

# Portfolio Compass



December 4, 2014

## Navigating the Markets

The *Portfolio Compass* provides a snapshot of LPL Financial Research’s views on equity and alternative asset classes, the equity sectors, and fixed income. This biweekly publication illustrates our current views and will change as needed over a 3- to 12-month time horizon.

### Reading the *Portfolio Compass*

Fundamental, technical, and valuation characteristics for each category are shown by colored squares.

Negative, neutral, or positive views are illustrated by a solid black bar positioned over the color scale, while an outlined black bar with an arrow indicates change and shows the previous view.

Rationales for our views are provided beneath each category.

Simple moving average is a simple, or arithmetic, moving average that is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods.

All performance referenced herein is as of December 2, 2014, unless otherwise noted.

### Compass Changes

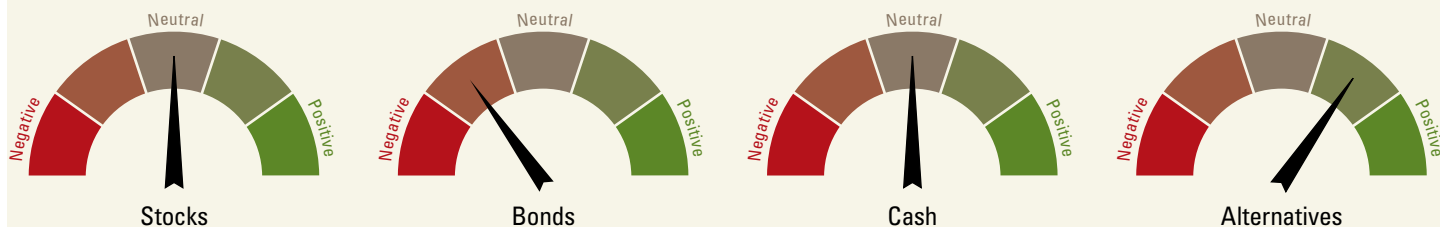
- No changes.

### Investment Takeaways

- We continue to favor U.S. stocks based on our just released *Outlook 2015: In Transit*, where we forecast high-single-digit S&P 500 returns in 2015, supported by estimated 5–10% earnings growth and stable price-to-earnings (PE) ratio.\*
- We favor U.S. stocks over their foreign counterparts due primarily to lackluster growth and structural impediments in Europe. Emerging markets are a top idea for 2015, but technicals hold us back in the near term.
- We continue to favor cyclical growth sectors, which tend to do well during the middle to late stages of the business cycle. Energy is an intriguing contrarian opportunity but caution is warranted.
- The decline in oil prices suggests a later start to Federal Reserve (Fed) rate hikes and may continue to support bonds over the near term.
- High-yield bonds continue to struggle amid the energy sector headwind and heavy new issuance. Longer-term, strong earnings, low defaults, and now more attractive valuations should help support the sector.
- From a technical perspective, the S&P 500 remains above its 200-day simple moving average and near all-time highs, which suggests the long-term trend remains bullish.

### Broad Asset Class Views

LPL Financial Research’s views on stocks, bonds, cash, and alternatives are illustrated below. The positions of negative, neutral, or positive are indicated by the solid black compass needle, while an outlined needle shows a previous view.



## Equity & Alternative Asset Classes

### Continue to Favor U.S. Stocks over International

- We forecast high-single-digit S&P 500 returns for 2015, supported by estimated 5–10% earnings growth and stable PE ratio.\*
- The upcoming third year of the four-year presidential cycle and the changing political landscape may bode well for stock market performance in 2015.
- We favor U.S. over large foreign, primarily due to our cautious view of Europe in spite of European Central Bank (ECB) actions. Europe is on the verge of another recession and structural impediments to faster growth remain.
- Emerging markets are one of our best ideas for 2015, but technicals are holding us back in the near term.
- We expect small caps to recapture some of this year's underperformance in the near term, although we have tempered our enthusiasm some as the business cycle matures, and we expect a sustained leadership shift toward large caps to occur in 2015.
- We maintain a preference for growth over value, based on cyclical sector exposure and relative valuations.
- The sharp sell-off in crude oil may provide an intriguing opportunity for a technical bounce in the commodity, although we believe caution is warranted due to ongoing supply pressures.
- Our positive alternative investments view reflects our interest in alternative sources of bond-like returns with less interest rate sensitivity, such as merger arbitrage. Central bank policy divergence provides an opportunity for global macro.

\* 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.

		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Style/Capitalization	Large Growth	■	■	■	■	■	■	
	Large Value	■	■	■	■	■	■	
	We see a shift in leadership to large caps in 2015 as the business cycle matures, but small caps may recover in the near term. Our cyclical sector preferences and valuations favor growth over value.							
	Mid Growth	■	■	■	■	■	■	
	Mid Value	■	■	■	■	■	■	
	Positive mid growth view reflects cyclical sector exposure, earnings growth, and potential up-capture. Mid should benefit from continued healthy acquisition activity.							
	Small Growth	■	■	■	■	■	■	
	Small Value	■	■	■	■	■	■	
Region	We expect small caps to pare some of this year's underperformance in the near term, though the aging of the business cycle leaves us less optimistic in 2015.							
	U.S. Stocks	■	■	■	■	■	■	
	Large Foreign	■	■	■	■	■	■	
	Small Foreign	■	■	■	■	■	■	
	Emerging Markets	■	■	■	■	■	■	
We favor U.S. over large foreign, primarily due to Europe's sluggish growth and structural constraints. Improving fundamentals and low valuations make EM one of our best ideas for 2015, but we would like better technicals and stable oil prices to consider a more positive near-term view.								
REITs	■	■	■	■	■	■	■	
Interest rate risk and above-average valuations keep us cautious; better job market helps some.								
Commodities	Industrial Metals	■	■	■	■	■	■	
	Precious Metals	■	■	■	■	■	■	
	Energy	■	■	■	■	■	■	
	Agricultural	■	■	■	■	■	■	
	After its sharp decline, oil is an intriguing opportunity on a potential technical bounce, but supply pressures suggest caution is warranted. Fed tightening, interest rate risk, and technicals keep us neutral on precious metals. Supply pressures continue to weigh on agriculture commodities.							
Other	Non-Correlated Strategies				■	■	■	
	Favor long/short equity funds that may participate in rising and falling markets, and event-driven funds for capital structure and merger arbitrage opportunities. Unconstrained eclectic well suited for opportunistic allocations. View low volatility alternative investment (AI) strategies as bond substitutes.							

Unconstrained eclectic strategies have a flexible investment style that does not limit the fund to a single asset class or security type.

Real estate/REITs may result in potential illiquidity and there is no assurance the objectives of the program will be attained. The fast price swings of commodities will result in significant volatility in an investor's holdings. International and emerging markets involve special risks such as currency fluctuation and political instability. The price of small and mid cap stocks are generally more volatile than large cap stocks. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. 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. These securities may not be suitable for all investors. Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses. Stock investing may involve risk including loss of principal.

## Equity Sectors

### Favor Cyclical Growth Sectors for Another Mid-Cycle Year in 2015

- We continue to favor cyclical growth sectors, which tend to do well during the middle to late stages of the business cycle.
- We have tempered our positive view of consumer discretionary as the business cycle matures, though we expect a good holiday shopping season.
- We expect industrials to benefit from improved U.S. business spending and were encouraged by how the sector managed slower growth in Europe during third quarter earnings season.
- Fundamentals, valuations, and technicals all support our positive technology view.
- The sharp OPEC-driven drop in oil may slow the U.S. energy renaissance, but it won't stop it. Caution is warranted, but oil's heavy losses provide an intriguing potential contrarian opportunity.
- Strong loan demand and potential for steeper yield curve offset the tough interest rate and regulatory environment for financials, leaving us neutral. We favor regional banks.
- We remain focused on cyclical sectors; though solid earnings, innovation, and Affordable Care Act (ACA)-related demand are positives for healthcare, and lower commodity costs help consumer staples companies' profit margins.
- We remain cautious on telecom and utilities due to their interest rate sensitivity, though telecom valuations are reasonable.

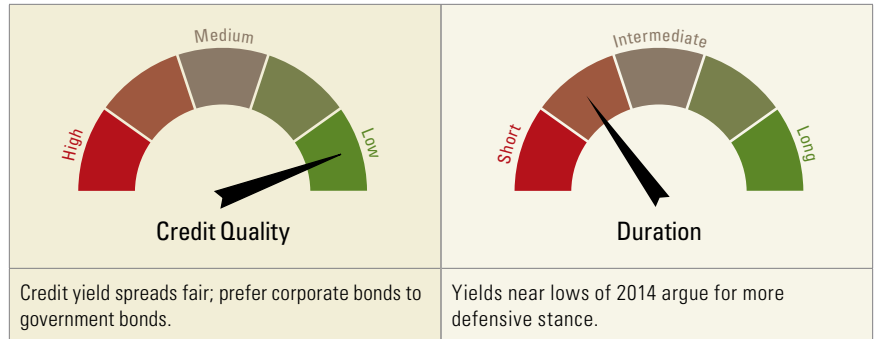
	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	S&P 500 Weight (%)	
Cyclical	Materials	■	■	■				3.2
	Chinese rate cut helps but we would like to see better growth in China to get more positive..							
	Energy	■	■	■				8.5
	Intriguing contrarian opportunity but supply pressures suggest caution is warranted.							
	Industrials	■	■	■				10.4
	We expect a pickup in business spending; solid earnings season despite headwinds; favor transports.							
	Consumer Discretionary	■	■	■				11.9
	We expect a pickup in business spending; solid earnings season despite headwinds; favor transports.							
	Technology	■	■	■				19.8
	Earnings, improving business spending, valuations, and technicals all supportive; more positive bias.							
Defensive	Financials	■	■	■				16.4
	Likely steeper yield curve and solid loan demand offset tough interest rate and regulatory climate.							
	Utilities	■	■	■				3.1
	Our negative view reflects interest rate risk, rich valuations, and our preference for cyclicals.							
	Healthcare	■	■	■				14.5
	Favorite defensive sector on solid earnings, robust innovation, and ACA-demand lift; positive bias.							
Consumer Staples	■	■	■				9.9	
Still favor cyclical sectors and Europe's slowdown is a risk, but low commodity prices help margins.								
Telecommunications	■	■	■				2.3	
Interest rate and business risks remain; valuations are below the S&P 500 and long-term averages.								

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

# Fixed Income

## Oil Slick

- The decline in oil prices has kept growth fears alive; resulting implications for low inflation and a later start to Fed rate hikes may continue to support bonds and the current lower yield range over the near term.
- Still low yields and higher valuations suggest very low future returns, and a lower than benchmark weighting to bonds may be appropriate.
- Municipal bond supply both new issue and in the secondary has led to minor underperformance to Treasuries. Valuations have cheapened but overall yields remain very low to compensate for potential longer-term interest rate risks. Supply/demand turns more favorable in mid-December.



		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Tax-Free Bonds	Munis-Short-Term	■	■	■	[Gauge: Needle in Negative zone]			
	Relative valuations improving due to strength in intermediate and long but yields still very low.							
	Munis-Intermediate-Term	■	■	■	[Gauge: Needle in Neutral zone]			
	Our preferred maturity exposure, but valuations are higher.							
	Munis-Long-Term	■	■	■	[Gauge: Needle in Neutral zone]			
	Treasury-induced strength is fading and may be subject to further reversal.							
Munis-High-Yield	■	■	■	[Gauge: Needle in Negative zone]				
Default risk is low but recent long-term bond strength may have pushed prices too high.								

Continued on next page.

For the purposes of this publication, intermediate-term bonds have maturities between 3 and 10 years, and short-term bonds are those with maturities of less than 3 years.

All 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. High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. Municipal interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. 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.

## Fixed Income (CONT.)

### Oil Slick

- For fixed income allocations, we emphasize a blend of high-quality intermediate bonds coupled with less interest rate-sensitive sectors such as high-yield bonds and bank loans.
- High-yield bonds continue to struggle as the energy sector has been a headwind; but a primary driver is heavy new issuance from late October through early December, which is pressuring prices. Longer-term, strong earnings, low defaults, and now more attractive valuations should help support the sector.
- Among high-quality bonds, we favor investment-grade corporate bonds due to their economic sensitivity and good fundamentals.
- Yields are higher on dollar-denominated EM debt compared with several fixed income sectors. Valuations are roughly fair but need to reach a more compelling level before warranting more serious consideration.

	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Taxable Bonds – U.S.	Treasuries	■	■	■	■	■	
	Yields are still near the lows of 2014 and longer-term prospects are unattractive.						
	TIPS	■	■	■	■	■	
	Low actual inflation, lower energy prices, and above-average interest rate risk are negatives.						
	Mortgage-Backed Securities	■	■	■	■	■	
	Valuations are slightly expensive and yields near 2014 lows.						
	Investment-Grade Corporates	■	■	■	■	■	
	Yield spread to Treasuries back to average and credit quality is stable.						
	Preferred Securities	■	■	■	■	■	
	Valuations are only fair, but fundamentals are firm.						
Taxable Bonds – Foreign	High-Yield Corporates	■	■	■	■	■	
	Credit quality metrics are good, and defaults are low; one of the more attractive areas.						
	Bank Loans	■	■	■	■	■	
	Attractive due to short-term nature and above-average yield.						
	Foreign Bonds – Hedged	■	■	■	■	■	
More expensive relative to U.S. government bonds; significant negative news priced in.							
Foreign Bonds – Unhedged	■	■	■	■	■		
Low yields, unattractive valuations, and euro currency weakness poses risks.							
Emerging Markets Debt	■	■	■	■	■		
Yield spreads not high enough to indicate more attractive risk/reward.							

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

All 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. High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors. Mortgage-backed securities are subject to credit, 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. International and emerging market investing involves risks such as currency fluctuation and political instability and may not be suitable for all investors. 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. Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index — while providing a real rate of return guaranteed by the U.S. government. 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. Foreign Bonds – Hedged: Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure. Foreign Bonds – Unhedged: Non-U.S. fixed income securities normally denominated in major foreign currencies.

**DEFINITIONS:**
**EQUITY AND ALTERNATIVES ASSET CLASSES**

**Large Growth:** Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Large Value:** Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**Mid Growth:** The U.S. mid cap range for market capitalization typically falls between \$1 billion and \$8 billion and represents 20% of the total capitalization of the U.S. equity market. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Mid Value:** The U.S. mid cap range for market capitalization typically falls between \$1 billion and \$8 billion and represents 20% of the total capitalization of the U.S. equity market. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**Small Growth:** Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Small Value:** Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as small cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**U.S. Stocks:** Stock of companies domiciled in the U.S.

**Large Foreign:** Large cap foreign stocks have market capitalizations greater than \$5 billion. The majority of the holdings in the large foreign category are in the MSCI EAFE Index.

**Small Foreign:** Small cap foreign stocks typically have market capitalizations of \$250 million to \$1 billion. The majority of the holdings in the small foreign category are in the MSCI Small Cap EAFE Index.

**Emerging Markets:** Stocks of a single developing country or a grouping of developing countries. For the most part, these countries are in Eastern Europe, Africa, the Middle East, Latin America, the Far East, and Asia.

**REITs:** REITs are companies that develop and manage real estate properties. There are several different types of REITs, including apartment, factory-outlet, health care, hotel, industrial, mortgage, office, and shopping center REITs. This would also include real estate operating companies.

**Commodities – Industrial Metals:** Stocks in companies that mine base metals such as copper, aluminum, and iron ore. Also included are the actual metals themselves. Industrial metals companies are typically based in North America, Australia, or South Africa.

**Commodities – Precious Metals:** Stocks of companies that do gold- silver-, platinum-, and base-metal mining. Precious metals companies are typically based in North America, Australia, or South Africa.

**Commodities – Energy:** Stocks of companies that focus on integrated energy, oil and gas services, oil and gas exploration and equipment. Public energy companies are typically based in North America, Europe, the United Kingdom, and Latin America.

**Merger Arbitrage:** A hedge fund strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. A merger arbitrageur looks at the risk that the merger deal will not close on time, or at all. Because of this slight uncertainty, the target company's stock will typically sell at a discount to the price that the combined company will have when the merger is closed. This discrepancy is the arbitrageur's profit.

**Long/Short:** An investment strategy generally associated with hedge funds. It involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value.

**EQUITY SECTORS**

**Materials:** Companies that engage 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.

**Energy:** 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 or the exploration, production, marketing, refining, and/or transportation of oil and gas products, coal, and consumable fuels.

**Industrials:** 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.

**Consumer Discretionary:** Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services, and education services.

**Technology:** Companies 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 and equipment include manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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

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

**Healthcare:** Companies in two main industry groups: Healthcare equipment and supplies or companies that provide healthcare-related services, including distributors of healthcare products, providers of basic healthcare services, and owners and operators of healthcare facilities and organizations or companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

**Consumer Staples:** Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

**Telecommunications:** Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth, and/or fiber-optic cable network.

## FIXED INCOME

**Credit Quality:** 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.

**Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest rate risk or reward for bond prices.

**Munis – Short-Term:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of less than three years.

**Munis – Intermediate:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of between 3 and 10 years.

**Munis – Long-Term:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of more than 10 years.

**Munis – High-Yield:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally offer higher yields than other types of bonds, but they are also more vulnerable to economic and credit risk. These bonds are rated BB+ and below.

**Treasuries:** A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semiannually and the income that holders receive is only taxed at the federal level.

**TIPS (Treasury Inflation-Protected Securities):** A special type of Treasury note or bond that offers protection from inflation. Like other Treasuries, an inflation-indexed security pays interest every six months and pays the principal when the security matures. The difference is that the underlying principal is automatically adjusted for inflation as measured by the consumer price index (CPI).

**Mortgage-Backed Securities:** A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

**Investment-Grade Corporates:** Securities issued by corporations with a credit rating of BBB or higher. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters A and B to identify a bond's investment-grade credit quality rating. AAA and AA (high credit quality) and A and BBB (medium credit quality) are considered investment-grade.

**Preferred Stocks:** A class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights.

**High-Yield Corporates:** Securities issued by corporations with a credit rating of BB+ and below. These bonds generally offer higher yields than investment-grade bonds, but they are also more vulnerable to economic and credit risk.

**Bank Loans:** In exchange for their credit risk, these floating-rate bank loans offer interest payments that typically float above a common short-term benchmark such as the London Inter-Bank Offered Rate, or LIBOR.

**Foreign Bonds – Hedged:** Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure.

**Foreign Bonds – Unhedged:** Non-U.S. fixed income securities normally denominated in major foreign currencies.

**Emerging Markets Debt:** The debt of sovereigns, agencies, local issues, and corporations of emerging markets countries and subject to currency risk.

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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 indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

Stock investing involves risk including loss of principal.

Preferred stock investing involves risk, which may include loss of principal.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

This research material has been prepared by LPL Financial.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit