LPL RESEARCH WEEKLY MARKET COMMENTARY

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REVISING 2020 FORECASTS

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The S&P 500 Index entered a bear market on Thursday, closing -27% below its February 20 high. While the drop has created what we think is an attractive opportunity for long-term investors, it makes sense to be careful here given the ongoing uncertainty surrounding the impact of the COVID-19 pandemic and increased odds of a US recession. In response to the pandemic, we have lowered our forecasts for economic growth, stocks, earnings, and Treasury yields.

THE LATEST

The global COVID-19 pandemic has caused significant economic disruption globally and driven stocks into a bear market for the first time in over a decade. The impact has been most acute in the most affected countries, notably China, Italy, and South Korea, where containment efforts have been most aggressive. But as the outbreak spreads in the US and more domestic consumer spending and business activity is derailed, the economic impact adds up and earnings for corporate America will likely take a hit. Stimulus measures and more aggressive containment can help us get through this, but it's tough to see the other side from where we sit today.

Unfortunately, we don't have evidence of a peak in COVID-19 cases in the US as of today, but the experience in China provides some reassurance that containment efforts can limit the spread. When market participants get some hint that new cases are peaking as quarantines work, we think stocks can make some headway. Until then, volatility will likely remain elevated.

Below we have provided our updated economic and market forecasts with relevant context for the changes.

REVISED ECONOMIC GROWTH FORECASTS

The uncertainty around the scope of the outbreak makes forecasting economic growth difficult. Our revised forecasts are shown in **FIGURE 1**, including potential downside risks in a recession scenario.

1 COVID-19 IMPACT ON GLOBAL GROWTH, EARNINGS, AND INTEREST RATES IS SIGNIFICANT

Real Gross Domestic Product Growth Forecasts (YoY)	2019	2020 Previous	2020 New
United States	2.0%	1.75%	1–1.25%
Developed ex-U.S.	1.3%	1.5%	0.75–1%
Emerging Markets	3.9%	4.6%	3.75–4%
Global	3.5%	3.5%	2.75–3%

U.S. Market Forecasts	2020 Previous	New
10-Year Treasury Yield	2–2.25%	1.25–1.75%
S&P 500 Earnings per Share	$175	$160–162.50
S&P 500 Fair Value	3,250–3,300	3,150–3,200

Source: LPL Research, Bloomberg 03/11/20

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The economic forecasts may not develop as predicted.

EMERGING MARKETS

In our updated global economic growth forecasts, we start with the epicenter of the outbreak in China. If containment continues to progress there as we expect, we could begin to see an economic rebound in the second quarter following contraction in the first quarter, based on gross domestic product (GDP), followed by gradual recovery over the remainder of the year that puts the Chinese economy back near its prior 5.5% to 6% growth run rate by year end. That may put full-year 2020 GDP growth in China 1% to 1.5% below the current 6.0% Bloomberg-tracked consensus. With China comprising such a large piece of emerging market economies, in addition to the broader region’s commodity exposure, we have lowered our emerging market GDP growth forecast for 2020 to 3.75-4% from 4.6%. Longer term, we expect limited permanently lost economic output from the outbreak.

DEVELOPED INTERNATIONAL

European economic growth had slowed for two years prior to the outbreak to around 1%. COVID-19 disruptions could put much of Europe in recession, and even with a rebound in the second half, growth for the year much above 0.5% may be a stretch. Italy has nearly 10,000 cases and has undertaken some of the most extreme containment measures in the world outside of China, shutting down all retail except for drug stores and grocery stores. France, Germany, and Spain each have over 1,000 cases, while the impact in the UK has been more modest. Bloomberg-tracked consensus for EU GDP growth in 2020 is currently .9%, which we think may end up being cut in half.

The Japanese economy probably already entered recession after a consumption tax went into effect in October 2019, with fourth quarter GDP contracting by more than a 6% annualized rate. Outbreak containment efforts and weaker export markets will add to the weakness, with lower energy costs providing only a small offset. We expect the Japanese economy to contract modestly this year, slightly more conservative than Bloomberg's consensus GDP growth for 2020 at 0.1%.

Factoring in the rest of the developed international economies, we forecast growth overall of 0.75-1% in 2020, but acknowledge the downside risk due to significant uncertainty.

UNITED STATES

Containment efforts and consumer behavioral shifts in the United States have gotten increasingly aggressive in recent days, adding to near-term downside for economic growth and bringing the odds of a recession to perhaps 60-70% if not more.

The US economy is being impacted in a number of ways. Supply chain disruptions for corporate America, less demand from Asia, and reduced travel delivered the first blow. The latest hits were to energy producers from the collapse in oil prices and to consumer spending as people shop less and stop going out to eat. Now we have a negative wealth effect from stock market losses and tightening credit markets on top of all that. These factors add up to a meaningful loss of economic activity, even if only in the short term.

We estimate that these factors could potentially trim as much as 0.75% off of US GDP over the next several months before containment and an eventual recovery in the second half of the year. That puts GDP growth in the US at 1-1.25% in 2020, though there is some downside risk to that range depending on how long containment takes. In a US recession scenario, full-year 2020 GDP growth could potentially be flat.

On a more optimistic note, the US economy was in pretty good shape before COVID-19 struck, which will help us weather the storm.

GLOBAL

Our initial estimate of the negative impact on global growth from the COVID-19 outbreak that we shared on February 28 on the LPL Research blog was 0.2-0.3%. Factoring in the economic impact on China, the US, and Europe as discussed above, a back-end loaded 3% GDP growth for 2020 may be a best case scenario for the global economy this year, compared to our prior forecast of 3.5%.

DOWNSIDE RISK TO EARNINGS

We indicated here two weeks ago that we thought flat earnings this year were achievable amid supply chain disruptions and containment efforts. That would put the number for S&P 500 Index earnings per share (EPS) in the range of $163. The additional downside from more aggressive containment efforts and the impact to the energy sector put lower numbers in play. We think $160-163 is a reasonable range, representing a mild earnings recession, if the US economy skirts an economic recession. If the US economy does indeed enter recession this month, a realistic scenario, then something closer to $145-150 in S&P 500 EPS could potentially be in play. The current FactSet-tracked consensus is $173 per share.

In fact, we think our previous 2020 estimate of $175 is a reasonable target for 2021 based on currently available information. Markets will likely soon begin to look through some of the 2020 turmoil to 2021 expectations. Investors will have to wait longer for those earnings to come through, however, and the outlook is less certain. We don't think the price-to-earnings (PE) multiple we were using to calculate our 2020 fair value target for the S&P 500 at 18.75 factors any of that in.

Because of reduced earnings expectations for 2020 and our belief that market participants' will be reluctant to pay as high of a PE multiple on 2021 earnings in this environment, we have lowered our year-end fair value target range for the S&P 500 slightly. Our revised forecast of 3,150-3,200 (down from 3,250-3300 previously), is based on a PE slightly over 18, supported by lower interest rates, and S&P earnings per share in 2021 of $175.

In a US recession scenario that brings earnings down further, we could see a downside scenario on the S&P 500 to near 2,200, a roughly 35% decline from the S&P 500's record high on February 20 and near the average recessionary bear market. At 2,200, the S&P 500 would be trading at about a 15 PE based on $145 in S&P 500 EPS in 2020.

BOTTOMING PROCESS IN BOND YIELDS MAY BE FURTHER ALONG

The move lower in bond yields has been historic, with the 10-year Treasury yield hitting a record low below 0.5% last week. The flight to safety globally pushed yields well below what we would deem as fair value. The bond market has priced in a federal funds rate of zero, suggesting a recession has already been priced in. The stability in yields late last week suggested bond yields may be further along in establishing a bottom.

Given the environment we are in, with a potential for US recession, falling inflation expectations, plummeting oil prices, and zero or negative rates around the world, we think it makes sense to lower our target for US yields at year-end. Our revised forecast for the 10-year Treasury yield at year-end is 1.25-1.75% (down from 1.75-2%). The wider range reflects the level of uncertainty. Looking beyond the outbreak to a potential economic rebound later this year, we would anticipate a sharp reversal higher in yields from current levels.

OUR TAKE

We believe stocks have fallen to levels we would consider very attractive based on our assessment of economic and market fundamentals. That has us thinking about upgrading our equities recommendation to overweight from market weight, which we lowered from overweight in March 2019. Ironically, the amount of discomfort we as investors are feeling gives us confidence that getting more optimistic about the stock market is probably the right thing to do.

For now, our best advice would be to stay the course, or possibly think about some rebalancing into equities where appropriate. We will get through this, but given the short-term uncertainty, patience is key. We think some positive market catalysts will begin to emerge over the next week or two. Stay tuned.

We will keep you updated on our views on the economy and markets as this difficult situation develops. Everyone stay well.

WMC

IMPORTANT DISCLOSURES

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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.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS is an important variable in determining a share's price and serves as an indicator of a company's profitability.

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

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

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