emerging markets over their developed international markets counterparts.

	Sector	Overall View	Relative Trend	Rationale
Market Capitalization	Large Caps			The relatively greater financial strength enjoyed by most **large cap** companies has helped during the pandemic. But smaller market cap companies tend to perform better early in economic expansions and during the early stages of bull markets, which has caused market participation to broaden out.
	Mid Caps			**Mid caps** enjoy some of the early cycle characteristics of small caps, and therefore, should perform well as a more durable recovery develops. We believe mid cap stock valuations are more attractive than those of small caps in general.
	Small Caps			We maintain our neutral view of small caps with a positive bias. As the end of the pandemic approaches, the chances of sustained small cap leadership may improve. The early-stage bull market and beginning of the new economic expansion provide tailwinds for small cap stock relative performance.
Style	Growth			We maintain a slight preference for growth stocks, bolstered by strong earnings trends and favorable positioning for the pandemic. As the threat of COVID-19 subsides and the economic recovery picks up steam, we would expect cyclical value stocks to get a boost.
	Value			As a more durable economic recovery emerges in the coming months, we would expect cyclical value stocks to perform well. Value stocks remain attractively valued relative to their growth counterparts. The latest fiscal stimulus package helps. Our financials upgrade this month is a step toward value.
Region	United States			Among developed markets, we remain US-focused, but international developed equities have become more interesting as the world moves closer to the end of the pandemic and the US dollar weakens. We see solid gains for US stocks in 2021, but the gap between US and developed international stocks has started to narrow.
	Developed International			As a more durable economic expansion materializes and the US dollar potentially weakens further, performance for European and Japanese markets may improve. We give the edge to Japan over Europe based on the country's massive stimulus efforts and relative success containing COVID-19.
	Emerging Markets			We expect solid economic growth across Asia to support continued outperformance by emerging market equities over developed markets in 2021. China has led the way out of the global health crisis and is the only major economy in the world expected to grow in 2020. US-China tensions may calm some under a Biden administration. Political instability in certain emerging countries carries risk.

Trend is measured by relative performance of the index for the past 12 months, minus the most recent month, compared to the other indexes in a particular sector or asset class grouping.

EQUITY SECTORS

Continue to Favor Cyclical Sectors

We continue to favor cyclical sectors in general for 2021 based on the early cycle stage of the economic expansion and bull market. However, a challenging near-term outlook with a still significant threat posed by COVID-19 leads us to a somewhat more balanced approach. Our favorite sectors are technology, healthcare, and materials. We have upgraded financials this month due to an improving interest-rate outlook and better performance. Our communication services downgrade reflects regulatory risk and risk of rotation away from interactive media stocks.

	Sector	Overall View	Relative Trend	S&P Wgt	Rationale
Cyclical	Materials			2.7	As China's economy outpaces the rest of the world, metal and agriculture prices have firmed. Beneficiary of weak US dollar and strong housing market. Additional fiscal stimulus passed in December 2020 helps.
Cyclical	Energy			2.4	Production has become more profitable after oil's rally. Demand outlook has improved, and technical analysis signals are improving. US supply overhang and prospects for more international production still suggest caution.
Cyclical	Industrials			8.3	Expected to be among the biggest beneficiaries of an eventual durable economic recovery. Support from strong Chinese economy and weak US dollar. Earnings poised to rebound strongly in 2021.
Cyclical	Communication Services			10.7	Beneficiary of the stay-at-home environment. Risk of rotation toward cyclicals as economy reopens is a concern, and regulatory environment may toughen. Valuations are reasonable.
Cyclical	Consumer Discretionary			12.8	Historically a strong early-cycle performer. E-commerce and housing are booming, supporting our neutral view despite rich valuations and likely long wait for hospitality, travel, and leisure industries to fully recover.
Cyclical	Technology			27.5	Strong earnings outlook, benefiting from work-from-home environment and some powerful secular mobile and cloud computing trends; valuations are still reasonable overall, in our view.
Cyclical	Financials			10.4	Upgraded view driven by steeper yield curve, rising interest rates, improving economic outlook, and higher shareholder payouts. But interest rates are still low, and a durable economic expansion hasn't arrived yet.
Defensive	Utilities			2.7	Valuations are reasonable, and more green energy spending may help boost growth, but we still expect interest rates to rise and prefer healthcare among defensives.
Defensive	Healthcare			13.6	A favorable healthcare spending outlook, demographics, resilient earnings, and attractive valuations are supportive. Democratic-controlled Congress potentially may drive more spending, but also introduce regulatory risk.
Defensive	Consumer Staples			6.5	Historically a poor relative performer early in economic cycles. Resilient revenue streams may help some near term, but will likely be a drag as the recovery progresses.
Defensive	Real Estate			2.4	Fundamentals are mixed overall, with particular challenges in the retail and office areas. Favor healthcare, technology, and industrial segments.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

FIXED INCOME

Limit Rate Sensitivity With Intermediate Focus

We suggest a blend of high-quality short-to-intermediate bonds in tactical portfolios. We expect the 10-year Treasury yield to climb to 1.25–1.75% in 2021 as economic activity continues to recover. Compensation for longer-maturity, rate-sensitive bonds remains unattractive, in our view, supporting our positive view of MBS. We still see incremental value in corporate bonds over Treasuries, but credit spreads have little room for further tightening. We favor municipal bonds as a high-quality option for taxable accounts, although valuations relative to Treasuries have normalized.

		Low	Medium	High	Rationale
Positioning	Credit Quality		●		Credit spreads have tightened significantly, but the economic outlook may be supportive despite near-term risks.
		Short	Int.	Long	
	Duration	●			Extraordinarily low interest rates and prospects of economic acceleration increase interest-rate risk.

		Neg.	Neutral	Pos.	Rationale
Sectors	US Treasuries	●			Yield spreads to international sovereigns remain attractive. Valuations have become expensive after COVID-19-related demand. Inflation breakeven rates leave TIPS fairly valued versus Treasuries .
	MBS			●	Fed buying is supportive, spreads are wider than other quantitative easing (QE) periods, and refinancing and prepayment are slowing. MBS may provide some resilience if rates rise. Diversifying source of yield among high-quality options.
	Investment-Grade Corporates		●		Risks tempered as economy improves and vaccine development progresses, but valuations appear rich compared to history. Leverage metrics have increased, but cash levels are high. Interest-rate sensitivity has increased but shorter maturity options exist.
	Preferred Stocks		●		Higher credit quality among the riskier fixed income options. Bank fundamentals sound overall. Can be rate sensitive but may be able to tolerate gradual increases.
	High-Yield Corporates	●			Valuations have grown rich but economic environment may become more supportive. Distressed high-yield bond levels are back to pre-COVID-19 levels and defaults have slowed. More attractive for income-oriented investors. We believe equities have more upside and high-quality options may be better diversifiers.
	Bank Loans	●			Weaker investor protections and Fed unlikely to raise rates for some time, which may limit investor demand. Valuations approaching neutral. Distressed loans levels have recovered to pre-COVID-19 levels and defaults have slowed.
	Foreign Bonds	●			Rich valuations, interest-rate risk, and potential currency volatility are among the negatives.
	EM Debt		●		Dovish central banks improve the valuation picture. Stronger global growth and commodity prices could be supportive, but spreads no longer attractive. Liquidity can be an added risk during periods of stress.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk. **Bank loans** are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk. For the purposes of this publication, **intermediate-term bonds** have maturities between 3 and 10 years, and short-term bonds are those with maturities of less than 3 years.

All bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. **Corporate bonds** are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Investing in **foreign and emerging market debt (EMD)** securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. **High-yield/junk bonds** are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. **Municipal bonds** are subject to availability, price, and market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. **Mortgage-backed securities (MBS)** are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

COMMODITIES

Favor Precious Metals

Our view of **industrial metals** is positive, reflecting China's strong economic growth outlook, an improving outlook for growth in the United States, and the strong technical momentum of copper. A potentially weaker US dollar could provide a boost to industrial metals and the broader commodities complex.

Our **precious metals** view is neutral. Our December downgrade of this asset class was driven primarily by our technical analysis work that suggested less upside potential in the near term. The attractiveness of precious metals is further reduced by the improving economic outlook and rising interest rates, although the potential for additional US dollar weakness and the latest surge in COVID-19 may help attract some interest in the **gold** commodity and support the price.

We have upgraded our **crude oil** outlook to neutral primarily due to improving signals from our technical analysis work. At the same time, the global demand outlook has improved recently as the end of the pandemic comes into view, and higher oil prices have increased the amount of potentially profitable production. Our concerns remain the US supply overhang that may limit upside potential for prices, the potential for more production internationally as prices rise, and the likely slow recovery in travel-related demand, particularly air travel.

ALTERNATIVE INVESTMENTS

Event-Driven Strategies Ended 2020 On A High Note

Alternative investment strategies ended 2020 on a positive note, with event-driven strategies—our preferred implementation solution—returning 2.18%, as measured by the HFRX Event Driven Index. For 2020, the index gained 8.89%, with an equity beta of 0.25 and a volatility of 7.5%. The merger and acquisition environment remains extremely active, and at the end of November, year-over-year deal activity was down only 8%. This is a rather remarkable turnaround when considering that deal volume was down 40% at the end of the second quarter of 2020.

Going forward, the merger and acquisition backdrop is supported by access to cheap funding, private equity cash hordes, and the ability to use all-time-high share prices for share transactions. While this environment has been healthy for transactions, unfortunately it's led to the average deal spread tightening to roughly 5%, which is in line with the historical average and something we are closely considering. At this point, we believe the sheer number of investment opportunities across the event-driven space compensates for the average deal spread, and we believe skilled active managers will continue to add value. While the strategy continues to feature a conservative risk profile, if spreads continue to decline and if merger announcements were to taper off, we would consider revising event-driven strategies as our top alternative investment pick..

IMPORTANT DISCLOSURES

This material has been prepared for informational purposes only, and is not intended as specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors and they do not take into account the particular needs, investment objectives, tax and financial condition of any specific person. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing. Any economic forecasts set forth may not develop as predicted and are subject to change.

Stock investing involves risk including loss of principal. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Value investments can perform differently from the market as a whole and can remain undervalued by the market for long periods of time. The prices of small and mid-cap stocks are generally more volatile than large cap stocks. Bonds are subject to market and interest rate risk if sold prior to maturity.

Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Corporate bonds are considered higher risk than government bonds. Municipal bonds are subject to availability and change in price. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply. U.S. Treasuries may be considered “safe haven” investments but do carry some degree of risk including interest rate, credit, and market risk. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue’s ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor’s portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments. The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks. All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

Earnings per share (EPS) is the portion of a company’s profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company’s profitability. Earnings per share is generally considered to be the single most important variable in determining a share’s price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

All index data from FactSet.

For a list of descriptions of the indexes referenced in this publication, please visit our website at lplresearch.com/definitions.

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