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TOP 10 INVESTOR QUESTIONS

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Many investors, ourselves included, find it difficult to understand why stocks have done so well lately in such a challenging economic environment and COVID-19 still an ongoing threat. We heard that question quite a bit at our annual national conference for LPL financial professionals held virtually in late August. That isn't the only question we've been getting recently, so we've compiled our top-10 investor questions and answers.

QUESTION #1: CAN STOCKS KEEP GOING HIGHER, CONSIDERING THE RISKS?

With the S&P 500 Index up more than 50% since the March lows and stocks pricing in an optimistic recovery in the economy and corporate profits, we believe stocks may be due for a pullback—and the drop that occurred September 3–4 may be the start of it. The S&P 500 is near our bull-case scenario of a fair-value target of more than 3,450 that we highlighted in our [Midyear Outlook 2020](#) publication—and our base-case target of 3,300 is under review. We also expect a pickup in volatility ahead of the November election.

From a technical perspective, we may see a little more near-term upside in the 3,700 range, potentially helped by positive COVID-19 news, another fiscal stimulus package—we still expect another one of more than \$1 trillion—and continued strength from stocks that have performed better in the pandemic, mostly technology stocks. On the downside, we would see technical support at around 3,200.

QUESTION #2: HOW WILL THE ELECTION IMPACT STOCKS AND THE ECONOMY?

Historically, stocks have generated positive returns under all political combinations in the White House, House of Representatives, and Senate, including Democratic and Republican sweeps. While this is a very important election, as they all are, as investors we want to keep any impact to the stock markets in perspective.

Strictly from a markets perspective, a potential Democratic sweep of the Senate and presidency possibly could bring higher corporate, individual, capital gains, and dividend tax rates that may be expected to translate into lower stock values, all else being equal. But it could also bring more fiscal spending, including an infrastructure package, and lower tariffs. A victory by President Donald Trump may help keep taxes low, but it also may lead to escalating tensions with China, more tariffs, and further decoupling of the trade relationship between the two countries, all of which could potentially lead to bouts of market volatility.

For more in-depth answers to this question, read our last two *Weekly Market Commentaries* in which we discuss the potential economic and market implications of wins by [former Vice President Joe Biden](#) and [President Trump](#).

QUESTION #3: HOW CAN CURRENT STOCK VALUATIONS BE JUSTIFIED?

The S&P 500 price-to-earnings ratio (PE) based on estimated 2021 earnings is over 21, above the peak levels that historically have marked the end of bull markets (in the 18–19 range) and the long-term average of 15–16. We acknowledge stock valuations are high. However, we don't think they are irrational given: 1) the massive stimulus from the federal government and the Federal Reserve (Fed); 2) depressed interest rates that reduce the attractiveness of bonds and enhance the value of future corporate profits; 3) corporate profits are on the upswing with many winners in this environment; and 4) potential vaccine availability within the next 6 to 12 months.

QUESTION #4: WHAT TACTICAL ASSET ALLOCATION CHANGES HAVE YOU MADE RECENTLY?

We're frequently asked when the decade-long leadership in growth-style stocks might reverse. At this point, despite the big drop September 3–4, we're sticking with our preference for growth style until it becomes clearer that the US economic recovery is more durable, but we recognize growth stock valuations look stretched and value style will eventually have its day in the sun. The sharp sell-off in growth stocks recently was a reminder of what can happen when the rubber band gets stretched too far, though we believe fundamentals and technicals still support leaning toward the growth style.

We have warmed up to small caps as the new bull market has taken hold, and we selectively added some exposure in our tactical model portfolios in August. On the sector side, our last move was to upgrade materials to positive in August on US dollar weakness and strong technical momentum; we downgraded financials to negative in a corresponding move.

QUESTION #5: WHAT SECTORS DO YOU LIKE?

We continue to favor cyclical sectors in general, but with an emphasis on the sectors we think are best positioned for the economic challenges presented by the pandemic, namely communication services, healthcare, and technology.

QUESTION #6: WHAT IS YOUR OUTLOOK FOR CHINA?

China has led the way out of the global crisis in terms of containing the virus and reopening its economy. Bloomberg's economists' consensus is calling for 2% growth in China's gross domestic product (GDP) in 2020, compared to contractions anticipated in Europe (-8%) and the United States (-5%).

More broadly, our positive emerging markets view is based on prospects for relatively better economic growth for emerging market countries broadly in 2020, particularly in Asia, as well as attractive valuations and a weaker US dollar. However, US-China tensions appear likely to remain high, at least through Election Day, and warrant continued scrutiny given the risk to supply chains and the sectors that are most global, such as industrials and technology.

QUESTION #7: ARE YOU WORRIED ABOUT NARROW STOCK MARKET LEADERSHIP?

The fact that all of the gains this year in the S&P 500 have come from the top five contributors (Apple, Amazon, Microsoft, Facebook, and Nvidia) and that the top five weights in the S&P 500 are roughly 24% of the index is

of concern. The performance differential has been stark, with Strategas Research Partners recently pointing out that the gap between the top five performers in the S&P 500 and the other 495 stocks was more than 40% over a recent six-month period, even greater than at any time during the dot-com bubble. While these high-fliers may be due for a pause, the underlying strength in profits for technology, e-commerce, and digital media companies provides much stronger support for these stocks in our view than the top performers when the bubble burst 20 years ago.

QUESTION #8: IS IT TIME TO INCREASE EXPOSURE TO DEVELOPED INTERNATIONAL?

The weaker US dollar, attractive stock valuations, and massive stimulus by Japan enhance the attractiveness of developed international equities relative to US equities for domestic investors. However, we expect the US economy to hold up better than Europe's in the near term, we remain concerned about structural challenges facing both Europe and Japan, and the United States has a more growth-oriented sector mix for the current environment. As a result, we continue to maintain limited exposure to developed international equities on a tactical basis and emphasize US equities, and, if suitable, to hold a modest emerging markets allocation. On a strategic basis, we remain comfortable allocating about 20–25% of equities to non-US positions.

QUESTION #9: WHAT ARE YOUR FIXED INCOME IDEAS?

Tactically, we continue to focus on mortgage-backed securities (MBS) to potentially provide a little more resilience in a rising-rate environment without losing much income generation. Refinance activity has hurt MBS, but it may be past its peak, and Fed purchases are supportive. We continue to see incremental value in investment-grade corporate bonds compared with US Treasuries given the improving economic environment, and we would position bond exposure with above-benchmark credit sensitivity and below-benchmark interest-rate risk.

QUESTION #10: IS THE EXPANSION IN CORPORATE CREDIT WORRISOME?

We don't think so, at least not in the foreseeable future. The Fed's stimulus programs have provided tremendous support for the corporate credit markets. Interest rates remain very low, making the debt cheap to service. Rates could stay low for quite some time because of the Fed anchoring short-term rates near zero and buying bonds, while interest rates outside the United States in many cases are negative. Further, as the impact of the pandemic subsides, we expect a sustained economic expansion to support steady improvement in corporate profits. Until interest rates rise or credit spreads widen out materially (or both), we do not worry about corporate America's ability to manage its debt load.

CONCLUSION

So there you have it. Our top investor questions, centered on assessing this extraordinarily unusual economic environment. The key theme to these answers: Markets continue to look forward, not backward, and our goal is to try to see what they're seeing, and even a little ahead.

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Mortgage backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

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.

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.

Tactical allocation may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

All index data from FactSet.

Please read the full [Midyear Outlook 2020: The Trail to Recovery](#) publication for additional description and disclosure.

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