Origin ID: RESEARCH

DELIVERY OPTIONS
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LPL Financial Research Presents:

OUTLOOK 2015
In Transit

NOV 2014
Tracking #
1-328832
Exp. 11/15

STKS 5–9
BNDS FLT
GDP 3+

ATHNDQ C8H18-77 BLLISH 1900AU1200 VOLINCR 001AIS GOOMPGO

PG 2-3: INTRANSIT
PG 4-5: DOOR2DOOR
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PG 10-11: YELLENINDICATORS
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LPL Financial

IN TRANSIT

Since the wind-down of the Great Recession in early 2009, the latest economic expansion has certainly delivered the goods and rewarded investors' mailboxes with six consecutive calendar years of positive gains for stocks. "Neither snow nor rain nor heat nor gloom of night" has kept a lid on the continuation of one of history's greatest bull market advances for stocks, and LPL Financial Research believes this trend of rising equity prices may continue in 2015.

But unlike the last two years, when the global economy produced improved growth on the back of a stabilizing economic backdrop, 2015 will be a year marked by transitions. Likely changes in monetary policy around the world, the return of volatility, and the recent shift in the political balance of Congress could mean 2015 is a year that will have the global economy, markets, and central banks all on the move. To help prepare for rerouting to this more volatile road ahead, our *Outlook 2015: In Transit* expedites the delivery of the investment insights needed to navigate an economic backdrop shifting to the latter stages of the business cycle.

Significant elements that are in transit in 2015 include:

- ✓ **The U.S. economy continues its transition from the slow gross domestic product (GDP) growth of 2011–2013 to more sustained, broad-based growth.** Ongoing progress in the labor market, an uptick in wage growth, and continued improvement in both consumer and business spending have propelled an uptrend in U.S. economic output. We believe inflation—which has historically accelerated as the economy moves into the second half of the business cycle—is poised to continue proceeding higher, but only modestly so.
- ✓ **Central banks around the world will also be on the move in 2015.** In the United States, the economy is likely to continue to travel toward a point where the Federal Reserve (Fed) will begin raising interest rates, albeit gradually, for the first time in nine years. The Eurozone and Japan—the world's second and fourth largest economies, respectively—could benefit, as central banks in those regions embark on more aggressive policy actions aimed at restarting and reaccelerating their long-dormant economies.
- ✓ **Washington shifts from a relatively quiet 2014 to take a bigger role in 2015.** The Republican takeover in the Senate and approaching debt ceiling limit might provide the opportunity for some movement out of the gridlock that has plagued Washington in recent years.

Despite significant improvement on almost all economic and market fronts, the route we have been on over the last six years has been undoubtedly long and winding. The package of strong economic growth ordered up following the Great Recession of 2008–2009 has resulted in a delivery that has been at times disjointed and behind schedule. Journeys like the one we have been on since 2009 rarely unfold in a straight line. The reality is that point-to-point navigation often masks the many twists and turns—and ups and downs—that a voyage undertakes, just as the 236% cumulative increase in stock returns since the current bull market began* hides the true nature of the market's successful but volatile path.

Transition, like we forecast on the road ahead in 2015, is just another word for change. And while the backdrop looks favorable for continued economic and market advances, we know that not all change is good, just as not all movement is forward. The shifting economic and market landscape in 2015 offers great opportunities alongside major challenges, and investors will need more than just a GPS to navigate them all. As we shift toward the latter stages of the economic cycle in the years ahead, bumps and potholes in the form of rising volatility will be more frequent. Yet it will likely not be the road conditions that throw most investment portfolios off track, as we forecast relatively strong economic growth unfolding over the horizon. Rather, it will be the pull of our emotions that could derail a potentially rewarding journey. As investors, keeping our emotions in check when confronted with a bumpy road will ultimately be the key to success in 2015. It is human nature to weigh the market potholes substantially more than the long, smooth roads of strong market returns between them. However, with an investment strategy in hand and a destination in mind, 2015 is poised to be a volatile but potentially favorable year.

To help you prepare for this market in transition, LPL Financial Research has boxed up timely advice into our *Outlook 2015: In Transit* for an on-time delivery of what could likely be another year marked with positive advances by stocks, flat returns for bonds, heightened volatility, and strong U.S. economic growth.

*Measured by the S&P 500 Index from the market's closing low on March 9, 2009 to October 31, 2014.
Past performance is not indicative of future results. One cannot invest directly into an index.

Door-2-Door Delivery

BY: LPL FINANCIAL RESEARCH

SHIPPING OPTIONS

How to Manage, Track, and Deliver Investment Ideas in 2015

Investment Themes in Transit

Stock prices in 2015 may potentially record their seventh consecutive year of positive returns. Transitioning another year closer to the end of the cycle, large cap and cyclical growth stocks historically outperform.

Global central bank policies will be in focus and contradictory. The Fed will use a stronger U.S. economy to set the stage for embarking on late 2015 or early 2016 rate increases, while central banks in Europe, Japan, and emerging markets kick-start their economies with easing policies.

Volatility returns to more normal levels after several years of below-average swings in equity prices. With only three pullbacks greater than 5% over the last two calendar years, 2015 could be a bumpier road for investors.

ECONOMY

3% + GROWTH

Consumer and business spending may lead U.S. economic growth to its highest annual advance since 2010.

STOCKS

5–9% RETURNS

Tempered by increasing levels of volatility, stocks are poised to advance mid- to high-single digits on the back of strong earnings growth.

BONDS

FLAT RETURNS

Battling the dual threat of the Fed's impending rise in rates and expanding economic growth, bonds offer little, if any, growth potential in 2015.

Express Shipping

Investment ideas worthy of expedited delivery into portfolios in 2015

- U.S. Cyclical Growth Stocks
- Emerging Markets Stocks
- Credit & High-Yield Bonds
- Global Macro Alternative Strategies

Bulk Shipping

Investment ideas that should make up the bulk of investor portfolios in 2015

- U.S. Large Cap Stocks
- U.S. Mid Cap Stocks
- Municipal Bonds
- Merger Arbitrage Alternative Strategies

Fragile Shipping

Investment ideas requiring careful handling in 2015

- International Developed Market Stocks
- U.S. Defensive Stocks
- High-Quality Long-Term Bonds
- International Developed Market Bonds

RDT016

HOW TO INVEST

PLEASE LOOK OUT This Document Contains Helpful Recommendations

My other vehicle is a DIVERSIFIED PORTFOLIO

NOV OUTLOOK 14 2015 In Transit

Caution: Volatility on the Rise

THIS END UP

U.S. Economic Growth Picks Up

As the economy continues to grow at a moderate pace in 2015, we expect this expansion to potentially take us into 2016, where we could likely find tightening labor market conditions and a rising fed funds rate.

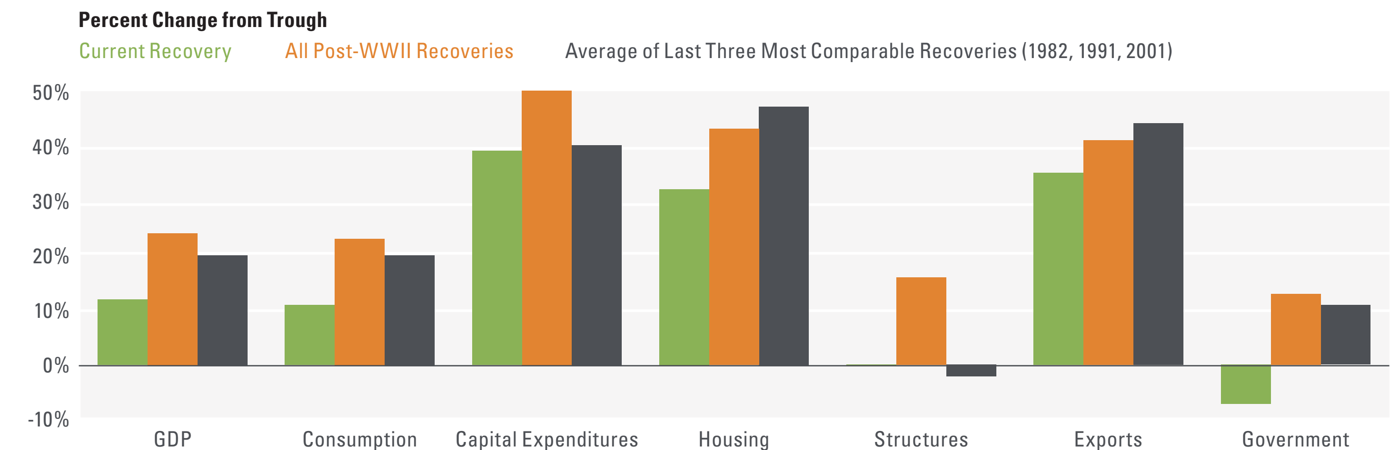
We expect the U.S. economy will expand at a rate of 3% or slightly higher in 2015, which matches the average growth rate over the past 50 years. This forecast is based on contributions from consumer spending, business capital spending, and housing, which are poised to advance at historically average or better growth rates in 2015. Net exports and the government sector should trail behind.

The United States is in the middle stage of the economic expansion, presenting investment opportunities and risks for investors. While the U.S. economy has grown over time, the growth has not been in a straight line. The variations in the pace of growth around the long-term trend are called economic cycles. Economic cycles have four distinct stages: recession, early (recovery*), middle (mature), and late (aging).

The early stage of the economic cycle following a recession, usually referred to as a recovery, is typically characterized by stimulus from the Fed as economic activity, employment, and the stock market recover the losses stemming from the recession. The U.S. economy has passed this early stage and is now firmly in the middle or mature phase.

By historical standards, the economic recovery that began in mid-2009 has been by far the most tepid recovery on record, with GDP through third quarter 2014 just 11% above its 2009 trough. In all recoveries since the end of World War II (WWII), the economy expanded 24% on average in the first five years of recovery. The current recovery even lags the last three (beginning in 1982, 1991, and 2001), which we believe are the most comparable. Five years into those recoveries, the economy stood 16% above its recession lows. The pace of this recovery thus far has lagged behind those prior in each of the major GDP categories [Figure 1].

1 | CURRENT CONDITIONS LAG PAST RECOVERIES IN ALL MAJOR GDP CATEGORIES



Source: LPL Financial Research, Bureau of Economic Analysis, National Bureau of Economic Research (NBER) 11/14/14

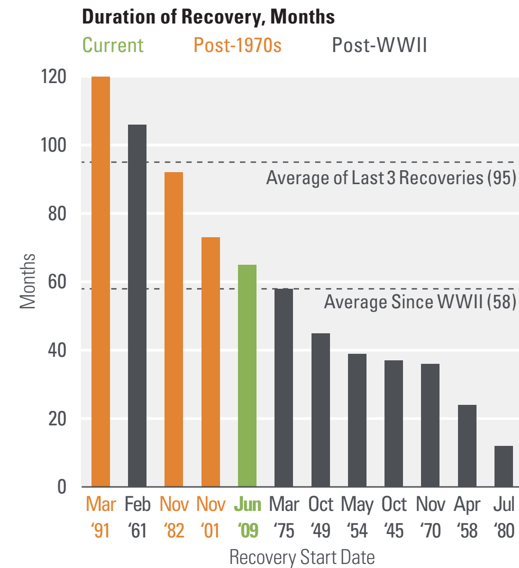
TAKING THE SCENIC ROUTE: THE UPSIDE TO A SLOWER PACE

Although the weak pace of this recovery has been frustrating for both the public and policymakers alike, there have been several silver linings. The lackluster expansion has put downward pressure on hiring, wages, and in turn, inflation, as the economy continues to operate well below its long-term potential growth rate. The lack of inflation has allowed the Fed to be patient in its journey toward removing the massive amount of stimulus it has added to the economy since 2008; but another solid year of economic growth in 2015 could tighten labor market conditions and likely begin to drive wages higher. This transition from a subpar recovery to a more normal recovery in 2015 is likely to convince the Fed—which ended its quantitative easing (QE) program on schedule in October 2014—that the economy has made enough progress on the road toward the Fed's dual mandates of full employment and low, stable inflation to start normalizing policy. At that point (likely in the latter half of 2015 or early 2016) the Fed may begin slowly raising its fed funds rate target, starting the long journey back to more normal, and higher, rates. Importantly, the start of Fed rate hikes does not signal the end of economic expansions. Indeed, since 1950, the start of Fed rate hikes meant that the economy was roughly 40% through the expansion.

Another positive outcome of this modest economic growth is the economy has not yet built up any imbalances or excesses. Imbalances, rather than high-profile shocks (such as the late-1990s tech bubble and the 1973 oil embargo), have been the cause of a vast majority of recessions in the post-WWII era. The lack of overbuilding, overspending, and overinvesting in virtually every sector of the economy since 2009 supports our belief that the current expansion may have more room to run.

* Throughout this document, expansion and recovery are used interchangeably. For more detail on the economic cycle, please see our infographic on page 10 of the *Mid-Year Outlook 2014*.

2 | THE CURRENT EXPANSION IS THE FIFTH LONGEST POST-WWII EXPANSION



Source: LPL Financial Research, National Bureau of Economic Research (NBER) 11/14/14

TRACKING OUR PROGRESS THROUGH THE EXPANSION

At 65 months (through the end of November 2014), the current recovery is the fifth-longest expansion since World War II, and is already longer than the average economic recovery since that time (58 months).* Looking back over just the past 50 years, the average expansion has been 71 months. On that basis, the current recovery may surpass the average in the middle of 2016 [Figure 2].

As we mentioned earlier, perhaps the best comparison for the current expansion may be the three economic expansions since the end of the inflationary 1970s, a period that has seen the transformation of the U.S. economy from a domestically focused, manufacturing economy to a more import-heavy, service-based economy. On balance, this economic structure is less prone to inventory swings that drove the shorter boom-and-bust cycles of the past. On average, the last three expansions—the ones that began in 1982, 1991, and 2001—lasted 95 months, or roughly eight years. Using those three expansions as the standard, the current economic expansion still has the legs to potentially deliver growth for the next couple of years. Regardless, this economic expansion is likely entering its latter half, which is marked by strong economic growth but also the potential for rising inflation, accelerating wage growth, and eventual Fed rate hikes. All expansions come to an end, but 2015 does not appear to be the final destination for this current economic recovery.

MORE DRIVERS WANTED: LABOR MARKET LIKELY TO BUILD ON 2014 IMPROVEMENT

The labor market is a lagging indicator of overall economic activity. The current economic expansion began in June 2009, but the private sector economy did not regularly begin creating jobs until early 2010. Since then, the economy has added 10.3 million jobs, or just under 200,000 jobs per month. In the 12 months ending in October 2014, the economy created nearly 220,000 jobs per month, despite a run of harsh winter weather that held down job growth in late 2013 and early 2014. Looking ahead to 2015, if GDP growth achieves our 3% forecast, the economy should routinely create between 200,000 and 250,000 jobs per month, as it has during the middle of every business cycle over the past 30 years when economic growth was between 3% and 4%.

Thus far in this economic expansion, most of the jobs created continue to be in the service sector, and particularly the areas where businesses do the best job exporting what we like to call "good old American know-how." Since the beginning of 2010, the goods-producing area of the economy has created just 1.5 million jobs, with half of those gains coming in the manufacturing sector. Over that same time period, the service sector has added six times that amount—nearly 9 million new jobs—and more than 50% of those new jobs can be tied to the United States' comparative advantage in areas like engineering, consulting, financial services, education, legal services, technology, research and development, and other areas that benefit from our nation's ability to harness and export the power of the mind.

*According to the National Bureau of Economic Research, the nonpartisan think tank that determines business cycle start and end dates.

AIRMAIL: OVERSEAS MARKETS TO MOVE TOWARD STABILITY IN 2015

Overseas, policies already in place—and those that we expect to be enacted over the course of 2015—are likely to be big drivers of global growth, impacting most of the world's largest economies outside of the United States. In the Eurozone, which has endured two recessions since 2007, its fractured financial system continues to cause a delay in its long-overdue return to growth. However, actions taken by the European Central Bank (ECB) in late 2014 may set the stage for a transition in the Eurozone from the fragile economic backdrop seen between 2007 and 2014 to a more stable environment in the coming years. We expect the ECB will increase the pace of its QE program over the course of 2015, and governments in the Eurozone will begin to finally loosen fiscal policy. While it may take several years to restart Europe's journey toward fully participating in the global economy, 2015 may mark the beginning.

China's economy is still in the midst of its long route of varied growth and a changing economy. From growing at a 10–12% rate in the early to late 2000s, China has transitioned to an economy currently growing at closer to 7%* that is more dependent on domestic consumption than trade and investment. Over the past year, Chinese authorities have been more willing than ever to deliver monetary, fiscal, and administrative stimulus to the Chinese economy to facilitate the transition to a more stable growth path. China's housing bubble deflated slowly over the course of 2014 and may continue to deflate in 2015 and beyond; the consequences of that deflation to the rest of the Chinese economy may continue to be felt in 2015 globally and domestically, adding to economic and market volatility. With low inflation as well as massive currency and fiscal reserves, China has the ability to continue helping its economy shift to its next destination. As it does so—and as other reliant economies adjust to the transition—it may cause an increased level of economic volatility across the globe.

Japan's economy has traveled in and out of recession, deflation, and depression for the better part of the past 25 years. Yet, bold actions by Japanese policymakers (fiscal and monetary) over the past several years could begin to transport Japan's economy toward more fully contributing to global growth in 2015 and beyond. After announcing an expansion to its QE program at the end of October 2014, it is likely that the Bank of Japan will enact another round of QE in 2015, as it attempts to break the decades-long cycle of deflation. But as in the United States, Europe, and elsewhere, the journey out of deflation cannot be made by monetary policy alone; and for Japan to add to global growth in 2015, coordination between the Japanese government—on fiscal policy and structural reform—and the Bank of Japan is critical.

We will continue to monitor current government policies around the world—and those to come—for their potential ramifications on the U.S. economy and global economic growth to look for signs that the global economic expansion remains on schedule.

*According to the National Bureau of Statistics of China.

Deflation is a prolonged period of falling prices and wages.

Returns on investments in foreign securities could be more volatile than, or trail the returns on, investments in U.S. securities. Investments in securities issued by entities based outside the United States pose distinct risks, since political and economic events unique to a country or region will affect those markets and their issues.

S&P IS NOT GDP

S&P	≠ GDP
2/3 Manufacturing	2/3 Consumption
20-25% Business Spending	70% Consumer Spending
15% Consumer Discretionary Spending	20-25% Discretionary Consumer Categories
40% Overseas	10% International Trade
Higher Commodity Prices BOOST	Higher Commodity Prices DRAG

U.S. economic growth has been subpar during much of the ongoing economic expansion. Yet, the S&P 500 has returned nearly 236% cumulatively since the bear market low on March 9, 2009. How can this happen? Quantitative easing (QE) is a reasonable answer, but so is less policy uncertainty in Washington, or more confidence in the growth outlook. These all helped to some degree, but we think the best answer is earnings growth, which has far outpaced the growth of the U.S. economy. S&P 500 companies have different drivers for earnings growth than the components that drive GDP growth, enabling them to significantly outpace GDP. Corporate profits are more manufacturing and business spending driven than GDP, more dependent on foreign trade, and generally benefit from commodity price increases; while GDP is more services and consumer driven, less dependent on international trade, and generally hurt by higher commodity prices.

TRACKING YELLEN'S INDICATORS

Labor Market Indicators Are Making Progress, But Most Have Not Yet Reached Their Destination

Several labor market indexes — which have been referred to as the "Yellen indicators" — are being closely monitored by the Fed chair and the Federal Open Market Committee (FOMC), the results of which will likely affect future monetary policy. Over the course of 2014, Fed Chair Janet Yellen has mentioned several labor market indexes that she and other FOMC members are watching closely to assess the effectiveness of monetary policy. In May 2014, Fed staffers released a white paper introducing the Labor Market Conditions Index (LMCI). This paper received a great deal of attention from market participants as it may contain clues to the timing of interest rate hikes.

This infographic details the performance of this broad range of indicators since the mid-2000s. Although most metrics have partially recovered from their Great Recession lows, only a few have returned to "normal." Until they do — or at least until they make significant progress toward normal — markets should expect that the Fed will be content with keeping its fed funds rate target near zero. In our view, the Fed is not likely to begin raising rates until late 2015, or possibly early 2016.

Values are scaled.
100%=Prerecession High
0%=Cycle Low

The further the truck is from the center, the closer it is to prerecession levels.

	Label	Description	Prerecession High – Recession Low	Current Reading	Have reached or exceeded their prerecession levels
Unemployment & Underemployment	UR	Unemployment rate: % of labor force	4.40% – 10.00%	5.86%	
	LFPR	Labor force participation rate: year-over-year change, % of unemployed	0.4% – -1.1%	0.0%	
	PTER	Part time for economic reasons: % of labor force	2.7% – 6.7%	4.8%	
	LTU	Long-term unemployed: 27 weeks or more, % of unemployed	15.9% – 45.3%	32.0%	
	DU	Duration of unemployment: weeks	7.3 – 25	13.7	
Employment & Work	PPE	Private payroll employment: millions	116.0 – 107.2	117.8	●
	GPE	Government payroll employment: millions	22.6 – 21.8	21.9	
	THE	Temporary help employment: millions	2.7 – 1.7	2.9	●
	AWH	Average weekly hours (production): hours	33.9 – 33.0	33.8	
	AWHPW	Average weekly hours of persons at work: hours	39.7 – 36.2	38.7	
	WR	Wage rates: average hourly earnings, year-over-year % change	4.2% – 1.3%	2.2%	
Job Market Environment	HW	Composite help-wanted: index	4250 – 2750	5072	●
	HR	Hiring rate: % of payroll employment	4.5% – 3.2%	3.9%	
	TRUE	Transition rate from unemployment to employment : % of unemployment	29.6% – 15.9%	23.6%	
	JPHG	Jobs plentiful vs. hard to get: diffusion index	11.4% – -46.1%	-12.6%	
	HP	Hiring plans: diffusion index	19% – -10%	10%	
	JHF	Jobs hard to fill: %	31% – 8%	24%	
Layoffs & Quits	IUR	Insured unemployment rate: % of covered employment	1.9% – 5.0%	1.8%	●
	JLOS	Job losers unemployed less than 5 weeks: % of employment	45.4% – 14.7%	26.8%	
	QR	Quit rate: % of payroll employment	60% – 39%	58%	
	JLEA	Job leavers unemployed less than 5 weeks: % of employment	48.8% – 17.5%	32.4%	

Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 11/14/14
The time frame for all data is the last 10 years: 2004–2014.

PRIORITY SHIPPING

Stocks Should Deliver the Goods

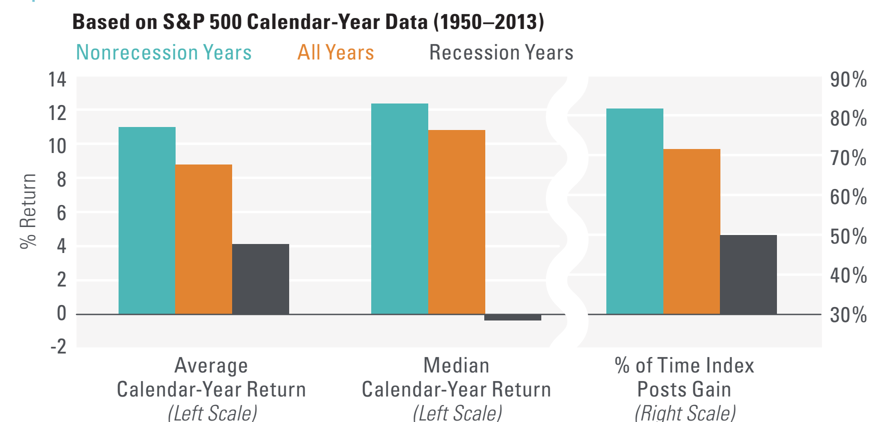
We believe stocks will navigate the various cycles in transit and deliver mid- to high-single-digit returns in 2015, with a focus on earnings over valuations.

Stocks should deliver mid- to high-single-digit returns for investors during a 2015 in transit based on our belief that 3% economic growth, benign global monetary policy, and a more favorable policy climate from Washington indicate that the powerful, nearly six-year-old bull market should continue. Historically since WWII, the average annual gain on stocks has been 7–9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5–9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015. Stocks may not be shipped express, as there will be delays along the way, but we expect stocks, not bonds, to be the precious cargo for investors in 2015.

Cycles that are in transition can also cause potential fluctuations and volatility even if they have historically provided solid stock market performance. The most important cycle, the economic cycle, is unlikely to reach a recession destination in 2015, positioning the stock market to potentially offer up solid gains to investors. In fact, since 1950, in years during which the U.S. economy does not enter recession, the odds of a positive year for the S&P 500 were 82%, with an average gain of 11% [Figure 3]. Recessions do not run on a set schedule and are difficult to pinpoint in advance, but our belief, based on our favorite leading indicators for the economy, is that stocks could potentially send investors solid returns in the coming year.

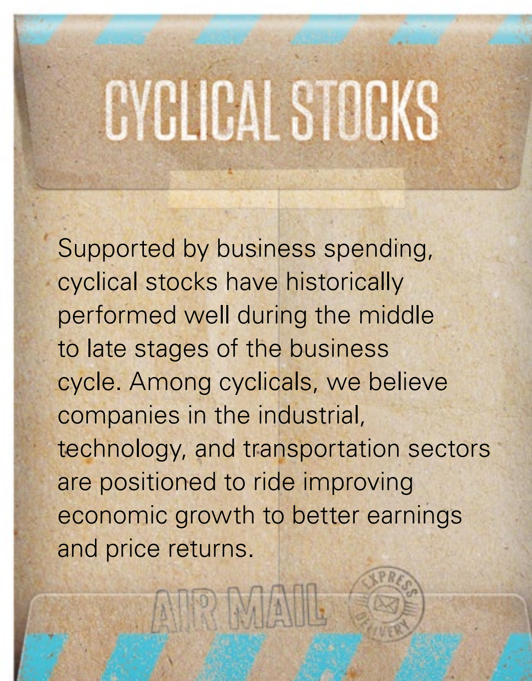
3 | PROBABILITY OF SOLID STOCK MARKET GAIN IS HIGH IF U.S. ECONOMY IS NOT IN RECESSION

Based on S&P 500 Calendar-Year Data (1950–2013)



Source: LPL Financial Research, Bloomberg data, NBER 11/14/14

Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested into directly.

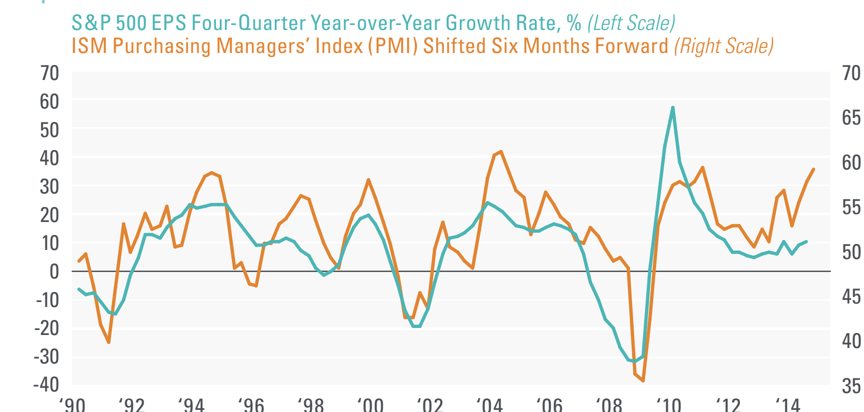


Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

EARNINGS SHOULD DO THE HEAVY LIFTING

We expect earnings, and not valuations, to do the heavy lifting in producing potential stock market gains for investors in 2015. Steady, though not spectacular, economic growth in the United States and mixed, but largely stable, growth overseas may support continued low- to mid-single-digit revenue growth for the S&P 500. As the economic cycle advances further, cost pressures may begin to emerge and limit companies' ability to expand profit margins. However, with limited wage pressures, currently low commodity prices (for non-commodity producers), and low borrowing costs, profit margins should remain relatively stable; in addition, share buybacks by corporations—though slowing—may continue to lift the EPS calculation. Based on this, we believe the S&P 500 is on schedule to potentially deliver a year of high-single-digit EPS growth, a pace consistent with the signal from our favorite leading earnings indicator, the Institute for Supply Management (ISM) Purchasing Managers' Index [Figure 4].

4 | EARNINGS INDICATOR IS POINTING HIGHER



Source: LPL Financial Research, Thomson Reuters, FactSet 11/14/14

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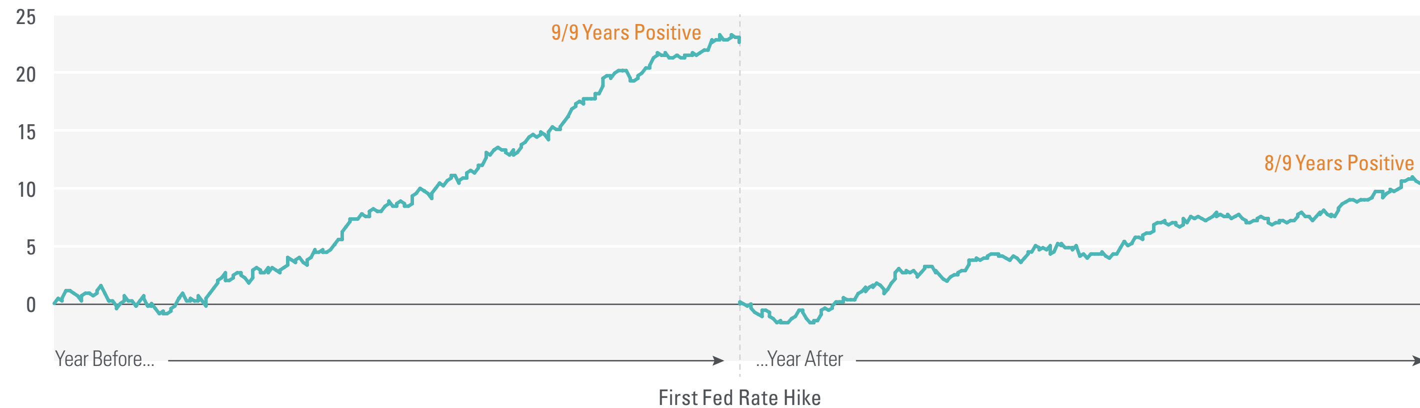
MONETARY POLICY IN TRANSIT AS FED POLICY SHIFTS

Monetary policy is also in transit in 2015, when stocks will face a transition from the very loose monetary policy of the Fed's QE program, which ended in October 2014, to an environment in which the Fed begins to hike interest rates. Although this transition may contribute to an increase in stock market volatility in the short term, we do not expect the start of Fed rate hikes to derail the stock market in 2015. In fact, history has shown that stocks performed well when the Fed began to hike interest rates, due to the better

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.

5 | STOCK RETURNS HAVE BEEN HEALTHY IN THE YEAR PRIOR TO THE FIRST RATE HIKE...AND IN THE YEAR FOLLOWING

Average S&P 500 Change over Last Nine Expansions Around First Rate Hike (1954–Present),%



Source: LPL Financial Research, Bloomberg data, FOMC 11/14/14

Past performance is not indicative of future results.

Indexes are unmanaged and cannot be invested into directly.

economic and profit growth that prompted the Fed to act to combat inflation. Figure 5 shows the average path of the S&P 500 around the first Fed rate hike during the past nine economic expansions, suggesting stocks are less likely to be derailed in 2015 by changing Fed policy.

The above analysis suggests stocks may continue to rise in 2015, despite the start of a Fed rate hike campaign. A look at a longer time period reveals that the current bull market may still have quite a bit further to travel after that first rate hike. Over the past 50 years, the first hike has tended to occur a bit before the halfway point of economic cycles and well before bull markets have ended. During the previous nine economic cycles, the median S&P 500 advance from the first rate hike until the stock market peaks is 25% (the average at 58% is skewed by the outsized bull markets of the 1980s and 1990s, when stocks more than doubled and tripled after the first rate hikes).

WEIGHING THE RISKS: THIS BULL MARKET HAS NOT YET REACHED ITS FINAL DESTINATION

Despite the favorable backdrop of improving economic growth and attractive corporate fundamentals, meaningful risks remain for stocks in 2015. The Eurozone, which is teetering on the brink of another recession, and the possibility of a further slowdown in China, both present risks to global growth. Structural constraints may also slow Europe's return to reasonable growth levels. The good news is that companies grew earnings during Europe's second recession from late 2012 through early 2013, and have managed the latest slowdown in Europe well, with minimal disruption to earnings through third quarter 2014. However, a possible prolonged recession is perhaps the one factor that could push the profit train off the tracks.

Geopolitical risks, such as the Russia-Ukraine conflict and the rise of Islamic State militants, remain on investors' minds as potential risks that could drive increased volatility during 2015, as they did at times during 2014. Last, the possibility exists that a policy mistake in Washington—such as another debt ceiling debacle—could take stocks off schedule, though even with a Republican-controlled Congress and Democratic president we see that possibility as quite remote.

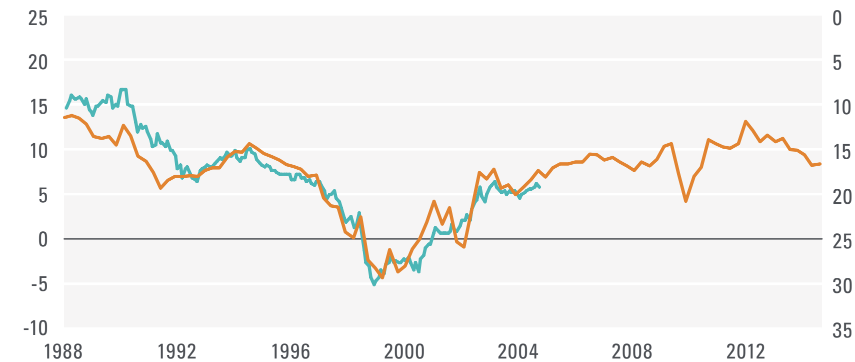
All investing entails risk, including loss of principal.

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

6 | OVER THE LONG TERM, PEs HAVE PROVIDED A ROAD MAP FOR EQUITY RETURNS

S&P 500 Index Annualized 10-Year Percent Change over Next 10 Years, % *(Left Scale)*

S&P 500 Index Trailing Price-to-Earnings Ratio *(Right Scale, Inverted)*



Source: LPL Financial Research, Standard & Poor's 11/14/14

WEIGHING VALUE

Valuations for the S&P 500 remain slightly above the long-term average PE of between 16 and 17 times trailing earnings, indicating a slightly expensive market. However, valuations have had virtually no predictive power in timing market tops or major pullbacks. But over long time periods, such as over the next 10 years, PE ratios have a strong historical record of forecasting the market's direction [Figure 6]. Important to note, even when valuations indicate performance below the historical averages, they rarely point to negative returns. Thus, while valuations are the single most important long-term factor affecting stock prices, in the short term, they are much less impactful.

Valuations can tell you when the market has become fully priced and may be more vulnerable to any deterioration in the economic cycle; but we do not view slightly above-average valuations as a risk to continued stock market gains in 2015. Our expectation that stock market returns track mid- to high-single-digit earnings growth suggests valuations are less likely to get out of hand. Valuations are also context dependent. Economic growth prospects and factors such as the interest rate environment can have an important influence on the level at which valuations are sustainable. Given the favorable forward earnings guidance from corporate America and the ultra-low interest rate environment, we believe stocks may support above-average valuations on their way to an expected mid- to high-single-digit gain in 2015.

The PE ratio (price-to-earnings ratio) is a valuation ratio of a company's current share price compared with its per-share earnings. A high PE suggests that investors are expecting high earnings growth in the future, compared with companies with a lower PE.

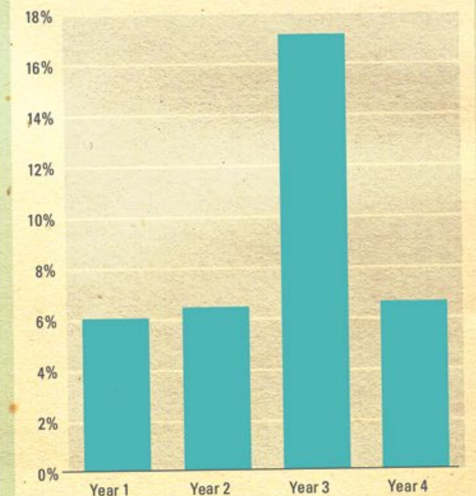
Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested into directly.

HISTORICALLY THE BEST YEAR

2015 is the third year of the four-year presidential cycle, which historically has been the best year to own stocks. Since 1950, during each of the other three years of the cycle—including the presidential election year—stocks gained an average of about 6%, excluding dividends. But during the third year of the cycle, which is one year before the election, stocks have produced an average gain of 17%. This transition through the presidential cycle is a tailwind supporting a potentially strong backdrop of stocks in 2015.

Year Three Has Been the Best Year of the Four-Year Presidential Cycle

Average Returns for the S&P 500 Since 1950



Source: LPL Financial Research, Bloomberg data 11/14/14

Greater volatility involves the potential for greater loss.

ADDED POSTAGE REQUIRED

Volatility Brings Opportunity and Challenges

As the economic and market cycles progress, increased volatility should be expected; however, none of our Five Forecasters show elevated reason for concern, indicating a recession is unlikely in 2015.

PULLBACKS DO NOT MEAN THE END OF A BULL MARKET

The relatively stable and upward-sloping stock market trajectory of recent years has caused investors to become unaccustomed to pullbacks, making them more likely to overreact during any spike in market volatility. An important element to remember is that an increase in volatility, especially in the latter stages of an economic expansion, is quite common. In addition, pullbacks in equity prices are frequent occurrences and showcase a healthy relationship in the tug-of-war between buyers and sellers, bulls and bears. In fact, during this current bull market that started on March 9, 2009, in which the S&P 500 has delivered a 236% cumulative return,* there have been 20 modest market pullbacks of 5% or more. During the 1990s bull market, there were 13; in 2002–2007, there were 12. Considering the average of 3–4 pullbacks per year, the last couple of years have been uncharacteristically quiet, but that is likely to change in 2015 [Figure 7].

Pullbacks do not mean the end of the bull market is near. In fact, most bull markets since WWII included only one correction of 10% or more, and the current expansion has had two already (2010 and 2011), though 2012 and 2014 brought close calls. Bull markets do not end because of a rise in volatility, an increased frequency of market downdrafts, or even the lengthening duration of the economic expansion. The labor markets are improving but are not strong enough yet to generate anything more than modest upward pressure on wages to drive inflation, and U.S. factories have excess capacity. As a result, the Fed is unlikely to start hiking interest rates until the latter part of 2015 at the earliest.

7 | NUMBER OF STOCK MARKET PULLBACKS & CORRECTIONS DURING BULL MARKETS SINCE WWII

Start of Bull Market	# Pullbacks	# Corrections
6/13/1949	13	3
10/22/1957	5	1
6/27/1962	3	1
10/7/1966	4	1
5/26/1970	4	1
10/3/1974	15	6
8/12/1982	10	1
12/4/1987	7	1
10/11/1990	13	1
10/9/2002	12	1
3/9/2009	20	2
Average	**9.6**	**1.7**

Source: LPL Financial Research, Bloomberg 11/14/14

Pullbacks defined as S&P 500 losses of more than 5%. Corrections defined as 10–20% losses.

*Measured by the S&P 500 Index from the market's closing low on March 9, 2009 to October 31, 2014. Past performance is not indicative of future results. One cannot invest directly into an index.

WHAT TO DO WHEN THE MARKET DELIVERS A PULLBACK

Given the likely increase in volatility and the more frequent occurrences of market downdrafts, what is the right way to navigate a pullback or even a correction in stock prices? The simple answer is to follow your investment plan and not let emotions dictate a detour. Fear and subsequent overreaction are almost always the best ways to ruin a great plan. As investors, we must understand that volatility is a part of the market. Pullbacks provide a balance that helps to cull excesses before they become larger problems; they can even help to set the stage for investment opportunities.

We advocate two steps to best approximate the severity of a market downdraft (i.e., pullback, correction, or bear market) and consequently, determine when a market decline becomes an attractive opportunity. First, understanding the distributions of declines helps to frame stock market pullbacks. In short, since the start of the bull market in 1982, 47% of the 8,282 days for the S&P 500 Index have been negative but only 62 have turned into pullbacks, 6 into corrections, and only 5 have turned into bear markets (losses of 20% or greater).* When declines happen, the bumps feel terrible. We then extrapolate the worst case scenario and feel worse. But the reality is, in investing (and in life itself), the worst case scenario rarely happens—and the outcomes are far less drastic than we emotionally feel when living through it.

Second, using LPL Research's three-question approach can help you evaluate the likely severity of a market decline. When stocks decline, take this step-by-step approach and ask yourself the following questions:

1. Is a recession likely around the corner?
2. What caused the stock market decline?
3. What are the catalysts for reversal?

Asking and understanding these three questions can help estimate the potential severity of a decline, targeting the most likely scenario as either a pullback (0–9% decline), correction (10–19% decline), or bear market (20% or more decline), which can then set the stage for making rational decisions and even transforming a challenging period into a potentially profitable opportunity. It is important to note that nothing is completely predictive of the market's future direction, especially during periods of increased volatility and market downdrafts, as investor panic is a powerful force. But staying patient, following a financial plan, and understanding this three-question framework can help in weathering short-term spikes in market volatility.

*According to Bloomberg data and LPL Financial Research analysis as of 11/14/14.

MERGER ARBITRAGE

For investors seeking diversification, merger arbitrage may be an investment idea to consider. Merger arbitrage involves investing in companies seeking transformative events through mergers or acquisitions, and historically demonstrates an ability to produce low correlations to stocks and bonds, with risk similar to fixed income. At this stage in the business cycle, we tend to see more merger and acquisition activity as companies are feeling more confident, cash is plentiful, and financing costs are low.

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

Merger arbitrage is a strategy that consists of buying shares of the target company in a proposed merger and fully or partially hedging the exposure to the acquirer by shorting the stock of the acquiring company or other means.

QUESTION 1: IS A RECESSION LIKELY AROUND THE CORNER?

The goal of this question is to determine the likelihood that the market backdrop can create the conditions for a full-blown bear market. The bottom line is that bear markets rarely occur outside of recessions. In fact, since 1980, there have been five bear markets and all but one happened around or during a recession, which leads to the question: How do you know if a recession is on the doorstep? We look for excesses in the market and economy by examining the Five Forecasters—data series that have had a statistically significant historical track record of providing warning signs that we are transitioning to the fragile, late stage of the economic cycle [Figure 8]. Once we receive these signals, on average, we can expect a recession within the next 6 to 12 months. It is important to note that none of the Five Forecasters currently show cause for concern, which indicates a recession (and the subsequent bear market) is unlikely in 2015.

8 | Reviewing the Five Forecasters

Forecaster	The Signal	Late-Cycle Warning?	Why It Works	The Record
Treasury Yield Curve	An inverted yield curve, defined as a 3-month Treasury yield more than 0.5% higher than the 10-year Treasury yield.	No	Indicates the Fed is elevating short-term rates to slow down an overheated economy and/or rising inflation.	Yield curve inversion preceded 7 out of 7 recessions in the last 50 years by 5–16 months.
Leading Economic Indicators	The year-over-year change in the Conference Board's Leading Economic Index (LEI) turns negative.	No	The LEI is a weighted composite of a diverse set of leading indicators that together tell a general story of where the economy is likely heading.	A negative year-over-year change in the LEI has preceded recessions by 0–14 months and successfully predicted each of the last 7 recessions with only 1 false positive.
Market Breadth	A decline in a measure of the number of stocks advancing compared to the number declining over time when the price level of the NYSE Composite Index is still making new highs.	No	Shows periods when the market continues to rise but is being carried by only a few names. Technical analysts call this a divergence.	Since 1970, 6 confirmed divergences tended to precede a recession by 1–16 months and have usually preceded a significant stock market decline.
Purchasing Managers' Sentiment	There is no clear signal, but an unambiguous peak in the ISM Purchasing Managers' Index (PMI) can be considered a potential warning.	No	The demand for manufactured goods is a strong general indicator of economic activity.	The PMI has a statistically significant history of forecasting changes in earnings growth, the key fundamental driver of the stock market.
Market Valuation: Price-to-Earnings Ratio (PE)	The PE for the S&P 500 (the S&P 500 Index price divided by 1-year trailing operating EPS) is above 17; however, it can stay elevated for a long period of time.	On Watch	Elevated valuations increase the likelihood that markets have become overly optimistic about future earnings growth.	Every bull market since the end of WWII has ended with a trailing PE between 17 and 18, except for 2000, which saw PEs peak much higher.

Source: LPL Financial Research 11/14/14

QUESTION 2: WHAT CAUSED THE STOCK MARKET DECLINE?

Once the likelihood of a recession and bear market has been assessed, the next two steps help to hone in on the subtle, but significant, differences between whether a market drawdown is a run-of-the-mill pullback or of the more significant correction variety. In other words, is the market's wound a deep cut or a scratch? The first step is to determine the cause of the decline. Usually, corrections of 10% or more happen if the cause is a single significant event (a geopolitical event, a natural catastrophe, etc.), rather than the culmination of many smaller events. For example, the uncertainty surrounding the run-up to the Iraq War in 2003 saw a 14% correction. Corrections often need a "deep cut" to instigate a major decline rather than a series of market "scratches." For example, in the fall of 2014, stock prices fell sharply but did not quite reach correction territory. Numerous reasons—including the rise of Islamic State militants, the Ebola outbreak, the prospect of Europe headed to a recession, China's slowdown, extended valuations, and the Fed taper—drove the sell-off. As a result, this "scratches" scenario signaled to investors that the market decline was likely limited to a pullback and not a correction.

QUESTION 3: WHAT ARE THE CATALYSTS FOR REVERSAL?

Last, are there compelling reasons for potentially turning the market's "frown" upside down? Naturally, if there are several strong catalysts to lure bulls back into a market in decline, the likelihood is a less severe experience. We forecast that the continuing recovery of the labor market, attractive corporate fundamentals, and strong earnings growth can serve as the sparks that could keep most of 2015's increased volatility in the pullback category, suggesting investors may be better served viewing these declines as opportunities rather than challenges.

In summary, to navigate a pullback effectively, first evaluate the change in the context of history; and second, evaluate the specific drivers in the current scenario.

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.

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.

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.

Currency risk is a form of risk that arises from the change in price of one currency against another.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, disease, and regulatory developments.

BONDS

While interest rates are near all-time lows and the prospects of Fed rate increases dampen bond returns, fixed income remains one of the best diversifiers of equity market declines. Being selective across sectors and maturities will be key. Best ideas include intermediate maturities, high-quality corporates, and municipal bonds to help buffer against equity market volatility.

GLOBAL MACRO

Global macro is a broad strategy of macroeconomic analysis and forecasting to assess future economic trends and their impact on equity, bond, currency, and commodity markets. Recent years' performance of global macro managers has disappointed, as their traditional analytical frameworks are less effective in an environment with central bank intervention. With global monetary policy beginning to transition toward divergence, we would expect volatility, particularly in currency and commodity markets, while correlations are expected to continue declining from post-2008 peaks. Macro managers should be well positioned to provide strong diversification benefits, with reduced correlation and a potentially attractive risk/return profile.

HANDLE WITH CARE

Fragile Returns Inside

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

With sustained improvement in economic growth, slowly rising inflation, and the approach of the Fed's first interest rate hike, bond prices are likely to decline in 2015. High-yield bonds and bank loans can help investors manage this challenging bond market.

Bond markets are likely to transition to a flat-return environment in 2015 after a volatile, but surprisingly positive return environment in 2014. We expect returns to be roughly flat or in the low-single digits for 2015. The journey to the Fed's first interest rate hike has not been derailed and will continue in 2015. Short and intermediate Treasury yields were marginally higher through the first 10 months of 2014 in preparation for this transit, despite the more widely publicized decline in longer-term 10- and 30-year Treasury yields. A reduced weight to bonds may be the right ticket as bond investors face improving economic growth, slowly rising inflation, and the approach of the Fed's first interest rate hike, likely in late 2015 or early 2016, all of which would likely contribute to pushing bond prices broadly lower in 2015 [Figure 9].

9 | A 0.25% TO 0.75% RISE IN BOND YIELDS TRANSLATES TO LOW OR MARGINALLY NEGATIVE TOTAL RETURNS

Change in Bond Yields, %	-0.50	-0.25	0.00	0.25	0.50	0.75	1.00
Total Return, %	6.08	4.69	3.30	1.91	0.52	-0.87	-2.26

Source: LPL Financial Research, Barclays Aggregate Bond Index data 11/14/14

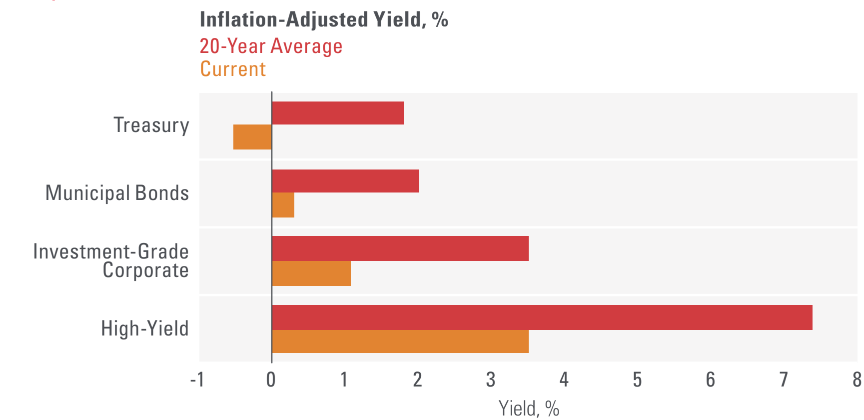
Barclays Aggregate Bond Index Total Return Scenario Analysis: Projected total return over one-year horizon for given change in interest rates.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

DELIVERY DELAYS

Even if the Fed postpones the first interest rate hike to early 2016 or beyond, the opportunity for fixed income investors remains limited. Lower yields provide a small buffer against the prospects of future price declines associated with rising interest rates; in addition, they augur for low returns — even if the Fed decides to push back the timing of a first interest rate hike.

10 | INFLATION-ADJUSTED YIELDS REMAIN BELOW HISTORICAL NORMS



Source: LPL Financial Research, Bloomberg, Barclays Index data 11/14/14

Inflation-adjusted yields may be below zero if inflation is greater than yields.

Valuations also remain expensive across the bond market, providing limited opportunities for investors. Inflation-adjusted yields remain well below historical norms and perhaps best illustrate how expensive bonds remain [Figure 10]. A modest rise in interest rates or inflation will mean bond investors are facing flat or possibly negative total returns, after taking into account the impact of inflation.

High-yield bonds and bank loans continue to stand out within the bond market. Good corporate fundamentals and a low-default environment indicate lower-rated bonds can help investors manage a challenging bond market. Bouts of weakness in high-yield bonds during 2014 were based on non-fundamental factors, such as global social unrest, geopolitics, and general profit-taking. But high-single-digit earnings growth through the first three quarters of 2014 and low defaults suggest the ability of corporations to repay debt obligations can remain strong in 2015 [Figure 11].

Continued economic expansion and higher yields give corporate bonds a slight edge as investors seek to maximize bond returns. The probability of a recession remains low, and steady economic growth should continue to reinforce corporate credit quality. Corporate fundamentals are likely to remain quite healthy and higher yields could potentially be an important source of return. In a rising-rate environment, yield provides not only a source of return, but also a cushion against price declines associated with rising interest rates.

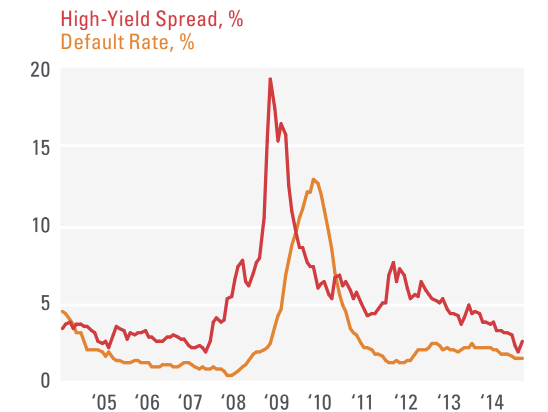
HIGH-QUALITY FOCAL POINTS

Among high-quality fixed income sectors, investment-grade corporate bonds and municipal bonds provide rays of light in an otherwise dark landscape. Corporate fundamentals are likely to remain firm and the average yield advantage of 1.1% stands out in a low-yield world, despite being below the 20-year average of 1.3% (as of October 31, 2014).* Yield will be an important source of return, given that additional contraction in yield spreads (which may lift prices) is unlikely.

*According to Barclays Index data.

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

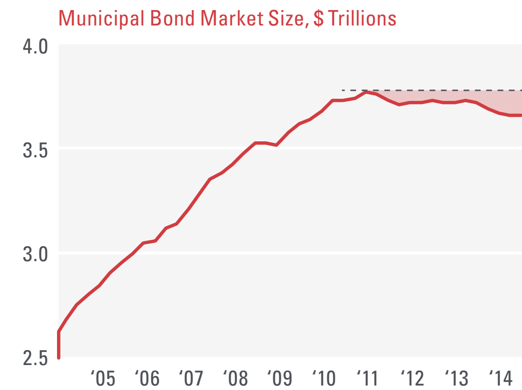
11 | LOW DEFAULTS SHOULD SUPPORT HIGH-YIELD BOND VALUATIONS



Source: LPL Financial Research, Moody's, Barclays Index data 10/31/14

High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

12 | SMALLER PACKAGES: THE MUNICIPAL BOND MARKET MAY CONTINUE TO SHRINK IN 2015



Source: LPL Financial Research, Federal Reserve Flow of Funds 6/30/14

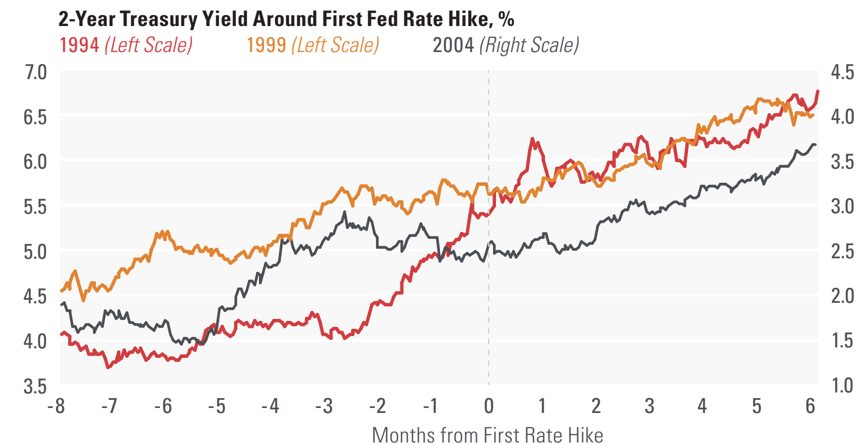
Municipal bonds could likely benefit from another year of limited supply. State and local government revenue has improved over the past few years but expenses have grown as well, which will keep state budgets under pressure. The capacity to take on new debt-funded infrastructure projects is therefore limited, and tax-free issuance should remain low by historical standards. The municipal bond market could likely experience another year of limited net growth, which should provide a tailwind for relative returns [Figure 12].

At the same time, the demand for tax-exempt income remains elevated, creating a favorable supply-demand balance for municipal bonds. Like investment-grade corporate bonds, additional valuation improvement is likely to be limited after the 2014 rebound; but on a longer-term basis, municipal bond valuations remain attractive.

NO RETURN TO 2013

The Fed's journey to interest rate hikes began way back in 2013 with taper talk and has been widely anticipated, which should limit the potential surprise to investors. A sharp decline in bond prices and spike in yields is unlikely, and we expect a gradual move toward higher interest rates. Normally, Treasury yields react more forcefully three to six months before the first interest rate hike [Figure 13]. As a result, the latter half of 2015 may prove more challenging for bond investors as the specter of Fed rate hikes draws nearer.

13 | TREASURY YIELDS BEGIN TO MOVE 3–6 MONTHS BEFORE FIRST HIKE



Source: LPL Financial Research, Bloomberg data 10/31/14

Past performance is not indicative of future results.

INTERNATIONAL RESTRICTIONS

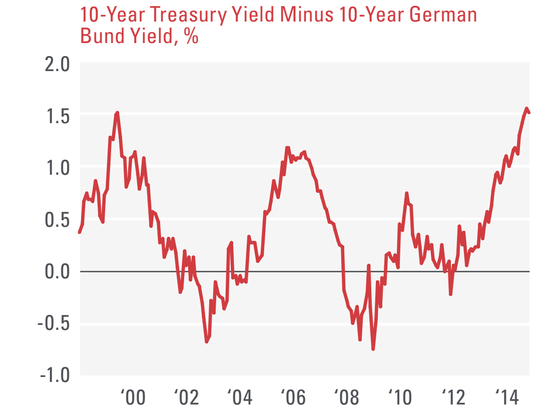
High-quality foreign bonds remain more expensive compared with domestic counterparts. Inflation-adjusted yields on high-quality European bonds are lower, compared with U.S. bonds, which have already priced in more robust action from the ECB, as well as a pessimistic economic backdrop for 2015 and beyond. Low yields, including negative yields on top-rated, short-term government bonds, suggest recessionary conditions are fully priced in. However, if the Eurozone economy manages to muddle along rather than fall into recession, or if ECB action ends up sparking better growth, bond prices may decline. Recently completed stress tests showed European banks have unloaded bad loans, and another ECB bank-lending operation in December 2014 may help spur loan growth, which could give the Eurozone economy a lift.

The 10-year U.S. Treasury is a beacon of yield relative to most other developed nations. The gap between the yield of the 10-year U.S. Treasury and the 10-year German bund, for example, recently reached record levels with the additional yield being greater than 1.5% [Figure 14]. Since the creation of the European Union, this gap in yield represents a peak and highlights the relative and absolute success of the U.S. economic recovery. On a positive note, the strength of overseas demand is another reason why we expect the rise in domestic bond yields to be gradual.

Emerging markets debt (EMD) remains a more attractive proposition relative to developed markets, but we await even more attractive valuations. EMD's greater sensitivity to geopolitical risk, concerns over the Fed's move toward an interest rate hike, as well as a potential slowing in the Chinese economy, suggest cheaper valuations are warranted before increasing exposure. However, despite mixed economic results among EM countries, overall EM growth could likely remain firmly positive and supportive of credit quality.

In summary, bond investors are limited by the imminent first interest rate hike, expensive valuations, and the potential for even a modest rise in inflation. High-yield bonds and bank loans can help investors manage a challenging bond market; and among high-quality bonds, municipal bonds and investment-grade corporate bonds offer modest value.

14 | STRONG FOREIGN DEMAND MAY HELP SUPPORT TREASURIES DUE TO A WIDE YIELD ADVANTAGE



Source: LPL Financial Research, Bloomberg data 10/31/14

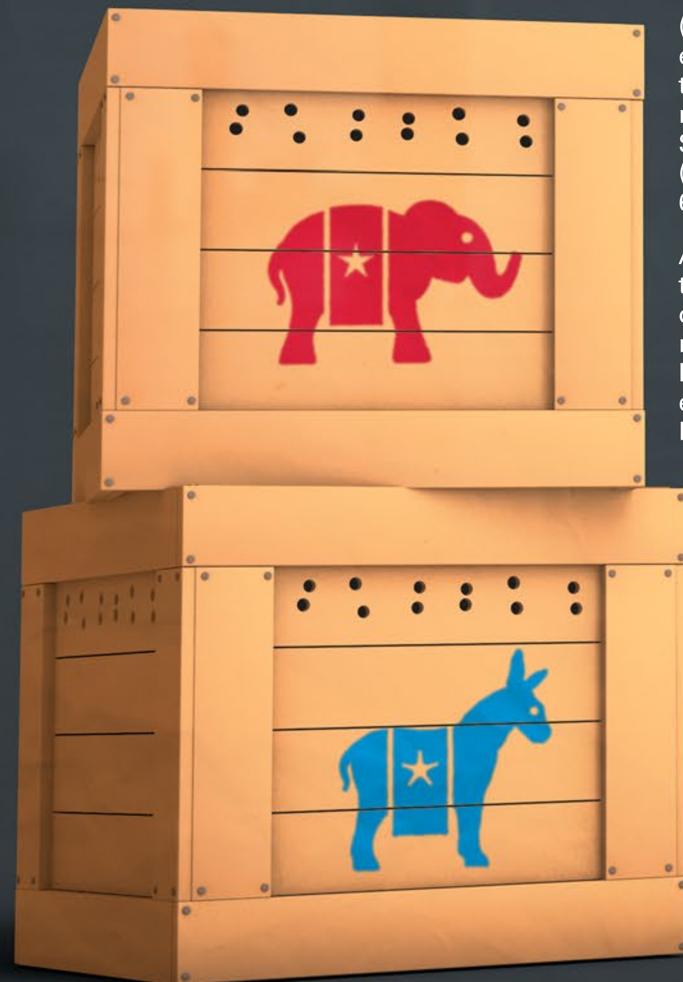
Past performance is not indicative of future results.

MUNICIPAL BONDS & INVESTMENT-GRADE CORPORATE BONDS

Among high-quality bonds, municipal bonds and investment-grade corporate bonds offer modest value. A yield premium creates a cushion to withstand some rate increases and the attractive supply-demand dynamics of municipal bonds add to the relative attractiveness.

DESTINATION WASHINGTON:
CONTENTS SHIFT UPON DELIVERY

In the recent midterm Congressional elections, the Republican Party won a majority in the U.S. Senate and increased its advantage in the House. This Republican control of Congress sets up a slightly different policy dynamic in Washington than the one that has been in place since 2006, when Democrats took control of the Senate. This transfer of power to the Republican Party could have a meaningful impact on broad policy measures such as the Affordable Care Act (ACA), tax reform, and presidential appointees to the Fed, as well as on several key sectors of the economy. Accordingly, after a relatively quiet 2014, Washington, D.C. will likely be front and center again in 2015.



The president's signature policy initiative, the ACA (also known as Obamacare), is unlikely to be repealed en masse next year, although there is a strong chance that the most unpopular parts of the law will be repealed. While the Republican Party will control the Senate, it does not have a filibuster-proof majority (60 seats) and is still far short of having a veto-proof 67-vote majority.

Although broad tax reform — which would likely take the form of closing corporate, personal, and other tax loopholes while lowering the overall tax rate — would be welcomed by markets. However, the Republican majority in the Senate may not be large enough to deliver more than piecemeal changes. Fiscal issues outside of major tax reform, such as addressing the country's long-term structural budget problems, could still be influenced by both sides of the political spectrum. As a result, market participants are likely to see a return of some policy-induced uncertainty. The big unknown is whether Democratic President Barack Obama and the Republican-led Congress will find common ground in 2015 and cut a long-awaited deal on the budget, or even avoid revisiting the debt ceiling debacle, an issue that could re-emerge in the first half of 2015. However, given the backlash following last year's government shutdown, as well as initial comments from likely Senate Majority Leader Mitch McConnell (R-KY), we believe Congress is likely to avoid such a standoff.

WEIGHING THE SECTOR IMPLICATIONS OF MIDTERM ELECTION RESULTS

As President Obama potentially seeks common ground with a Republican-controlled Congress and focuses on his legacy, we see several noteworthy potential sector implications:

ENERGY:

Expect more exports and faster permitting. We expect the Republican Congress to help quicken the pace of permitting for oil and gas production, encourage petroleum exports, and push through approval of the controversial Keystone XL Pipeline. Progress toward crude oil exports may be slow, given the risk of higher prices, but bipartisan support in key energy states should help. The potential build-out of the Keystone Pipeline is positive for energy and industrial companies—creating construction jobs, facilitating exports, and alleviating the U.S. oil inventory glut. Transportation stocks such as rails should continue to chug along as they benefit from increasing U.S. energy production.

HOUSING FINANCE REFORM:

Legislation possible, but significant hurdles exist. Government-sponsored enterprise (GSE) reform is possible in 2015, though the Obama administration must balance the desire to solve the dilemma and encourage access to low-cost mortgages against the significant income the GSEs are generating for the U.S. Treasury. Congress must also work out its differences regarding the government's role in mortgage finance, and there is currently no viable alternative to broad housing finance beyond Fannie Mae and Freddie Mac. Some reform may be achieved, but the road to get there may be bumpy; and the potential impact to mortgage lenders is unlikely to be significant.

HEALTHCARE:

ACA changes likely on the way. The impending Supreme Court ruling in mid-2015 about the legality of ACA subsidies affecting more than 7 million subscribers may force the Obama administration to work with Congress to make significant changes to the law to improve its economics. The odds that the entire law, key to President Obama's legacy, is repealed in 2015 (or 2016) are very low, so we would view healthcare weakness related to speculation about the law's repeal as a buying opportunity, especially in hospital stocks.

FINANCIAL SERVICES:

Possible relief on the horizon for regional banks. Under a Republican-controlled Congress, regulatory requirements for regional banks related to the Systemically Important Financial Institution (SIFI) criteria may be eased. The breakpoint for the designation may be raised, potentially to $100 billion in assets from $50 billion, alleviating some of the regulatory burden. Community banks may benefit from a reduction in loans they must retain on their balance sheets.

LOOKING AHEAD

As activity in Washington becomes more closely watched in 2015, the markets will already be looking ahead to 2016. Much will be at stake in the 2016 presidential election, as Republicans will defend their newly assumed control of Congress and Democrats will try to retain the White House. History favors a change in control of the Oval Office, as the party of a two-term president almost never wins a third consecutive term. The incumbent party could not ride the coat tails of Clinton, Nixon, Eisenhower, or Wilson. Discounting Truman and Roosevelt, who were both already president before they had to run for the first time, Reagan was the only two-term president since Grant in 1876 to enable his party to pull off a third consecutive victory. Democrats are aware of this trend, and it will make for a contested and market-moving 2016 election cycle.

A Systemically Important Financial Institution (SIFI) is any firm, as designated by the Federal Reserve, whose collapse would pose a serious risk to the economy.

Shipping Lanes

Unmistakably, 2015 is a year in transition, one that bridges a maturing economic recovery with the latter stages of the business cycle. But every transition, every journey, is a passage to a new destination. For 2015, this shift sets the stage for an extremely important delivery of sweeping changes in 2016 — a date that may seem far off now, but the importance of which will be felt throughout this coming year. Markets are always looking forward, and as important as 2015 will prove to be, it only will be the foundation for what is ahead in 2016.

On the heels of a resounding Republican takeover of Congress, 2016 will see voters elect a new president in what could be one of the most contentious and significant elections in many years. And while the Fed may begin its higher interest rate policy in the latter parts of 2015, it will almost assuredly be well underway in 2016. This transition from low to higher interest rates will test the sustainability of this market expansion. But perhaps most importantly, the Fed's likely restrictive monetary policy will start the markets on recession watch in 2016. By the end of 2016, the business cycle will be almost eight years long and approaching the upper end of historical age. While we, and our Five Forecasters, do not predict a recession over the next two years, there is a strong possibility for one beyond that horizon.

Amid this heightened activity in Washington and shifts in monetary policy, the shipping lanes are wide open as 2015 may be poised to deliver strong economic growth, improving labor conditions, a continued environment for fast-growing corporate earnings, and a favorable backdrop for expanding equity prices. But 2015's most important delivery will be setting the stage for 2016. ■

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 security. 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 indexes are unmanaged and cannot be invested into directly.

Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

The Leading Economic Index (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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.

The Barclays Aggregate Bond Index is an unmanaged market capitalization-weighted index of most intermediate-term U.S. traded investment-grade, fixed rate, non-convertible, and taxable bond market securities including government agency, corporate, mortgage-backed, and some foreign bonds.

NYSE Composite Index is an index that measure the performance of all stocks listed on the New York Stock Exchange. The NYSE Composite Index includes more than 1,900 stocks, of which over 1,500 are U.S. companies.

The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy. The FOMC is composed of the board of governors, which has seven members, and five reserve bank presidents.

The Labor Market Conditions Index (LMCI) is a dynamic factor model of labor market indicators, which extracts the primary common variation from 19 labor market indicators. This tool was recently developed by the Federal Reserve.

Quantitative easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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