

2010 Mid-Year Outlook at a Glance



We expect the economy and markets will stay on the course for growth in 2010. We are maintaining our forecasts for the year:

- U.S. economy grows 3–4%, with growth slowing in the second half of the year to a below average 2–3%
- Stocks post modest single-digit gains on solid earnings growth, accompanied by high volatility
- Bonds post flat-to-mid single-digit gains as rates begin to slowly rise

Tacking Into the Headwinds

In late 2009, as we prepared our 2010 Outlook, we believed that following a solid start, a challenging second half of 2010 would unfold for investors. At the halfway point in the year, we take the opportunity to update and refine our outlook. We now believe some of the tailwinds we cited are likely to be with us for longer. For example, the Federal Reserve (Fed) is less likely to hike rates this year given the continuation of low inflation and the emerging concerns in Europe, leaving potent monetary stimulus intact. However, some of the headwinds we anticipated in the second half of the year have hit us sooner, such as China's slowdown fears. In addition, new headwinds have emerged and more may arise.

The Recovery Is Over, Welcome to the Expansion

The economic recovery in the United States that likely began in the summer of 2009 is ending as we enter the summer of 2010, but an economic expansion is now getting underway. Nominal Gross Domestic Product (GDP)—the broadest measure of economic activity in the United States—has already recovered all the ground it lost during the Great Recession of 2007–2009 and is now back above its prior peak.

While consumer spending, which accounts for more than 70% of GDP, and government spending have already surpassed their pre-recession peaks and are now firmly in recovery mode, not every area of the economy has recovered. For example, the United States economy shed nearly 8.5 million private sector jobs between December 2007 and December 2009. Through May 2010, the private sector of the economy has only added 500,000 jobs back.

Exports, business capital spending, housing construction, and spending on commercial real estate also remain below their pre-recession highs, but most if not all of these categories of spending are on track to surpass that important milestone in the coming months and quarters. For example, the return of global trade has led to a surge in U.S. exports since the end of the recession in the summer of 2009. The surge in exports in turn has led to a sharp rebound in business capital spending and inventory restocking.

In our view, the recovery was the easy part. The United States (and other major countries) just had to provide enough stimulus—both fiscal (more government spending) and monetary (interest rate cuts and the purchase of debt by central banks)—to provide the initial boost.

Today, near the midpoint of 2010, sustaining the recovery as the stimulus begins to fade is the hard part. Nominal GDP, nominal consumer spending, and other key indicators, such as the Institute of Supply Management's (ISM) Purchasing

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Managers Index, are back to new highs. The pace of economic growth is likely to slow, and the two-steps-forward, one-step-back pattern of data points will contribute to volatility.

As is typical when making a transition from recovery to sustainable growth and expansion, the economy in mid-2010 faces several key obstacles—most notably the fiscal problems in Europe and the labor market in the United States.

Through mid-June of 2010, we have yet to see any concrete evidence that the European fiscal and financial woes have spread to the rest of the globe, nor have we seen any evidence that widespread damage has been done to the global financial system. The caveat, however, is that it may be too soon after the flare-up (late winter/early spring 2010) for the slowdown in Europe to have reached other countries. We will continue to monitor this situation very closely in the coming months.

One of the other key areas we are watching is the labor market in the United States. While recoveries do not need job growth, an economic expansion cannot be sustained without it. After shedding almost 8.5 million jobs during the Great Recession, the U.S. economy has only added back about 500,000 private sector jobs over the first five months of 2010. The leading indicators of the labor market (hours worked, hiring of temporary workers, hiring of workers in cyclically sensitive industries like retail, transportation, and furniture manufacturing) point to further job gains in the months ahead. In addition, virtually every other employment indicator released as we approach mid-year 2010 (layoff announcements, initial filings for unemployment insurance, hiring intention plans of corporations) continues to suggest that solid, but not spectacular, job growth is under way and will persist over the remainder of 2010.

Based on these leading indicators of the labor market, we believe that job growth of around 200,000 to 250,000 per month is likely over the next 12 months. While not a robust jobs recovery, the job growth we forecast will be enough to drop the unemployment rate close to 9% by the end of 2010. As of May 2010, it stood at 9.7%.

For now, we remain confident in our forecast for 3–4% real Gross Domestic Product growth in the United States in 2010. We continue to expect stronger GDP growth (3–5%) in the United States in the first half of 2010 will give way to a slowdown (2–3%) in the second half.

European Contagion?

We have not materially altered our economic or market outlook in the face of the latest wave of financial stress focused in Europe. While we view the European debt problem as serious, we believe markets are taking an overly pessimistic view, including the prospect of a sovereign default, an event that is unlikely to be realized, in our opinion. Europe, with the help of the International Monetary Fund (IMF), has responded to the problem with a TARP-like bailout package, and several countries have announced fiscal belt-tightening measures intended to gradually reduce debt burdens.

Ultimately, we believe the U.S. will escape this contagion and the main consequence of the recent European events will be slower Eurozone economic growth. The spending cuts and tax hikes announced by Greece, Spain, and Portugal will likely tip their economies into recession, or, in the case of Greece, keep it there. However, so far no evidence has materialized indicating European debt problems have spread to other economies around the globe. In fact, in late May 2010, the Organization for Economic Cooperation and Development (OECD) increased its global economic growth forecast for 2010 and 2011.

In the U.S., the bright spot of the economic recovery has been the export sector, and on that front, the prospect of slower European economic growth does not appear to have caused a derailment of the U.S. economic expansion. Exports comprise roughly 12% of U.S. economic growth, as measured by GDP, and Europe accounts for 20% of U.S. exports. The bulk, roughly 50% of U.S. exports, is consumed by faster-growing emerging market countries. Since exports contributed 0.82% to first quarter GDP growth, exports to Europe overall, and not just the 16 member countries that share the Euro currency, affected U.S. real GDP by



0.1% to 0.2%. Should European consumption of U.S. exports fall dramatically, the impact to the U.S. economy would likely be marginal.

With regard to financial markets, the European Union (EU) and IMF commitment of nearly \$1 trillion to support European sovereign debt markets enabling Greece and others to avoid having to raise money in the public markets if needed, should stabilize financial market confidence and liquidity. The package is aggressive in nature as the total dollar amount covers all the maturing bonds of the troubled Eurozone issuers—Spain, Portugal, Greece, Ireland, and Italy—for nearly three years. While European sovereign debt markets remain volatile, the EU support package provides an important funding backstop.

The European contagion could affect U.S. banks in the unlikely event of a sovereign default. Direct exposure to European sovereign debt among U.S. banks is very small at less than 0.5% or \$60 billion (as of June 20, 2010), according to estimates from Creditsights, an independent research firm. However, should a European financial institution fail as a result of a sovereign default, exposure to losses might be greater due to broader bank ties between U.S. and European banks. Such a sequence of events could change our investment view. To monitor this risk we will be watching several indicators closely:

- The TED spread. The TED spread (the difference between 3-month LIBOR and the 3-month T-bill yield) is a measure of stress in the banking system based on the willingness of banks to lend to each other. It has risen this year to slightly above the long-term average of 41 bps. While the TED spread has increased from a low of 15 bps, it remains well off of the crisis peak of 463 bps in 2008.
- The level of European interest rates and credit default swaps (CDS). Yields and CDS have both declined from recent peak levels. Should yields rise to double-digit levels or CDS increase to levels indicative of a distressed issuer, we would view this as the financial market's indication of a possible default or debt restructuring.
- Corporate bond issuance. New issuance, the lifeblood of healthy corporate bond markets, has contracted sharply, reflecting tighter financing conditions. Thankfully, most corporations have done an excellent job of refinancing near-term maturities and do not have a pressing need to access credit markets.
- The use of central bank liquidity swaps and funding facilities. Use remains light so far, but a significant increase would indicate financing pressures overseas.

Material deterioration would prompt us to re-evaluate our outlook and may warrant a more defensive investment stance. In the meantime, investors may wish to consider the “silver lining” of European debt fallout. U.S. residential mortgage rates are back near the historic lows set in early 2009. Fear over weak European demand has driven down gasoline prices. Both of these effects put more cash in consumers' pockets. In addition, concerns over European growth will likely keep the Fed on hold for longer.

The Headwinds Arise

In late 2009, as we prepared our 2010 Outlook, we believed that following a solid start, a challenging second half of 2010 for investors would unfold. We anticipated the extraordinary global policy efforts that created a tailwind for markets in 2009 would fade, or even transition, to headwinds that may contribute to a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors.

We now believe some of the tailwinds for growth are likely to be with us for longer:

- The Fed is less likely to hike rates this year, leaving potent monetary stimulus intact.
- Other central banks may stall or slow their efforts to rein in monetary stimulus.

The market value of Corporate Bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.



- Commodity asset class prices, particularly oil, fell sharply in May 2010. The decline in prices is likely to translate into negative inflation readings for the second quarter and alleviate the typical upward pressure on commodity prices that can act to slow the pace of growth.
- Only about half of the \$787 billion American Recovery and Reinvestment Act funding has been paid out so far, leaving plenty of stimuli still in the pipeline.
- The environment for business is likely to be stronger for longer due to these lingering tailwinds. Given the constrained labor, tax, and interest expenses for businesses, profit margins are likely to be even wider than our initial forecast in the second half of the year.

While the tailwinds for growth are likely to be with us for longer, headwinds are increasing. In fact, some of the headwinds we anticipated in the second half of 2010 have been pulled forward, as evidenced by China's economic slowdown, and new headwinds have emerged, such as Europe's debt troubles.

The good news is that many of the headwinds are now priced into valuations for stocks, setting the market up for a potential rebound from the recent pullback. However, the bad news is that the rebound may be limited by more headwinds that may arise. The following headwinds are priced in to some degree and have pushed valuations back down to lows not seen since the end of March 2009:

- Legislative uncertainty regarding taxes, financial regulatory reform, energy, and climate change.
- The May 6 "flash crash," where stocks plunged and sharply rebounded 7% within an hour due to trading glitches, undermined confidence in the integrity of the markets.
- China's economy is beginning to respond to the efforts to slow its internal pace of growth.
- As policy stimulus begins to fade in the United States, it is leaving behind the drag of a huge federal budget deficit that must be financed.
- While the EU and IMF rescue package combined with other measures addressed Europe's short-term liquidity problem, the long-term cost of austerity in the form of slower growth and the question of solvency linger.
- Economic indicators are peaking in the United States, suggesting the slowdown in economic momentum of the recovery.

Treasury yields have priced in the above headwinds, as have commodity asset class prices. Stock market valuations also have discounted these concerns with the price-to-earnings ratio at 12 times the analyst consensus next 12-month earnings estimates. Of course, there may also be unforeseen headwinds that arise and affect the economy and markets:

- The Fed beginning to hike interest rates sometime later this year or early next year.
- The risk of much higher energy prices if the Gulf of Mexico's oil supply is tightened due to regulatory measures, an above average storm season that disrupts production, or geopolitical events that disrupt deliveries.
- Worldwide geopolitical risk associated with the Korean peninsula, the uncertainty surrounding the actions of an increasingly desperate Israel, the threat of a belligerent Iran, and Latin American instability.

The combination of lingering tailwinds and the onset of new headwinds have led to the return of volatility in the first half of the year, demonstrated by the S&P 500 moving in a band of about 1050–1225, oil prices ranging from about \$70 to \$85, and the yield of the 10-year Treasury note bouncing between 3–4%. While we expect the markets to end the year near the high end of these ranges, the markets may remain range-bound during the second half of the year as the headwinds keep a lid on the rallies.

How to Potentially Profit and Protect in the Headwinds

As the economy transitions from recovery to sustainable growth, we expect an economic expansion that will feature uneven economic data, evolving market leadership, and elevated levels of market volatility. The difficulty with investing in markets that are in flux is that they are moved by both positive and negative factors—often at



the same time. With a focus on opportunistic investing, LPL Financial Research attempts to position portfolios to become aggressive when volatility presents opportunity, but profit defensively when market volatility suggests danger.

To thrive in the transitioning markets we expect in the second half of 2010, several considerations may contribute to help investment success, including focusing on yield, finding opportunities in the face of headwinds, seeking benefits from the elevated volatility, and utilizing a more active rebalancing approach.

Focusing on Yield

In an environment where volatility is the primary characteristic, LPL Financial Research prefers strategies that focus on the income stream of an investment rather than solely on potential price appreciation to generate total returns. We believe a higher yield may benefit portfolios by providing a consistent income component that is received regardless of price movements, cushioning downward market moves. There are several ways to help benefit from a focus on yield: High-Yield Bonds, Real Estate Investment Trusts, Emerging Market Bonds, and Dividend Paying Stocks.

Finding Opportunities in the Face of the Headwinds

With the emerging headwinds on the rise, one attractive strategy for portfolio success is to find investments that tend to benefit when many other investment vehicles struggle. This includes finding strategies that may thrive in periods of potentially rising inflation rates, increasing tax rates, and the shift to restrictive monetary policies, such as Bank Loans, Commodities, Municipal Bonds, and Small Cap Equity.

Seeking Benefits From Elevated Volatility

With volatility on the rise, finding investments that may benefit from heightened uncertainty helps not only to potentially improve returns, but also reduce portfolio risk by including Alternative Strategies (Global Macro and investment vehicles exposed to Long/Short and Covered Calls) and Large Blend Equity.

Utilize a More Active Rebalancing Approach

We believe that a more active rebalancing strategy that employs a tactical approach to investing may enhance performance by positioning portfolios to become aggressive when volatility presents opportunity, but may profit defensively when market volatility suggests danger. One way to try and benefit from greater tactical opportunities without the need to conduct frequent asset allocation changes is to implement shifts with balanced strategies that opportunistically move from fixed income to equities, commodity asset classes to sectors, and everywhere else in between to help take advantage of the most attractive investment opportunities.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses, such as losing the entire amount paid for the option.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Stock investing may involve risk including loss of principal.

Municipal bonds are subject to availability, price and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Small Cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the Small Cap market may adversely affect the value of these investments.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.



IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

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This information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. We suggest that you discuss specific tax issues with a qualified tax advisor.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. There is no assurance that the investment objective will be attained.

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.

ISM Manufacturing Index: An index based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

London Interbank Offered Rate (LIBOR): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

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