Mid-Year Outlook 2013 Abridged

Investors' Trail Map to the Markets

The investment landscape for the first half of 2013 has proven to be a tough one to navigate. And, LPL Financial Research believes the second half of this year will be equally difficult to navigate. There is a lot of rocky terrain and potentially some surprises ahead that investors need to prepare for. To help you plan for what lies ahead, we bring you our *Mid-Year Outlook 2013: Investors' Trail Map to the Markets* to provide you with what you need to know before you go and check before you trek.

Converging on the Path of Least Resistance

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In our *Outlook 2013: The Path of Least Resistance*, published in November of 2012, we laid out three paths the markets could follow in 2013 as the path of least resistance: bull, bear, and base.

- On the bull path, obstacles are overcome and investors embrace market opportunities and drive up valuations.
- On the bear path, fiscal policy results in a much weaker economic backdrop and markets plunge.
- On the base path, the path we deemed most likely to emerge, growth in the economy and earnings remains below average, and the challenged markets produce modest gains with a lot of volatility.

Rather than a single path emerging, the paths of least resistance for the economy and markets diverged in the first half of 2013. The different markets took all three paths.

- Stocks took the bull path as investor confidence rose when the worst of the fiscal cliff outcomes was avoided and the Federal Reserve's (Fed's) bond-buying program continued. This helped to lift stock valuations and prompted individual investors to put money into the market at the strongest pace in years, according to flows into domestic stock funds tracked by the Investment Company Institute (ICI).
- Commodities asset classes took the bear path on weakening economic data around the world as tax increases and spending cuts sunk in here

in the United States, Europe's recession broadened and deepened, and China's growth slowed. Copper, wheat, and gold futures—to name just a few—all plunged during the first half of 2013.

- Bonds took the base path with the Barclays Capital Aggregate Bond Index remaining between +/-2% through June 20, 2013 and a volatile 10-year Treasury note yield that has ranged between 1.6% and 2.6% over the same time period.

This type and magnitude of disagreement among the markets has been rare. To attempt to coin a new phrase: "a market divided against itself cannot stand." In other words, the divergence in the paths taken by different markets is unlikely to continue in the second half. Instead, the markets are likely to converge in a second half that likely holds modest—but volatile—gains for investments such as stocks, bonds, and commodities. In other words, we expect the different markets to follow a similar path in the second half.

Gearing Up for the Trail

Key elements of our second half outlook:

- The U.S. economy will continue to grow at about 2% supported by housing, as well as consumer and business spending, offsetting the drag from government spending cuts. Inflation remains tame, but rises

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

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

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

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.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

modestly from the recent 1% pace. The European economy remains in recession in the second half, but may begin to show some improvement late in the year. China's growth remains around 7%. This may support demand for raw materials.

- The Federal Reserve has communicated that it will begin to slow its bond-buying program, known as "QE" (quantitative easing), in the fall. The slowing will be dependent upon the economy meeting the Fed's forecast and is expected to end by mid-2014 as the unemployment rate falls to about 7%. The Fed will maintain zero interest rates throughout the remainder of this year and next.
- The fiscal cliff and sequester had only a small measurable effect outside of government jobs and spending in the first half and may also remain benign in the second half. The budget is improving this year and will for the next few years, according to the Congressional Budget Office (CBO), so the debt ceiling debate in the second half may not be much of an issue for the markets.
- We expect low single-digit returns for the broad bond market in the second half, resulting in flat returns for the year. Given our expectation of stabilization in bond yields, we expect interest income to offset price declines and result in low single-digit returns for high-quality bonds in the second half. Still-high bond valuations, stabilization in Europe's economies, and a gradual reduction in QE might result in a further, but modest increase in bond yields in the second half of 2013. Slow but steady growth, combined with rising yields favors corporate bond over government bond exposure.
- The stock market goes from a gallop to a grind higher as stocks end the year modestly higher, from current levels on the S&P 500 Index, after a strong first-half gain of about 12% (as of June 20, 2013). The gains are primarily driven by mid-single-digit earnings growth, aided by record-breaking buybacks, wide profit margins, and contained labor costs. Those gains come with a substantial uptick in volatility, however, which may present opportunities. Soft global growth and a strong dollar favor U.S. over international stocks.

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The second half of 2013 may act as a bridge to a new path for policy, the economy, and markets: the aggressive stimulus from the Fed over the past five years is likely to begin to fade, the government may shrink as a portion of the U.S. economy to the lowest levels in a decade, the economic drag from higher taxes and spending cuts implemented in the first half of 2013 starts to diminish, and corporate profit margins may reach all-time highs. The four-year-old recovery in the economy and markets is unlikely to be the end of the path, but instead a new beginning that may refresh the pace of growth in the coming years.

We Are Not Out of the Woods Yet

While the dark forest depths of the financial crisis of 2008 are long behind us, we are not out of the woods yet. There is no clear or easy trail in the second half of 2013. The markets and global economy remain in uncharted territory with geopolitical, monetary, and fiscal policy at significant crossroads. Despite a recovering housing market and improving job growth, sluggish economic growth persists and creates uneven footing and potential hazards ahead.

On journeys filled with as many twists and turns as we have navigated over the last five years, uncertainty is a natural emotion. And, so is apprehension—even doubt. But with LPL Financial Research and your advisor as your trusted guides, you are never alone on this trek. Even in the deepest of forests, in places where hiking trails cannot be forged, markers of experience, integrity, and perseverance exist. To the most veteran of hikers these markers are called cairns, which are small piles of rocks serving as the rustic signposts directing the lost to a trail and the uncertain to confidence.

The path ahead is far from obvious, but a lack of clarity does not need to lead to a lack of action or direction. Simply standing around, as opposed to trekking on, only leads to disappointment. This is also true in investing—staying on the sidelines leads to missed opportunities.

LPL Financial Research stands poised to navigate this uncharted investment landscape and leave the investment cairns for you and your advisor to follow with confidence. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) 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 indexes are unmanaged and cannot be invested into directly.

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

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

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

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.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

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.

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

International Monetary Fund (IMF) is an international organization created for the purpose of promoting global monetary and exchange stability, facilitating the expansion and balanced growth of international trade, and assisting in the establishment of a multilateral system of payments for current transactions.

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