LPL RESEARCH WEEKLY MARKET COMMENTARY

June 15 2020

POTENTIAL PATHS FOR STOCKS IN THE SECOND HALF

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Stocks staged perhaps the strongest rally in history—a more than 44% gain for the S&P 500 Index from March 23 through June 8—before pulling back about 6% late last week. With so much economic healing ahead of us and a still-uncertain path for COVID-19, the key question for investors is whether stocks are pricing in an overly optimistic scenario for the recovery in economic activity and corporate profits.

MARKETS REFLECT A LOT OF OPTIMISM

Our expectations for a gradual economic recovery in the second half, discussed here last week, appear to be in conflict with the stock market's rapid ascent over the past 12 weeks. On one hand, gains appear appropriate based on the likelihood that the recession—officially declared on June 8—may be the shortest ever, aided by the massive stimulus response by policymakers and initial progress toward a vaccine.

On the other hand, the risk of a second wave of COVID-19 remains, particularly as some southern and western states have seen increases in infections and hospitalizations. In addition, some of the 20 million jobs lost in March and April as reported by the Labor Department will take a while to come back due to social distancing constraints and potentially lasting changes in consumer behavior.

The uncertainty around these paths suggests stocks may have come too far too fast. Although some recessions see stocks quickly recover bear market losses (1980, 1990), most of the time the journeys back to record highs take a year or more **[Figure 1]**.

1 BEAR MARKET RECOVERIES CAN TAKE YEARS

Date of S&P 500 Peak	Bear Market Duration (Months)	Magnitude of Decline	Months to Recover
Aug '56	14	-22%	11
Dec '68	17	-36%	21
Jan '73	21	-48%	69
Nov '80	21	-27%	3
Jul '90	3	-20%	4
Mar '00	31	-49%	56
Oct '07	17	-56%	49
Feb '20	1	-34%	?

Source: LPL Research, FactSet, CFRA 06/12/20

A bear market is when a stock index or security closes 20% or more above a 52-week high.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The modern design of the S&P 500 index was launched in 1957. Performance before then incorporates the performance of its predecessor index, S&P 90.

VALUATIONS MAY SLOW STOCKS DOWN

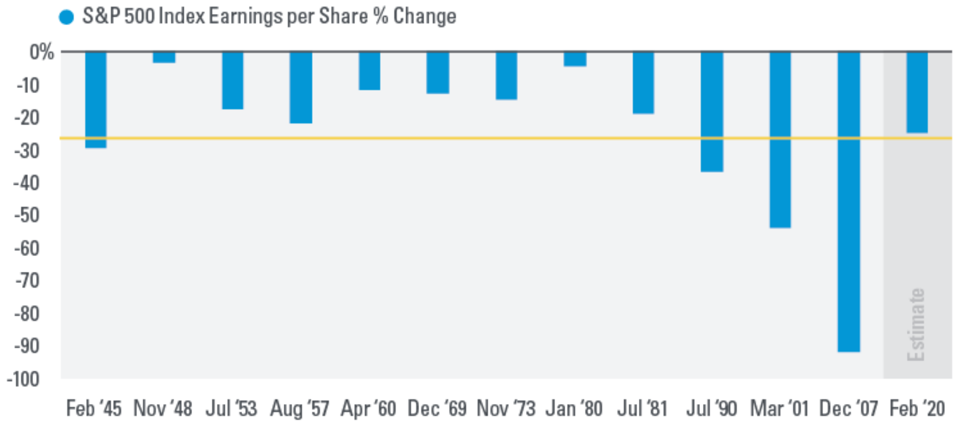
Stock market valuations have gotten more expensive because earnings have fallen, which may bring volatility if the recovery disappoints.

Using the 2021 consensus earnings estimate (source: FactSet) that we believe is overly optimistic, the S&P 500's price-to-earnings ratio (PE) over 18 is well above historical averages. However, low interest rates make bonds a less attractive alternative, while the absence of inflation, massive fiscal and monetary stimulus, and good prospects for a COVID-19 vaccine next year make these valuations tolerable. We are hesitant to place too much emphasis on valuations given they have not historically been good predictors of short-term stock market performance.

EARNINGS FACE LONG AND UNCERTAIN ROAD BACK

Our S&P 500 earnings forecast for 2020 is $120 to $125 per share. At the midpoint, earnings would drop about 25% from 2019's level of $163, roughly in line with the average historical decline in recessions **[Figure 2]**, reflecting: 1) the severity of the decline in economic activity in March and early April, 2) the initial snapback in activity after many states began to reopen beginning in mid-April, and 3) growth headwinds that will constrain the trajectory of the recovery later this year.

2 EARNINGS PER SHARE DECLINES DURING RECESSIONS



Source: LPL Research, NBER, Strategas 06/12/20

LPL Research assumes that the current recession that started in February continued at least through April, although that isn't offical as of June 12, 2020.

Estimates may not develop as predicted.

The severity of the recession and challenges for businesses incorporating social distancing introduce downside risk to this forecast, though encouraging progress to date in reopening the economy and reluctance to shut down again may limit the downside.

MARKETS LOOKING TO 2021 AND BEYOND

We believe the optimistic economic recovery scenario reflected in stocks may limit their upside potential over the rest of the year. Our year-end target range is 3,150-3,200 **[Figure 3]**, based on a price-to-earnings ratio (PE) of about 19 and a normalized earnings figure of $165. At the high end of that range, that only allows for 5% upside from the June 12 close.

An annual earnings run rate like that may not be achievable until well into 2021. But with interest rates so low and the possibility of a COVID-19 vaccine during that time, we are comfortable using a longer-term earnings target to value stocks here.

3 2020 MARKET FORECASTS

	2020 Base Case	2020 Bear Case
10-Year US Treasury Yield	1.25–1.75%	0–0.5%
S&P 500 Earnings per Share	$120–125	$110–115
S&P 500 Fair Value	3,150–3,200	2,650

Source: LPL Research 06/05/20

Economic forecasts set forth may not develop as predicted and are subject to change.

Although we believe stocks may have come too far too fast in the short-term, for long-term investors, we continue to believe stocks are more attractive than bonds. The early phases of bull markets have historically been accompanied by strong gains, which we think still leaves room for additional gains in the second half and in 2021. Our research shows that while the average two-year gain for the S&P 500 coming off bear market lows is 47%, leaving little room for additional upside, the bigger drawdowns have been followed by stronger two-year bounces, including following the bear markets in 2008-2009 (96%) and 2000-2001 (58%).

BEAR CASE

The potential for a second wave of COVID-19 introduces downside risk to our earnings and stock market forecasts on top of the uncertainty around how fast profits in some of the harder-hit areas of the economy can come back. Given what we have learned since March fighting this battle, including experiences in other countries that have successfully contained the virus, we are optimistic that the economic and profit impact of a potential second wave would be more moderate than what we have just experienced.

We see potential downside in S&P 500 earnings in 2020 of $110 per share and a possible downward move in the S&P 500 to 2,650. We place a 10-15% probability on this scenario.

BULL CASE

Meaningful progress toward a COVID-19 vaccine could act as a market catalyst in the second half and potentially enable a stronger snapback in economic activity and corporate profits than we anticipate. In that scenario, we could see the S&P 500 break to new highs in the fall and propel S&P 500 earnings back to 2019 levels in 2021. We place a 15-20% probability on this scenario and consider it slightly more likely than the bear case.

EQUITY POSITIONING

We continue to favor large caps over small caps and US over developed international. Our style preference in the near-term is to lean toward growth in the still-challenging economic environment, though we would anticipate intermittent periods of value strength in the second half as more evidence of a durable economic recovery emerges. Our favored sectors are communication services, healthcare, and technology, which we believe offer the best combinations of strong balance sheets and earnings stability for the challenging near-term environment and growth potential beyond the recession. Consumer discretionary, financials, and industrials would be likely beneficiaries in the event that our bull case scenario materializes.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

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.

All index data from FactSet.

Please read the full Outlook 2020: Bringing Markets Into Focus publication for additional description and disclosure.