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DOWNSIDE RISK REMAINS

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Stocks fell last week, and many blamed the drop on high stock valuations, Federal Reserve Chairman Jerome Powell's gloomy outlook, and rising US-China tensions. Perhaps investors also are increasingly skeptical about prospects for a smooth V-shaped recovery. Regardless, stocks may have been due for a pullback after gains in late March through April and could potentially have further to fall.

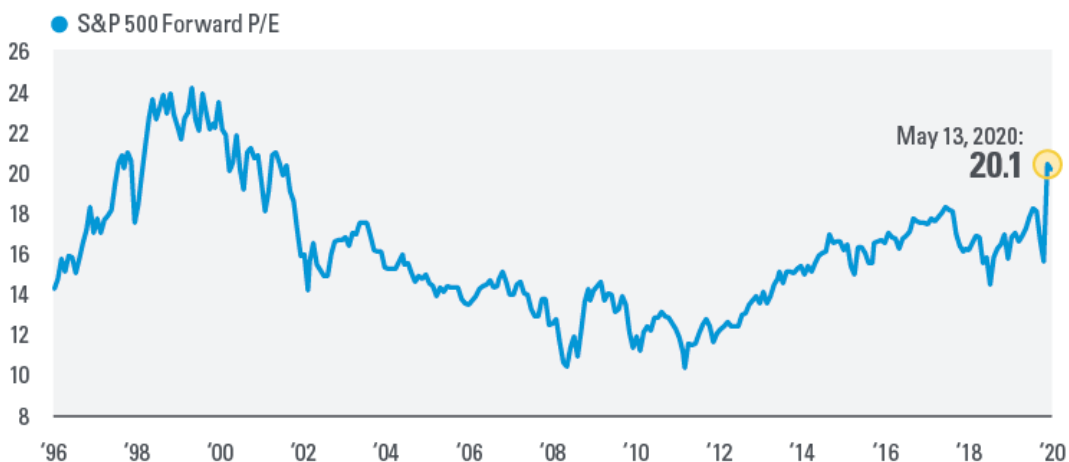
THREE BIG STORIES

We think the three biggest stories for investors in the last week were: 1) elevated stock market valuations, 2) Federal Reserve (Fed) Chair Jerome Powell's gloomy outlook, and 3) rising US-China tensions.

Elevated valuations. As stocks rallied more than 30% off the March 23 lows and earnings expectations were cut dramatically, stock valuations have become increasingly concerning for many investors—including some high-profile hedge fund managers quoted in the financial press. The forward (next 12 months) price-to-earnings (PE) multiple for the S&P 500 Index recently eclipsed 20, which is overvalued based on historical averages and at the highest level since the technology bubble in the late 1990s and early 2000s [\[Figure 1\]](#).

Valuation fears may be exaggerated if we get a steady earnings recovery beginning later this year, as we expect. Also, currently low interest rates and low inflation have been associated with higher valuations historically, and valuations are not very good at predicting where stocks will go over the near term.

1 STOCKS HAVE GOTTEN EXPENSIVE: S&P 500 INDEX PRICE-TO-EARNINGS (PE) RATIO IS HIGHEST SINCE THE TECH BUBBLE



Source: LPL Research, FactSet 05/13/20

So, while we acknowledge valuations are high relative to historical trends, and a larger pullback would not surprise us over the near term, the market's forward PE ratio using depressed 2020 earnings doesn't worry us too much given the environment.

Federal Reserve. Powell's outlook for the economy, based on his May 13 comments, hardly inspired confidence, but he did not tell investors anything they didn't already know. The US economy is contracting sharply, the recovery may be tricky, and more fiscal policy support from Congress may be needed, though it appears more may be coming in June. We think markets generally have already priced in a historically sharp—but short-lived—economic contraction, even though along the road to recovery there may be some bumps that bring periodic bouts of market volatility. Powell sprinkled in some optimism in his May 17 *60 Minutes* interview in saying the country will get to a better place, and it won't take very long.

Powell also threw more cold water on the idea of negative interest rates, something the European Central Bank and Bank of Japan have undertaken to provide more support for their financial systems and economies. The potential unintended consequences of negative interest rates continue to concern the Fed (and us, too). Several Fed presidents have expressed skepticism recently about the idea of negative rates. The central bank has more tools at its disposal that it could use before resorting to negative rates, including potentially expanding lending facilities or asset purchases.

Bottom line, we would be surprised to see negative rates from the Fed under Powell's leadership, but given that the fed funds futures market had briefly priced in negative interest rates for next year, we most likely should pay attention.

US-China relations. Rhetoric from the White House on China has become tougher in recent weeks. Anti-China sentiment has become more of a bipartisan issue as many Americans are unhappy with China's response to the COVID-19 outbreak, not to mention the question of whether China could have prevented the virus from spreading in the first place. If the Trump administration thinks taking a tough approach with China may help secure votes in November, then we may see more market volatility around the issue. It may not be a coincidence that the strong rhetoric picked up at the end of April around the same time this latest pullback began.

From an economic perspective, tariffs may be a very unlikely tool for retaliation against China with such a weak US economy, but markets might get jittery if it looks like the United States may pull out of the trade deal signed with China in January. It's more likely we may see the Trump administration push harder for domestic companies to bring their supply chains back to the United States from international locations.

SHORT-TERM CAUTION

We continue to follow our [Road to Recovery Playbook](#) to help guide us through this challenging market environment. We are encouraged by progress in containing COVID-19 and reopening parts of the US economy. Since late March, massive stimulus has provided stocks with a tailwind that may get stronger in the coming weeks, with another stimulus package potentially on the way.

However, potentially stretched valuations and our technical analysis suggest we may be due for a larger pullback in stock prices. The S&P 500 has had a difficult time breaking through the 2,935 level, and 10% corrections after big rallies from major bear market lows have been typical historically. For tactical investors, we would look for 2,650 on the S&P 500 as a potential attractive entry point. Still, we think the economic

recovery in the second half of the year may be strong enough to justify our overweight equities recommendation over an intermediate-term period, especially in the context of dampened return prospects for bonds at such low interest rates.

Our 2020 year-end S&P 500 fair-value target range remains 3,150–3,200, roughly 10% from the market's close on May 15 at the low end of the range. Though the timing of achieving “normal” earnings is uncertain, and the path to get there may be volatile, we believe a PE of 19 on \$165 per share in S&P 500 earnings 12 to 24 months out, which gets us to a fair-value target around 3,150, is a reasonable fair-value target once normalized earnings come into view.



IMPORTANT DISCLOSURES

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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.

Forward Price To Earnings (Forward P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

All index data from FactSet.

Please read the full [Outlook 2020: Bringing Markets Into Focus](#) publication for additional description and disclosure.

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