LPL RESEARCH WEEKLY MARKET COMMENTARY

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MARCH MADNESS: STOCK MARKET EDITION

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With the NCAA college basketball tournament getting underway this week, LPL Research is getting in the spirit with its own version of March Madness. Here we share our “Final Four Factors” for the stock market in 2021: Vaccines, Policy, Profits, and Rates. While we see several strong competitors in this field, we believe the likely winner of this tournament is clear, and it will push stocks higher over the balance of the year.

FACTOR #1: VACCINES

Perhaps the most important factor in assessing economic growth prospects

The distribution of COVID-19 vaccines is bringing us closer to a fully reopened economy and is likely the most important factor in assessing economic growth prospects for 2021.Their importance to the outlook for the US economy and financial markets cannot be overstated.

Since the approval of the first vaccine candidate in early December 2020, the United States has administered over 100 million doses and has fully vaccinated roughly 13% of the total population, according to data from Johns Hopkins. The current pace of over 2.4 million shots per day is expected to pick up soon as the Johnson & Johnson single-dose vaccine—granted emergency use approval on February 27—becomes more widely available. The vaccine is easier to store and transport

The vaccine rollout and ongoing containment measures have helped quell the winter surge in cases. New daily cases have fallen from a peak near 300,000 on January 8 to an average of around 50,000 last week. The number of people hospitalized with COVID-19 in the United States has also plummeted. And currently approved vaccines appear to be effective against current variants of COVID-19, helping quell the risk of another wave of infections.

Thanks in large part to the efficacy of the vaccines, we expect the economy to move closer to a full reopening over the next several months as the end of the pandemic approaches.

FACTOR #2: POLICY

Added stimulus provides a clear near-term benefit. But what about long-term risks?

President Biden signed a nearly $1.9 trillion stimulus bill into law on March 11, 2021. This latest stimulus package comes on the heels of approximately $3.4 trillion in stimulus passed by former President Trump in 2020, the last a $900 billion bill signed into law on December 27.

Markets generally cheer stimulus, at least in the short term, and we've seen a historic amount of debt-financed fiscal support in the past year. Markets are forward looking, suggesting much of the stimulus has likely largely been priced into markets. At the same time, stimulus helps protect against economic downside and could still contribute to an upside surprise in conjunction with vaccines.

The Federal Reserve (Fed) is also continuing to provide monetary stimulus, both by keeping its policy interest rate near zero and through its bond purchase program to help contain longer-term interest rates. The Fed has signaled that they will be cautious about raising rates, the most recent Fed policy committee projection putting the first rate hike of the economic cycle in 2023. Well before that, the Fed may start to signal growing comfort with the trajectory of the economy by easing off bond purchases, possibly as soon as this year.

While stimulus is likely to continue to support markets over the near term, the risks are longer term. A widely expected temporary rise in inflation would be manageable, but a structural change in inflation may roil markets. We believe the longer-term forces keeping inflation in check, such as demographics, globalization, and technology innovation, remain in play. High debt levels carry a financial cost, but the impact on growth is likely to be gradual over a long period of time.

FACTOR #3: PROFITS

Strong economic recovery sets the stage for substantial revenue and profit growth

The economic recovery to date continues to surpass expectations, bolstered by massive stimulus, potentially setting the United States economy up to grow 6% or more in 2021. A strong economic recovery sets the stage for a potential substantial increase in revenue and profits over the next year.

Against that strong economic backdrop, our estimate for S&P 500 Index earnings per share in 2021 is $170, which is below consensus estimates of $175 (source: FactSet), and may end up being conservative. Fourth-quarter earnings season was stellar—S&P 500 earnings grew 4% year over year when a near double-digit decline was anticipated at quarter-end. And estimates have increased nicely over the past couple of months—by about 5%—all of which solidify the positive earnings outlook.

Strong earnings growth is a key part of the bull case for stocks, given valuations are elevated. As we noted in *Outlook 2021: Powering Forward*, we expect stocks to grow into their valuations this year and move higher as earnings rebound strongly from their lockdown and recession-driven collapse in 2020. S&P 500 earnings could end up growing 25% or more this year and by double digits in 2022, based on consensus estimates.

FACTOR #4: RATES

How quickly rates rise matters more than the level

Long-term interest rates are rising as the economic outlook improves. More important than the level of interest rates is how quickly we get there. If interest rates move higher too quickly, there could be spillover to the economy and stocks.

Interest rates play an important role in economic and business conditions as they influence rates on consumer and business loans as well as impact returns on many investments. This year, we've seen the yield on the 10-year Treasury increase by 60 basis points (0.6%) to 1.6%, a full percentage point above last year's lows on March 9 that were matched on August 4. While we don't believe yields at these levels necessitate a repricing of financial assets, a meaningful move higher from these levels may cause financial conditions to tighten.

We continue to believe yields will move higher throughout the year with an upward projection of 1.75% (our year-end range for the 10-year rate remains 1.25% to 1.75% for now). If rates move too high too fast, we would expect the Fed to intervene to ensure rising rates don't become too restrictive and disrupt equity markets or the real economy. Stock market performance during prior periods of rising rates is reassuring, as we discussed here last week. As the economy reopens and expectations for growth and inflation evolve, the level and trajectory of interest rates will continue to be top of mind for investors.

AND THE WINNER IS…

We're giving the championship to the vaccines in a rout!

The distribution of COVID-19 vaccines is bringing us closer to a fully reopened economy and is likely the most important factor in assessing economic growth prospects for 2021. Earnings and stimulus are strong competitors which we believe will help support stock market gains this year. We expect interest rates to fade as a threat to markets as the game plays out.

We continue to recommend an overweight to equities and underweight to fixed income relative to investors' targets, as appropriate. We reiterate our S&P 500 Index fair value target range of 4,050–4,100 at year-end 2021, based on a price-to-earnings (PE) multiple near 21 and our 2022 earnings forecast of $195.

IMPORTANT DISCLOSURES

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

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

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

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full Outlook 2021: Powering Forward publication for additional description and disclosure.