LPL RESEARCH

WEEKLY MARKET COMMENTARY

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STOCKS RALLY AND ROLL

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The rally continued as the S&P 500 Index closed out May on the positive side. The disconnect between stocks and the economy generated widespread concern among some investors. At the same time, reopening optimism and massive stimulus overshadowed some concerns about a second wave of COVID-19 infections and increasing US-China tensions.

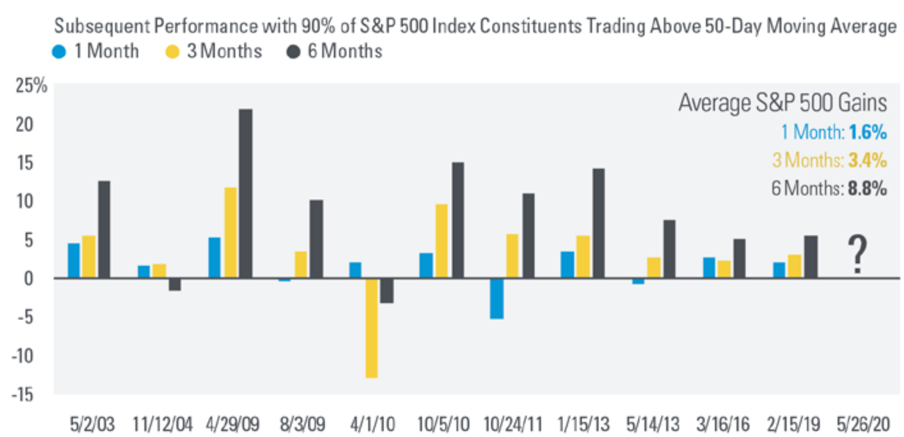
THE RALLY CONTINUES

Stocks have continued to move higher despite concerns that the rally off the March lows has come too far, too fast and concerns about the near-term prospects for the economy and corporate profits.

Economic conditions also have been improving, although they are improving from extremely depressed levels. Several real-time economic indicators, such as map requests from Apple, TSA air travel activity, hotel occupancies, seated diners, and gasoline consumption, have shown improvement. On May 28, the US Bureau of Labor Statistics reported a drop of roughly 4 million in continuing claims for unemployment insurance, an encouraging sign workers are being hired back, although data irregularities in certain states may have overstated the improvement.

Gains also were particularly impressive in the face of fears of a US-China trade war related to Hong Kong, as well as rising regulatory risk for the social media giants that have drawn President Donald Trump's ire. Regardless, as lockdowns are lifted and businesses reopen—and are bolstered by massive stimulus—the path of least resistance for stocks is higher for now.

1 STOCK MARKET RALLIES WITH EXTREMELY STRONG BREADTH TEND TO KEEP GOING



Source: LPL Research, FactSet 05/29/20

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

GOOD BREADTH

Market breadth refers to the unusually high percentage of companies exhibiting strong momentum. It's important to look at similarly strong rallies in recent history to determine if the current momentum may be too strong. One way we can measure momentum is by comparing stocks to their average price over the past 50 trading days. While momentum and breadth have been really strong lately, and stocks might look ripe for a pullback, historical S&P 500 data reveals that these momentum surges have tended to be followed by solid returns. Bumps along the way typically have been short-lived, and the uptrends often have continued.

Putting numbers to this, when the number of S&P 500 constituents—the 500 stocks that comprise the S&P 500 Index—with returns above their 50-day moving averages has exceeded 90%, performance for the S&P 500 over the subsequent one, three, and six months has been above average. That was the case the week of May 25; additionally, the reading exceeded 95% of S&P 500 constituents on May 27 and May 28 for the first time since 1991. Our chart displays 17 years of data, but returns in this scenario have been above average going back four decades **[FIGURE 1]**.

The recent market rally has been extremely broad, as nearly all stocks have rebounded significantly from the late-March lows. This doesn't change our expectation that stocks are due for a pullback, but it does support our preference for stocks over bonds for the rest of 2020 and the long term.

WILL ROTATION BECOME A TREND?

One of the more interesting stock market developments during the last week of May was the rotation from the recent leaders to the recent laggards. Some of the worst performers during the pandemic-induced bear market were among that week's top performers. For example, at the sector level, financials and industrials were strong, while small cap stocks beat large cap stocks, and value-style stocks trounced growth-style, based on the Russell 1000 and 3000 indexes. Rotations like that beg the question whether this rally will continue and, if so, for how long.

We maintain a slight positive bias toward growth-style stocks in the short term and expect value style's run of outperformance to fizzle out fairly quickly for these reasons:

1) We expect the next phase of the economic recovery to be more difficult, which may favor companies that can grow without much help from the economy, such as growth stocks.
2) The earnings outlook for the growth style is far better. Russell 1000 Growth Index earnings are expected to fall only 7% in 2020, compared to 32% for the Russell 1000 Value index. Growth index estimates for this year have been cut by 13 percentage points since March 31, compared to 28 percentage points for value (source: FactSet).
3) Stronger balance sheets of companies represented by growth-style stocks should warrant a premium in a recessionary environment, in our view. (This view also supports our preference for large caps over small caps.)
4) Stay-at-home trends probably will not reverse fully anytime soon. The growth-oriented sectors, including communication services and technology, are well positioned for the current environment.
5) The interest-rate environment may likely remain challenging for financials, the biggest value sector, well into 2021, in our view, and consistent with recent communications from the Federal Reserve.

As a stronger and more durable economic recovery becomes evident, we think value will have its day. At that point, we would expect better performance for small caps and the cyclical value stocks found in the financials and industrials sectors. However, right now we think it's too early.

TACTICAL VIEWS UNCHANGED

Our year-end 2020 fair value target range for the S&P 500 remains 3,150–3,200. To get to this number, we use a price-to-earnings ratio (PE) of about 19 and a normalized earnings figure of $165. An annual earnings run rate like that may not be achievable until late 2021 and early 2022. With interest rates so low, the potential for a vaccine during that time frame, and support from massive stimulus, we are comfortable using a longer-term earnings target to value stocks. For long-term investors, we find stocks more attractive than bonds at current valuations and recommend overweight allocations, and a corresponding underweight to fixed income for suitable investors.

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 Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

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.

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 and market data from FactSet and MarketWatch.

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

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