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COMMENTARY

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Our Three Predictions for the Rest of 2020

- The economy will likely experience a U-shaped recovery
- Market volatility will remain elevated, but we do not expect a retest of March lows
- Widening market breadth could lead to a shift in market leadership

Recessions are a normal part of the business cycle. However, the COVID-19-induced recession was not normal as it simultaneously impacted both the supply and demand parts of the economy. Social distancing has worked to reduce both the number of cases and deaths caused by the virus, but these same efforts have unfortunately led to mounting economic costs. As states begin to reopen, optimistic investors have been looking beyond today's awful data and focusing on economic recovery. With this as a backdrop, we have three primary predictions for the balance of this year—a U-shaped economic recovery, elevated market volatility (though a retest of new 2020 lows is unlikely), and a possible rotation in companies and sectors that lead markets forward. These expectations represent our base-case scenario, but are subject to change if unanticipated events occur, such as a renewed U.S.-China trade war, the emergence of a second wave of virus in the fall, or a vaccine is developed.

As the economy reopens, there is much to debate about the shape of its recovery—its speed and velocity. Will the fall and subsequent rise be quick like a V shape, or will we be at the bottom a little longer, like a U shape? The most common shapes are V-shaped, L-shaped, and U-shaped. All three begin with a sharp drop in economic growth, with the ensuing recovery defining the shape. We don't anticipate a V-shaped recovery with its immediate sharp economic rebound: the economic impact from the virus was too big, there are still too many virus unknowns, and a weaker job market and general caution may lead to guarded consumer spending. Similarly, we do not anticipate an L-shaped recovery where the economy continues to weaken: the significant and unprecedented amount of monetary and fiscal stimulus, which could eventually reach $7-$8 trillion, will likely limit the economic downside. In our opinion, the most likely scenario is U-shaped, where the recovery is positive, albeit at a slow pace. We feel that the economic pain in this recession is front-loaded, and April will likely represent the data rock bottom, with readings on employment, services, and manufacturing likely improving after the gradual reopening of the economy this month.

Our second prediction is that markets will remain volatile, but are not likely to hit the lows seen in late March. On the positive front, there are reasons to be optimistic: monetary and fiscal stimulus should help bridge the gap until we see clear evidence of an economic recovery; social distancing and other containment measures have helped slow the growth of new COVID-19 cases; and since many second-quarter economic data estimates had anticipated a June reopening, the lifting of these measures this month is a positive surprise to equity investors. On the other hand, this year's severe drop in corporate earnings, elevated market valuations that are near 2020 highs, and the economic fallout from sharply lower oil prices will continue to weigh on investor sentiment for some time. Moreover, valuations based on forward earnings projections recently hit their highest level in over 15 years for U.S. large cap stocks. Taken together, these market headwinds and

tailwinds will likely keep volatility elevated, and potentially pressure equities. Despite this, we believe markets will not test the March lows, and that a more likely scenario is a 10% to 15% correction from current levels. Keep in mind that markets tend to average a correction about once every 12 months, so these pullbacks are fairly normal.

Our final prediction for rest of this year is that we will likely see market breadth widen and lead to a shift in market leadership. For some time, the U.S. stock market has been led by a handful of companies primarily in the technology sector. Since technology is the largest weighting within the large cap growth asset class, this asset class has been the domestic frontrunner. That said, recessions have historically had consequences that have led to shifts in market dynamics. We believe this current recession will not be different, and one likely outcome is that the current narrowness will not last.

According to Factset, year-to-date through the end of April, the S&P 500 has fallen 9.9% while the five largest stocks in this index have risen 11%. These five stocks have an average price-to-earnings ratio of 36x on forward 12-month earnings (as compared to the 18x for the rest of the S&P 500), and while they represent 20% of the index, they only account for 8% of its revenues. Given this wide divergence, we anticipate market breadth to widen as investors look for other investment opportunities.

As the economy reopens and starts to recover, this widening market breadth will likely lead to new sector leadership and consequently improve prospects for value investing. While the technology sector will continue to benefit from growth in innovation, the importance of information access, ease of mobility, and general time savings, the prospects of other sectors are also improving. Financials, the largest value sector, will likely benefit from the economic recovery as lending rises. Healthcare, the second-largest value sector, should see a pickup in virus-related spending. Furthermore, the 18% drop in first-quarter healthcare spending suggests that a rise in essential hospital and dentist visits is possible later this year. Lastly, industrials, the fourth-largest value sector, could benefit from any increase in infrastructure and supply-chain shift spending. The improving prospects of these sectors, along with value sectors' cheap relative valuations to growth, could provide opportunities for investors.

We continue to recommend sticking to risk tolerances consistent with your long-term goals and objectives and being diversified among sectors and asset classes. We do think there will continue to be opportunities in this market, but we are looking for more clarity before we declare an all-clear signal. These are challenging times, but your financial professional can help you stay on course.

This report was created by Cetera Investment Management LLC

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Glossary

The **S&P 500 is an index** of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

The **Dow Jones Industrial Average** is a price-weighted average of 30 U.S. blue-chip stocks traded on the New York Stock Exchange and NASDAQ. The index covers all industries except transportation, real estate and utilities.

The **Russell 2000 Index** measures the performance of the small cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The **NASDAQ Composite Index** includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index includes over 2,500 companies, spanning all 11 sector groups.