

# Outlook 2012



## Meeting in the Middle

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# Meeting in

The year 2012 will be one where the wide divergences of the prior year converge to meet in the middle while candidates seek to attract the middle voter.

Over the last four years, the market declined in excess of 2% in a single day around 100 times, more than any other four-year period since the S&P 500 Index's formation in 1957. On the flip-side, the market also recorded a 2% or greater gain in a single day more than any other four-year period.

While the last few years have been highlighted with record swings in market returns and widely oscillating economic data, we expect 2012 will be less about the fringes and more about the middle. While volatility is likely to remain elevated, the market and its economic backdrop may begin to migrate from the extremes—oftentimes even polarized extremes—toward a more normalized period where investor sentiment, economic activity and the market's direction start to move increasingly in alignment.

While moving away from the drastic extremes will be a welcome environment for whipsawed investors, the center offers its own distinct challenges and opportunities. The key hurdle for the market in 2012 will be finding the right balance.

Recently we have experienced a market of extremes. In 2012, finding a middle ground, or **Meeting in the Middle**, is going to be key for growth in the markets and economy. Consumer sentiment, business leaders, policymakers and geopolitics are going to have significant impact on the investment environment. We believe that:

- **Soft sentiment and hard data find middle ground.** We expect the U.S. economy to grow about 2%, which is below the consensus forecast, while emerging markets post stronger growth and Europe experiences a mild recession. U.S. gross domestic product (GDP) is likely to produce below-average growth of about 2% in 2012, supported by solid business spending and modest, but stable, consumer spending.

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.



# the Middle

- **Stocks supported by converging outlook for earnings growth.** The U.S. stock market is likely to post an 8–12%\* gain, supported by mid-to-high single-digit earnings growth when the pessimistic outlook for profits reflected in the markets rise to converge with a slide in the lofty expectations for earnings projected by Wall Street analysts. Stocks may receive a boost from a slight improvement in valuations from the current 20-year low as confidence returns that the business cycle will continue.
- **Government and corporate bond yield gap narrows.** The performance gap between government and corporate bonds reverses in 2012 with corporate bonds outperforming as they post modest single-digit gains as interest rates rise and credit spreads narrow. Bond yields may be volatile within a 1.7–3% range, but we expect them to rise over the course of the year, with the yield on the 10-year Treasury ending the year around 3%. Ongoing economic growth will help to normalize interest rates as will a continuation of Federal Reserve (Fed) policy, stable inflation and tightening fiscal policy. The wide gap between yields on government bonds and those of other borrowers is likely to converge some in 2012.
- **Major policy-driven events will converge on the financial markets in 2012.** We believe a mild recession emerges in Europe, in contrast to the consensus forecast for continued growth, and the debt dilemma continues to grab headlines and move markets, while the outlook for growth and financial stress in China will also garner attention from investors. In addition, the 2012 elections in the United States are likely to hold major consequences for investors. The key fight this election is over those in the middle. The party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in the federal budget policy since World War II.

\*LPL Financial Research provided this range based on our earnings per share growth estimate for 2012, and a modest expansion in the price-to-earnings ratio. Additional explanation can be found throughout this publication.



# Sluggish U.S. Economic Growth

We believe 2012 will be another year of sluggish growth for the U.S. economy. GDP is likely to average about 2% in 2012, supported by solid business spending and modest, but stable, consumer spending. While inflation may recede early in the year, by year-end it may begin to re-emerge as the impact of a falling dollar, rising commodity prices and the record-breaking monetary stimulus by the Fed begins to be reflected in prices. We expect global growth in 2012 to be supported by solid emerging market growth including the consensus of 8–9% growth in China, the world's second largest economy, while Europe experiences a mild recession.

We believe there is a one-in-three chance of entering a recession in 2012. However, provided we avoid a shock from unforeseen events, interest rates do not surge above 5% and oil prices do not soar to record highs, we believe the business cycle likely lasts until around 2015—the average cycle duration of five years experienced since 1950. This leaves 2012 as a mid-cycle year of continued, though sluggish, growth.

Many investors fear the U.S. economy is poised for a business cycle much shorter than the average of eight years seen in recent decades. The fear of a return to recession just three years after emerging from the Great Recession of 2008–2009 is driven largely by the concerns over a lack of job growth and the fiscal budget and debt problems here in the United States and overseas. While we recognize the challenges posed by unsustainable government budget deficits and relatively high unemployment rates, we believe the support of strong business productivity and a corporate spending boom are being overlooked by investors.

## The Gap Between Facts and Feelings

Rather than an economic recession, we seem to be experiencing a recession in confidence. This belief is quantified by comparing the very soft sentiment reading to the hard economic data [Chart 1]. There is noteworthy divergence between consumer confidence, measured by the widely watched University of Michigan Consumer Sentiment Index, and the Index of Leading Economic Indicators from the Conference Board.

The market clearly believes the headlines that the fall of business and consumer confidence to historical lows will inevitably lead to an economic recession—no matter what positive signs the data brings. Market participants are placing a high probability that businesses will not merely slow their rate of hiring and investment, but actually make cuts despite strong sales and rising profits. They also expect that consumers are in the process of shutting down their spending, despite the fact that retail sales have remained solid coupled with the credit card delinquency rate declining further to near record lows.

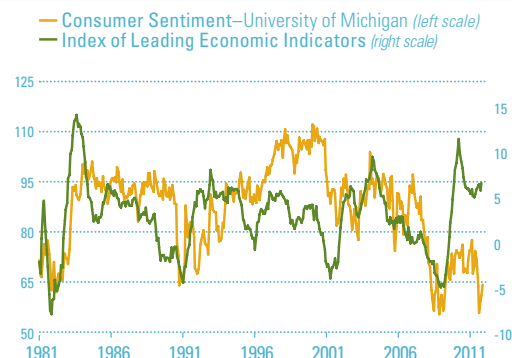
During the second half of 2011, consumer and investor feelings and confidence plunged to levels only seen one other time in the past 30 years: during the financial crisis of 2008–2009. However, the economic data that measures the actions of consumers and businesses indicated moderate economic growth. This growth actually translated to the third quarter 2011 GDP of 2.0%. Typically, how consumers and businesses feel and act are aligned, but they periodically diverge. In the past, when they have diverged it has been sentiment rather than the data that has closed that gap, which is likely to be the case in today's environment.

The last time we saw such a wide gap between facts and feelings, in the late 1990s and early 2000s, it was the reverse of the current situation with sentiment too optimistic relative to the data. At the end of the 10-year economic expansion (1991–2001), confidence was high amidst booming financial and housing markets and the backdrop of relative quiet on the domestic and international policy fronts. However, the data on the economy, including business spending, new orders, rail traffic, auto and truck sales, and hours worked, among others, were all pointing to a less rosy fundamental economic environment. A similar episode occurred in 2005–2007, when consumer sentiment remained strong—as the stock market and housing prices hit all-time highs—even though the data suggested a deteriorating economy.

Markets seem to believe the odds of a recession are well over 50%. This is after sentiment has rebounded some from the summer of 2011—when investors priced in odds of a recession approaching 100% as measured by stock market valuations and bond yields falling to or below the levels seen in prior recessions. However, we believe actions speak louder than surveys. We place the odds of recession at just one-in-three, substantially lower than what the markets are placing on such an event.

The market is often said to climb a wall of worry. History shows that it does not take much for the market to turn from agonizing over a wall of worry to climbing it. This occurs when confidence is high that impediments to growth—both real and imagined—will be overcome no matter how bad they may seem at the time causing the market to trend upward. Importantly, the risks do not need to be resolved, merely confidence needs to return that the risks will be overcome.

### 1 The Gap Between Facts and Feelings is Wide



Source: LPL Financial, Bloomberg 11/03/11

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

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

Past performance is no guarantee of future results.

The convergence of facts and feelings will be largely driven by consumers feeling more confident in continued growth as the labor market improves, and the unusual factors that negatively impacted 2011 are unlikely to repeat.

Looking ahead to 2012, we believe the data and sentiment gap will converge. 2011 had a lot of unusual factors—many of which were not directly related to markets—that weighed on investor sentiment including:

- Civil and social unrest in the Middle East
- Soaring consumer energy and food prices
- Unprecedented discord among policymakers in the United States
- Stubborn inaction among policymakers in Europe
- The devastating earthquake and tsunami in Japan which disrupted the global supply chain for more than half a year
- A series of severe natural disasters globally

The memories and impacts of these events have already begun to fade and will continue to do so. At the same time, the Fed's actions to stimulate the economy overall and the housing market in particular may help to further stabilize that sector. The ongoing stagnation in the housing market has played a key role in driving consumer sentiment to 30-year lows. In addition, there will certainly be an uptick in political rhetoric over the course of the year as we approach the 2012 presidential and congressional elections.

The convergence of facts and feelings will be largely driven by consumers feeling more confident in continued growth as the labor market improves, and the unusual factors that negatively impacted 2011 are unlikely to repeat. However, the economic data may also soften relative to the second half of 2011, when U.S. and global economic activity was artificially boosted as the global supply chain recovered from the Japanese earthquake and tsunami.

### Business Rather Than Consumer Spending to Drive U.S. Economic Growth

It is during times like these that we are often reminded that 70% of U.S. economic growth is driven by consumer spending. This dependency has raised worries that a persistently high unemployment rate and low sentiment levels will make a recession self-fulfilling as consumers rein in their spending. However, there is much more to this story beyond the headline.

- **Most consumer spending is not discretionary.** While it is true that consumer spending accounts for about two-thirds of GDP, two-thirds of consumer spending—and most of consumption growth—comes from services and staples, such as healthcare, housing, education, food, energy and others. These categories of spending do not change much from year to year; instead they tend to steadily rise at the pace of inflation. Actual discretionary consumer spending, which is made up of more flexible, voluntary categories of spending, such as travel, electronics and autos, makes up only one-third of the total.
- **Most spending is done by those with the largest capacity to spend.** The top 5% of income earners make up 37% of consumer spending, and the top 20% make up 60% of all consumer spending. These groups have continued to spend as indicated by retail sales, which is more discretionary, having risen by 7.3% year-over-year as of October 2011.

Because of these spending dynamics and anticipated job gains of about 150,000 per month, we believe the U.S. economy will experience modest consumer spending growth in 2012 despite the high unemployment rate and sluggish income growth.

We forecast U.S. business spending to grow at several times the pace of consumer spending in 2012. Business spending has been strong in 2011, as demonstrated by third quarter 2011 capital spending by businesses on equipment and software rising at an annualized rate of over 17%. One of the reasons that businesses were able to achieve record profits in 2011 despite employing fewer workers is because businesses have become more productive and are doing more with less and investing in productivity enhancing technologies. 2011 marked a change from an extended period of underinvesting by U.S. companies. Businesses are hesitant to invest when their costs are hard to forecast. The sweeping regulatory and legislative changes, and prospects for additional changes, affecting industries, such as Financials, Energy, Utilities and Health Care, that took place in 2010 are fading and may even be reversed—with the outcome of the 2012 election. Therefore, in 2012, business spending may continue to enjoy what may be a new multi-year cycle supported by this clearer regulatory and legislative environment.

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# The S&P Decouples From GDP

Even in an environment of sluggish GDP growth the S&P 500 can produce solid gains. We believe the S&P 500 will post a gain of 8–12% in 2012. This is based on our economic outlook unfolding as forecasted, interest rates staying benign (10-year Treasury below 4%), and oil staying below prior record prices. Although our outlook is for U.S. economic growth of about 2%, we expect solid, but volatile returns for the S&P 500. We believe these gains are driven by earnings growth in the mid-to-high single digits and a modest rise in valuations from recession-like levels as the gap between soft sentiment and hard data begins to converge.

Over the past 40 years, the S&P 500 median return is 10% when real GDP grows less than 3%. It is important to recognize that the S&P is not GDP. S&P 500 companies have different drivers for earnings than the components that drive GDP.

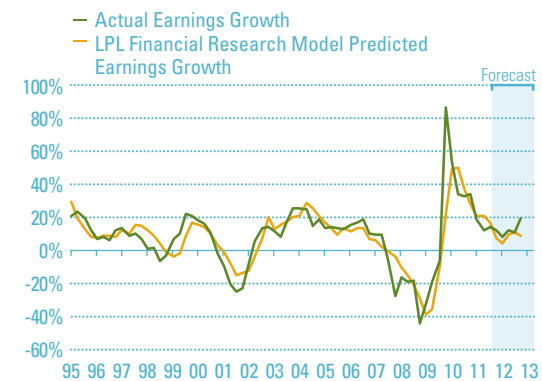
- Two-thirds of S&P 500 profits are from manufacturing, while two-thirds of U.S. consumption in GDP is services.
- While 70% of GDP is consumer spending, only one-third of it is from discretionary categories, while an even lower 15% of S&P 500 profits come from consumer discretionary spending. A more significant 20–25% of S&P 500 earnings come from business spending.
- International trade only accounts for 10% of GDP and acts as a drag since the United States imports more than it exports. Today, about 40% of S&P 500 profits come from overseas—with about half of that from rapidly emerging market economies. This makes S&P 500 earnings less dependent upon U.S. growth than just 15 years ago, when 20% of S&P profits were foreign-sourced, and 30 years ago when only a small portion of earnings came from overseas.
- While higher commodity prices weigh on GDP, they benefit S&P 500 companies, in general, because most of the S&P 500 companies either produce commodities (Energy and Materials), supply commodity

producers with equipment (Industrials) or do not heavily use commodities (Information Technology, Health Care, Financials, Telecommunications).

Given the backdrop of solid business spending in the broader context of low GDP growth and mixed global demand, we expect mid-to-high single-digit earnings growth for S&P 500 companies in 2012. The typical mid-cycle earnings growth rate for the S&P 500 over the past 80 years of business cycles has been around 10%. Slower revenue growth based on sluggish global economic growth will weigh on earnings leading to slightly-below-average mid-cycle growth. This expectation is supported by our model of earnings growth using key drivers of earnings as inputs: commodity prices, the yield curve, labor costs and global leading economic indicators [Chart 2].

The consensus for earnings growth among Wall Street analysts may come down—especially for the fourth quarter 2012 forecast of a 19% year-over-year increase. But, with investors pricing in flat, at best, earnings per share (EPS) in 2012 relative to 2011, stocks may post gains as confidence in earnings growth rises, with investors and analysts meeting in the middle.

2 LPL Financial Research Predicted Earnings Growth Closely Tracks the Actual Earnings



Source: LPL Financial, Thomson Financial 11/21/11

What if Weak Economic Growth Turns into a Recession?

An analysis of the S&P 500 earnings cycles presented in the table below reveals that, typically, earnings grow for five to ten years, averaging about 6% a year from the prior peak before they pullback. As of mid-2012, there will have been only three years since the last recession ended. However, if we did enter a recession in 2012, earnings would likely fall rather than grow in 2012. During a recession, EPS typically falls about 12–24%. The only exception to this 12–24% range was in 2008 when the companies in the Financials sector, the largest sector by earnings at the time, were forced to write off a decade of profits in just one quarter.

Historical Earnings Cycles for S&P 500 Companies

Cycle Peak	Duration in Years (Peak to Peak)	EPS Peak	EPS Trough	Annualized EPS Growth (Peak to Peak)	EPS Decline (Peak to Trough)	Trailing PE at EPS Trough
4Q 1950		2.84	2.34	6.6%	-18%	7.2
3Q 1956	5.25	3.69	2.88	5.1%	-22%	13.1
3Q 1959	3.00	3.43	3.03	-2.2%	-12%	16.6
3Q 1969	10.00	5.89	5.13	5.6%	-13%	15.8
3Q 1974	5.00	9.11	7.76	9.1%	-15%	7.0
4Q 1981	7.25	15.36	12.43	7.5%	-19%	8.0
2Q 1989	7.50	25.91	19.63	7.2%	-24%	12.3
3Q 2000	11.25	56.89	44.32	7.2%	-22%	25.9
2Q 2007	6.75	91.76	50.84	7.3%	-45%	14.3
3Q 2011	4.25	95.19	?	?	?	?
<b>Average</b>	<b>6.69</b>	<b>31.01</b>	<b>16.48</b>	<b>5.9%</b>	<b>-21%</b>	<b>13.36</b>

Source: LPL Financial, Thomson Financial, Bloomberg data 10/28/11

Past performance is no guarantee of future results

## Price-to-Earnings Ratio (PE)

The price-to-earnings ratio measures how much value an investor gives a stock per dollar of current earnings. The long-term average for this method of valuation is around 15. Of course, investors expect earnings to continue in the future. In general, if they expect strong growth in the future they are willing to pay more and if they expect earnings to decline they are willing to pay less. Movements in PE can be a potent driver of stock market returns on the upside and the downside.

Historically, the trailing PE for the S&P 500 averages 13.4 at the recession-driven earnings trough. Some periods were much lower and occurred during periods of double-digit inflation in the late 1970s and early 1980s. Other periods were much higher for various reasons, including the lingering tech bubble mania in the early 2000s. Over the past three years as earnings have reached new highs, valuations have not kept up and actually retreated to recession lows in 2011 as investors feared the earnings rebound would not last.

Valuations currently suggest investors fear an EPS decline associated with a recession or an interest rate surge. We continue to believe that, rather than recession, weak economic growth will continue in 2012. We also expect profits to post a mid-to-high single-digit rise. Despite the rally in October, markets are pricing in flat earnings growth in 2012. However, we believe the analysts' and market participants' outlooks for earnings will converge in 2012 to an 8–12% gain.

If the economy deteriorates further and the United States enters a recession, we believe earnings would only fall roughly 12% from current levels. We believe the pullback would be at the lower end of the historical range for several reasons.

- **First, we have not had the buildup of corporate debt levels.** This steady build up of leverage typically inflates earnings in the later years of a business cycle and then rapidly deflates them over just a few quarters and acts as a multiplier on the earnings pullback. The opposite has been taking place in recent years, as corporations have continued to reduce debt after the downturn ended, leaving much less leverage to exacerbate the downside to earnings in a recession.
- **Second, S&P 500 companies now get about one-quarter of their sales from fast-growing emerging markets.** These areas of the market are relatively unaffected by a recession in the developed markets and their growth may continue regardless of the U.S. economic backdrop. This is one of the key reasons profits have boomed at a double-digit pace despite the very sluggish economic growth in the United States in the first and second quarter of 2011.
- **Third, businesses have not yet done a lot of hiring this business cycle.** The vast majority of corporate costs are labor. Businesses have not reached the point where a pullback in demand from a recession would result in them being suddenly overstaffed and forcing them to suffer high costs associated with early retirement, mass layoffs or retaining excess workers as demand falls.
- **Fourth, earnings as of the third quarter of 2011 have now just exceeded the prior peak.** In general, earnings pullbacks are proportional to the gain they achieved during the cycle. The fact that earnings have experienced below-average gains is likely to result in a below-average pullback. For example, in 1959, the cycle was short; earnings never grew above the prior peak and, during the correction, earnings fell just 12%.

If a recession develops and earnings fall 12%, the total EPS of the past four quarters, which now stands at a little over \$95 for S&P 500 companies (as of November 2011), would fall to about \$84. This would return EPS to a level first achieved only five years ago. If we assume a recession EPS of \$84 and multiply that by the average recession price-to-earnings ratio of 13.4, we get a level where recession is fully priced in to the stock market at about 1120 for the S&P 500. This level is roughly where the Index bottomed out four times during the summer and fall of 2011.

## The Rise of the PE

In 2012, we believe the investment environment will transition from an early cycle environment of EPS recovery to a mid-cycle environment of PE recovery. The S&P 500 PE may begin to climb back toward the long-term average of 15. Improving confidence in the outlook for continued economic and profit growth will be the key to lifting valuations. Investors' lack of confidence in economic growth, corporate profit forecasts and the actions of policymakers is likely already fully reflected in the markets and creates the potential for valuations to rise as confidence rebounds from multi-decade lows.

Volatility, a major characteristic of 2011, is likely to remain present in 2012 as macroeconomic and policy drivers result in market swings. However, we see a greater potential for gains in 2012. Our base case is for stocks to post a solid gain in 2012 of around 8–12%.

# Bond Market Under Pressure

A number of factors will likely keep bond yields relatively low in 2012 and may translate into a low return environment for the bond market. For 2012, we expect a low-to-mid single-digit total return for the high-quality bond market as different segments of the bond market meet in the middle. We believe the economy will avoid slipping back into recession in 2012, which should pressure yields higher and benefit more economically sensitive bond sectors at the expense of U.S. Treasuries. The risk-on, risk-off trading environment that characterized bond market performance in 2010 and 2011 is likely to persist in 2012.

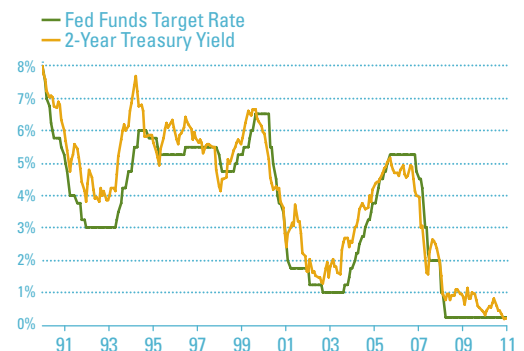
We expect yields to remain relatively rangebound in 2012, but end the year higher. Economic soft spots or periods of financial market turmoil will likely spark bouts of safe-haven buying, pushing bond prices higher and yields lower. We expect the 10-year Treasury yield to fluctuate between 1.7% and 3% in 2012. Although a wide range, it is narrower than the 1.7% to 3.7% range the 10-year Treasury yield fluctuated within during 2011. Ultimately, we expect bond yields to finish the year at the high end of the range, around 3.0%, as fears of recession fade and the passage of the presidential election portends fiscal changes in the United States.

## Federal Reserve Helps Keep Yields Rangebound

A number of factors should support a range-bound market and keep Treasury yields low relative to history. The most important of these is the Federal Reserve's (Fed) monetary policy.

The Fed's commitment to keeping short-term interest rates on hold through the middle of 2013 removes a key source of interest rate risk from the market. This unprecedented step by the Fed may continue to encourage investors to consider moving out of lower-yielding short-term bonds and into higher-yielding intermediate- and long-term bonds. Historically, the Fed has been one of the primary drivers of interest rates [Chart 3], but with the Fed on the sidelines, interest rate risk is reduced which will help keep yields lower than in the absence of such a promise.

### 3 The Fed Has Been a Primary Driver of Interest Rates



Source: Bloomberg, Federal Reserve, LPL Financial 11/02/11

The Fed may find itself increasingly between a rock and a hard place as 2012 matures. Too little growth and the fear of deflation is the “rock” that the Fed has been aggressively focused on avoiding. The Fed is much less concerned about the “hard place,” or all of the stimulus it has provided leading to too much inflation.

Furthermore, the Fed surprised investors twice in 2011. First, in August, by announcing the aforementioned commitment to remain on hold; and secondly, in September, by announcing a bolder-than-expected Operation Twist, a program to sell short-term Treasuries and buy long-term Treasuries to pressure long-term interest rates lower. In late October 2011, Fed officials discussed so-called Quantitative Easing 3 (QE3), or another round of large-scale securities purchases, perhaps this time in the mortgage-backed securities market. While we think another program of stimulus from the Fed faces high hurdles, it is clearly leaning towards keeping rates low, which is generally a positive for the bond market.

However, the Fed may find itself increasingly between a rock and a hard place as 2012 matures. Too little growth and the fear of deflation is the “rock” that the Fed has been aggressively focused on avoiding. The Fed is much less concerned about the “hard place,” or all of the stimulus it has provided leading to too much inflation. Now, the distance between the two risks is far apart. However, the Fed may find itself in an increasingly narrow gap between a rock and a hard place as 2012 matures leading to higher yields in the bond market by year-end.

The Fed has pumped a record-breaking amount of dollars into the financial system, much of which is sitting on bank balance sheets waiting to be lent out to stimulate economic growth. Demand has cooled and the extra money in the system is not yet resulting in too many dollars chasing too few goods and services leading to generally higher prices. But, the Fed has piled up so much kindling in the form of stimulus that when the spark of growth finally ignites it may start a raging fire that will quickly stoke inflation. This abrupt shift from too little growth to too much inflation could happen relatively quickly.

Even though the Fed has committed to keeping rates low until mid-2013, inflation worries may begin in 2012, gradually pressuring yields higher and, commensurately, bond prices lower. This may also mean that the Fed will not have the luxury of slow 0.25%-at-a-time interest rate hikes in 2013 and instead may have to slam on the brakes with much larger rate hikes. The potential for aggressive rate hikes from the Fed in 2013, combined with the negative consequences it would have for housing and borrowing, may limit the rise in yields in 2012 to under 3% on the 10-year Treasury note.

While the Fed may have to scramble in 2013 to begin to take up some of the extraordinary amount of monetary stimulus now in the system, in the meantime it is likely that the economy will fail to live up to the Fed’s relatively lofty expectations for growth. The Fed’s economic projections released from the November 2011 Fed meeting call for 2.5–2.9% GDP growth in 2012, well above our estimate of 2%, and an even more robust 3.0–3.5% pace of growth in 2013. [\[See accompanying table on page 13\]](#)

The slow pace of growth and high unemployment rate will continue to widen the output gap. The output gap is the difference between the economy’s long-term growth rate and the economy’s current growth trajectory. In general, the wider the output gap, the greater the slack in the economy, such as high unemployment, high vacancy rates and low rates of resource utilization. The greater the slack in the economy, the lower the risk of inflation and the higher the risk of deflation, or falling wages and prices. While a severe bout of deflation is unlikely, the Fed has to guard against this outcome. As the economy fails to produce growth on par with the Fed’s expectations, they may consider adding even more policy stimulus to the system, including QE3, once the current Fed stimulus program, Operation Twist, concludes in June 2012. In 2012, the Fed may also communicate its forecast for the Fed Funds

Rate in order to give the public, as well as financial markets, even more clarity on interest rates and monetary policy and seek to make any moves in interest rates gradual.

#### Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents (%)

Variable	Central Tendency <sup>1</sup>					Range <sup>2</sup>				
	2011	2012	2013	2014	Longer Run	2011	2012	2013	2014	Longer Run
Change in Real GDP	1.6–1.7	2.5–2.9	3.0–3.5	3.0–3.9	2.4–2.7	1.6–1.8	2.3–3.5	2.7–4.0	2.7–4.5	2.2–3.0
June Projection	2.7–2.9	3.3–3.7	3.5–4.2	N/A	2.5–2.8	2.5–3.0	2.2–4.0	3.0–4.5	N/A	2.4–3.0
Unemployment Rate	9.0–9.1	8.5–8.7	7.8–8.2	6.8–7.7	5.2–6.0	8.9–9.1	8.1–8.9	7.5–8.4	6.5–8.0	5.0–6.0
June Projection	8.6–8.9	7.8–8.2	7.0–7.5	N/A	5.2–5.6	8.4–9.1	7.5–8.7	6.5–8.3	N/A	5.0–6.0
PCE Inflation	2.7–2.9	1.4–2.0	1.5–2.0	1.5–2.0	1.7–2.0	2.5–3.3	1.4–2.8	1.4–2.5	1.5–2.4	1.5–2.0
June Projection	2.3–2.5	1.5–2.0	1.5–2.0	N/A	1.7–2.0	2.1–3.5	1.2–2.8	1.3–2.5	N/A	1.5–2.0
Core PCE Inflation <sup>3</sup>	1.8–1.9	1.5–2.0	1.4–1.9	1.5–2.0	N/A	1.7–2.0	1.3–2.1	1.4–2.1	1.4–2.2	N/A
June Projection	1.5–1.8	1.4–2.0	1.4–2.0	N/A	N/A	1.5–2.3	1.2–2.5	1.3–2.5	N/A	N/A

Source: Federal Reserve November 2011

Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The June projections were made in conjunction with the meeting of the Federal Open Market Committee on June 21–22, 2011.

1. The central tendency excludes the three highest and three lowest projections for each variable in each year.

2. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

3. Longer-run projections for core PCE inflation are not collected.

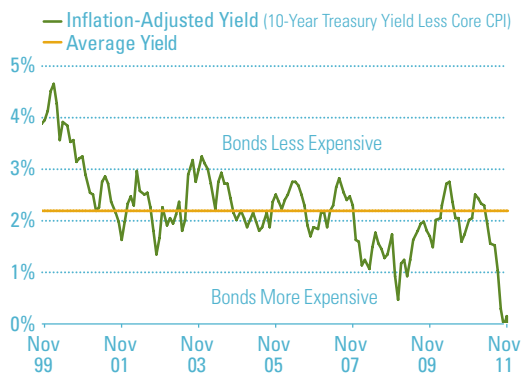
### Other Factors Help Keep Yields Rangebound

Beyond the critical issue of Fed policy in 2012 there are a number of additional factors that should support a range-bound bond market and keep Treasury yields low relative to history including: sluggish economic growth, tightening fiscal policy, stable inflation and European debt developments.

- **Sluggish Growth:** The bond market became priced for recession during 2011. Avoiding recession is likely to lift yields, but our outlook for below-average U.S. economic growth in 2012 keeps a lid on upward pressure on interest rates. Low growth means slack demand for borrowing (at least for the private sector) and less income growth to contribute to a broad rise in inflation.
- **Tightening Fiscal Policy:** Stimulus enacted in 2010 will begin to fade in 2012. Congress still needs to act in order to extend payroll tax cuts and unemployment benefits which are set to expire at the end of 2011. Furthermore, the Bush tax cuts are slated to expire at the end of 2012. And finally, the over \$1 trillion in deficit reduction over the next 10 years, mandated by the August 2011 debt ceiling deal, would trigger broad-based cuts to discretionary spending starting in 2013. The increasing economic drag from a slowing pace of government spending, combined with less need to finance a growing deficit, will likely be a factor throughout 2012 and help support bond prices and keep yields low.
- **Stable Inflation:** The pace of inflation more than doubled from late 2010 to late 2011. While bond market pricing indicates a deceleration in inflation, we believe inflation rates are likely to simply stabilize at current levels.

Treasury valuations remain more expensive than during the peak of the financial crisis — such a valuation is not warranted and current Treasury valuations are unsustainable.

#### 4 Extreme Treasury Valuations Are Unsustainable



Source: Bloomberg, LPL Financial 11/02/11

Past performance is no guarantee of future results.

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month.

This may lift yields from current levels in 2012, but it would likely take continued acceleration to push yields sharply higher. Still, stable inflation should erode the premium embedded in Treasury valuations.

- European Debt Developments:** The European summit in late October 2011 produced measures that were clearly a positive and remove the extreme risks in our view. However, details will be slowly forthcoming over the next several months and implementation risks remain. Bouts of safe-haven buying of Treasuries may occur if delays or disruptions undermine market confidence or if European economic growth becomes weaker than expected and investors deem recently agreed upon safeguards as insufficient causing peripheral European government bond weakness.

All of these factors lead to Treasury yields remaining low relative to history. The real, or inflation-adjusted, yield of the 10-year Treasury is likely to remain below the average of the past decade. However, as [Chart 4](#) reveals, Treasury valuations remain more expensive than during the peak of the financial crisis—such a valuation is not warranted and is consequently unsustainable. Therefore, we expect the safety premium in Treasuries to slowly erode causing the 10-year Treasury yield to finish 2012 at the upper end of our 1.7–3% yield range. Assuming core inflation remains stable at 2%, a 3% 10-year Treasury yield results in a 1% inflation-adjusted yield. This is still more expensive than average, but far less extreme than the current valuation, relative to the period average illustrated in [Chart 4](#).

### Getting Credit

After stronger performance by the highest credit quality bonds in 2011, we believe the best potential for fixed income investors in 2012 remains in higher-yielding, more economically sensitive bonds, in particular High-Yield Bonds. Corporate bond valuations, both investment grade and high yield, still reflect a very high probability of recession, something that we believe only has a one-in-three chance of taking place.

High-yield bond pricing reflects an expected surge in defaults, which we believe is unwarranted. After the typical once-per-decade surge in defaults in 2008 and 2009, we have seen the default rate plunge. Corporate bond credit quality is solid, with high cash balances on corporate balance sheets and solid profit growth supporting interest payments. Furthermore, we believe the impact of credit contagion from Europe is much less than feared. We believe that corporate bonds, both investment grade and high yield, could outperform Treasuries in 2012 by a substantial margin as they offer relatively high yields and rising prices—the opposite of what we are likely to see from Treasuries in 2012. This may lead to some convergence in yields among different bond sectors in 2012, as they meet in the middle.

### Rising Yield Range and Converging Sector Yields

The performance gap between government and corporate bonds reverses in 2012 with corporate bonds outperforming as they post modest single-digit gains as interest rates rise and credit spreads narrow. Bond yields may be volatile within a 1.7–3% range, but we expect them to rise over the course of the year, with the yield on the 10-year Treasury ending 2012 around 3%. The impact of ongoing economic growth will help to normalize interest rates as will a continuation of Fed policy, stable inflation and tightening fiscal policy. The wide gap between yields on government bonds and those of other borrowers is likely to converge in 2012.



# Market-Moving Events in 2012

Major policy-driven events will converge on the financial markets in 2012. Europe's debt dilemma will continue to grab headlines and move markets. The 2012 elections in the United States are likely to hold significant consequences for investors. And the outlook for growth and financial stress in China will garner attention from investors.

## European Debt Dilemma: Better, but Not Over

The fear among some market participants is that a default by a European government will trigger the collapse of financial institutions and a crisis throughout Europe and beyond. This potential path echoes the chain reaction that followed the bankruptcy of Lehman Brothers in September 2008 that led to a global financial crisis.

In late October 2011, European policymakers crafted a ground-breaking agreement that addressed recapitalizing the banking system, created an orderly default by Greece and provided financial buffers against losses on future bond issuance among euro-zone members. All of these steps were in an effort to reverse the tide of money that flowed out of the European sovereign bond market and pushed up borrowing costs. These actions have averted a 2008-like financial crisis. However, over the long term, concerns remain about the outlook for economic growth in Europe and the ability of some countries to meet budget targets.

As hurdles to implementation of the debt plan are materializing, bond yields of some European nations have risen to levels that make progress on balancing budgets very difficult. There are seven European countries with yields over 6%. Italian and Spanish 10-year borrowing costs are near the 7% threshold that forced Greece, Ireland, and Portugal to seek bailouts in 2010.

The long-term success of these efforts is dependent upon European nations taking additional steps to adhere to their plans for achieving financial stability and deficit reduction. It is no coincidence that Greece, Italy and Spain have seen a change to their governments in 2011. Lack of enforcement of budget rules is a big part of what drove Europe to the current state. Going forward, the European policymakers want to ensure important steps are taken before extending additional support. We expect the passage of the difficult, but

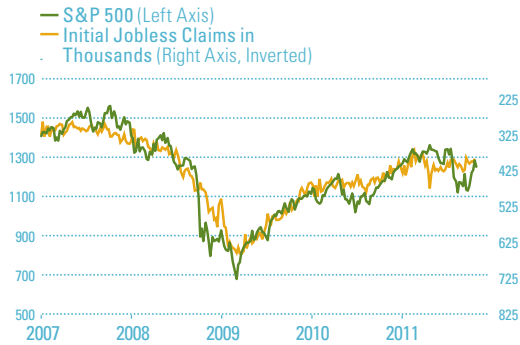
## European 10-Year Government Bond Yields

Greece	26.5%
Portugal	12.0%
Hungary	9.3%
Ireland	9.3%
Italy	7.2%
Spain	6.6%
Poland	6.1%
Belgium	5.8%
Czech Rep	4.2%
Austria	3.8%
France	3.7%
Finland	2.9%
Netherlands	2.7%
Norway	2.3%
UK	2.3%
Germany	2.3%
Denmark	2.0%
Sweden	1.6%
Switzerland	0.8%

Source: Bloomberg data 11/27/11

**It is no coincidence that Greece, Italy and Spain have seen a change to their governments in 2011.**

## 5 Stock Market Tracking Economic, Rather Than European, Developments



Source: Bloomberg, LPL Financial 11/04/11

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

necessary, reforms among the troubled nations, including Italy, to return to a sustainable fiscal path as 2011 turns to 2012.

The concerns may be shifting from a crisis to a recession in Europe. It is likely that Europe will experience a mild recession next year. Some nations in Europe are already on the brink of, or have entered, mild recessions. However, European growth could be even weaker in light of the spending austerity and potential for less lending by the banks. The key to a successful European stabilization plan is for the European Central Bank to commit to the path of rate cuts established in November 2011 so as to promote growth and lending.

With every move in the stock market seeming to coincide with a headline coming out of Europe, it would be easy to conclude that this is the only issue that matters to investors. But stepping back from the day-to-day and week-to-week trading, we can see a different, longer-term pattern of performance emerging—one that reflects a different focus entirely.

If we look back at the past five years, we can see that stocks have very closely tracked real-time economic data, as measured by the weekly tally of initial claims for unemployment benefits [Chart 5]. It appears the issues in Europe over the past couple of years have merely created volatility around the true focus of investors on the fundamental economic backdrop that continues to slowly improve.

## 2012 Elections May Have Major Consequences

In 2011, the markets disliked the uncertainty and the bickering among a divided Congress. The elections in 2012 may bring a new Congress with a mandate for action and enough control by one party to accomplish it.

The key fight this election is over those in the middle. While those that identify with a party are unlikely to shift allegiance, independent voters are the swing factor. For example, 80% of Democrats approve of the job President Obama is doing, while only 12% of Republicans do. In the middle is the independent voter whose approval rating of the President has been fading and now stands at only 37% [Chart 6].

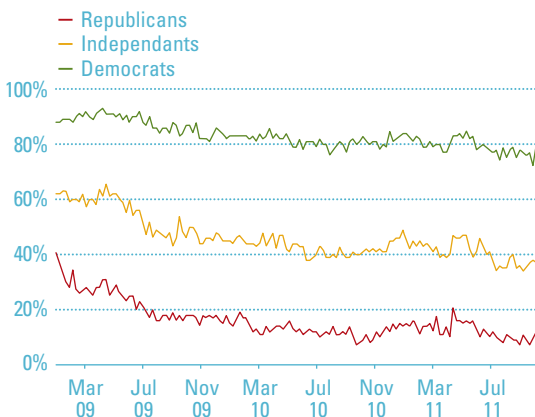
Before we share our insights into what is unique to this particular election for investors, we will present the typical pattern of performance in election years. Historically, the four-year presidential cycle of stock market performance has been driven largely by changes in monetary and fiscal stimulus to the economy. These changes are evident again in this cycle. In fact, the S&P 500 again traced much of its average performance during the presidential cycle [Chart 7].

However, there has been a deviation from the pattern with the decline in stocks in mid-2011. Stocks have begun to close this gap, but are unlikely to reconnect with the historical pattern of performance.

As we look out to the next year, it would seem that a flat year for stocks is in store, based on the presidential pattern [Chart 7]. However, what is important to note in Chart 8 is that while it is true that the first three quarters of a presidential election year are usually pretty flat, the fourth quarter is not and tends to break out. This breakout was to the upside in 1992, 1996 and 2004 and to the downside in 2000 and 2008.

Most often the breakout is to the upside as the uncertainty surrounding the fiscal and regulatory policy environment resolves. However, 2008's dismal fourth quarter performance—as the global financial crisis erupted from the

## 6 Obama Job Approval by Party Affiliation



Source: Gallup 11/08/11

failure of Lehman Brothers—lowered the long-term average to reflect a fourth quarter dip [Chart 8].

The 2012 election is likely to be consequential for investors. There is a growing consensus that a plan to save about \$4–5 trillion over the next decade is necessary to stabilize the debt-to-GDP ratio in the United States. Despite the efforts of the “super committee” tasked with finding the \$1.5 trillion agreed to in the terms of the debt ceiling deal crafted in early August 2011, a package this size is unlikely to become law before the election.

Since Congress is unlikely to pass a major deficit reduction bill before the 2012 election, the outcome will have major implications for investors. The party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in the federal budget policy since WWII. While it is still early, it appears that the GOP will retain control of the House and may pick up enough seats to take control of the Senate by a modest margin, based on polling data and the fact that two-thirds of the seats up for election in the Senate are currently held by Democrats. Having both chambers in the hands of one party greatly increases the odds of policy action.

Failure to pass a major deficit reduction package in the wake of the 2012 election, regardless of what the rating agencies do, will likely result in a loss of faith by investors that the federal government will get on a fiscally sustainable path absent a financial crisis. Of course, this loss of faith could create a crisis, with major implications for the markets, and force a major deficit reduction deal.

Regardless of the details of the plan—and we have many proposals to choose from blending a mix of tax increases and spending cuts—most proposals phase in the impact so it is not until five years from now that the full impact would be felt. The cuts would likely be equivalent to about 3% of GDP, or about 14% of the federal budget. This would be one of the biggest policy shifts in modern U.S. history. While the markets may welcome a resolution of the uncertainty and a path to fiscal sustainability, certain areas of the market may feel the brunt of the cuts, such as Health Care and the Defense industry. Other asset classes may be impacted as well if changes are made to the tax-advantaged status of municipal bonds for some taxpayers.

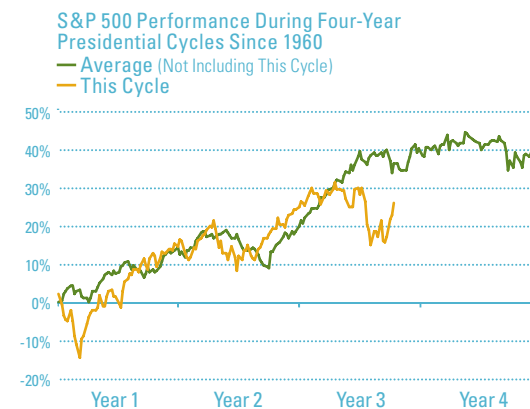
As we look out to the next few years, the old adage that the market likes “gridlock,” or balanced government between the two parties, may not hold. It is apparent in recent market performance that investors recognize that substantial, defining fiscal policy changes—difficult to forge in a divided Congress—are needed. We will be watching as the election battle heats up to gauge the market impact of what will likely be a very consequential election year.

### Growth and Financial Stress in China

The outlook for China is important to the markets in 2012 on two fronts. First, China’s growth trajectory and composition is important to world growth. Second, the risk of a banking collapse in China may grab investor attention.

China will likely grow about 8–9% in 2012, and avoid the “hard landing” scenario (5–6%) feared by some market participants. The slowdown they have planned and executed through what were originally thought to be crude means were remarkably effective. China is likely to shift from slowing speculative growth and inflation pressures to looking to maintain core growth in 2012.

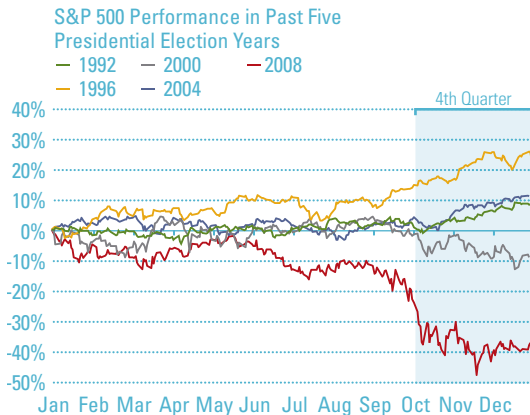
### 7 Presidential Cycle Pattern of Performance



Source: Bloomberg, LPL Financial 11/03/11

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

### 8 Recent Presidential Year Performance



Source: LPL Financial, Bloomberg 01/01/09

The S&P 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

**China will likely grow about 8–9% in 2012, and avoid the “hard landing” scenario (5–6%) feared by some market participants.**

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Additionally, China’s transition to become more consumer driven may be evident in 2012. China derives one-third of its growth from consumer spending, but this is likely to gain share as a percentage of GDP over the coming years as more urban consumers will desire more household appliances, electronics, healthcare and personal products. Rising city residency and steady full-time jobs are likely to lead to greater consumer credit availability and debt growth as the consumer economy matures.

However, on the negative side, Congress risks starting a trade war with one of our largest trading partners. There is already a bill that has passed the Senate that would impose tough tariffs on certain Chinese goods in the event of a finding by the Treasury that China was improperly valuing its currency to gain an economic advantage. The renewed trade pressure on China from the United States may result in more rapid currency appreciation versus the dollar further spurring a desire to grow domestic consumption in China.

A risk that may garner market attention is an overheated property market and overextended banking system in China. In some areas, China’s property markets are extended well beyond what is supported by the fundamentals. Bad loans in the Chinese banking system are on the rise and may increase sharply over the next several years. The Chinese banking system, for the most part, is the Chinese government. And the Chinese government has plenty of capital to help recapitalize the Chinese banking system if it becomes necessary. In fact, China has periodically recapitalized portions of its banking system several times in the past decade in order to continue to finance growth and avoid the social unrest that can come from rising unemployment. We do not expect a banking crisis to emerge in China in 2012, yet the headlines may provoke volatility.

There is the potential for many market-moving events in 2012—either to the middle or the fringes. 2012 will be a year to watch how these events develop abroad and in our own backyard.



# Investing in 2012

Rather than looking for a rock to hide under, investors should be looking under rocks to find investment opportunities in unusual places in 2012. While rising interest rates generally mean bonds should be avoided, not all bonds behave the same way. Fortunately, other sectors such as high-yield corporate bonds are likely to provide solid returns. Also, it is natural to think that if global economic growth is going to be weak then stocks are to be avoided. However, investors may find attractive returns by investing in U.S. stocks, particularly cyclical, mid and small caps, and emerging market stocks.

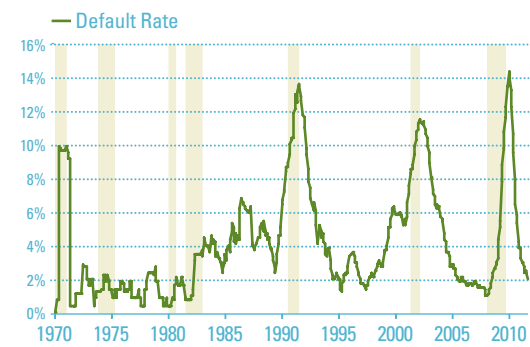
## Fixed Income Investing in an Environment of Rising Interest Rates

It would be easy to assume that the inverse relationship between bond prices and yield coupled with our forecast for modestly higher Treasury yields in 2012 would prompt us to recommend avoiding fixed income. Not all bonds behave the same way, however, and the potential to generate positive relative and absolute returns in a rising rate environment still exist. With the Fed on hold, the catalysts for higher rates will likely be modest growth prospects and rising inflation expectations. While negative for Treasuries, these drivers are positives for more economically sensitive high-yield bonds. The prospect of rising rates, attractive valuations and improving fundamentals contribute to our thesis that high-yield bonds represent one of the best opportunities for fixed income investors in 2012.

High-yield bonds tend to demonstrate much less sensitivity to changes in interest rates than most high-grade fixed income sectors. Since 1983, the start of the Barclays Capital High-Yield Bond Index, the trajectory of Treasury yields has been a downward path, albeit with bouts of volatility. The 5-year Treasury yield, which shares about the same duration as high-yield bonds, has finished the year higher in just 11 of those 27 years. In each of those years, high-yield bonds generated excess returns over the Barclays Capital Aggregate Bond Index, with an average excess return of 6%. During the 16 years in which the 5-year Treasury yield finished lower, high-yield bonds

With the Fed on hold, the catalysts for higher rates will likely be modest growth prospects and rising inflation expectations.

## 9 High-Yield Default Rate Unlikely to Double Spike



Source: Moody's, NBER, LPL Financial 10/31/11

Shaded areas indicate recession.

Default rate is the rate at which debt holders default on the amount of money that they owe. It is often used by credit card companies when setting interest rates, but also refers to the rate at which corporations default on their loans. Default rates tend to rise during economic downturns, since investors and businesses see a decline in income and sales while still required to pay off the same amount of debt.

underperformed by an average of 4% and outperformed 7 times. History suggests that if our forecast for higher Treasury yields at the end 2012 proves accurate, high-yield bond investors are poised to take advantage.

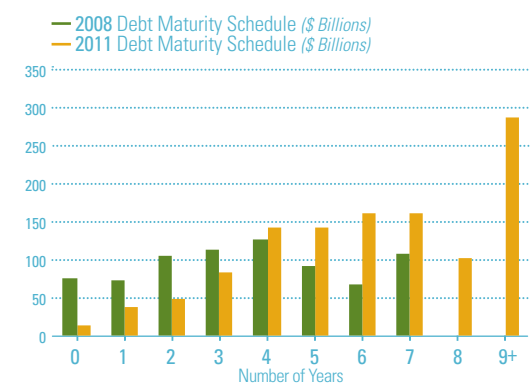
Since emerging from the financial crisis in 2009, fundamentals for high-yield companies have steadily improved. Leverage ratios, measuring the indebtedness of U.S. corporations, have declined for eight consecutive quarters and may stabilize in 2012, similar to past credit cycles. Improved earnings results and a focus on de-risking balance sheets will enable companies to better meet their debt obligations going forward. Highly leveraged companies at the start of the Great Recession have either defaulted and are no longer operating or have restructured their debt and reduced their interest burden. The result is that surviving high-yield companies are better positioned to withstand an economic soft spot and should thrive in a slow to moderate growth environment.

Valuations on high-yield bonds are attractive in our view and appear to more than compensate for default risk. The average yield premium of high-yield bonds to Treasuries of roughly 7.5% implies a default rate of between 7–8%, a sharp increase from the 1.8% trailing 12-month default rate reported by Moody's at the end of November 2011. While yield spreads may prove volatile and spike during periods of market stress, the default rate has historically been more stable and "double spikes" in the default rate have never occurred [Chart 9]. Credit cycles last for several years and sharp downturns are followed by long periods of stability during which default rates have remained low.

Capital markets have proven extremely receptive to high-yield borrowers over the last three years and companies have taken advantage by refinancing their debt. Low rates on Treasuries have enabled companies to reduce their borrowing costs despite above-average yield spreads. Back in 2008, the impending wall of maturities coming due for high-yield companies, shown in Chart 10, raised concerns that the default rate could remain elevated for several years. High-yield companies responded by refinancing their debt and extending the maturity several years into the future. More than \$200 billion of new issuance has come to market in 2011, second only to the record pace of 2010. Rather than engaging in shareholder friendly activity, 65% of the proceeds from new issuance have been used to refinance debt.

The segments of the bond market that we believe may deliver the best rewards are: High-Yield Corporate Bonds, Municipal Bonds and Emerging Market Debt.

## 10 High-Yield Maturity Wall has Been Extended



Source: JP Morgan, LPL Financial 10/31/11

- **High-Yield Corporate Bonds:** We believe the best opportunities for fixed income investors remain in higher-yielding, more economically sensitive bonds, in particular high-yield bonds. Corporate bond valuations, both investment grade and high yield, still reflect a very high probability of recession; something that we believe only has a one-in-three chance of taking place. The high-yield bond sector reflects an expected surge in defaults, which we believe is unwarranted. Furthermore, we believe the impact of credit contagion from Europe is much less than feared. Corporate bond credit quality is solid with substantial cash balances in corporate America, coupled with strong profit growth supporting interest payments and continuing a low default rate.

- **Municipal Bonds:** We continue to find municipal bonds attractive for 2012. Top-quality municipal bond yields exceed those of Treasuries and have led to some of the most attractive valuations since spring 2009. However, the now lower level of yields suggests a slower pace of

performance going forward and investors should temper expectations. We expect a mid-single-digit return for Municipal Bonds in 2012. A repeat of 2011's high-single-digit return, which was fueled by panicky valuations at the start of 2011 and higher yields, is unlikely.

- **Emerging Market Debt:** Among global bonds, we find Emerging Market Debt attractive but would avoid foreign bonds, which contain exposure to Japanese and European government bonds. We still expect emerging market (EM) economic growth to be two or three times stronger than that of developed countries and find market concerns over a recession among emerging market countries as vastly overstated. While we find a greater opportunity in High-Yield Bonds, EM Debt valuations remain attractive—offering a greater than 3% yield advantage to comparable Treasuries.

While we acknowledge that Treasury yields will continue to experience bouts of volatility during 2012, our bias is that they are unlikely to remain near record low levels and will ultimately finish the year higher. Rising rate environments do not necessarily translate into lackluster returns for all types of fixed income investments and high-yield bonds are likely to benefit. High-yield companies are well positioned to withstand a backdrop of below-trend growth, given actions taken to reduce leverage and extend maturities. Default rates may increase modestly, but valuations more than compensate. High-grade bond investors may have to accept low single-digit rates of return, but high-yield investors have more reasons for optimism.

## Stock Market Investing in a Sluggish Global Economy

It is natural to think that if global economic growth is going to be weak then stocks are to be avoided. However, despite our outlook for sluggish U.S. economic growth of about 2% and a mild recession for Europe in 2012, we expect high single-to low-double-digit returns for the S&P 500. We expect these gains to be driven by earnings growth in the high single digits and a modest rise in the PE ratio from recession-like levels as sentiment begins to rebound. Domestically, we expect stocks to decouple from U.S. GDP growth, as corporate profits are driven more by business spending and manufacturing than the more consumer spending-driven GDP. Overseas, while Europe is likely to experience a mild recession in 2012 and Japan struggles to rebound from recession, solid growth is expected in emerging economies benefitting a substantial 25% of U.S. corporate revenues. The net result is slow growth, rather than a contraction that would not favor stock market exposure.

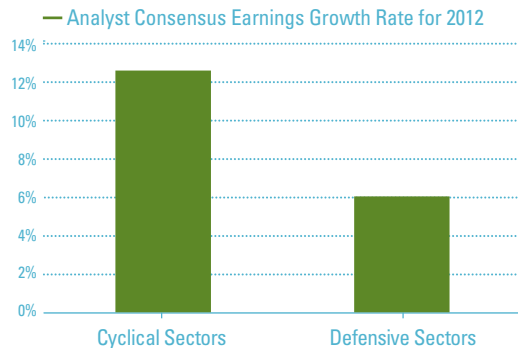
Slow growth is not bad for the stock market. In fact, over the past 40 years, the S&P 500 median return is 10% when real GDP grows less than 3%. More important for stocks than domestic GDP growth is business spending, which we forecast to grow at several times the pace of consumer spending in 2012. In the third quarter of 2011, capital spending by businesses on equipment and software rose at a strong annualized rate of over 17%.

As the business cycle matures, growth often becomes variable. With the official end of the last recession in mid-2009, mid-2012 will mark three years of expansion. GDP and corporate profits have rebounded to an all-time high. As we progress from the early stage of rebound to the middle stage of slower and more variable growth, stocks still tend to provide solid returns—although lower than in the early years of the rebound. Looking back at mid-cycle years during the last two business cycles, 1995 and 2006, they experienced slower-than-average economic growth but produced double-digit gains for the stock

## Active Management

2011 was a very difficult year for active equity portfolio managers with a small minority of managers (roughly 20%) beating their respective benchmarks. Stocks have diverged from company fundamentals as macroeconomic developments dominated, and correlations among individual stocks have been very high, creating a challenging environment for portfolio managers to outperform. Manager performance moves in cycles and we expect 2012 to be marked by a turn in the success of active managers.

## 11 Wall Street Analysts Expect Stronger Earnings Growth for Cyclical Sectors in 2012

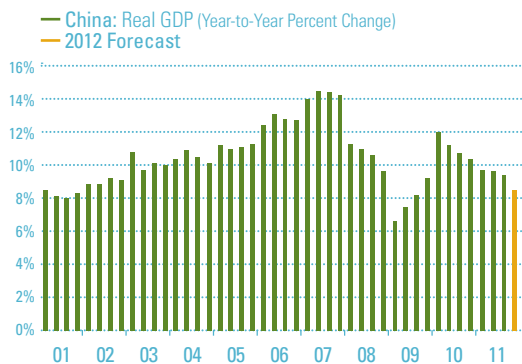


Source: LPL Financial Research, Factset 11/04/11

Cyclical Sectors include Consumer Discretionary, Energy, Financials, Industrials, Technology and Materials. Defensive Sectors include Consumer Staples, Health Care, Telecom and Utilities.

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

## 12 Despite Slowing Markedly Over the Past Year, China's Economy is Still Growing Solidly



Source: China National Bureau of Statistics, Haver Analytics 11/04/11

Past performance is no guarantee of future results.

market. During those years, business spending increased at high single-digit to low double-digit rates, while consumer spending grew at a modest pace between 2–3%, similar to what we expect in 2012.

The stage of the business cycle can also be a guide as to where to invest within the equity market. Periods in the middle of business cycles tend to favor the most economically sensitive, or cyclical sectors, such as Industrials. Although there may be opportunities to move into defensive sectors in 2012 tactically over the course of what we expect will be another volatile year, we expect better returns from the more economically sensitive sectors. Stocks continue to price in a very pessimistic growth and profit outlook. While we believe the Wall Street analyst consensus for earnings growth is a bit too high for next year, we agree with the analysts that companies in more cyclical sectors are likely to grow earnings at a more rapid pace than those in defensive sectors in 2012 [Chart 11].

In 2012, stock market investors may benefit from focusing on areas that are likely to be rewarded by the strongest areas of growth driven by business spending and emerging market demand: Commodity Stocks, Small and Mid Caps, and Emerging Markets.

- Commodity Stocks:** The stocks of commodity producers are well positioned heading into 2012 due to their exposure to fast-growing demand from emerging market economies as well as their cyclicality. Very stimulative U.S. monetary policy, a weak dollar and emerging supply constraints in several key commodities, including copper, should also be supportive. We believe these stocks will perform well if China's growth stabilizes (a soft landing) after deliberately slowing in the past couple of years. Commodity stocks are trading at below-average historical relative valuations despite the favorable, middle stage of the U.S. business cycle that has historically favored these stocks along with strong growth prospects in emerging market countries.
- Small- and Mid-Cap U.S. Stocks:** We expect Small- and Mid-Cap U.S. stocks can provide attractive returns for investors in 2012. Smaller capitalization companies tend to perform better after the economy emerges from mid-cycle soft spots and credit markets improve. We expect Small and Mid Caps to benefit from increased merger and acquisition activity in 2012 due to the significant amount of cash, north of \$1 trillion, on non-financial company balance sheets. Potential headwinds include less exposure to fast-growing emerging market economies. We believe Mid Growth is particularly well positioned due to the concentration in cyclical sectors.
- Emerging Markets:** We see attractive return potential in 2012 for Emerging Markets as economic growth far exceeds that of the developed world. In addition, monetary policy is becoming more positive with central banks beginning to reverse course and cut interest rates. We see China averting a hard landing, growing in the 8–9% range rather than 5–6% as some fear [Chart 12]. Emerging market economies in aggregate should only slow marginally in 2012 and still grow at about a 6% pace. A weaker US dollar may add to attractive Emerging Market returns in 2012.

In general, we caution investors not to ignore valuations to chase yield. We do not expect an emphasis on yield to be as rewarding in 2012 as it has been in 2011, since interest rates will likely rise and valuations for the highest yielding sectors leave less room for valuations to rise than the lower yielding, more cyclical sectors. Through November 2011, stocks in the S&P 500 yielding more than 3% have returned 4%, while those yielding less than 1% have matched the S&P 500 with essentially break-even returns.

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#### 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.

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 may involve risk including loss of principal.

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.

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.

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.

Credit quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Default risk is when companies or individuals will be unable to make the required payments on their debt obligations. Lenders and investors are exposed to default risk in virtually all forms of credit extensions. To mitigate the impact of default risk, lenders often charge rates of return that correspond to the debtor's level of default risk. The higher the risk, the higher the required return, and vice versa.

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

Health Care Sector: Companies are in two main industry groups—Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Moody's Inc. is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments. Moody's backs its ratings with exhaustive financial research and unbiased commentary and analysis.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Information Technology Sector: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

Quantitative easing 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.

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

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Spread is the difference between the bid and the ask price of a security or asset.

Mortgage-Backed Securities are subject to credit risk, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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

Mutual Fund investing involves risk which may include loss of principal.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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 Capital High-Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

Barclays Aggregate Bond Index is comprised of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least \$100 million.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

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

Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

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.

Mid-capitalization companies are subject to higher volatility than those of larger capitalized companies.

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