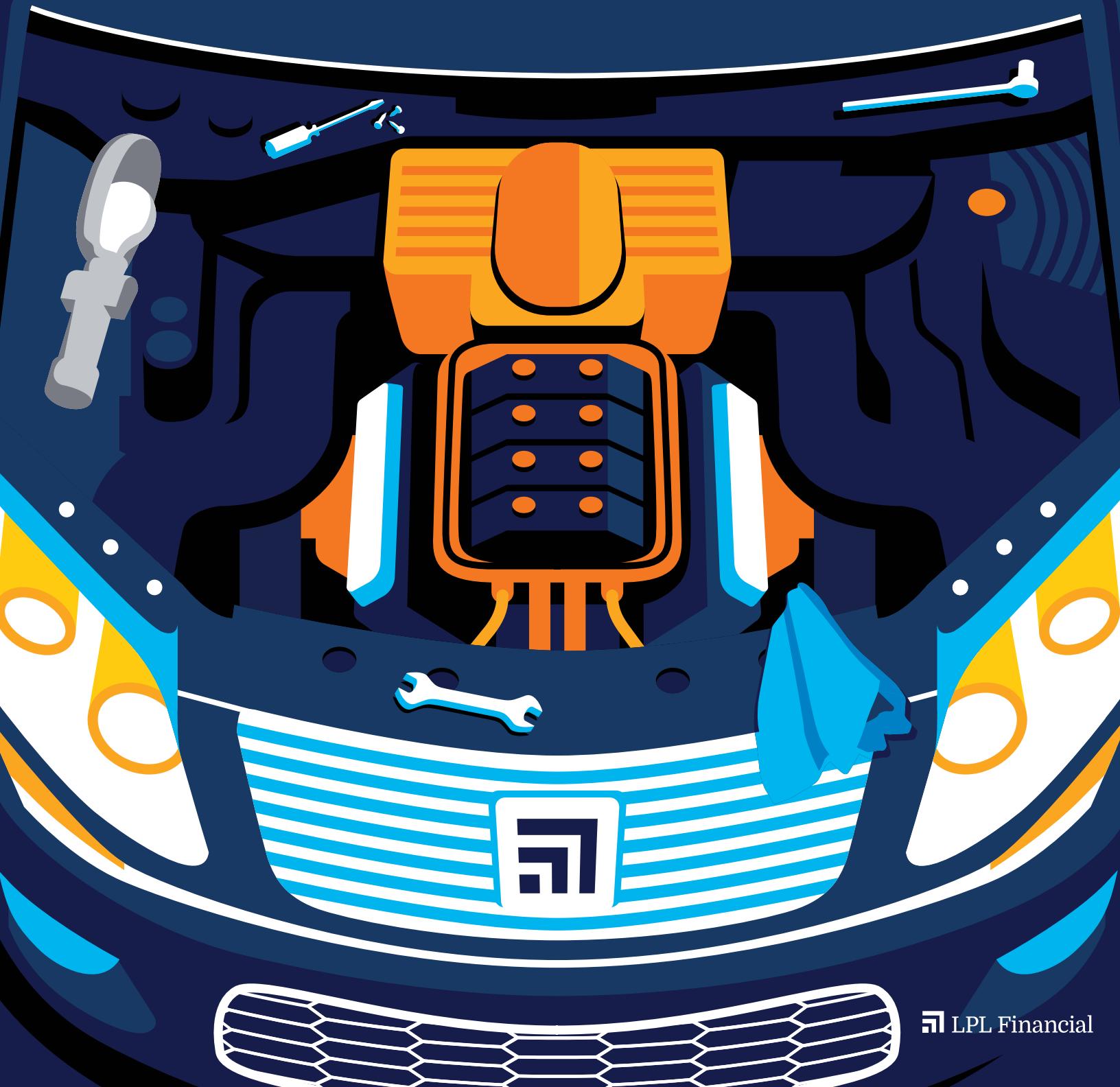


LPL RESEARCH PRESENTS

# OUTLOOK 2021

POWERING FORWARD





INTRODUCTION

# POWERING FORWARD

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**MORE THAN MOST YEARS**, it's hard to look ahead to the next year, to 2021, without looking back at 2020. A global pandemic, a massive economic collapse, a bear market, a surprisingly sharp reversal, a hotly contested election where passions ran high, the impact of lockdowns—it was an unusual year of extraordinary challenges. In 2021 it's time to restart the engines, but things are going to look different, feel different. 2020 has changed us, the way we do business, the way we connect. It's also shown us our constants, what works for us, and what we hold on to.

In 2021 we restart the engine, but we're not driving toward the same world we left behind in 2019. It's not even our destination. There has been damage to areas of the economy that may never fully recover, but there are other areas that will adapt, reinvent themselves, and help reinvigorate growth. In our *Outlook 2021: Powering Forward*, we'll talk about stocks and bonds, the economy, and the post-election policy environment, but in the background will be new challenges, new opportunities, and new ways of doing things.

Thankfully, one constant has been the value of personal and professional relationships, even if we've had to learn how to connect in new ways. Sound financial advice offered a long-term map for many investors that helped them from getting off course in a turbulent 2020. There are still risks to navigate in 2021, but it's time to get back on the road.



OUTLOOK 2021

# WHERE WE ARE



**COVID-19:** Over the course of the year, we have seen an increased understanding of how to contain the COVID-19 virus, important progress on how to treat those hospitalized, and promising developments on treatments and potential vaccines. Nevertheless, conditions have worsened heading into late 2020, with a record number of confirmed cases and increased hospitalizations. We believe we will see continued advances in 2021 that will further limit the impact of the virus by the end of the year, but it will be a process. In the meantime, the goal remains keeping the economy as open as possible while making sure that our healthcare system doesn't get overwhelmed and the most vulnerable are protected.



**POLICY:** We expect global central banks to remain supportive and for individual economies to continue to refine their responses to COVID-19. In the United States, what will likely be a divided government may help limit the size of any tax hikes and regulation while still supporting additional fiscal stimulus that may include high-priority items for both Democrats and Republicans. We could also see movement toward a similar deal on infrastructure. Greater clarity on trade may make it easier for some companies to do business, but a more challenging regulatory environment may be an offset.



**DOMESTIC ECONOMY:** Continued progress in the response to COVID-19, including further stimulus, will be the key to sustaining the recovery. COVID-19-impacted service industries may be the last to bounce back. We expect some of the accelerated innovation that came with the COVID-19 response to have a positive long-term impact. We forecast 4–4.5% US gross domestic product (GDP) growth in 2021.



**INTERNATIONAL ECONOMY:** Emerging market economies may lead in a global rebound. We believe growth in international developed economies may lag behind the United States, although a strong fiscal response may help Japan. We forecast global GDP growth of 4.5–5%.



**STOCKS:** A strong earnings rebound in 2021 may allow stocks to grow into somewhat elevated valuations. Cost efficiencies achieved during the pandemic may persist. We see an S&P 500 Index fair value target range of 3,850–3,900 in 2021 with potential for upside with better-than-expected vaccine progress.



**BONDS:** Inflationary pressure is likely to be limited, and the Federal Reserve (Fed) is expected to keep rates low, but economic improvement and even normalizing inflation could put upward pressure on rates. We see the 10-year yield finishing 2021 in a range of 1.25–1.75% with a bias toward the lower end.



# A NEW COURSE



**IT CAN BE** tempting to over-emphasize the importance of elections in formulating investment strategies. But in 2020—from a markets perspective—the elections garnered a distinct level of importance with so much at stake, including potential impact from COVID-19 policy, tax increases, a change in direction on trade relations, and multi-trillion dollar government spending programs.

Getting past the uncertainty presidential elections bring, with all else being equal, has been positive for the stock market historically. 2020 was no different, with a strong post-election rally in November as investors gained some clarity.

The Senate, however, has not delivered the policy clarity investors and corporate leaders would like. Control of the Senate will be decided on January 5 with runoff elections for Georgia's two Senate seats, with Republicans currently holding a 50–48 advantage. If the Democrats win those two seats, the vice president would cast any tiebreaking votes, effectively giving the Democrats control of the Senate.

The makeup of the Senate—favored to remain in Republican control—has significant policy implications. Our focus is on what appears will be the most likely

outcome—a Congress split between a Republican Senate and Democratic House of Representatives with Joe Biden as president—which we view as market friendly. History shows that stock returns have been strongest with Congress split, which we expect in 2021 [Figure 1].

## TAKING A NEW COURSE

Perhaps the most important implication of divided government is that it likely takes President-elect Biden's large proposed tax increases off the table. The corporate tax changes Biden has proposed—now very unlikely to happen—would potentially cut S&P 500 earnings by 10% or more in 2021. Smaller targeted tax increases might still be possible to fund a scaled-down version of Biden's green energy and infrastructure investment programs, but big and broad tax increases are probably off the table. Biden might reduce or eliminate tariffs, which could grease the wheels of global trade and provide a boost to earnings.

A fifth COVID-19 relief bill may be the first priority for the new administration, but a package would have to be smaller than previously discussed to get through the likely Republican-controlled Senate. With a vaccine likely coming soon, Republican Senators may balk at a trillion dollar package, so we could get something less than that either in the lame duck session of Congress or after Inauguration Day.

Possible investment implications of the new political landscape include:

- **FINANCIAL SERVICES:** The regulatory environment for financial companies may be tougher under a Biden administration, but probably not materially so without support of a Democratic-controlled Congress. Prospects for less fiscal stimulus remove a potential catalyst for higher interest rates.



- **HEALTHCARE:** A split Congress adds significant hurdles for major healthcare reform, a big positive for the healthcare sector. A public option to compete with private health insurers could have been very damaging for publicly traded managed care organizations, though drug price regulations—which we see as manageable—are likely.
- **TECHNOLOGY:** We view technology companies as big beneficiaries of a split Congress, as the regulatory environment was expected to be much tougher in a Democratic-sweep scenario. This includes digital media and e-commerce as well.
- **GROWTH OVER VALUE:** Given the incrementally tougher interest rate outlook for financials and tailwinds for technology and internet stocks, a split Congress may favor growth. However, a vaccine-fueled boost to economic growth may support value stocks.
- **EMERGING MARKETS EQUITIES:** A potentially weaker US dollar and less contentious global trade environment may support emerging markets, notably China. Developed international equities may also get a boost and help limit

the drag from recently implemented COVID-19-related lockdowns in the region.

- **MUNICIPAL BONDS:** Divided government may limit aid to states and local governments, and if individual tax rates aren't raised, it would remove a likely positive catalyst for tax-exempt fixed income.

### FED'S PEDAL TO THE METAL

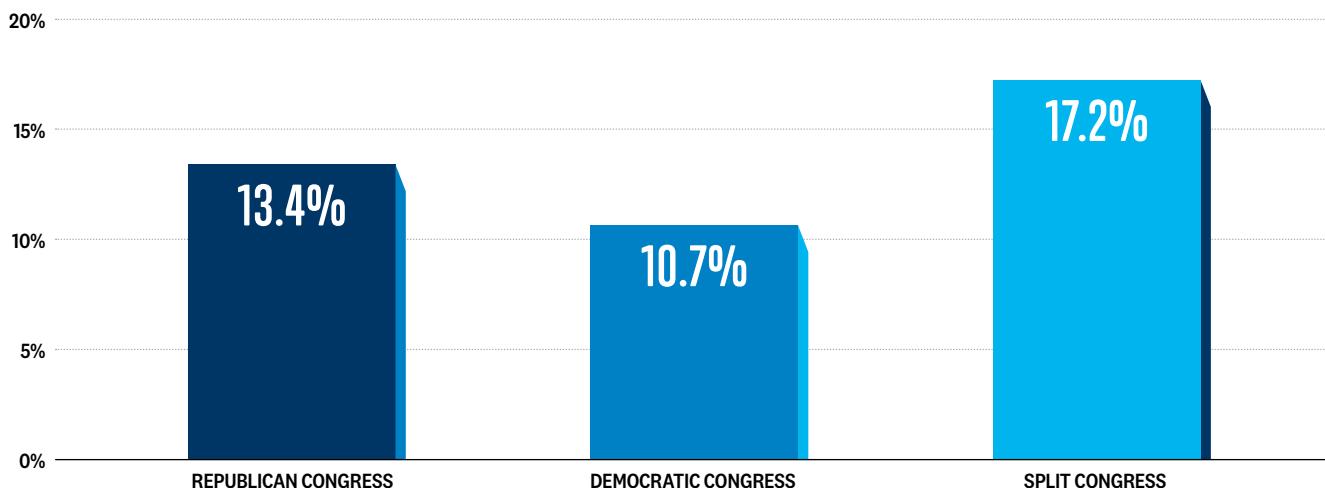
With a divided government, we may not be able to count on another large fiscal stimulus package to steer the economy out of trouble if conditions deteriorate. That leaves the Fed as potentially the only game in town if COVID-19 causes further financial and economic stress. Some potential responses to support the economy may include more bond purchases, additional lending facilities, or a change in messaging that could lengthen the period of time the central bank is expected to maintain its accommodative policy stance. We do not expect the Fed to consider negative interest rate policy, which has met with limited success in Europe and Japan.

1

## HISTORICALLY, A SPLIT CONGRESS HAS BEEN POSITIVE FOR STOCKS

PERFORMANCE BASED ON CONGRESS MAKEUP

■ AVERAGE S&P 500 INDEX ANNUAL RETURN



Source: LPL Research, Bloomberg 11/04/2020

Data are from 1950–2019. 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 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.



# A NEW START

**THE US ECONOMY** was improving nicely early in 2020 after a modest slowdown in the fourth quarter of 2019, and then it skidded to an abrupt stop in the face of COVID-19. The pandemic ended the longest economic expansion ever, lasting more than 10 years. The ensuing recession was unique—we didn't see the usual extremes like excessive spending or over-leverage that have been the hallmarks of the end of past economic cycles. This recession was caused mainly by the government closing businesses and people staying home in response to COVID-19.

Once the economy began to shift into gear again later in 2020, a new economic expansion likely began. We said this probably would be one of the shortest recessions ever, and although it's not official as of December 1, 2020, the recession probably lasted less than six months. We believe we are now in the early stages of a new economic cycle.

With an assist from the Fed, high per capita income, and modern banking and business practices, our economy doesn't have the same booms and busts that developing countries tend to experience, and our economic cycles tend to last longer. Economic expansions since World War II have lasted more than five years on average, with the past four expansions averaging more than eight years. The new expansion may be only a few months old, and with record amounts of monetary and fiscal stimulus firmly in place and a viable vaccine likely to become available in early 2021, we anticipate many more years of growth **[Figure 2]**.

## SPEEDING UP AND SLOWING DOWN

After GDP contracted an annualized 5% during the first quarter of 2020 and then a record 31% in the second quarter, the economy revved back up with a 33% jump in the third quarter, bouncing off depressed levels. Efforts to limit COVID-19's spread, better therapeutics, and optimism over an eventual vaccine helped the economy open back up, but until we have a widely distributed, effective vaccine, many service-oriented parts of the economy will continue to struggle.

This dichotomy that has characterized this recovery may persist well into 2021, as the services part of the economy will be hampered by restrictions, while manufacturing and goods production have moved forward at record speed. Many consumers who can work from home effectively are doing quite well.

Hard-hit services businesses include airlines, hotels, movie theaters, restaurants, and theme parks. About 8 million jobs in the leisure and hospitality industries were lost during the spring lockdowns, according to US Bureau of Labor Statistics, and only about half of them have come back. Disney already has laid off 32,000 park employees. The impact on these industries will likely be felt beyond 2021.

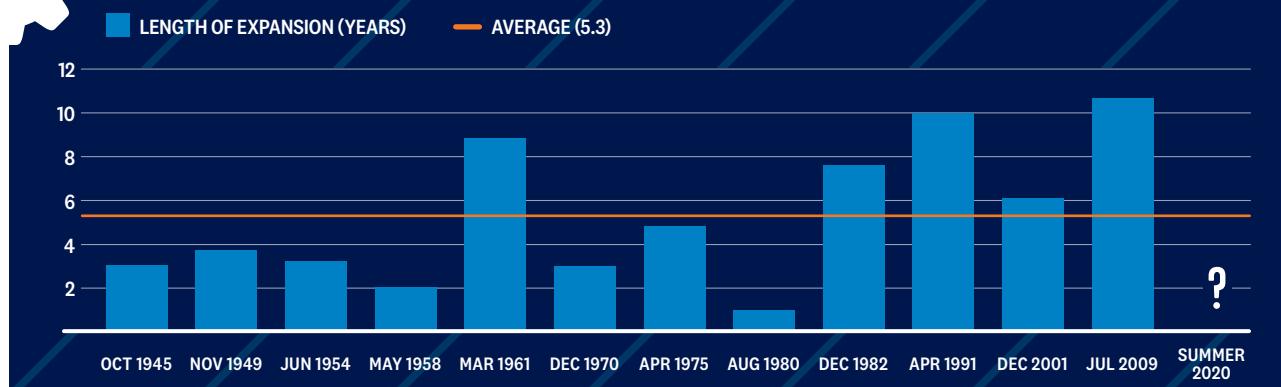
At the same time, income replacement from stimulus, a strong housing market, and booming e-commerce activity have remarkably helped drive retail sales to well above their pre-pandemic peak, according to the latest US Census Bureau data. Total US consumer spending surged 41% during the third quarter, on an annualized basis, and has recovered 85% since April 2020 (source: US Department of Commerce). The US consumer has been incredibly resilient during this challenging time.

## SWOOSH-SHAPED RECOVERY

We believe a swoosh-shaped recovery is still the most likely scenario—a quick, sharp decline, then a partial snapback, followed by a more gradual recovery. The snapback part of the recovery occurred in late summer of 2020, and now the next leg of economic growth—likely to take at least a year—

## 2

## NEW ECONOMIC EXPANSION MAY HAVE YEARS TO RUN



Source: LPL Research, National Bureau of Economic Research 11/06/20

Economic forecasts set forth may not develop as predicted and are subject to change. While NBER has not officially dated the end of the recession, and typically does not until approximately a year after the economy has troughed, on average, we are provisionally dating summer 2020 as the economic trough based on record retail sales and expanding manufacturing and services data.

may be tougher. We like the swoosh shape over the square root-shaped recovery some have suggested, as it reflects a more favorable latter phase of recovery.

The idea of a K-shaped recovery has gained traction as a way to characterize this economic recovery. If you think about a K, it has one part pointing higher, or improving, while the other part is pointing lower, or deteriorating. As is common during recessions and recoveries, parts of the economy have been improving quickly, while other parts are lagging. If you view this also in relation to workers, then this recession and subsequent recovery have widened the divide between the haves and have-nots.

One way to demonstrate this is by breaking the labor market into high- and low-wage employees. The fortunes of high-wage employees (annual salaries greater than \$60,000) have been better than those of low-wage

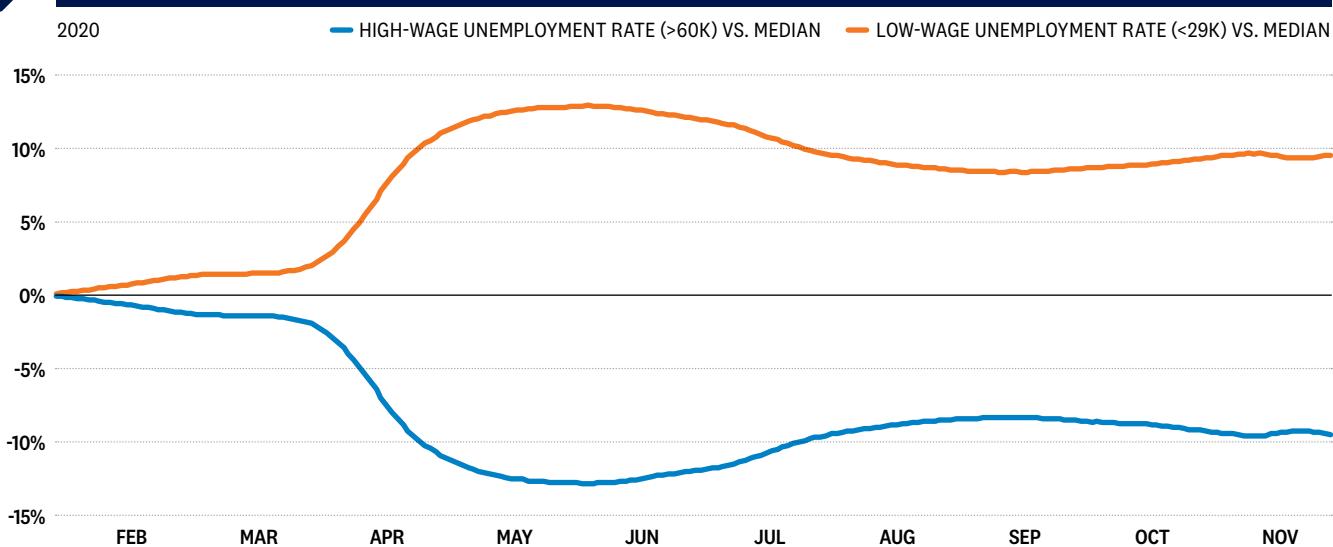
employees (less than \$27,000 per year) based on the unemployment rates of these two segments [Figure 3], while heading into the recovery they were more similar.

Many of these higher-paying jobs are in industries that are racing ahead, such as technology, digital communications, e-commerce, and residential construction, while lower-paying jobs in areas where social distancing is more difficult, such as restaurants, hotels, airlines, and cruise ships, have been lost and may take much longer to come back.

Continued fiscal support, such as stimulus payments, is needed to help those who are struggling, but a widely available vaccine is needed to help shore up the weaker parts of the economy and lift up the bottom half of the "K." Even as COVID-19 continues to spread, we expect the economic recovery to continue, bolstered by stimulus. As the pandemic subsides, restrictions are lifted, and

## 3

## HIGH-WAGE JOB MARKET HAS HELD UP BETTER DURING COVID-19 IN 2020



Source: LPL Research, Opportunity Insights, 11/01/20

Median unemployment measured as median between high- and low-wage unemployment rates.

# A DIFFERENT VIEW

Although not our base case, we think the odds of a potential double-dip recession, two recessions spaced closely together, may increase as we move into 2022. Recessions are necessary to flush out the excesses. Given many industries and people haven't felt this latest recession, that flushing process didn't fully take place this time around, making this recession atypical—and opening the possibility of another short-lived recession down the road.

The length of this recession—we think about six months—was also unusual. The previous shortest recession ever was six months in the early 1980s, which was followed by a weak expansion and then a double-dip recession starting about a year later. Historically, the average recession has lasted about one year, which suggests perhaps more time may have been needed for the economy to properly reset.

consumers' daily lives return to something resembling "normal," the pace of the recovery should pick up speed. We expect this to occur in mid-2021, fueling above-average GDP growth for the full year [Figure 4].

## SMALL BUSINESS HOLDS THE KEYS

The health of our economy is best gauged by the strength of our small businesses, as they are the economy's bedrock. Companies with under 500 employees account for more than 95% of US businesses, and they employ about half of the US workforce. With many boots on the ground, small businesses can sometimes spot turning points in the economy before they show up in economic reports—and before many economists and central bankers see them.

Small businesses are quite optimistic about the future of our economy. In September, the Small Business Optimism Index from the National Federation of Independent Business (NFIB) returned to its February peak. This could be one sign for a stronger economy in 2021. As the economic recovery continues, the health of small businesses will go a long way toward determining how robust that recovery will be.

## DOLLAR DOWNTREND COULD BE LASTING

We believe the US dollar is in a major structural downtrend that may potentially continue for years to come. The dollar experienced a historic surge in March 2020 during the height of the lockdowns, as the greenback offers the ultimate safety trade during times of stress. Prior to the surge, the dollar had been weak amid record budget and trade deficits that combined to put pressure on the currency versus major global alternatives. As the economy began to open up and COVID-19 fears began to subside, the dollar once again rolled over and moved lower.

The Fed has made it very clear it plans to stay quite dovish for a very long time, which should be another tailwind for a lower-trending dollar. The dollar has a history of very long cycles, having made major peaks in 1985, 2001, and again in 2017, with years of dollar weakness after the peaks, suggesting another long cycle of dollar weakness may lie ahead.

A potentially weaker dollar would benefit US multi-national companies' profits, boost returns of international investments for dollar-based investors, and potentially provide support for commodities prices.

## 2021 ECONOMIC FORECASTS

4

### REAL GDP GROWTH FORECASTS (YoY%)

	2019	2020	2021
United States	2.2%	-4.0%	4.0-4.5%
Developed ex-U.S.	1.3%	-7.0%	3.75-4.25%
Emerging Markets	4.3%	-0.7%	5.0-5.5%
Global	2.8%	-3.9%	4.5-5.0%

Source: LPL Research, Bloomberg 11/06/20

### U.S. ECONOMIC DATA

	2019	2020	2021
Inflation (YoY%)	1.8%	1.2%	1.9%
Unemployment	3.7%	8.3%	6.7%

Economic forecasts set forth may not develop as predicted and are subject to change. 2020 GDP and 2020 and 2021 inflation and unemployment forecasts are based on Bloomberg-surveyed economists' consensus. 2021 GDP estimates are LPL forecasts. Inflation is measured by the Consumer Price Index. Unemployment rate provided by US Department of Labor.



STOCKS

# EARNINGS REBOUND MAY SPARK 2021 GAINS



5

## 2021 US MARKET FORECASTS

	2020	2021
S&P 500 Index Fair Value	3,450-3,500	3,850-3,900
S&P 500 Earnings Per Share	\$133 <small>FactSet consensus estimate</small>	\$165
10-Year U.S. Treasury Yield	1-1.5%	1.25-1.75%

Source: LPL Research, Bloomberg, FactSet 11/06/20  
Economic forecasts may not develop as predicted and are subject to change.

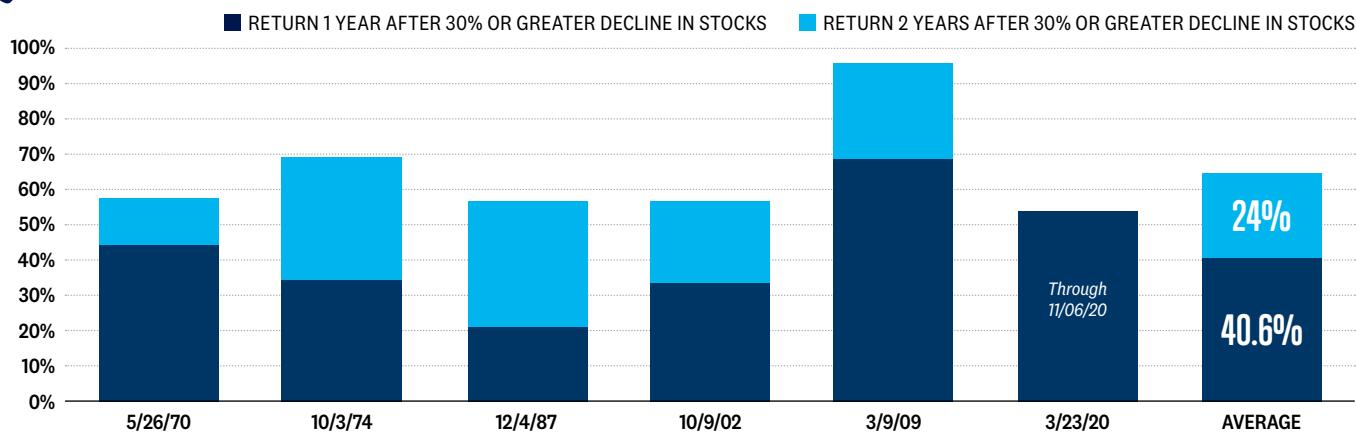
**2020 WAS ONE** of the most difficult years we've experienced: The worst pandemic in 100 years. A deep recession. A bear market. Election uncertainty. And yet, 2020 has been a good year for stocks. The market is forward-looking and has looked forward to better times [Figure 5].

Historically, the worst economic conditions have been followed by some of the biggest rallies. In 2020, the S&P 500 Index was able to fully recover its bear market decline in only six months, when it usually takes years. In fact, for the first time ever, stocks are in position to produce a gain in a calendar year after being down by more than 30% at any point during that year. Quite a comeback.

After such a strong rally from the March 2020 lows, it would be logical to think returns going forward may be more muted. Reviewing some of the previous major bear market lows—most recently in March 2009—reveals that stocks tended to add gains well after the initial surge [Figure 6].

6

## NEW BULL MARKETS HISTORICALLY BUILT ON STRONG FIRST-YEAR GAINS



Source: LPL Research, FactSet 11/06/20

Includes returns following declines of 30% or more in the S&P 500 Index since 1970. Year 2 returns include benefits of compounding from year 1 returns. All indexes are unmanaged and can't be invested in directly. Past performance is no guarantee of future results.



On average, stocks have historically gained about 65% during the first two years of a new bull market after an average 41% gain during year one. Even with the S&P 500 roughly 60% above its March 23, 2020, lows, we see further potential upside in 2021. Favorable prospects for a safe and effective vaccine in early 2021, in our view, introduce the possibility of exceeding these historical averages as stocks did in 2009–10 when the S&P 500 nearly doubled in two years.

### STRONG EARNINGS MAY HELP STOCKS' VALUATIONS

Corporate earnings fell sharply in 2020 due to the lockdowns and recession. Despite lingering effects of COVID-19, in 2021 we expect the economic recovery to drive a big rebound in profits. We potentially could see S&P 500 earnings growth of 25% in 2021, boosted by cost efficiencies achieved during the pandemic [Figure 7].

As the threat of COVID-19 diminishes and the economy moves toward fully reopening, we anticipate corporate America will begin to showcase its much-improved earnings potential. Up to \$190 per share in S&P 500 earnings could be possible in 2022, a 15% increase from our \$165 earnings per share (EPS) estimate for 2021.

### EXPECT STOCKS TO GROW INTO THEIR VALUATIONS

The combination of strong stock market performance since the March 2020 lows and depressed corporate earnings has left the price-to-earnings (PE) ratio for the S&P 500 based on consensus earnings estimates for the next 12 months near 21, well above its long-term average (source: FactSet). That may leave stocks at risk of additional volatility if earnings disappoint.

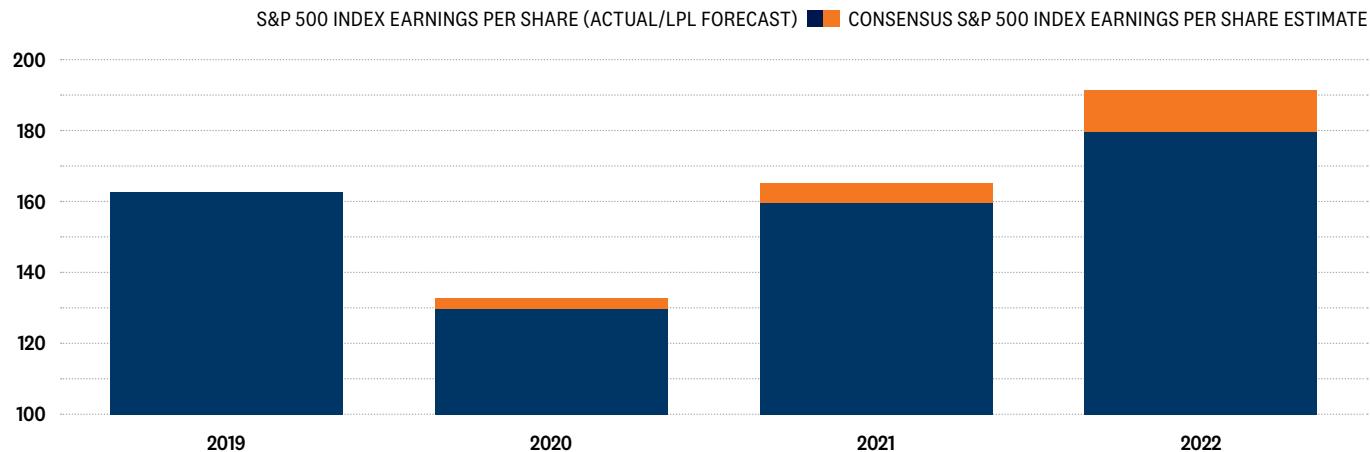
However, we anticipate the expected pickup in earnings growth after the pandemic may enable stocks to grow into these valuations. Low interest rates are helping, making bonds relatively less attractive and enhancing the value of future profits in today's dollars.

Our year-end 2021 S&P 500 fair value target range is 3,850–3,900, based on a PE around 20—slightly below current valuations—and our preliminary 2022 EPS estimate of \$190, which is below FactSet's consensus estimate of \$195. We expect stocks to outpace bonds in 2021 and maintain a recommendation for investors to consider an overweight to equities relative to fixed income compared with their target allocations.

We acknowledge the difficulty of forecasting in this environment, but we believe our assumptions are reasonable, despite the risk that more restrictions to combat the latest wave of COVID-19 may hamper the economic recovery.

# 7

## EARNINGS POISED FOR A SHARP REBOUND IN 2021 AND 2022



Source: LPL Research, FactSet 11/01/20

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

## BONDS

# STAYING IN THEIR LANE



### AWAITING STYLE ROTATION

We expect the strong performance by growth-style stocks to continue into 2021, bolstered by strong earnings trends and favorable positioning for the pandemic.

As the economy makes additional progress toward a return to normal in the coming year, and the areas hit hardest by the pandemic begin a more robust recovery, we would expect participation in this young bull market to broaden and potentially help boost some of the more economically sensitive laggards on the value-style side.

### WARMING UP TO SMALL CAPS

We warmed up to small cap stocks in the third quarter of 2020 due to their historical track record of outperformance early in bull markets and prospects for a strong post-pandemic earnings rebound. As 2021 begins, our view on small caps remains neutral, but as the end of the pandemic comes into view, the chances of sustained small cap leadership may improve.

### TECH LEADERSHIP POISED TO CONTINUE

Despite such a strong 2020, technology remains a favored sector for the coming year for its strong earnings outlook and favorable positioning for an environment in which so many people are working or attending school remotely. Communication services, digital media, and e-commerce stocks are similarly well positioned.

While we generally favor cyclical sectors such as industrials and materials over defensives such as consumer staples and utilities, we expect healthcare stocks to perform well as policy uncertainty subsides.

### EMERGING MARKETS GROWTH STANDS OUT

We expect the solid economic growth across Asia to support continued outperformance by emerging markets equities over developed markets in 2021. China has led the way out of the global health crisis and is the only major country expected to grow its economy in 2020.

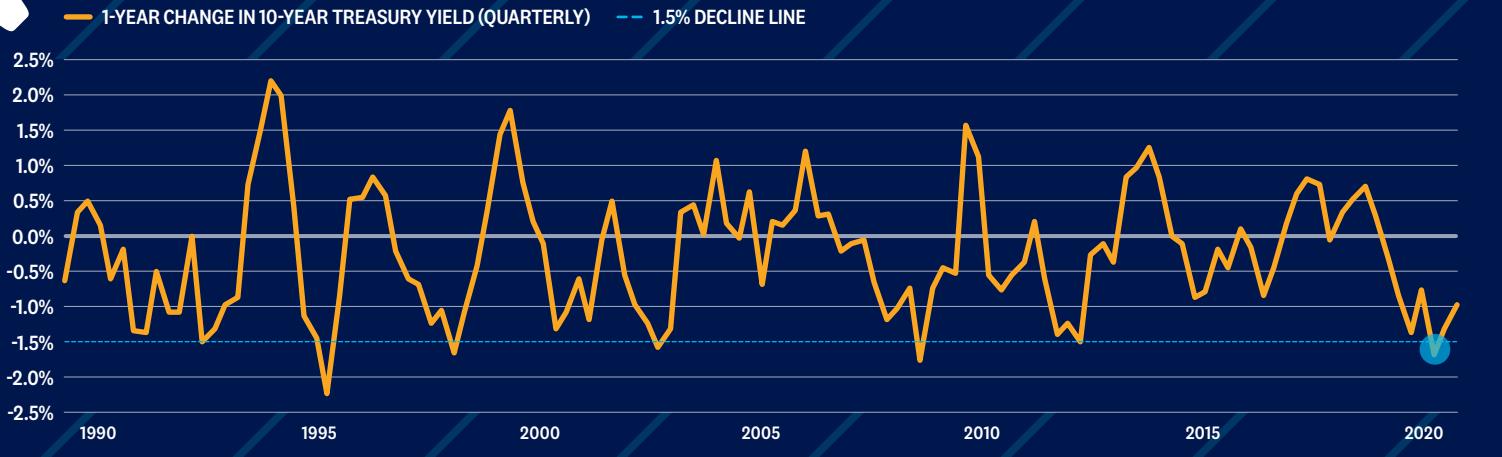
As a more durable global economic expansion materializes and the US dollar potentially weakens further, performance for European and Japanese stocks may improve—with an edge to Japan based on massive stimulus efforts and relative success containing COVID-19.

**THE ECONOMY MAY** be kicking back into gear, potentially providing a tailwind for stocks, but the story isn't the same for investment-grade bonds. An improving economy generally leads to higher interest rates, and when rates go up, bond prices go down, weighing on bonds' total returns. But a better economy helps some bond sectors too. When the economy picks up, default rates fall and credit spreads—the yield difference compared with Treasuries—tend to narrow or at least hold steady, supporting credit-sensitive bonds.

There still will be opportunities for bond investors in 2021, but it may be a year that requires greater patience, lowered expectations, and a more opportunistic approach. 2021 is the 40-year anniversary of the start of the great bond bull market, and four decades of falling rates have been a boon for bond investors. But yields provide the best picture of prospective bond returns, all else being equal, and yields are now historically low. While rates could possibly still fall, they are approaching their lower bound.

Overall, based on our view of rates and the economy, we expect near-flat to low-single-digit returns for the Bloomberg Barclays US Aggregate Bond Index in 2021, with some potential for losses. A positive yield for the broad index still points to gains over the long run, although not at levels seen in the past. Low current yields do, however, increase the risk of a negative year.

## LARGE DECLINES IN US TREASURY YIELDS HAVE TURNED HIGHER OVER THE NEXT YEAR



Source: LPL Research, Federal Reserve 11/01/20

### INTEREST RATES

The forecasted path of the 10-year Treasury yield provides a baseline for our fixed income views. We are targeting a 10-year Treasury yield range of 1.25–1.75% for year-end 2021, helped by the economic recovery and normalizing inflation, with a bias toward the lower end of the range. The Fed's accommodative monetary policy and potential inflows as rates rise, including foreign buyers drawn to higher US rates, may help limit any increases beyond our target range.

From a historical perspective, the large decline the 10-year Treasury yields experienced from the end of first quarter 2019 to the end of first quarter 2020 points to a meaningful increase in yields. Since 1990 we have experienced six yield declines of at least 1.5% over four calendar quarters [Figure 8]. In all six cases, the 10-year Treasury yield was higher a year later, by an average of 90 basis points (0.9%), as well as six quarters later, by an average of 110 basis points (1.1%).

Looking beyond Treasury yields, the economic recovery should also support stable-to-narrowing credit spreads, although COVID-19-related economic risks remain. With credit spreads for investment-grade corporates already near their long-term median, the impact may be modest. However, if Treasury yields were to approach the upper end of our target range, it would likely signal a more robust recovery, which could help narrow spreads further, offsetting some of the impact of higher Treasury rates.

### THE CASE FOR QUALITY BONDS: DIVERSIFICATION

Despite lower return expectations, high-quality bond holdings may continue to play their role as portfolio

diversifiers. During the six stretches in which the S&P 500 declined at least 10% between 2010 and 2020, Treasuries typically led and the Bloomberg Barclays US Aggregate Bond Index gained on average [Figure 9]. There was one period of stock declines in early 2018 when inflation concerns in particular were one of the catalysts. During that stock market decline, rates actually rose slightly, and neither the broad Bloomberg Barclays Aggregate Bond Index nor Treasuries provided a safe haven for investors. While we think inflation will be contained in the near term, this scenario may become more important as the new cycle ages.

There's an important lesson in the overall pattern. Even when positioning for a rising-rate environment, exposure to core bonds, including Treasuries, can help provide important ballast. If rates do run higher because of strong economic growth, potential stock gains may be able to offset bond losses.

### POSITION FOR RISING RATES

With only modest return expectations for quality bonds in aggregate, we recommend suitable investors consider positioning for a rising-rate environment, trading off some potential diversification benefits if stocks pull back and rates fall for greater resilience if rates rise. With an extraordinarily low starting yield for Treasuries compared to history, we would recommend a meaningful overweight to Treasuries while not totally eliminating exposure altogether.

Correspondingly, we would consider being overweight mortgage-backed securities (MBS) and investment-grade corporates. MBS do not offer the upside of corporate bonds, but they can be more resilient in a rising-rate environment.





Investment-grade corporates tend to be more rate sensitive than MBS, and their credit sensitivity may make them more vulnerable than MBS if stocks pull back.

For suitable income-oriented investors, adding more credit-sensitive sectors, such as high-yield bonds and emerging market debt, to their portfolios may help compensate for the reduced income potential of a low-rate environment, but we

would still recommend that high-quality bonds make up the bulk of any bond allocation. High-yield bond credit spreads are in line with typical expansionary levels, but emerging market debt may still have some potential upside from valuations. If renewed COVID-19-related restrictions were to slow the economic rebound significantly, though, these sectors would be more vulnerable.

## THE FED IN THE DRIVER'S SEAT

Fed policy influences short-term rates, which anchor longer-term rates to a degree, but longer-term rates can still move quite a lot while short-term rates hold steady. The Fed can also influence longer-term rates through its bond-buying program, known as quantitative easing, although if investors see the additional Fed support as a positive sign for the economy, rates can actually push higher during periods of bond purchases, as happened last cycle.

Current expectations are that the Fed will not raise rates for some time. The median Federal Open Market Committee (FOMC) member “dot plot” forecast doesn’t show an initial rate hike until after 2023. The Fed’s updated policy framework, announced in August 2020, also points to the Fed being on hold for some time. The new framework shifts the Fed’s inflation target from simply 2% to a long-term average of 2%, allowing inflation potentially to run higher if it has run lower for an extended period, as it has in the recent year.

In the wake of the Great Recession, the Fed did not raise its policy rate for seven years after lowering it to near 0%.

## INFLATION IN THE BACK SEAT

Massive fiscal and monetary stimulus may set the table for a meaningful pickup in inflation down the line, but beliefs were similar in 2009. We believe the near-term inflationary pressures may be limited and that a healthy economy remains a precondition for a meaningful upside surprise in the future. In the near term, slack in the labor market and spare industrial capacity are likely to remain in play at least through 2021, taking some key drivers of inflation out of play.

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## HIGH-QUALITY BONDS HAVE HELD UP DURING EQUITY MARKET DECLINES

S&P 500 INDEX MARKET DECLINES (>10%)	10-YEAR CONSTANT MATURITY TREASURY YIELD (%)			RETURN (%)		
	START	FINISH	CHANGE	S&P 500 INDEX	BARCLAYS AGGREGATE	TREASURIES
4/23/10 - 7/2/10	3.84	3.00	-0.84	-15.6	3.0	4.4
4/29/11 - 10/3/11	3.32	1.80	-1.52	-18.6	5.4	8.6
5/21/15 - 2/11/16	2.19	1.63	-0.56	-12.8	2.2	4.1
1/26/18 - 2/8/18	2.66	2.85	0.19	-10.1	-1.0	-0.9
9/20/18 - 12/24/18	3.07	2.74	-0.33	-19.4	1.6	2.5
2/19/20 - 3/23/20	1.56	0.76	-0.80	-33.8	-0.9	5.4
	AVERAGE:		-0.64	-18.4	1.7	4.0

Source: LPL Research, FactSet 11/01/20

All indexes are unmanaged and can't be invested in directly. Past performance is no guarantee of future results. Indexes (from left to right): S&P 500 Index, Bloomberg Barclays US Aggregate Bond Index, Bloomberg Barclays US Aggregate Government - Treasury Index.

# THE JOURNEY CONTINUES



**2020 HAS BEEN** an extraordinary year filled with uncertainty and unexpected challenges that will stay with us for a long time. But looking at 2020 market performance—and ignoring the path to getting there—it was not that unusual a year at all. For long-term investors, 2020 was another year of making steady progress toward long-term investing goals.

2021 may offer similar market performance, although we believe it will offer a smoother path and an economic environment that may simply feel better. Markets are always looking ahead, and even back in March 2020—early in the COVID-19 crisis—they began to respond to the economy and corporate America to power forward, even if the timing was uncertain. Whether we're looking at earnings or economic data, we've exceeded those early expectations to date. 2021 is about continuing to follow that course and maintaining the momentum.

If our base case—or something close to it—plays out, then years from now market participants may look at the market landscapes in 2020 and 2021 and conclude they had a lot of similarity. Market conditions within each year may have been remarkably different, but in the end they were just another leg on the journey.

*Outlook 2021: Powering Forward* was designed to help you navigate a year in which economic conditions may continue to improve dramatically. Understanding the road immediately ahead is essential for navigating its twists and turns, but it will be thoughtful planning and sound financial advice that will keep us on the journey.



# GENERAL DISCLOSURES

The opinions, statements and forecasts presented herein are general information only and are not intended to provide specific investment advice or recommendations for any individual. It does not take into account the specific investment objectives, tax and financial condition, or particular needs of any specific person. There is no assurance that the strategies or techniques discussed are suitable for all investors or will be successful. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing.

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All index data from FactSet.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

## GENERAL RISK DISCLOSURES

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. Investing in foreign and emerging markets debt or 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.

## GENERAL DEFINITIONS

**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.

**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.

**The Standard & Poor's 500 Index** 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 Bloomberg Barclays U.S. Aggregate Bond Index** is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

## EQUITY RISK

Investing in stock includes numerous specific risks including the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market. 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. They 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.

## EQUITY DEFINITIONS

**Cyclical stocks** typically relate to equity securities of companies whose price is affected by ups and downs in the overall economy and that sell discretionary items that consumers may buy more of during an economic expansion but cut back on during a recession. Counter-cyclical stocks tend to move in the opposite direction from the overall economy and with consumer staples which people continue to demand even during a downturn.

**Growth stocks** are shares in a company that is anticipated to grow at a rate significantly above the average for the market due to capital appreciation. A value stock is anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

**Value stocks** are anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

**Large cap stocks** are issued by corporations with a market capitalization of \$10 billion or more, and small cap stocks are issued by corporations with a market capitalization between \$250 million and \$2 billion.

## FIXED INCOME RISKS

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. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. 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. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

## FIXED INCOME DEFINITIONS

**Credit Quality** is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default. 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. The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Base-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

**The Bloomberg Barclays Aggregate US Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

**International debt securities** involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

**High yield/junk bonds** (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

**Municipal bonds** are subject to availability and change in price. They are subject to 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. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

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