THE US EQUITY MARKET AT A CROSSROAD

by **Robert F. DeLucia, CFA**
Consulting Economist

Summary and Major Conclusions:

As always, the short-term investment outlook is uncertain, as headlines, emotions, technical factors, and trading patterns dictate the direction of the financial markets on a daily, weekly, and monthly basis. However, based upon underlying fundamental forces, the outlook for the next one to two years appears highly favorable for common stocks and negative for the fixed-income market. Concrete evidence of a sustained economic recovery should spark a shift in equity market leadership to value stocks.

- The strong rally in the equity market since the end of March has caught many investors off guard. As I have highlighted in recent reports, most investors are fearful and continue to maintain a highly risk-averse mentality, as manifested in an unprecedented mountain of cash on the sidelines earning next to zero.

- There are several explanations for the very strong rally in stocks in recent weeks. The news on the medical front has been promising, most importantly in the form of very preliminary progress toward a breakthrough in COVID-19 medications.

- Moreover, very recent data suggest that the recession ended in April, with some tentative signs of improvement in May. A restarting of the economy should be accompanied by increasingly positive economic data as businesses slowly open, an increasing number of workers return to their jobs, and as consumers begin to spend.

- Finally, credit markets continue to heal, benefitting from the flood of liquidity provided by the Federal Reserve. Additional monetary and fiscal support for the economy should be forthcoming in future months.

- US corporations have issued debt at a record pace in recent months, as yield-hungry investors shift their portfolio allocations from stocks to bonds. Through May 31, investment-grade and high-yield corporate bonds have delivered positive returns of 12% and 20%, respectively, off the March 23 bottoms.

- My forecast assumes that April was the economic trough and that business conditions will gradually improve as the year unfolds. The most serious risk to the economy involves a premature relaxation of social distancing, resulting in a resurgence in infections.

- Nationwide statistics on infections, hospitalizations, and deaths are mixed and vary considerably on a state-by-state basis. Although there remain many states with rising cases, both the number of new infections and fatalities remain in a slight downtrend on a nationwide basis.

- The news pertaining to the development of a vaccine has been promising. There is a strong likelihood that a vaccine will be produced in small batches for emergency use prior to yearend, setting the stage for a steep ramp-up of production during 2021.

- I continue to believe that the initial impact of the recession on the economy was profoundly deflationary and that the rate of inflation is likely to trend lower throughout 2021. Beyond the medium term, the risk of a rising inflation rate increases in 2022 and beyond.

- My economic forecast is consistent with superior rates of return on common stocks relative to bonds. Improving economic news along with a gradual recovery in company earnings should support both higher stock prices and bond yields.

- I expect stock prices to be higher one year from now, based upon the following assumptions: A progressive recovery in economic output; expectations for a sharp rebound in corporate profitability; continued very low inflation and interest rates; a sustained cyclical decline in the US dollar; and an expansion in equity valuations.

- Over the next one to two years, there is a high likelihood that value stocks will outperform growth stocks, based upon historical patterns. History reveals that value stocks have outperformed growth stocks in the first several years of every economic recovery since 1960.

- Major risks to the outlook include a powerful second wave of coronavirus infections in the fall and winter; a serious setback in medical research, especially with respect to a vaccine; a shift in job losses from temporary to permanent; and a decision by the Trump administration to escalate its trade war with China.

The strong rally in the equity market since the end of March has caught many investors off guard. As I have highlighted in recent reports, investors are fearful and continue to maintain a highly risk-averse investment posture. The unprecedented mountain of cash on the sidelines earning next to zero is a manifestation of a highly cautious and defensive posture for both retail and institutional investors. There is a low level of trust and conviction in the recent rally, and confidence in the economy remains severely depressed.

WHAT EXPLAINS THE STRONG RALLY IN STOCK PRICES?

Both the S&P 500 and the Dow Industrials have risen by more than 10% in less than six weeks. Since the March 23 bear market low, the gains have been 37% and 36%, respectively. There are several explanatory factors at work:

- The rally began off an unusually depressed bottom, as investors vastly overreacted to the health crisis at that time.

- Very recent data suggest that the recession ended in April, with some scattered signs of improvement in May, most notably in the housing market.

- A reopening of the economy should be accompanied by increasingly positive economic news as businesses slowly reopen, an increasing number of workers return to their jobs, and as consumers begin to spend.

- Credit markets continue to improve, reinforcing the momentum in the equity market. Total returns on investment-grade and high-yield corporate bonds off the March 23 bottom are 12% and 20%, respectively.

- The news on the medical front has been promising, most importantly in the form of concrete progress toward a breakthrough in COVID-19 medications.

- Government policy remains highly expansionary, with further stimulus on the way.

- Exceptional strength in the technology sector — which comprises more than 25% of the S&P 500 Index — has turbo-charged the rally in the overall market. If one includes Amazon, Facebook, and Alphabet, the broad information technology sector comprises a whopping **45%** of the entire index.

HOW CAN YOU BE CERTAIN THAT THE ECONOMY HAS BOTTOMED?

One can never be certain because the economy remains highly fragile and vulnerable to a relapse. However, there is a meaningful probability that April was the bottom and that economic conditions will continue to improve as the year unfolds. There are several factors to consider in this regard:

- All 50 states have relaxed lockdown mandates, allowing businesses to reopen to varying degrees, some workers to return to their jobs, and consumers to be somewhat more mobile.

- Preliminary economic data indicate some modest improvement in spending, most notably with respect to the single-family housing market. Both home sales and mortgage applications are in a steady uptrend.

- The vast majority of the $3 trillion fiscal stimulus package will be spent in the second quarter, suggesting that the immediate impact on aggregate spending will be concentrated in Q3 and Q4.

- The Federal Reserve is determined to underwrite a sustained economic recovery and will continue to add monetary stimulus until the economy is on a firm upward path.

The most serious risk to the economy involves a premature relaxation of social distancing practices, resulting in a resurgence in infections. Assuming continued stabilization in new infections and hospitalizations, aggregate spending and output should gradually improve in coming months.

COULD YOU ELABORATE ON DEVELOPMENTS ON THE PUBLIC HEALTH FRONT?

Nationwide statistics on infections, hospitalizations, and deaths are mixed and vary considerably on a state-by-state basis. There are still many states with rising cases, and the numbers could worsen as the economy reopens. Both the number of new infections and fatalities are declining on a nationwide basis, but at a painfully slow rate. A sharp increase in testing accounts for some of the rise in new cases. At a pace of 3.5 million, the number of tests conducted nationwide has more than doubled in less than a month.

News pertaining to the development of a vaccine has also been promising, with virtually all major pharmaceutical companies deploying vaccines in clinical trials. According to Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, there is a strong likelihood that a vaccine will be produced in small batches for emergency use prior to yearend, leading to much larger quantities during 2021.

WHAT SHOULD INVESTORS EXPECT IN TERMS OF AN ECONOMIC RECOVERY?

Because of the unique nature of the recession, the economic recovery is expected to differ from the typical business cycle recovery of previous decades. My forecast assumes that the recovery will occur in two stages:

- **Stage One**: The first stage covers the period through the first half of next year and is predicated upon a smooth and sustained reopening of the economy. Because of the numerous challenges associated with restarting the economy, the process will likely be choppy with possible setbacks along the way. Housing, manufacturing, and government will be the leading sectors, partially offset by a slower recovery in consumer spending, capital investment, and services.

- **Stage Two**: The second phase will likely begin in the middle of next year and is predicated upon the mass availability of one or more vaccines for COVID-19. The mass availability of a safe and effective vaccine during 2021 will spark a revival in discretionary sectors of the economy, including travel, tourism, recreation, culture, sporting events, and a wide variety of business and consumer services.

The key point is that the economic recovery is most likely to resemble a U, rather than a V, because of various lingering headwinds to growth. A sharp V-shaped recovery can occur only with widespread availability of a vaccine for COVID-19. A widely feared L-shaped recovery is unlikely and would occur only in the event of a massive second wave of infections more severe than the initial wave, resulting in widespread shutdowns.

WHAT ARE THE KEY ASSUMPTIONS OF YOUR FORECAST?

The specific components of my forecast can be summarized as follows:

- The peak-to-trough contraction in US real GDP will likely exceed 12%, triple the 4% contraction triggered by the 2008 financial crisis.
- The level of US real GDP will not return to its 2019 peak of $19.22 trillion until the fourth quarter of next year.
- Using yearend year-over-year data, real GDP could expand by 8% in 2021 and 6% in 2022. The compound annual growth rate of GDP over this three-year period ending in 2022 would be slightly less than 2%.
- Compared with S&P 500 company earnings per share (EPS) of $163 in 2019, per share profits could decline to $125 this year before rising to $155 in 2021 and $175 in 2022, a 2% annualized growth rate over these three years.
- Core consumer inflation should remain comfortably below the Federal Reserve's official target of 2% throughout 2021, falling to a low of 0.5% during the second quarter of next year. Much higher inflation is possible in the years beyond 2022.

PULLING IT ALL TOGETHER, WHAT ARE THE INVESTMENT IMPLICATIONS?

As always, the short-term investment outlook is uncertain, as headlines, emotions, technical factors, and trading patterns dictate the direction of the financial markets on a weekly and monthly basis. However, based upon underlying fundamental forces, the outlook for the next one to two years appears highly favorable for common stocks and negative for the fixed-income market.

Breakthrough research in the pharmaceutical industry should allow for a more aggressive reopening of the economy, thereby supporting higher stock prices and a rising trend in bond yields. The outlook for bonds is grim, as a gradual steepening of the yield curve over the next year exerts downward pressure on bond prices.

WHY DO YOU EXPECT STOCK PRICES TO BE HIGHER ONE YEAR FROM NOW?

The equity market should benefit from a confluence of factors that could push stock prices gradually higher over the next year:

- A recovery in economic output predicated upon vaccine availability
- Expectations for a solid rebound in earning in 2021 and 2022
- Continued depressed inflation and interest rates throughout 2021
- A sustained cyclical decline in the US dollar
- A gradual expansion in equity valuations

MANY ANALYSTS CONTEND THAT EQUITY VALUATIONS ARE ALREADY ELEVATED. WHY DO YOU EXPECT VALUATIONS TO INCREASE?

Equity market valuations should drift higher from current levels for at least four reasons:

- Sustained low levels of inflation and interest rates are consistent with rising price-to-earnings (P/E) ratios. At current and expected low levels of interest rates, P/E ratios in excess of 20x are justified, in my judgment.
- Continued aggressive monetary stimulus in the form of escalating liquidity. The Federal Reserve's balance sheet has expanded from $4 trillion prior to the crisis to $7.5 trillion, and could exceed $10 trillion by yearend.
- A sustained improvement in company earnings later this year and in 2021 should restore market confidence in the health of the corporate sector.
- Prospects for an extended business expansion cycle that could persist for several years beyond 2021.

As vaccines become increasingly available in 2021 and 2022, there should be no formidable obstacles to a sustained business expansion, possibly through the middle of this decade. The availability of one or more vaccines by yearend should be an important catalyst in allowing the economy and financial markets to gradually return to normal.

ARE THE RECENT SIGNS OF A SHIFT IN MARKET LEADERSHIP A PRELUDE TO A SUSTAINED PERIOD OF VALUE STOCK OUTPERFORMANCE?

In the short term, the outlook for equity market leadership is uncertain. The implication is that investors should be cautious in interpreting recent market trends until there is greater clarity on the economic outlook. Over the next one to two years, *there is a high likelihood that value stocks will outperform growth stocks, based upon historical patterns*. My analysis of stock market history reveals that value stocks have outperformed growth stocks in every economic recovery since 1960, typically for a sustained period of three years.

WHAT DO YOU PERCEIVE AS THE BIGGEST RISKS TO THE OUTLOOK?

There are several risks to the outlook, pertaining to medical and public health developments, economic growth, domestic politics, and geopolitics. Of greatest importance is the path of the pandemic and the potential severity of a second wave of infections.

- A *powerful second wave of infections* in the fall and winter could trigger renewed shutdowns and quarantines, which would undermine economic growth and possibly result in another downturn in spending.

- A *serious setback in medical research*, especially with respect to a vaccine and/or a therapeutic, would be catastrophic. A healthy and sustained economic recovery is not possible without a safe and effective vaccine for COVID-19.

- A *shift in unemployment from temporary to permanent* would significantly slow the pace of economic recovery. *More than 80% of job losses have been temporary furloughs as opposed to permanent job eliminations*. In the worst-case scenario of a surge in permanent job losses, businesses would need to recruit and retrain new workers, causing a significant loss of productivity.

- *Increased tensions between China and the US* could result in a decision by the Trump administration to escalate its trade war with China. There is also a growing risk of anti-growth/populist pandering by both presidential candidates with the approach of the November elections.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.