LPL RESEARCH
GLOBAL PORTFOLIO STRATEGY

July 2020

The Comeback Continues

LPL Research's monthly global review and look forward

Investment Takeaways

Stocks continued their strong run in June, despite rising COVID-19 cases in several western and southern states. Reopening progress, better-than-expected economic data, optimism around vaccine prospects, and the likelihood of more stimulus offered support. We have upgraded our view of growth stocks to positive.

- **Our equities recommendation remains overweight**. Although we continue to believe markets may be pricing in an overly optimistic economic recovery scenario and a pullback may be overdue, reopening progress, surprisingly strong recent economic data, and progress on COVID-19 treatments are encouraging, while massive fiscal and monetary stimulus and low interest rates improve the attractiveness of stocks relative to bonds.
- Our year-end 2020 fair-value target for the **S&P 500 Index** of 3,150–3,200 is under review now that stocks have achieved that level. That target is based on a price-to-earnings multiple (PE) of 19 on $165 in normalized index earnings per share (EPS). We plan to announce our new target on July 14 with the launch of *Midyear Outlook 2020*.
- We maintain our preference for **large cap stocks** for their relatively stronger financial positions as the economy faces a challenging road back to pre-pandemic levels of activity.
- We have upgraded our view of **growth stocks**, which we believe are better positioned for the economic recovery in the second half of the year.
- China has led the way out of the global crisis and supported **emerging market** equities, which we find attractively valued relative to **developed markets**.
- **Our fixed income view remains underweight.** While Federal Reserve (Fed) policy and current economic uncertainty may limit the risk of yields moving substantially higher, a likely second-half economic recovery may continue to support riskier assets going out a full year.
- We favor a blend of **high-quality intermediate bonds** with a modest underweight to **US Treasuries** and an emphasis on short-to-intermediate maturities with sector weightings tilted toward **mortgage-backed securities** (MBS).

Key changes from June's report: Upgraded growth stocks to positive from neutral and downgraded value stocks from neutral to negative.

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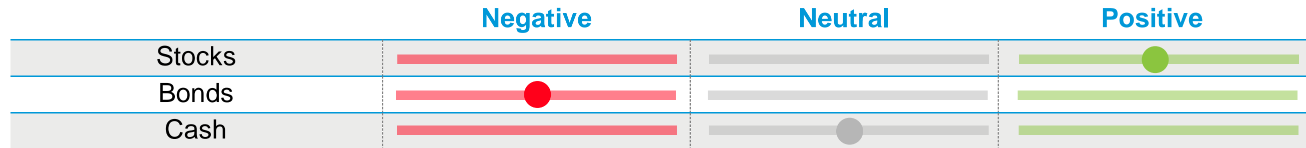
Broad Asset Class Views: LPL Research's Views on Stocks, Bonds, and Cash



Our Asset Class & Sector Choices

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
Emerging Markets Equities Large Cap US Equities Growth Equities	Communication Services Healthcare Technology	Mortgage-Backed Securities	Event Driven

Data as of July 8, 2020

2020 Market Forecasts
COVID-19 Creates Significant Earnings and Interest Rate Uncertainty

	June GPS Forecast	Base Case	Bear Case
10-Year US Treasury Yield	1.25–1.75%	1.0–1.5%	0–0.5%
S&P 500 Earnings per Share	$120–125	$120–125	$110–115
S&P 500 Fair Value	3,150–3,200*	Under review	2,650

*As noted in our *Weekly Market Commentary* dated 06/15/2020, our year-end fair value target for the S&P 500 of 3,150–3,200 is based on a price-to-earnings ratio (PE) of about 19 and potential normalized S&P 500 earnings per share of $165 in 2021–22.

Source: LPL Research, Bloomberg 07/8/2020
All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

2020 Economic Forecasts
COVID-19 May Have Sparked a Global Recession

	June GPS Base Case Forecast	Revised 2020 Base Case	Revised 2020 Bear Case
United States	-2% to -4%	-3% to -5%	-5% to -8%
Developed ex-US	-3% to -5%	-5% to -7%	-7% to -10%
Emerging Markets	flat to 2%	flat to 2%	flat to -3%
Global	-2% to flat	-1% to -3%	-3% to -6%

Source: LPL Research, Bloomberg 07/8/2020

The economic forecasts may not develop as predicted.

Equities Asset Classes: Favor US Large Caps and Emerging Markets

We expect recent outperformance by small cap stocks to fade as the path of economic recovery gets tougher and the broad stock market potentially pauses to digest recent gains. In that environment, we favor the relatively stronger financial positions of large cap companies. From a style perspective, we believe growth stocks appear better positioned than value in the near term, but as a more durable economic recovery potentially emerges later this year, value could stage a turnaround. We believe the United States remains well positioned for a recovery, but China is leading the way out of the global economic crisis, which we expect to support emerging market equities.

	Asset Class	Overall View	Relative Trend*	Rationale
Market Cap	Large Caps			We expect recent outperformance by **small cap stocks** to fade as the path of economic recovery gets tougher and the broad stock market potentially pauses to digest recent gains. In that environment, we favor the greater financial strength typically enjoyed by larger cap companies.
	Small Caps			**Small caps** have tended to perform relatively well early in economic expansions and the US economy likely emerged from recession in June. But our expectation for a choppy recovery and a potential stock market correction in the second half makes further small cap outperformance unlikely, in our view. We prefer fundamentals and valuations for **mid caps** over small.
Style	Growth			We have upgraded our view of **growth stocks** from a style perspective. We believe the ability to grow earnings without much help from the economy, more resilient businesses, and generally better balance sheets favor growth.
	Value			As a more durable economic recovery potentially emerges later this year, **value stocks** could stage a turnaround. Valuations of value stocks relative to their growth counterparts are very depressed compared with their history.
Region	United States			Among developed markets, we remain US-focused. We believe the US economy, bolstered by massive fiscal and monetary stimulus, is better positioned to recover from COVID-19 in the second half of 2020 than Europe. The US market has a good sector mix for the current environment in our view, led by mega-cap growth stocks.
	Developed International			We expect economies in **Europe** to contract more than the United States or Japan in 2020. In an eventual post-crisis economic recovery, fiscal deficits and populism may continue to weigh on sentiment, spending, and investment for the Eurozone. Conversely, movement toward a coordinated fiscal response to COVID-19 and potential further US dollar weakness may introduce potential long-term upside. Bloomberg's consensus forecasts for **Japan** 2020 GDP growth are calling for a smaller contraction than in Europe, supported by a very aggressive stimulus response. The latest fiscal proposal could bring Japan's fiscal policy boost to 40% of GDP, increasing the chances of a solid second-half recovery.
	Emerging Markets			**China** has led the way out of the global crisis in terms of containing the virus and reopening its economy. However, that has not been enough to enable emerging market stocks to outperform the United States in 2020, based on the MSCI Emerging Market Index. Still, we find emerging markets attractive based on relative valuations and prospects for better economic growth in 2020, and likely well beyond. Our primary concerns are increasing US-China tensions, emerging market's inability to convert economic growth into profits and shareholder value in recent years, political instability, and Brazil's and India's difficulty containing COVID-19.

*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.

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Equities Sectors: Favor Cyclicals for the Rebound

We continue to favor cyclical sectors in general, but with an emphasis on sectors we think are best positioned for the economic challenges presented by the pandemic, namely communication services, healthcare, and technology. Our neutral views of financials and industrials reflect a relatively weaker earnings outlook and potential underperformance in a pullback, though these sectors would be expected to perform relatively well once a more durable economic recovery is in place.

	Sector	Overall View	Relative Trend	S&P 500 Weight(%)	Rationale
Cyclical	Materials			2.5	As China's economy outpaces the rest of the world, commodity prices have firmed. But global demand will likely come back gradually, curbing our enthusiasm.
Cyclical	Energy			2.6	The recent rebound in oil prices to around $40 per barrel has been impressive, but defaults are poised to rise with oil prices still below producers' marginal cost.
Cyclical	Industrials			7.7	Significant hits to capital spending have significantly impaired the earnings outlook, richening valuations. Potential outperformer in an eventual durable economic recovery.
Cyclical	Communication Services			11.1	Several industries benefit from lockdowns and prevalence of work-from-home trends. Earnings outlook is above average, and valuations are fair. Regulatory risk for internet companies remains.
Cyclical	Consumer Discretionary			11.3	E-commerce is thriving and stimulus has propped up consumers' cash hordes, but brick-and-mortal retailers and companies reliant on travel face a long road back.
Cyclical	Technology			27.7	Among best earnings outlooks of all equity sectors, benefiting from the work-from-home environment. Top sector performer in the first half of 2020.
Cyclical	Financials			9.8	Difficult environment with the economy contracting, depressed interest rates, and dividends capped, although attractive valuations and historical tendency to outperform early in economic cycles are worth noting.
Defensive	Utilities			3.1	Valuations have become a bit more reasonable, but we expect interest rates to rise and we prefer healthcare or consumer staples for defensive sector exposure.
Defensive	Healthcare			14.4	The pandemic strengthens an already bullish case, based on a strong healthcare spending outlook, favorable demographics, and steady earnings growth with high visibility.
Defensive	Consumer Staples			7.0	Among the best positioned sectors to ride out the COVID-19 storms with attractive yields, relatively resilient revenue streams, and more reasonable relative valuations than in recent years.
Defensive	Real Estate			2.8	Fundamentals have deteriorated, particularly for the retail and office areas. At the same time, there are pockets of strength in the 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 intermediate bonds in tactical portfolios. We expect modestly higher long-term rates over the rest of 2020 as economic activity recovers in the second half of the year. Compensation for longer-maturity bonds remains unattractive, in our view, supporting our positive view of MBS.We still see incremental value in corporate bonds over Treasuries, but risks temper our view. We favor municipal bonds as a high-quality option for taxable accounts. Supply dynamics still look supportive for municipal bonds, and valuations relative to Treasuries are still attractive. Economic uncertainty remains elevated, and we are biased toward higher-quality issuers.

		Low Medium High	Rationale
Fixed Income Positioning	Credit Quality		Valuations are attractive, but uncertainty merits some caution.
		Short Intermediate Long	
	Duration		We prefer below-benchmark interest-rate sensitivity due to historically low longer-maturity Treasury yields and prospects of a second-half economic rebound.
		Neg. Neutral Pos	
Sectors	US Treasuries		Yield spreads to international sovereigns remain elevated but have narrowed. Valuations have become very expensive on COVID-19-related demand. Better valuations suggest adding TIPS to the mix.
	MBS		Fed buying is supportive, spreads are wider than other quantitative easing (QE) periods, and may provide some resilience if rates rise. Remains a diversifying source of yield among high-quality options.
	Investment-Grade Corporates		Risks elevated due to economic uncertainty, but Fed support a plus. Valuations have moved closer to neutral. High issuance a longer-term concern. Favor high-quality non-cyclical issuers.
	Preferred Stocks		Higher credit quality among the riskier fixed income options. Bank fundamentals firm prior to pandemic, but distributions optional and at increased risk. Can be rate sensitive.
	High-Yield Corporates		Valuations remain attractive, but we believe equities have more upside, and high-quality options may be better diversifiers. Sector mix a concern. More attractive for income-oriented investors.
	Bank Loans		Weaker investor protections and Fed unlikely to raise rates for some time, which may limit investor demand.
	Foreign Bonds		Rich valuations, interest-rate risk, and potential currency volatility are among the negatives.
	Emerging Markets Debt		Dovish central banks improve the valuation picture but may be vulnerable to COVID-19-related risk. Liquidity can be an added risk during periods of stress. Positive bias for second half of 2020.

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

We continue to favor **precious metals**, which are benefiting from safe-haven buying, lower interest rates, and massive stimulus from the Fed. The **US dollar** has reversed gains earlier in the year and may weaken further, providing additional potential support for precious metals, particularly **gold**.

Our neutral **industrial metals** view reflects a still-challenging near-term global demand outlook; however, China has been the first major global economy to emerge from the health crisis and is supportive of industrial metals, notably **copper**.

Our **crude oil** outlook remains negative, though we acknowledge progress in recent weeks toward balancing global supply and demand through global production cuts as economies reopen. We expect the next leg of the economic recovery to be gradual and choppy, travel will be slow to come back, and the US supply overhang may eventually cap gains if oil prices approach production costs in the $50 per barrel range.

Alternative Investments: Event-Driven Rebounded From Weak March

The HFRX Equity Hedge Index gained 2.2% during June, as the industry benefited from higher levels of net market exposure and strong sector positioning. Specifically, an overweight to the information technology and consumer discretionary sectors delivered gains on the long side, while an underweight and short exposure to value-oriented sectors also added value. While monthly performance was attractive, as a group, many long/short equity funds remain highly sensitive to the relative outperformance of growth versus value.

Event-driven strategies, which remains our preferred alternative category, also performed well with the HFRX Event Driven Index returning 2.7% during the month, bringing year-to-date performance into positive territory at 1.6%. While merger deal flow has experienced a significant decline, existing deal spreads remain attractive even after tightening since the peak levels in mid-March.

A Look Back at the Prior Month

Economy: Recovery Continues As the Economy Reopens

Economic data released in June reflected solid improvement in economic activity from depressed levels, although high-frequency data suggested a slower trajectory as COVID-19 cases increased in late June.

- **Conference Board's Leading Economic Index (LEI)** broke its two-month skid in May, rising 2.8%. Fewer jobless claims were cited as the primary driver of the gain in the index, while improvements in housing and stock prices also provided tailwinds. However, the report also noted that the breadth and depth of the previous decline suggests the economy will remain in recession territory in the near term.
- **Payrolls and Labor.** Nonfarm payrolls rose 4.8 million in June, continuing the momentum from the previous month, which saw a massive beat relative to economists' expectations. The US Bureau of Labor Statistics' May report was also revised up to 2.7 million from 2.5 million. The unemployment rate fell two points to 11.1% versus expectations of 12.5%, while misclassifications around the "absent from work but employed" issue would only add one point (compared with three points last month).
- **Inflation.** Weak demand continued to put downward pressure on inflation, as the core Consumer Price Index (CPI) declined 0.1% month over month in May. The Producer Price Index (PPI) halted a two-month skid in May, rising 0.4%. The index for final demand goods rose 1.6%, reflecting a jump in meat prices caused by efforts to contain COVID-19 outbreaks at meat processing plants.
- **US Consumer.** The Conference Board's Consumer Confidence Index increased in June but remained below pre-pandemic levels. The Present Situation and Expectations Indices also rose, buoyed by continued reopenings. Retail sales tallied the largest month-over-month gain since data began in 1992, growing 17.7% in May, with gains across all categories. While the rebound in retail sales is encouraging, recent COVID-19 outbreaks and tougher comparisons may limit gains in subsequent months, and sales remain well below February levels.
- **US Manufacturing**. The Institute for Supply Management (ISM) Purchasing Managers' Index (PMI) jumped nearly 10 points in June to 52.6, placing it in expansionary territory (above 50) for the first time since the pandemic began. The forward-looking new orders component surged, while supply chain pressures eased. The progress is encouraging, but the road to fully recover lost output is still a long one.
- **US Business.** Business sentiment remains depressed, but it showed slight improvement over the prior month as several regional Fed surveys suggested that activity is slowly rebounding off depressed levels as the US economy reopens. Rising geopolitical tensions have added to the impact of the COVID-19 outbreak, sinking durable goods orders nearly 30% year over year to the lowest level since 2009. Capacity utilization fell to its lowest level in history at 64.9%.
- **Policy.** Congress passed a five-week extension of the Paycheck Protection Program lending facility for small businesses. Negotiations for another round of fiscal stimulus are ongoing, with another $1 trillion package potentially coming in August. The Fed moved forward with its support for credit markets via the Primary Market Corporate Credit Facility, paving the way for direct purchases of new bond issues. While the Fed has dismissed the possibility of negative policy rates, discussions of yield curve control have gained traction if the economic recovery stalls.

Equities: Rally Continued

The **S&P 500 Index** continued its strong run with a 1.8% return in June despite recent increases in COVID-19 cases in several western and southern states and escalating US-China tensions. The bulls have focused on mostly steady reopening progress, better-than-expected economic data, optimism around vaccine prospects, and the likelihood of another stimulus package that could potentially end up in the $1 trillion range. Despite the deep recession, the S&P 500 has lost just 3% on a total return basis year to date.

Style/Capitalization

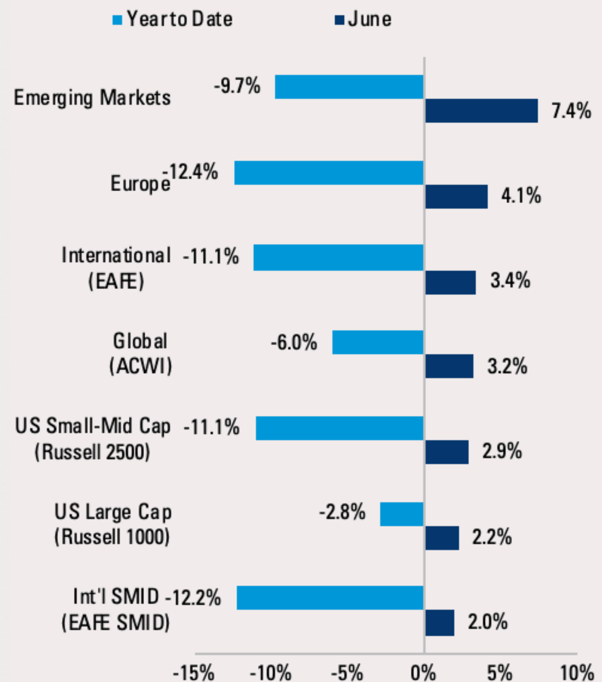
Small cap stocks bested their **large cap** peers for the third straight month in June, following their historical pattern of outperforming large caps coming out of recessions, as economic activity continued to pick up. **Mid cap stocks** struggled to keep up with large cap tech stocks, but underperformed only modestly for the month. Boosted by technology stocks and internet retail, **growth style** outpaced value for the ninth straight month.

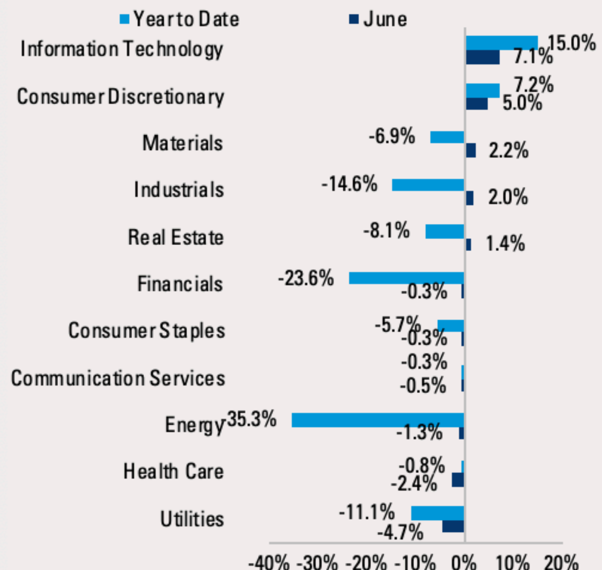
Global Equities

International developed and **emerging market** equities both solidly outperformed the United States in June. A weaker US dollar helped lift non-US returns, while emerging market equities got a boost from China's ability to contain COVID-19 and reopen its economy before most of the world.

Emerging markets equities gained an impressive 7.4%, based on the MSCI Emerging Markets Index, driven by strength across Asia, particularly in **China**, **South Korea**, and **Taiwan**.

International developed equities gained 3.4% for the month**,** based on the MSCI EAFE Index. Based on the MSCI EAFE country indexes, the biggest contributors to the gains included **France** and **Germany**, while **Japan** and the **United Kingdom** lagged.





Source: FactSet 06/30/20

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Stock investing involves risk, including loss of principal. Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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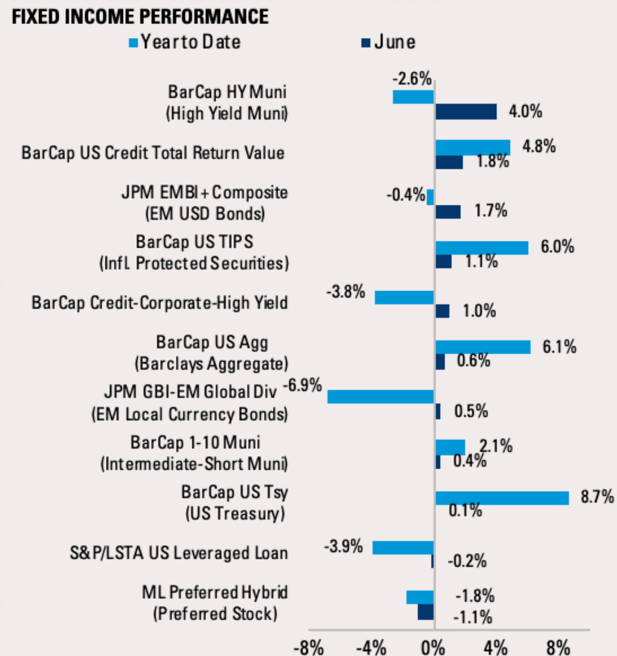
Fixed Income: Credit Strength

While equities continued to rally in June, Treasury yields remained quite steady. The **10-year Treasury yield** was nearly unchanged for the month of June, ending at 0.66%. The Treasury yield curve remained relatively stable during the month, maintaining its upward slope following the Fed's actions to lower short-term rates earlier in 2020 in response to the pandemic.

The Fed's policy actions remained an important catalyst for a risk-on environment for bonds. Investors were attracted to spread opportunities in the investment-grade bond market, as shown in the Fixed Income Performance Table. The **Bloomberg Barclays US Aggregate Bond Index (Agg)** rose 0.6% on corporate bond strength, bringing its year-to-date return to a solid 6.1%. **Treasuries** underperformed in June but remained the strongest fixed income sector in 2020. Lower-quality bond sectors delivered mixed results in fixed income, with **high yield** and **emerging markets debt** (in US dollars) outperforming the Bloomberg Barclays US Aggregate Bond Index, but **bank loans** underperforming. Higher-quality **municipal bonds** produced returns similar to higher-quality taxable bonds during June; however, **high-yield municipals** in particular had a very strong month.



US Treasury Yields

Security	5/31/20	6/30/20	Change in Yield
3 Month	0.14	0.16	0.02
2 Year	0.16	0.16	0.00
5 Year	0.30	0.29	-0.01
10 Year	0.65	0.66	0.01
30 Year	1.41	1.41	0.00

AAA Municipal Yields

Security	5/31/20	6/30/20	Change in Yield
2 Year	0.37	0.39	0.02
5 Year	0.68	0.68	0.00
10 Year	1.29	1.26	-0.03
20 Year	1.79	1.75	-0.04
30 Year	1.91	1.88	-0.03

Source: FactSet 06/30/20

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subjec t to availability and change in price.

Commodities: Risk On

Commodities gained 2.3% in June, as measured by the Bloomberg Commodities Index, supported by a weaker US dollar, though the index remained down more than 19% year to date.

A risk-on tone generally permeated throughout the commodities space as economies continued to reopen. Crude oil continued its rebound, climbing more than 8% for the month, while copper jumped more than 11%. Gold rose slightly, while silver and platinum, other safe havens, gave up some recent gains. Natural gas, which continues to battle supply pressures, fell double digits. Major agricultural prices were mixed, while livestock prices fell modestly, amid increasing skepticism regarding China's ability to fulfill its commitments made in the Phase 1 trade deal.

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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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