LPL RESEARCH
GLOBAL PORTFOLIO STRATEGY

March 2020

LOOKING FOR A BOTTOM

LPL Research monthly global review and look forward

The COVID-19 outbreak (coronavirus) roiled markets over the past two weeks, putting the S&P 500 into correction territory and near a 20% bear market decline. Though new cases in China slowed during the month, data out of China pointed to economic contraction and economic forecasts in the United States began to fall as new cases emerged in the United States and globally as containment efforts intensified.

Investment Takeaways

- The ongoing market correction may present an attractive medium-to-long term opportunity and our year-end 2020 fair value S&P 500 Index target of 3,250-3,000 may still be attainable*. However, given the uncertainty, our economic, earnings, and market forecasts are currently under review.
- We favor large cap **stocks** over small and a balance of growth and value equity styles where suitable.
- Attractive valuations and solid economic growth may favor **emerging markets** over foreign developed markets. Slowing new cases in China has helped buoy emerging market stocks in recent weeks.
- The emergency 50 basis point (.5%) rate cut by the Federal Reserve (Fed) March 3 in response to the risks to U.S. growth from the outbreak did little to stop cascading **yields at all-time record lows**.
- We favor a blend of high-quality intermediate **bonds** with a modest underweight to U.S. Treasuries and still see value in **mortgage-backed securities** (MBS) relative to Treasuries, but we have downgraded our view to neutral due to the potential impact of refinancing as mortgage rates fall.
- U.S. stocks corrected sharply in recent weeks, leaving markets oversold on various metrics. Bottoming can be a slow process, but sentiment reveals signs of extreme fear often associated with market lows.
- **Key changes** from February's report: Upgraded healthcare view from neutral to positive; downgraded industrial metals view to neutral from positive; downgraded MBS from positive to neutral.

Our Asset Class & Sector Choices

Equity Asset Classes	Equity Sectors	Fixed Income	Alternative Asset Classes
Emerging Markets Equities Large Cap Equities	Industrials Technology Financials	Mortgage-Backed Securities	Event Driven

Data as of February 29, 2020

*As noted in our *Outlook 2020: Bringing Markets Into Focus*, our year-end fair value target for the S&P 500 of 3,250–3,300 is based on a trailing price-to-earnings ratio (P/E) of 18.75 and S&P 500 earnings per share forecast of $175.

Economy: Pre-Outbreak Momentum Evident in U.S. Data

February data reflected some evidence of COVID-19 impact but generally held up well in the United States. That picture will likely change, however, when March data is reported. Globally, it was a different story, with first quarter data pointing to economic contraction in China, the epicenter of the outbreak.

- **Conference Board's Leading Economic Index (LEI)** rose 0.9% year over year in January. The strong bounce in the LEI after a string of lethargic readings signaled continued economic growth.
- **Payrolls and Labor.** Nonfarm payrolls increased 273,000 in February, well above expectations for a gain of 175,000. The gain, which is sufficient to maintain the current low unemployment rate, was above the 12-month average of 201,000. Wages rose 3% year over year in January, in line with recent trends.
- **Inflation.** The core Consumer Price Index (CPI), which excludes food and energy prices, increased 2.3% year over year, in line with the recent trend and not high enough to worry the Fed.

  On the **wholesale** side, the core Producer Price Index (PPI), excluding food and energy increased 1.5% year over year in January.

  Prices for core personal consumption expenditures (PCE), the Fed's preferred inflation gauge, increased a softer-than-expected 1.6% year over year in January, well within the Fed's 2% target.
- **U.S. manufacturing** slowed in February as the Institute for Supply Management's (ISM) Purchasing Managers' Index (PMI) edged lower to a marginally expansionary 50.1. Supplier delivery times lengthened due to China's measures to contain the COVID-19 outbreak.
- **U.S. Consumer.** The Conference Board's Consumer Confidence Index rose slightly in February and remained elevated despite increasing fears of a U.S. COVID-19 outbreak. Recent sales data reflected a 0.3% increase in January, in line with expectations. The retail sales component within gross domestic product (GDP) was unchanged after a 0.5% increase in December.
- **U.S. Business Investment.** Bookings for all durable goods dipped 0.2% month over month in January and fell 2.3% year over year. However, excluding volatile transportation orders, capital goods orders rose a solid 0.9% month over month and were flat year over year, reflecting continued sluggish capital investment from corporate America.
- **Federal Reserve.** The Fed announced an emergency 50 basis point (0.5%) rate cut March 3, the first intra-meeting cut since 2008, amid concerns about a widening COVID-19 outbreak. Even after the announcement, which failed to buoy market sentiment, the bond market was pricing in additional rate cuts at the Fed's March 17–18 policy meeting.

2020 Real GDP Growth Forecasts

Our real U.S. gross domestic product (GDP) growth forecast for 2020 is 1.75%.			
Our forecasts are all under review:	Developed International (ex. U.S.) now 1.5%	Emerging Markets now 4.6%	Global Growth now 3.5%

U.S. and global GDP estimates are LPL forecasts. Other GDP estimates are International Monetary Fund projections.

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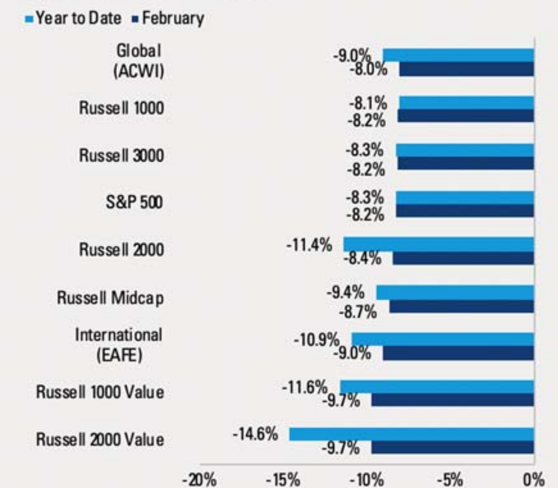
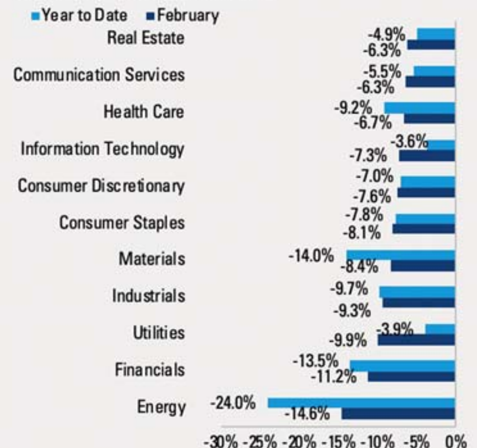
Equity Asset Classes: Virus Fears Drove Stocks Sharply Lower

The **S&P 500 Index** tumbled 8.2% in February, as the COVID-19 outbreak in China spread to dozens of countries around the world and increased fears of a global pandemic. The 12% drop in the S&P 500 during the last week of February was its largest since 2008 and registered the fastest ever 10% correction from a record high. Market volatility in early March left the S&P 500 near the technical definition of a bear market—a 20% or more decline based on closing prices.





Source: FactSet 06/30/19
Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.
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.

Style/Capitalization

Large cap and small cap stocks suffered similar losses during February, based on the Russell 1000 and Russell 2000 indexes, while large caps held up better during the first week of March. Growth stocks held up better than their value counterparts during the selloff as the top growth sectors—consumer discretionary and technology—outperformed the biggest value sectors—energy and financials.

Global Equities

Emerging equities stood out among regions in February with a more modest loss than U.S. and international developed market stocks. Modest gains for the U.S. dollar weighed on dollar-based international returns.

Emerging markets equities lost 5.3% in February, based on the MSCI Emerging Markets Index. **China** produced a modest gain for the month, based on the MSCI China Index, as cases of the COVID-19 there slowed. Stocks in **Taiwan** also outperformed, while stocks in **Brazil** lagged.

International developed equities lost 9% for the month**,** based on the MSCI EAFE Index. The **United Kingdom** market underperformed, based on the MSCI country indexes, while stocks in **Hong Kong** held up relatively well.

Over the first week of March, returns for the various global indexes were similar, though China's stock market continued to exhibit some resilience on a relative basis.

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Equities Asset Classes: Favor U.S. Large Caps and Emerging Markets

Asset Class	Comments
Market Cap	We favor U.S. large caps over their small cap counterparts as the business cycle ages and financial conditions potentially tighten further. The U.S.-China trade deal signed in January should be beneficial for more global large cap companies, while larger companies offer a superior corporate profit outlook, in our view.
Style	We maintain a balanced view of growth and value. Relative valuations and the duration and magnitude of the growth rally suggest value stocks may deserve overweight consideration. However, the aggressive rate cuts by the Fed—with more cuts being priced into markets for the months ahead—and slowing economic growth due to the COVID-19 outbreak may favor growth. The interest rate environment and credit concerns in the energy sector increase near-term pressure for the value-heavy financials sector.
Region	**United States.** Among developed markets, we remain U.S. focused, supported by relatively stronger but slowing economic growth, low inflation, and a supportive Federal Reserve. Although the earnings growth outlook for the next couple of quarters has been impaired by virus containment efforts, supply chain disruptions, and changes in consumer behavior, at this point we still think the S&P 500 could potentially deliver flat earnings in 2020, which may still be enough to outpace Europe and Japan. **Europe.** Fiscal deficits, populism, and exhausted monetary policies could weigh on sentiment, spending, and investment in Europe, though improving economic data before the outbreak caught our attention. **Japan.** Structural reforms have had limited success, and the recent consumer tax (VAT) hike contributed to a sharp economic contraction in the fourth quarter that may lead to a technical recession by the end of March. Corporate earnings contracted sharply in 2019. **Emerging Markets.** Attractive valuations and solid economic growth favor emerging markets over developed foreign markets. Although the benefits to the Chinese economy from the phase-one trade deal with the United States were derailed by the COVID-19 outbreak, the outbreak's cycle is further along in Asia than in the United States or Europe. This suggests the market had already started to price in an economic recovery there as March began. That said, we acknowledge the risk of a worsening health crisis in China and other emerging economies.

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Equities Sectors: Favor Cyclicals for the Rebound

Sector	View	S&P 500 Weight (%)	Comments
Materials	Neutral	2.6	Global growth and China trade were improving pre-outbreak, but virus risk is high.
Energy	Negative	3.4	Prior supply shocks had little sustained impact, and the virus outbreak and OPEC inaction add downside risk.
Industrials	Positive	8.6	Bullish case based on stable global growth, more trade, and more capital investment will take more time to play out. Valuations may provide support in a rebound.
Communication Services	Neutral	10.4	High valuations, regulatory risk for internet companies, and telecom exposure keep us neutral. Home entertainment getting a boost from the outbreak.
Consumer Discretionary	Neutral	9.8	Though valuations are rich, consumer spending has been resilient. Outbreak clouds near-term outlook for travel and leisure industries.
Technology	Positive	24.5	Productivity enhancements in areas such as mobile, cloud, automation, and artificial intelligence (AI) are driving demand. We still see earnings growth in 2020.
Financials	Positive	11.7	Fed's emergency rate cut March 3 and record-low Treasury yields add headwinds, but earnings have held up, valuations are attractive, and we see higher rates.
Utilities	Negative	3.7	We continue to favor cyclical sectors; valuations are high; and we expect interest rates to move higher.
Healthcare	Positive	14.5	Our upgraded view is driven by a solid healthcare spending outlook, favorable demographics, attractive valuations, steady earnings, and improved prospects for a moderate policy environment.
Consumer Staples	Negative	7.6	Our preference for cyclical sectors, sluggish growth, and rich valuations offset attractive yields.
Real Estate	Negative	3.2	Sound fundamentals and rich yields offset by interest-rate sensitivity and our preference for cyclicals.

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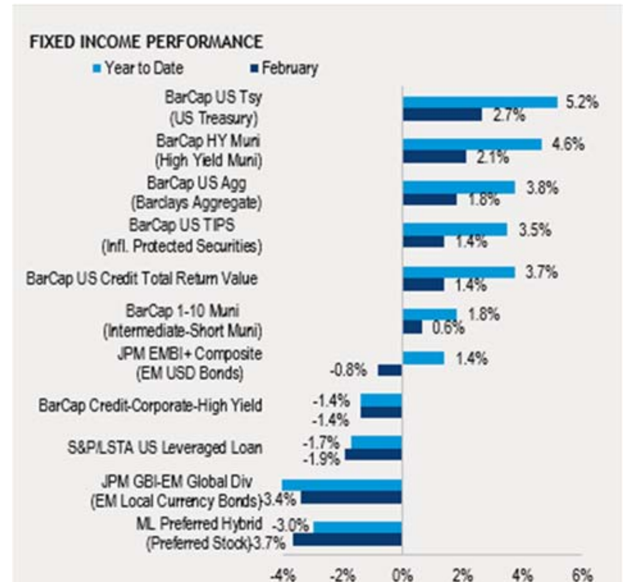
Fixed Income, Currencies, and Commodities

U.S. Treasury yields fell sharply in February as the spread of COVID-19 drove a safe-haven rally. The 10-year Treasury yield slid another 38 basis points (0.38%) during the month to end February at a record low of 1.14% and continued to decline in early March.

Performance was mixed across bond sectors, as shown in the **Fixed Income Performance Table**. There was a flight to quality during the month, as Treasuries paced gains. The Bloomberg Barclays U.S. Aggregate Bond Index (Agg) returned a solid 1.8%. Lower-quality bond sectors struggled, as emerging markets debt, high-yield corporates, and leveraged loans all posted negative monthly returns.



US Treasury Yields

Security	1/31/2020	2/29/2020	Change in Yield
3 Month	1.55	1.27	-0.28
2 Year	1.33	0.86	-0.47
5 Year	1.32	0.89	-0.43
10 Year	1.51	1.13	-0.38
30 Year	1.99	1.65	-0.34

AAA Municipal Yields

Security	1/31/2020	2/29/2020	Change in Yield
2 Year	0.91	0.76	-0.15
5 Year	0.93	0.80	-0.13
10 Year	1.27	1.09	-0.18
20 Year	1.74	1.52	-0.22
30 Year	1.88	1.65	-0.23

Source: FactSet 02/29/20
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 subject to availability and change in price.

Credit Quality: Medium

We maintain a more cautious approach as the cycle ages, but we still prefer corporate bonds to government bonds.

Duration: Short to Intermediate

We prefer below-benchmark interest-rate sensitivity due to the historically low longer-maturity U.S. Treasury yields and prospects of a second half economic rebound.

Bonds: Taxable

We suggest a blend of high-quality intermediate bonds in tactical portfolios. We expect modestly higher long-term rates in 2020 if we see a rebound in the second half of the year, and compensation for longer-maturity bonds remains unattractive in our view. We still see incremental value in corporate bonds and MBS over Treasuries, but risks specific to the individual bond sectors temper our views.

Bonds: Tax Free

We favor municipals bonds as a high-quality option for taxable accounts. Supply dynamics still look attractive, and valuations relative to Treasuries improved in February.

Commodities and Currencies

Safe-haven buying from COVID-19 outbreak fears and potential **U.S. dollar** weakness are possible catalysts for precious metals, where our view is positive. Our neutral industrial metals view reflects near-term COVID-19 risk. Our crude **oil** outlook remains negative on supply concerns and lack of sustained impacts from prior supply shocks.

Fixed Income and Alternative Investments: Limit Rate Sensitivity

Sector Views	View	Comments
U.S. Treasuries	Negative	Yield spreads to international sovereigns remain elevated, but have narrowed. Valuations have become very expensive on COVID-19-related demand.
Mortgage-Backed Securities (MBS)	Neutral	Diversifying source of yield among high-quality options. Refinancing activity due to lower mortgage rates may weigh on returns.
Investment-Grade Corporates	Neutral	We still find incremental value in corporate bonds due to the prospective economic backdrop. Overall credit quality compared to history remains a concern but valuations have improved.
Preferred Stocks	Neutral	Fundamentals for U.S. banks are still good. Higher interest-rate sensitivity and valuations may be concerns post-COVID-19 impact.
High-Yield Corporates	Neutral	Yields are attractive, and the economy is supportive, but high-quality options may be better diversifiers. High-yield bond sector exposure to energy is of concern following the collapse in oil prices.
Bank Loans	Negative	Weaker investor protections and falling rates reduce attractiveness.
Foreign Bonds	Negative	Rich valuations, interest rate risk, and potential currency volatility are among negatives.
Emerging Markets Debt	Neutral	Dovish central banks improve the valuation picture but may be vulnerable to COVID-19-related risk. Positive bias for second half.

Alternative Investments

Event Driven strategies have remained resilient during the recent bout of market volatility, with some managers seeking to prioritize deals with a shorter time to close. Healthy deal flow, private equity capital, and low interest rates continue to support the strategies' investment backdrop.

IMPORTANT DISCLOSURES

This material has been prepared for informational purposes only, and is not intended as specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors and they do not take into account the particular needs, investment objectives, tax and financial condition of any specific person. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing. Any economic forecasts set forth may not develop as predicted and are subject to change.

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. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. 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. 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.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results. For a list of descriptions of the indexes referenced in this publication, please visit our website at lplresearch.com/definitions.

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