LPL RESEARCH
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A POSITIVE OUTLOOK FOR 2021

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> To say that 2020 was a wild year would be an understatement. As we prepare to welcome in the New Year, we take a look at what we can expect in the stock and bond markets, the economy, and a new post-election policy environment in 2021.

SOME POLICIES MAY CHANGE

We understand the temptation for many to over-emphasize the importance of elections in making investment decisions. However, the post-election clarity may be more important than the outcome itself, and the strong November performance was a good example. Also, new policymakers in Washington, DC, bring some important new policy considerations for 2021:

- There are still some looming uncertainties regarding the makeup of the Senate, but it appears the most likely outcome will be a split Congress, which historically has produced the strongest stock returns.
- A split Congress will likely force both parties to negotiate on policy decisions, limiting the opportunity for dramatic changes.
- A fifth COVID-19 relief bill may be forthcoming, but recent headlines suggest the bill will be smaller in scale relative to previous relief bills.
- The Federal Reserve (Fed) took extraordinary measures to provide support to the economy and markets in 2020 and is unlikely to reverse course in 2021.
- Inflation risks may be skewed to the upside, an important consideration for the Fed moving forward.

THE ECONOMY IS OFF TO A NEW START

The US economy was performing well early in 2020; however, growth came to a screeching halt following the outbreak of COVID-19 and the imposition of “stay at home” orders. The ensuing data was astounding: Quarter-over-quarter gross domestic product (GDP) declined 31.4% in the second quarter, and unemployment skyrocketed to as high as 14.7%, both setting post-WWII records. The subsequent fiscal and monetary policy reactions probably helped pull the economy from the depths, and we believe we are now in the early stages of a new economic cycle. The US economy in 2021 will feature several key themes:

- Economic expansions since WWII have lasted more than five years on average, suggesting many more years of growth potentially lie ahead.
- Soft spots in the economy from COVID-19 may be transitory.

- The recovery of small business will be key, and recent survey data suggests that small business optimism has returned to its February peak (source: Small Business Optimism Index from the National Federation of Independent Business).
- The bifurcated recovery may persist into 2021 while we wait for vaccines. For example, housing is booming while service industries where social distancing is more difficult continue to struggle.

EQUITIES MAY DELIVER GAINS

Global stock markets went on quite the roller coaster ride in 2020, with the S&P 500 Index experiencing the fastest bear market in history in the first quarter when the outbreak of COVID-19 shocked markets, only to climb back to new all-time highs by August. Many investors are wondering where we go from here, but we have some ideas:

- We continue to believe the environment for stocks over bonds remains favorable.
- A strong rebound in corporate earnings may allow stocks to grow into their current valuations.
- Gains following major bear market lows—like the ones we had in 2020—tend to be positive through the second year, which we think plays out in 2021.
- While growth-style stocks may continue to perform well next year, we expect participation to broaden, which could boost cyclical value stocks.
- We've been warming up to small cap stocks in recent months, amid favorable early-cycle positioning and prospects of a strong earnings rebound.
- We prefer the stronger growth prospects of emerging market equities over developed international, and persistent US dollar weakness may provide an additional tailwind to those investors with international exposure.

BONDS MAY REQUIRE PATIENCE

The economic weakness that characterized 2020 sent bond yields to historic lows, presenting a challenge for bond investors in 2021, especially amid a backdrop of accelerating economic growth and normalizing inflation. Our bond market outlook for 2021 is even-tempered.

- We believe there still will be opportunities for bond investors in 2021, but it may be a year that requires greater patience as yields potentially move higher and limit returns for high-quality bonds.
- High-quality bond holdings should continue to play their role as portfolio diversifiers, but return expectations are modest, and we recommend that suitable investors consider positioning for a rising-rate environment.
- Investors may want to consider trading a degree of diversification for greater insulation from potentially higher yields.

LPL RESEARCH'S POLICY OUTLOOK

2020 was certainly an unusual year, but in terms of market performance over the entire year—if you ignore the path of the returns—it wasn't all that unusual. 2021 may offer similar performance, though we expect it will be a smoother ride to get there. Markets are always looking ahead, and as we continue to gain clarity for what the world may look like after the pandemic, we expect markets will follow suit. Read more of our market and economic insights for 2021 in LPL Research *Outlook 2021: Powering Forward,* available December 8.

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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 single 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 Midyear Outlook 2020: The Trail to Recovery publication for additional description and disclosure.

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