
LPL FINANCIAL RESEARCH
MIDYEAR OUTLOOK 2016
A VOTE OF CONFIDENCE

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During any presidential election, you can expect a barrage of promises from the yard sign endorsements, bumper stickers, stump speeches, and media headlines. All pledge to improve the economy, provide better education for all, and preserve the environment. This year has repeated that routine, and certainly hasn't lacked in drama. Oftentimes, when the big issues of the campaign are revealed — with the slogans, speeches, and promises leading the conversation — an unbiased source can help sort out rhetoric from reality.

A noisy year so far in financial markets has felt like a series of fiery stump speeches. In our *Outlook 2016* publication, we proposed that we should all "embrace the routine." Our forecasts called for what may be considered routine year-end results for the U.S. economy, stocks, and bonds in 2016. However, an important caveat was included: How we get there may be anything but routine.

Our emotions were tested at the start of 2016 — and again in late June. The S&P 500 had its worst start to a year ever, with a 10.5% decline in just 28 trading days, and more 1% daily moves up and down in the first two months of the year than we have seen since 2009. Investor sentiment polls showed the same small number of bulls as was seen near the March 2009 lows, and it seemed as though almost everyone was on recession watch. Yet, by mid-June, the S&P 500 was within 3% of its all-time high, had gone 50 days without a 1% drop, and had gained for three consecutive months.

After that bounce back, however, we faced new opposition in the form of an unlikely candidate. On June 23, 2016, the United Kingdom (U.K.) surprised everyone by voting to leave the European Union (EU). In the two days following the outcome — otherwise known as Brexit — the S&P 500 dropped by 5.3% to 2% below where it started the year. Following that two-day drop, however, the S&P 500 showed its resiliency and within two weeks it was actually above its pre-Brexit levels and up over 4% for the year. Much like the start of the year, we expect the remainder of the year to be similar — with the market remaining resilient and potentially posting gains by the end of 2016.

LPL Research proposes a vote of confidence: in the economy, the market, and most importantly, in our ability as investors to remain focused on our long-term goals. This is not always easy. We may be entering the eighth year of this economic recovery and bull market, but that doesn't mean the memories of the Great Recession have faded away; and the volatility we've seen this year revives those memories and takes an emotional toll.

A vote of confidence means having the belief that someone or something has the ability to succeed. It is more than being positive or negative, a bull or a bear. It is about trusting our assessments of the opportunities — and risks — that may lie ahead, formulating a solid investment plan, and sticking with it through the ups and downs we may face in the coming months and beyond.

Looking ahead to the rest of 2016, we maintain confidence in our existing forecasts, with some minor adjustments. We also expect periods of volatility throughout the rest of this year. The choppiness of the market may deliver pullbacks and comebacks in these final months, but we do not expect to enter a bear market or economic recession. Through this steady, although slow, economic growth, here are some of the key influential factors we'll be watching for:

- **Federal Reserve (Fed) rate hikes.** In part due to the political and economic uncertainty created by the Brexit vote, we have reduced our forecast for Fed interest rate hikes in 2016 from two to one, with additional rate increases next year. Should financial conditions tighten more than we expect, the Fed could remain on the sidelines all year.
- **International opportunities.** We remain cautious in our global outlook, but continue to look for opportunities, especially in emerging markets.
- **Corporate America investments.** A pickup in economic growth and an energy sector turnaround may boost companies' investments in their future growth, an element that has been lacking recently.
- **Second half turnarounds: oil, dollar, earnings.** These three turnaround stories are key for the rest of 2016. Despite heightened political uncertainty in Europe, we expect continued stabilization in oil prices and the U.S. dollar, both of which have been an earnings drag in the past several quarters. Should these drags ease, we expect an earnings rebound may occur in the second half of the year.

This has been a volatile year thus far, leaving some to question the continued strength for the second longest bull market in history. As we cast our ballots, our vote is that the current economic recovery and bull market may continue through 2016 and beyond. With the *LPL Research Midyear Outlook 2016: A Vote of Confidence*, you will be armed with the investment insights and market guidance for what may lie ahead for the rest of this year.

LPL RESEARCH MIDYEAR OUTLOOK 2016

A VOTE OF CONFIDENCE

CAMPAIGN AT A GLANCE

KNOW THE FACTS

HOW TO INVEST

RECOMMENDATIONS & INVESTMENT INSIGHTS

U.S. ECONOMY
2–2.5%
GDP

STOCKS
MID-SINGLE-DIGIT
RETURNS

BONDS
LOW-TO MID-SINGLE-DIGIT
RETURNS

Let's Work Together!

Although the disconnect between the market's expectation and the Fed's guidance on the path of interest rate hikes has closed over the first half of 2016, the disconnect on the pace of job growth has increased. The market may view a slowdown in job creation, which we expect may occur, as a precursor to a recession; but the Fed may consider that slowdown normal for this point in the business cycle. This disconnect over jobs has the potential to cause volatility and financial stress in the second half of 2016 and beyond.

Time for a Rebound

We believe the conditions are in place for a solid earnings rebound during the second half of 2016, due to the easing drags from the U.S. dollar and oil, coupled with minimal wage pressures. Following several quarters of earnings declines, a turnaround in growth should support our forecast for mid-single-digit gains for stocks in 2016.

PLAYING POLITICS

Political risks to the markets were exacerbated by the outcome of the U.K. vote in favor of leaving the EU. It is unknown what impact this vote will have on the U.K. economy and the rest of Europe. The terms of the separation must be negotiated, which creates uncertainty for businesses operating in the region. There are also fears that similar movements to separate will gain support in other European countries. In the U.S., the upcoming presidential election presents another source of uncertainty, more so in terms of policy outlook than stock or bond performance.

VOTE YES

Exit polls show these ideas may be worthy of adding to portfolios.

CYCLICAL STOCKS

Benefit from ongoing U.S. economic expansion and improving economic growth in the U.S. and emerging markets.

EMERGING MARKET STOCKS

Attractive valuations and likely boost from fiscal and monetary stimulus.

MASTER LIMITED PARTNERSHIPS

Yields are attractive, and MLPs should benefit from balancing of supply and demand in the oil market in the second half.

LONG/SHORT EQUITY

Long/short equity can be a good way to maintain exposure to the equity markets while also dampening some volatility.

RE-ELECT

Fundamental ideas that have earned continued support in portfolios.

LARGE CAP GROWTH STOCKS

Large cap stocks are well positioned for the mid-to-late stage of the business cycle, while growth stocks may demand a premium valuation in a modest growth environment.

HIGH-QUALITY INTERMEDIATE BONDS

In a low-yield environment, intermediate bonds provide diversification benefits and a favorable trade-off between yield and interest rate risk.

HIGH-YIELD BONDS

Above-average yields and fair valuations can aid income generation and return.

VOTE NO

Time for a change — these ideas may not be in a portfolio's best interest anymore.

U.S. DEFENSIVE STOCKS

Relative valuations are becoming expensive versus history and more help from falling rates is unlikely.

DEVELOPED INTERNATIONAL (LARGE FOREIGN) STOCKS

Structural challenges in Europe remain while economic growth is stalling out at low levels.

DEVELOPED INTERNATIONAL BONDS

Lower yields and higher valuations than U.S. counterparts along with currency risk offer limited value.

FORECASTING for the FUTURE

U.S. ECONOMY

2–2.5% GDP

For the first half of 2016, the U.S. economy—as measured by real gross domestic product (GDP)—is on track to grow at around 2.0%. Looking out into the second half of the year, aided by a dollar tailwind, stable oil prices, steady consumer spending, record high household net worth, and a slowing, but still solid labor market, the U.S. economy may grow between 2.0% and 2.5%. But even at just over 2%, actual GDP is growing faster than potential GDP (the maximum pace the economy can grow without causing inflation), taking up slack and slowly pushing up wages and inflation. If this persists, the Fed is likely on a path of one rate hike this year. Although the Brexit vote in late June 2016 may slightly lower U.S. GDP growth in the second half of 2016, we do not expect the U.S. to enter a recession this year.

STOCKS

MID-SINGLE-DIGIT RETURNS

We continue to expect mid-single-digit returns for the S&P 500 in 2016, consistent with historical mid-to-late economic cycle performance. We expect those gains to be derived from mid- to high-single-digit earnings growth over the second half of 2016, supported by steady U.S. economic growth and stability in oil prices and the U.S. dollar. A slight increase in price-to-earnings ratios (PE) above 16.6 is possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe, and begin to price in earnings growth in 2017. Low interest rates continue to provide support for stock valuations, making bonds a relatively unattractive alternative to stocks. Key risks include a policy mistake from Washington or the Fed, geopolitics including political uncertainty in Europe, and a surprising pickup in inflation that leaves the Fed playing catch-up. We expect to experience more bouts of volatility given these risks and being in the later stage of the business cycle.

BONDS

LOW- TO MID-SINGLE-DIGIT RETURNS

We have increased our full-year 2016 total return forecast for high-quality bonds to a low- to mid-single-digit total return, up from flat. A reduced number of Fed rate hikes, continued aggressive policy easing by overseas central banks (most notably the European Central Bank and Bank of Japan), and below-trend economic growth translate to a more supportive backdrop for bonds globally. The recent Brexit vote and its potential implications have added support to these forces. We expect limited bond returns over the second half of 2016. Expensive valuations and low yields may remain in place.

Source: LPL Research 06/30/16

This economic recovery, now seven full years in, has been marked by a slower pace of growth than some would expect or hope for, and in some cases this pace has varied greatly across sectors of the economy and even regions in the U.S. Depending on the source, headlines range from "solid economic recovery moves forward" to "stagnant, below-trend growth persists." So, which is it? Digging into the data shows that it's probably a little bit of both, and likely lands somewhere in the middle. Although this pace of growth may be below trend, we maintain our confidence in the potential for continued U.S. economic growth in 2016.

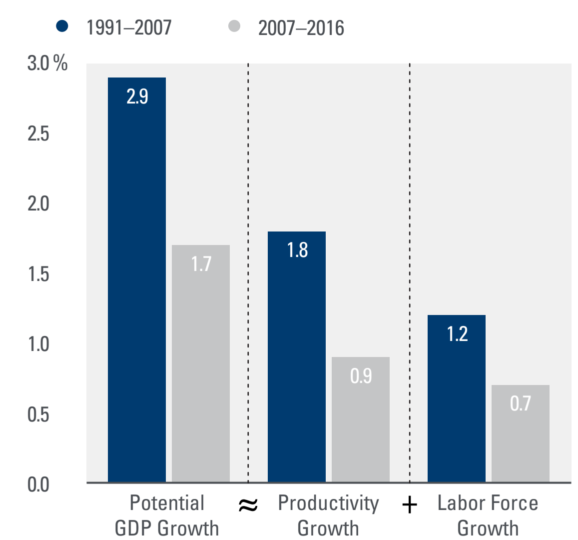
The Bar Has Been Lowered for GDP

To understand why GDP growth has recently been below the historical trend of 3%, it's important to look at its core components. The maximum rate at which the economy can grow without causing inflation (formally known as "potential GDP") is shown in Figure 1. The "building blocks" for potential GDP are productivity growth and labor force growth. The figure clearly illustrates that potential GDP and both of its building blocks have slowed since the onset of the Great Recession, relative to the decade and a half prior to it.

Since the end of the Great Recession, the causes of—and potential remedies for—the anemic pace of economic growth have been hotly debated by investors, business leaders, and policymakers alike. Productivity (as measured by output per hour worked) is slowing, not only here in the U.S., but around the world. The debate is whether the slowdown in productivity is cyclical (largely due to the nature and severity of the Great Recession), structural, or something else. That something else usually being a "measurement problem"; in a global economy that has become more service oriented and technology driven, it is more difficult to measure productivity the old-fashioned way, i.e., measuring the amount of hours of labor required to put out a particular amount of goods.

Labor force growth is the less flexible building block of potential GDP; demographics and long-term secular labor trends are difficult to reverse in the short term. There is some reason for optimism on the productivity side of the equation.

1 THE BUILDING BLOCKS OF POTENTIAL GDP, PRIOR TO AND SINCE THE GREAT RECESSION



Source: LPL Research, Organization of Economic Cooperation and Development 06/30/16

Past performance is not indicative of future results.

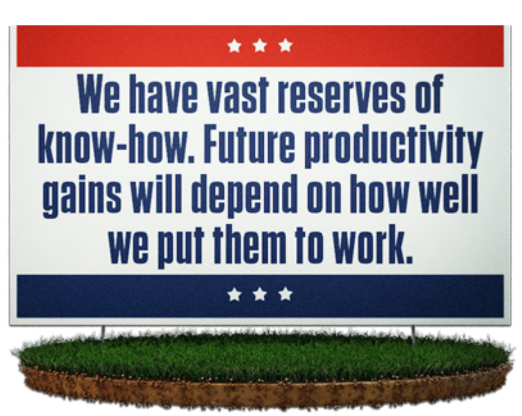
Still, improvement from the recent tepid pace of productivity will likely require, at minimum, better coordination between businesses, labor, and governments at all levels, and almost certainly more monetary and fiscal policy coordination among policymakers worldwide. Governments in the U.S. (federal, state, and local) and around the globe should be encouraging more spending on public and private infrastructure, training more existing and potential workers to be more productive in the 21st century economy, and keeping regulatory burdens low to allow businesses to thrive.

The Great Recession still looms large for many, but ultimately, businesses, governments, and individuals need to look forward and think about how to invest wisely in the future to drive renewed productivity growth. We have vast reserves of know-how. Future productivity gains will depend on how well we put them to work.

Our Good Friend, the Fed

Much like the views on the pace of economic growth, there has been a consistent disconnect between the market's expectation of Fed rate hikes and the Fed's guidance on future hikes. At the start of 2016, the federal funds futures market was pricing in two 25 basis point (0.25%) rate hikes for the year, versus the Fed's December 2015 guidance that it planned four hikes in 2016. In late February 2016, the fed funds futures market didn't see a rate hike until the end of 2017. Since then, the Fed has guided markets to expect just two hikes this year. The Fed had remained adamant that these hikes will happen, until just after the Brexit vote in late June 2016, when the Fed signaled a more cautious approach for this year.

Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year, potentially in December 2016. If Brexit uncertainty lingers, putting more downward pressure on the U.S. economy and inflation—and more pressure on financial conditions than we now expect—it is possible that the Fed could choose to stay on the sidelines all year. Similarly, if the impact of uncertainty around Brexit is short-lived, it is still possible that the Fed may hike rates twice this year, matching the forecast we made in November 2015. Three rate hikes by the Fed this year, which was a small possibility prior to the Brexit vote, now seems very unlikely.



Brexit vote aside, fundamentally it comes down to the labor market and inflation. So what do we expect to see over the remainder of 2016?

The Labor Market: It All Comes Down to Turnout

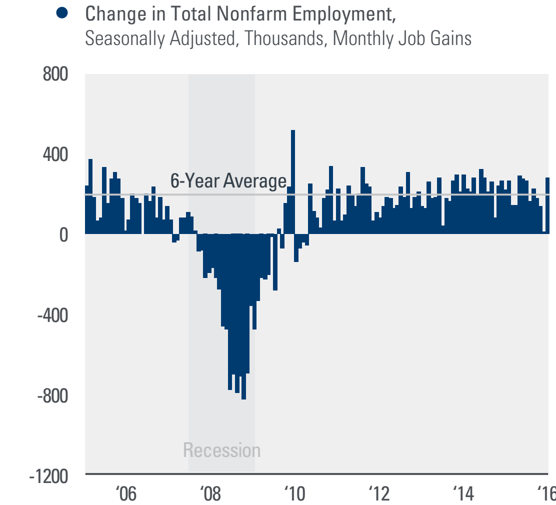
The labor market could be on the cusp of a slowdown in job creation. Even after surprisingly weak job growth in April and May 2016 (averaging just 80,000 per month), over the past six years, the U.S. economy has created more than 13.6 million net new jobs, an average of between 175,000 and 200,000 per month. Over that span, the unemployment rate has dropped from nearly 10% to 4.9%, and wage inflation (as measured by the year-over-year gain in average hourly earnings) has moved from a low of near 1.5% to over 2.6%. History suggests that given where we are in the business cycle, and how far the labor market has come, a routine downshift in the labor market may be at hand. "Temporary help" jobs, a key leading indicator of future job growth, have fallen by more than 40,000 jobs in the first six months of 2016. If sustained, this suggests a slowdown in overall job creation later this year.

Market participants may view this downshift as a sign that the economy is slowing, and may even begin preparing for the next recession and next set of rate cuts from the Fed. In the past 35 years, spanning 5 recessions (1980, 1981–82, 1990–91, 2001, 2007–2009), the average monthly job gain over 12 months typically falls by about 150,000 to 200,000 jobs from its average level before signaling a recession [Figure 2]. Applying that rubric to today suggests that the 12-month average on job creation would have to slow from the current 200,000 to around 25,000 to 50,000 per month to indicate that a recession is imminent.

But here's where the market and the Fed may be at odds. In a series of public appearances over the past few years, Fed officials noted that monthly job gains as low as 120,000 would still be enough to tighten the labor market, take up slack in the economy, and push up wages and ultimately inflation. Whereas the market would likely view a downshift to job creation of 120,000 jobs per month—or even 160,000 per month—as a sign of a slowing economy, and begin to worry about global growth and the onset of a recession.

Based on where we are in the business cycle and the recent downshift in temporary help jobs, we believe by the end of 2016, job growth will more routinely be in the

2 FED SAYS JOBS TARGET IS 125,000–150,000; MARKET LIKELY EXPECTS MUCH HIGHER



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 07/08/16

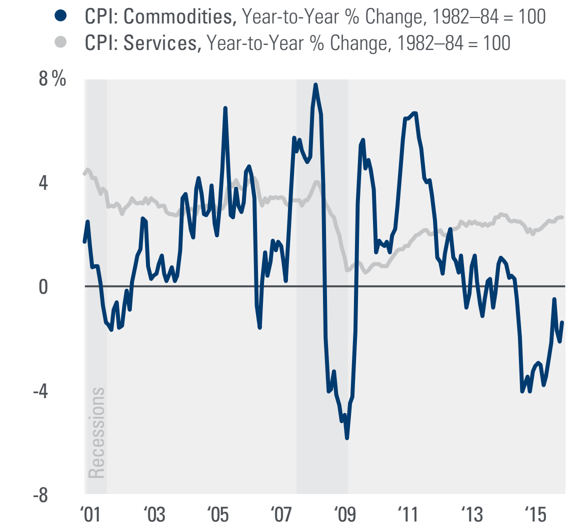
120,000 to 150,000 per month range, a clear deceleration from the 200,000 per month pace seen, on average, over the past six years. The uncertainty created by the Brexit vote may hasten the slowdown in job creation, but not materially so in our view. The main impact may be greater caution from the Fed. But market participants are still likely underestimating what the Fed may take to be sufficient job growth. Even if job growth slowed to 150,000 per month, it may still be enough for the Fed to tighten faster than markets expect. Yet another disconnect between the Fed and the market to worry about.

Inflation: Battleground State

The aftershocks of the Great Recession, plenty of global spare capacity, slower global GDP growth, and the globalization of product and labor markets have acted as restraints on inflation in recent years. However, at least in the U.S., the factors pushing inflation higher may begin to win the battle over the second half of 2016 and beyond.

The recent rise in commodity prices off the early 2016 lows increases the odds that inflation will continue to move toward the Fed's longer-run 2% target by year-end. The overall reading on the Consumer Price Index (CPI) at midyear is running at just 1.1% year over year; but beneath the surface, CPI for services (two-thirds of CPI) has recorded a 2.7% year-over-year gain—placing it in the middle of its recent range. Meanwhile, CPI for commodities (one-third of CPI) was down 1.4% year over year in May, but for much of 2015 and early 2016 that figure was closer to down 4% [Figure 3]. If oil and gasoline prices stay in their recent ranges, CPI for commodities will turn positive in the second half of 2016 and push overall CPI close to 2%. By then, the Fed may have already raised rates again.

3 IN THE U.S., FACTORS PUSHING INFLATION HIGHER MAY BEGIN TO WIN THE BATTLE OVER H2 2016 AND BEYOND



Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 06/30/16

Data for CPI are as of May 31, 2016, the most recent data available.

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, and is a commonly used measure of inflation.

While headline inflation remains low, most consumers would say that there is plenty of inflation, and they have the grocery and gasoline bills to prove it. In the 1960s, 1970s, and early 1980s, soaring inflation was a big concern in the voting booth; but today, low inflation—and the low wage increases that have accompanied it lately—are the big issues. The latest survey of consumer inflation expectations (via the University of Michigan's Survey of Consumers) revealed that consumers expected 2.3% inflation over the next 5–10 years, the lowest on record. But these days, consumers equate low inflation to slow wage growth. The good news is that those grocery prices are down nearly 1% and have been roughly unchanged for the past 18 months or so. The bad news (for politicians, at least) is that gasoline prices are up by nearly 75 cents per gallon since early this year—and if that trend continues into the summer and early fall, rising inflation could still become a key issue in the 2016 race.

POLICY EVOLUTION

When looking at factors influencing the economy and the market, we typically focus on monetary and fiscal policy, but given this is an election year, we can't forget about political policy. Both presumptive nominees are highly polarizing figures, and Congress is becoming increasingly polarized as well. Some of the election uncertainty has been focused on the potential impacts to policies affecting trade, healthcare, and financials in particular.

Trade

One area of at least partial agreement between the candidates is trade. Presumptive Republican nominee Donald Trump has made his skepticism on trade a hallmark of his campaign, initially suggesting a 20% tariff on imported goods and a 35% tariff on goods from Mexico, though he has since softened these positions. Presumptive Democratic nominee Hillary Clinton has officially denounced the Transpacific Partnership. Even prior to running for the nation's highest office, as senator from New York she voted against the Central American Free Trade Agreement (CAFTA), which effectively extends the NAFTA agreement to Central American nations.

Trade is also an area where personal style may make a large difference. Current trade law allows the President to act unilaterally in a number of circumstances, including limiting imports due to national security concerns and under "national emergencies," which is a loosely defined term. These laws are viewed unfavorably by U.S. allies and trade partners, and have rarely been used in their history. Clinton, as a former Secretary of State, would likely be hesitant to use these provisions. Trump has shown less sensitivity to these issues and is more likely to act unilaterally.

The S&P 500 derives a substantial amount of its revenue overseas in foreign currencies (we estimate approximately 40%), although trade only comprises about 15% of U.S. GDP. This sizable portion of overseas revenue is what makes the U.S. dollar so influential on corporate profits. So will a potentially more protectionist U.S. trade policy hurt corporate profits?

Based on what realistically can get passed in Congress and the likelihood that Trump softens his stance for the general election, we expect the earnings impact to be manageable. Still, the most trade-sensitive areas of the market such as autos, aircraft, machinery, and electronics may be volatile.

Financials

Financial services represent another area of difference with market implications. Clinton has supported the Dodd-Frank Act, increasing regulations on banks, and has promised to veto any attempt to repeal it. She has also called for a tax on high-frequency trading and for holding individuals and corporations criminally responsible for failures. Throughout her career, Clinton has generally been well received by Wall Street and the hedge fund community.

In contrast, Trump has announced plans to restructure Dodd-Frank that "would be close to a dismantling." A Trump administration would presumably enact fewer regulations on consumer lending and finance. Bank lending would probably increase, with easier standards on mortgage and commercial lending and a generally more relaxed regulatory environment may prevail. This would probably benefit all sorts of financial institutions, but in particular smaller and midsized banks regulated by the Comptroller of the Currency, which is part of the executive branch, rather than those regulated by the Fed.

Healthcare

Healthcare and financials are the two market sectors that may see the most divergence depending on who occupies the White House. On healthcare, both Trump and Clinton have suggested having Medicare negotiate with pharmaceutical companies, which would likely push down drug prices, and therefore, profits for drug makers. Republicans in Congress have repeatedly opposed this policy, and they might wield some influence over Trump in this regard.

A Democratic sweep of the presidency and Congress, though unlikely, would generally be considered a negative for drug companies. A Trump presidency and Republican Congress would also almost certainly result in a substantial modification if not outright repeal of the Affordable Care Act. This would likely be detrimental to insurance companies, hospitals, and other companies that benefit from having more insured patients. Congressional Republicans have advocated increased use of healthcare savings accounts and outpatient surgical centers, which would benefit companies that provide these services.

LOOKING FOR CHANGE IN THE GLOBAL ECONOMY

The outlook for overseas markets is highly uncertain and fraught with economic and geopolitical risks. On June 23, 2016, the U.K. voted to leave the EU. This has created great uncertainty in the financial markets. Thus, we remain cautious on overseas equities. However, developed international and emerging markets have underperformed U.S. stocks since the bull market began in 2009 [Figure 4]; this could lead to potential value opportunities. Overseas equities, particularly in emerging markets, could provide opportunities in the near future, when there is greater political and economic clarity.

What's the Future of International Markets?

One reason we are looking overseas is that valuations are more attractive compared to U.S. markets, both on an absolute basis as well as relative to their own history [Figure 5]. U.S. stock valuations have increased steadily over the last 10 years; however, emerging markets are currently trading just above their 10-year average.

Though the markets look attractively valued, macroeconomic and political risks keep us more cautious on overseas markets. Emerging economies can be more vulnerable to economic shocks and are more likely to experience political instability. A major driver of our international outlook is the diverging monetary policy between the U.S. and most of the rest of the world and the impact of this divergence on currencies.

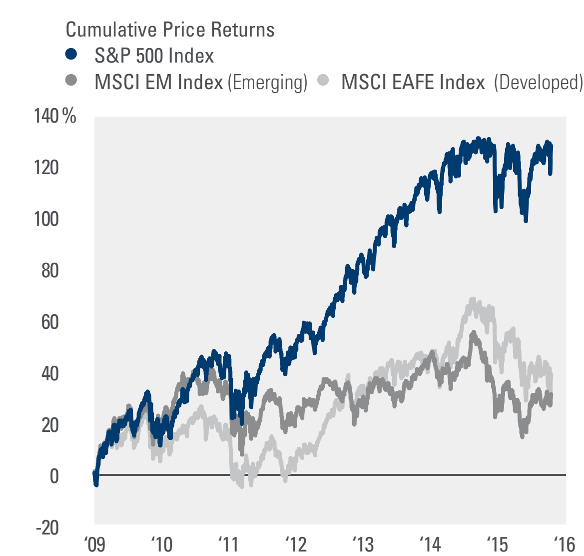
Brexit Response

The U.K.'s decision to leave the EU, the so-called Brexit vote, has set off a chain of events that initially caused volatility in the financial markets, and may continue to do so for the rest of the year. Given the continued expected volatility, we must consider developed international markets (defined primarily as Western Europe, Japan, Canada, and Australia) less attractive than they were prior to the vote.

Much of the increased volatility in these markets is associated with increased currency risk. Currency movement is one of the major drivers of relative

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

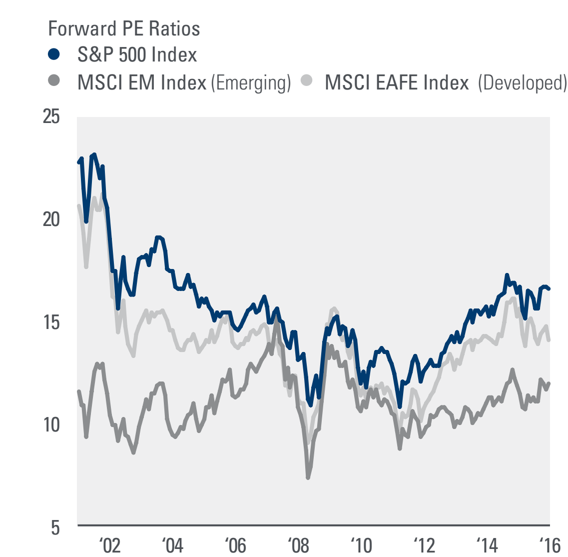
4 FOREIGN MARKETS HAVE TRAILED THE U.S.



Source: LPL Research, FactSet 06/30/16

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is not indicative of future results.

5 LOWEST STOCK VALUATIONS CAN BE FOUND OVERSEAS



Source: LPL Research, FactSet 06/30/16

Forward price-to-earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated PE analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

performance of international stocks compared to domestic ones. A weaker U.S. dollar increases returns for U.S.-based investors on their holdings of foreign stocks; a stronger dollar serves to decrease these returns. Historically, the major currencies for the developed international markets (primarily the Japanese yen, the euro, and the British pound) have been relatively stable over shorter time frames, but the Brexit vote has increased currency volatility. Furthermore, it strengthened the U.S. dollar relative to most other foreign currencies, keeping it attractive to investors seeking a safe harbor from currency volatility.

The Brexit vote creates two sources of uncertainty:

- The impact on the economy of the U.K. and the rest of Europe is unknown as it will take some time to negotiate the details of this separation. This creates uncertainty for businesses operating in the region and, consequently, less clarity on earnings and growth prospects.
- The U.K.'s vote to leave is the first reversal of what has been 70 years of increasing political and economic unity in Europe. There are similar movements in France, Italy, and other countries, leading to fears that Europe may unravel and countries will re-establish national currencies.

This unknown impact on corporate profits and increased currency volatility reduces our outlook for developed international equity markets. Within this asset class, financial services stocks are likely to be most affected due to London's place as a global financial center and the downward pressure on interest rates following the vote.

The impact on emerging markets is likely to be much smaller. There is an old adage that "when the developed world sneezes, the emerging markets get a cold." However, emerging markets appear more resilient to downturns in the developed world than they used to be, largely because they have increased trade with each other and rely less on trade with developed economies. Emerging markets are not immune to larger events, but may be more resilient today than they have been historically.

U.S. Dollar Strength

The market volatility around the Brexit vote suggests that the Fed will not be as aggressive in raising interest rates as previously anticipated. However, even with modest increases in U.S. rates, while overseas banks keep rates stable (or cut them post-Brexit), the value of the dollar may increase, which reduces the attractiveness of overseas markets. Our base case is that the dollar will move within the roughly 10% trading range it has been in for the past 18 months, but may not have a more sustained rally. Should the movement to leave the EU expand to other parts of Europe, we will have to change our projections to call for greater dollar strength.

China

Until there is greater clarity on how and when China will deal with its debt issue, our appetite for emerging markets will be reduced. The slowdown in the Chinese economy is revealing the excess of debt that helped protect it from a recession. We believe it is only a matter of time before the government engages in a nationwide debt restructuring. This will be very disruptive for investments in China, but as the debt holders themselves are mostly Chinese, the global impact should be muted.

Earnings

Ultimately, stock markets follow earnings and overseas earnings have been declining, even in local currency terms. Valuation metrics are therefore justifiably cheap. Historically, it's hard to get investors interested in owning stocks while corporate profits are still declining. Until there is more confidence in corporate earnings, investors may be more focused on safety (return of capital), than on growth (return on capital) and avoid international investing.

4 POINT PLAN FOR INTERNATIONAL MARKETS

To become more constructive on overseas markets, we want to see:

1. A measured political and economic response to the Brexit vote
2. The U.S. dollar staying within a reasonable trading range (we do not expect a continued post-Brexit surge in the dollar)
3. A credible plan by China to deal with its bad debt problem
4. Earnings growth to resume in Europe and Japan

In an election, voters generally select a candidate whose policy stances they have the most confidence in. A victory for your candidate may serve to increase your confidence in the future. Similarly, corporate America must have confidence in the economic outlook, and clarity around the policy outlook, in order to invest in its future. We have confidence in corporate America, but we'd also like to see corporate America have confidence in—and reinvest in—itself. Earnings weakness has been a restraint on corporate and investor confidence. But with the drags on earnings finally easing, an earnings turnaround may be on the horizon.

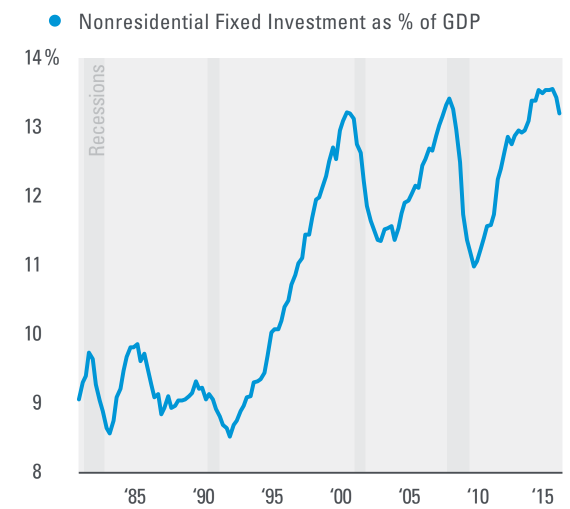
The Road to a Better Tomorrow Through Corporate America

Is corporate America investing enough in its future? A popular worry on Wall Street—and even on Main Street out on the campaign trail—is that companies are returning too much cash to shareholders in the form of share repurchases and dividends and not investing enough in future growth in the form of capital expenditures (or capex).

The current economic expansion, with a 2% average growth rate since the end of the Great Recession, has been sub-par. That slow growth has coincided with below-average growth of capex. But has corporate America been underinvesting? We would say yes, but the level of investment may be appropriate for an economy exhibiting slow growth. It does not appear that capex dollars are being crowded out by other competing capital allocation decisions, and the energy downturn is a big part of the weak investment story.

Figure 6 shows that our proxy for capex (nonresidential fixed investment) remains at the high end of its historical range. By this measure, companies are investing in property, plant, equipment, and intellectual property at an even higher rate, relative to the size of the economy, than they have historically. When considering the more than 30% reduction in energy capex since oil peaked in June 2014, the level of capex looks much better. This suggests that the level of investment may be on target given the level of economic activity. That's not great news, but it suggests that if economic growth picks up and the energy recovery continues, as we expect, capex would turn higher.

6 CAPEX HAS KEPT UP WITH GROWTH OF THE U.S. ECONOMY



Source: LPL Research, Haver Analytics 06/30/16
Data are as of Q1 2016.

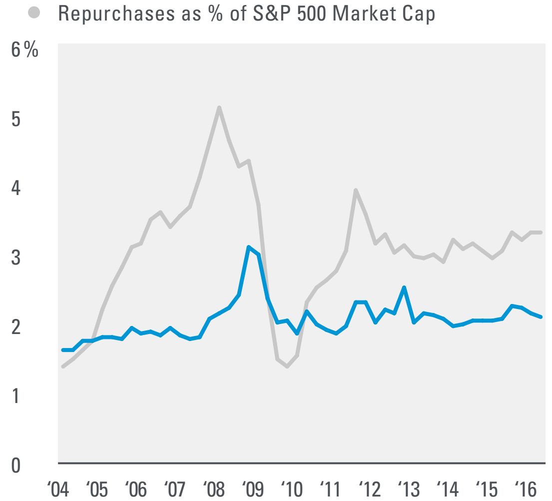
Where Is the Capital Going Now?

There are four primary potential destinations for companies' excess capital after regular costs of goods sold and operating expectations are incurred (including hiring and wages): share repurchases, dividends, mergers, and debt repayment.

- **Share repurchases.** We do not believe that companies' desire to return more capital to shareholders through share repurchases is much of an impediment to capex. In dollar terms, share repurchases for S&P 500 companies are near record highs, with $572 billion returned to shareholders in 2015. But when measured against market capitalization to create a repurchase yield, share repurchases are below the 10-year average (3.0% versus 3.2%) [Figure 7].

- **Dividends.** Similarly, the total dollar amount the S&P 500 paid out in dividends in 2015 of $385 billion was an all-time high and 2016 is shaping up to be another record year. But the dividend yield on the S&P 500—the size of that dividend pie relative to the total market capitalization of the index—stood at 2.1% at year-end and is at similar levels now, in-line with the 10-year average and well below the 50-year average of 3.0% [also shown in Figure 7]. Looking at dividends another way, companies are paying out a slightly smaller portion of earnings than they have historically, suggesting dividends are not crowding out investment.

7 DIVIDENDS AND SHARE REPURCHASES HAVE GROWN PROPORTIONATELY TO MARKET CAP



Source: LPL Research, FactSet, Haver Analytics 06/30/16

- **Mergers.** Buyers globally announced approximately $4.0 trillion in mergers and acquisitions in 2015, surpassing 2007 for the most on record. The environment in the U.S. remains ripe for mergers over the rest of 2016 and into 2017 with modest economic and earnings growth, low interest rates, and generally favorable credit conditions. However, Brexit- and U.S. election-related policy uncertainty remain wild cards.

- **Debt repayment.** Debt repayment was a popular destination for excess capital immediately after the financial crisis, as companies shored up weakened balance sheets and took advantage of lower interest rates to refinance existing debt and extend maturities. With those maturities extended at low borrowing rates, debt repayment is much less impactful.

We are hopeful that better economic growth and the energy sector's continued recovery will lead to more capital investment in the second half of 2016 and beyond. Looking out to the first year of the next President's administration, four factors are likely required for capex to increase:

- **Stronger economic growth.** More growth would lead to greater use of the economy's excess capacity, which would eventually spark more capital investment. Fiscal policy may provide a boost as both candidates favor increased infrastructure spending, although protectionist trade policies and Brexit-related uncertainty could work in the opposite direction.

- **An earnings rebound.** We do expect a solid rebound in S&P 500 earnings in the second half of the year even in the event of potential modest upward pressure on the U.S. dollar. More earnings would mean companies have more to invest.

- **Favorable credit conditions.** Credit conditions remain generally favorable with low interest rates, strong corporate balance sheets, manageable debt service costs, and generally receptive markets for debt offerings. In general, we expect these conditions to remain favorable, although we are watching developments in Europe closely.

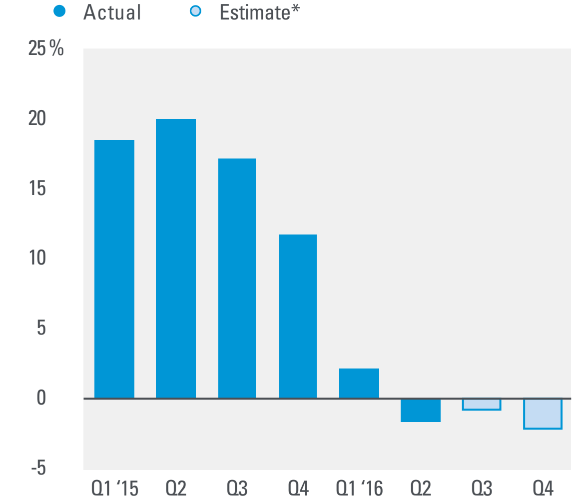
- **More confidence.** The lackluster economic recovery has left some CEOs lacking the confidence to invest. U.S. elections will likely bring greater policy clarity—we have very little now—and hopefully increase corporate confidence. Prospects for a relatively smooth transition for the U.K. out of the EU would also help.

There Is Hope for Earnings

Despite the slow growth of the U.S. economy, lackluster capital spending, and heightened political risk in Europe, we continue to believe the conditions are in place for a solid rebound in corporate profits during the second half of 2016, due to the easing drags from the U.S. dollar and oil, coupled with minimal wage pressures.

After a slow start to 2016, over the balance of the year we expect 2–2.5% economic growth, as measured by GDP. Nominal economic growth, which includes inflation and may exceed 4% during the second half of 2016, is highly correlated to corporate revenue. Revenue for the S&P 500 is expected to rise 3.6% in the second half based on the average consensus estimates of analysts and strategists. The recent improvement in the Institute for Supply Management's (ISM) Purchasing Managers' Index (PMI) for manufacturing, which has shown high correlation to corporate profits historically, is encouraging. The index is in expansionary territory despite the drag from the energy sector and is trending higher, pointing to better earnings growth ahead.

8 U.S. DOLLAR HAS TURNED INTO AN EARNINGS TAILWIND



Source: LPL Research, FactSet 06/30/16

*Changes for Q3 and Q4 are based on the assumption that the U.S. dollar stays at its 06/30/16 level of 95.64 for the rest of the year.

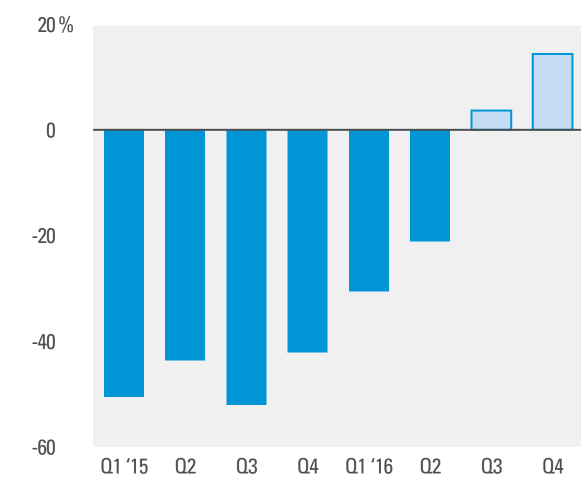
Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Past performance is no guarantee of future results.

Drags from U.S. Dollar & Oil Should Ease

We expect the drags from the energy downturn and strong U.S. dollar to potentially continue to ease over the balance of the year and drive earnings higher. Over the first half of 2016, the U.S. dollar weakened versus the currencies of our major trading partners as financial markets reconsidered the path of Fed policy over the coming years. In addition, relative calm in China after a difficult period of policy missteps in late 2015 and early 2016, along with signals that the Bank of Japan (BOJ) and the European Central Bank (ECB) had shifted to a "wait and see" mode after aggressively easing monetary policy in 2014, 2015, and early 2016, also helped to arrest the dollar's run higher. The U.S. dollar, should it remain near current levels, would be a potential tailwind for earnings in the third and fourth quarters of 2016, after representing as much as a 20% drag on foreign earnings in the second quarter of 2015 [Figure 8]. We do not expect a prolonged U.S. dollar rally as a result of Brexit, but that remains a risk to earnings in the coming months.

9 OIL COULD SHOW YEAR-OVER-YEAR PRICE GAINS BY THE THIRD QUARTER



Source: LPL Research, FactSet 06/30/16

*Changes for Q3 and Q4 are based on the assumption that oil prices stay at their 06/30/16 level of $48.33 for the rest of the year.

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.

Past performance is no guarantee of future results.

Should oil prices stay at current levels, the commodity would show year-over-year price gains in the third quarter of 2016 [Figure 9]; this, along with the significant capital spending and other cost reductions undertaken by oil and gas producers, could potentially enable the energy sector to reach consensus double-digit earnings gains by year-end and propel overall S&P 500 profit margins back to near record highs. Here again, a potential Brexit-driven rally in the U.S. dollar that drags oil prices lower is a risk.

Wages Remain in Check

Finally, although wage pressures are starting to build, and wages are the biggest component of companies' cost structure, increases have been gradual. Wage inflation remains below levels of prior decades based on the government's Employment Cost Index (ECI) for wages. The most recent ECI reading in the first quarter of 2016 increased 2.1% year over year (on an inflation-adjusted basis), compared to the 30-average of 3.0%. The payroll survey, which has a much shorter history, reflected a 2.6% increase in average hourly earnings in the June jobs report released on July 8, 2016. So far, excluding the energy sector, S&P 500 companies have done an excellent job of absorbing wage increases over the past two years. As long as wage gains remain gradual, we do not see modestly rising wage costs as a material threat to corporate earnings.

What's the Catch?

There are some headwinds to profit margins beyond higher wages, but we believe they may be mitigated. Government measures of productivity are weak, which may make margin expansion more difficult. Higher commodity prices may put upward pressure on input costs. Although maybe not an immediate risk, interest rates—and therefore, interest costs—could rise over the next several quarters as inflation increases and the Fed likely hikes interest rates. And finally, in Washington, minimum wage increases may add upward pressure on wages, particularly under a Democratic President with Democratic control of the Senate, which appears to be a realistic possibility. Industries with the most minimum wage jobs that would experience the most impact include restaurants, leisure and hospitality, and general consumer services (consumer discretionary), and certain segments of the healthcare, industrials, and materials sectors.

The Bureau of Labor Statistics' (BLS) Employment Cost Index (ECI) is a quarterly release which gives information on the costs of labor for businesses in the United States.

Investing in U.S. equities includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

How to Invest: Stocks

Domestic

As the economic expansion transitions from mid-cycle to the latter stages, we favor the generally less volatile and higher-quality large cap stocks, although elevated market volatility may provide opportunities to trade small and mid caps. We expect continued, though modest, economic growth to favor growth over value as markets reward those companies that can produce above-market earnings growth. An aging business cycle could mean a surprise late-year pickup in inflation, supporting the energy sector and high-yielding MLPs. The latter stages of the business cycle also offer a historically attractive opportunity for healthcare investments, which are attractively valued due to the market's overly pessimistic view of political risks, in our view.

International

The outlook for international investments has changed significantly due to the U.K.'s June vote to leave the EU. This vote has not only created near-term market uncertainty, but has raised legitimate fears about the future of the EU, and the euro, its primary currency. The two immediate impacts of this vote have been a strengthening of the U.S. dollar against most other currencies (note that the Japanese yen is the significant exception) and the likelihood of further central bank easing. This increased uncertainty and higher than anticipated currency volatility make investments in the developed international markets less attractive over the balance of the year.

Emerging market equities, on the other hand, appear relatively attractive. Overall, emerging markets have not experienced the increase in equity valuations that those in the U.S. and other developed countries have. Many of these countries have already seen a correction over the past few years with the fall of commodity prices. Emerging markets is an asset class where active managers have been able to add value to portfolios by selecting stocks from countries with more attractive risk and return profiles.

Investing in MLPs involves additional risks as compared with the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLPs.

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

OIL: SUPPLY. DEMAND. LEADERSHIP.

In the past two years, oil could be considered a political flip-flopper. After peaking at over $100 per barrel in June 2014, the price of oil started to fall and continued to drop steadily throughout 2015 until it finally hit lows of $26 per barrel in February 2016. At the midpoint of this year, oil prices seem to be stabilizing around the $40–50 range. Still, oil's relationship with stocks and bonds remains a top issue for investors.

Oil Prices and Stocks Are on the Same Ticket

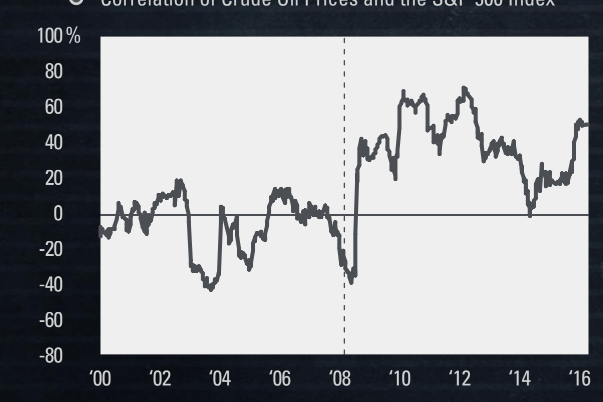
In our *Outlook 2016*, we noted that oil was one of the biggest keys for stock market performance in 2016. In addition to the energy sector's significant impact on overall domestic corporate profits, oil has been closely tied to capital spending, credit markets, and emerging market economies.

The rebound in oil has been a key driver of the stock market rebound from the February 2016 lows. But is it still as important now that crude prices are nearly double where they stood on February 11, 2016? The correlation between the S&P 500 and oil remains high despite oil's rally, suggesting that it still matters [Figure 10]. U.S. oil production has fallen by approximately 1 million barrels per day (roughly 10%) since its peak in June 2015. We expect the oversupply in the global oil market to be largely eliminated before the end of this year due to the combination of further production cuts, continued demand growth, and supply constraints (with little help from an increasingly marginalized OPEC). The correlation between stocks and oil is likely to fall as oil prices move higher, and therefore, would present less of a risk to the economy and markets; but as long as oil stays around $50 or below, it will likely remain a source of equity market risk.

High-Yield Still Slick

High-yield bond prices remain tightly linked to oil prices [Figure 11]. The average yield advantage, or spread, of high-yield bonds to comparable Treasury bonds has declined from over 9% in mid-February to under 6.5% as of June 30, 2016. (Note that bond yields and bond prices move in opposite directions.) The rise in oil prices since mid-February 2016 helped engineer the strongest four-month rally (mid-February to mid-June 2016) in high-yield bond prices since 2009 and the aftermath of the financial crisis. The rally pushed valuations into slightly expensive territory before Brexit-related weakness led to what we view as roughly fair valuations. Strength in oil prices has pushed high-yield bond prices higher than would be justified by fundamentals alone in our view. Defaults continue to rise, although the pace is decelerating. In today's low-yield world, a small allocation to high-yield bonds may be appropriate; but the sector's dependence on a single factor, oil, is a risk.

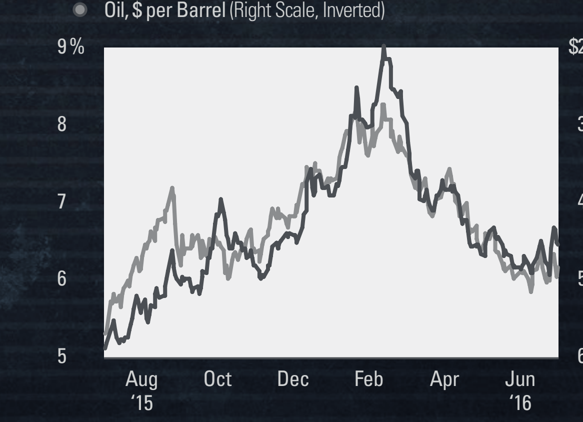
10 STOCKS REMAIN HIGHLY CORRELATED TO OIL PRICES



Source: LPL Research, FactSet 06/30/16

Price of oil is measured by West Texas Intermediate (WTI) crude oil. Data series represents one-year rolling correlation, weekly data.

11 HIGH-YIELD BONDS AND OIL PRICES REMAIN TIGHTLY LINKED



Source: LPL Research, Bloomberg 06/30/16

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

Despite our revised forecast for low- to mid-single-digit returns (up from flat) in 2016, bond investors still face a low-return environment. The "good" news (for bonds) has been largely factored into current prices, and absent signs of economic deterioration, further price gains, if any, may be limited. We expect the 10-year Treasury yield to finish the year roughly unchanged to 0.25% higher compared to a June 30, 2016 reading of 1.5%. An increase of 0.5% is certainly possible if the economy improves more than we expect over the second half of 2016, but tighter financial conditions due to Brexit may still mute the Fed's response. The 10-year Treasury yield is still likely on track to finish lower for all of 2016 [Figure 12].

Given lingering questions about the global economy (especially post-Brexit) and the still large yield advantage of U.S. Treasuries compared to other high-quality government bonds overseas, high-quality bond demand is likely to stay elevated and limit potential weakness, if any. Our scenario analysis illustrates potential return outcomes over the final six months of 2016 and also shows that if stocks or the economy falter and yields decline further, high-quality bonds still play an important diversification role even at near-record low levels.

12 INVESTORS STILL FACE A LOW-RETURN ENVIRONMENT OVER THE SECOND HALF

Change in 10-Year Treasury Yield, %	-0.25	0.0	+0.25	+0.50
Total Return, %	3.0	1.6	0.2	-1.2

Source: LPL Research, Barclays Aggregate Bond Index 06/30/16

Scenario analysis is based on a return of 1.5% as of 06/30/16 for the 10-year Treasury yield, based upon a six-month time horizon, parallel shift in the yield curve, no change to yield spreads, and no reinvestment of interest income.

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

Rising to the Challenge Amid Limited Opportunities

In a world of limited opportunity, an emphasis on higher-quality bonds may be prudent until better value emerges. Specifically, mortgage-backed securities (MBS) may offer opportunity in a world of expensive alternatives. We find MBS valuations attractive after failing to match the pace of Treasury gains over the first half of 2016. The sector offers more yield per unit of interest rate risk (duration) than most other bond sectors [Figure 13].

In a low-yield world, the additional yield can help support returns while limited interest rate risk aids price stability. A backdrop of limited yield changes has historically been a tailwind for MBS and fits with the stable to slightly higher yield scenario we envision over the remainder of 2016. In 2015, a year with limited changes to Treasury yields, the Barclays U.S. Mortgage-Backed Securities Index outperformed the Barclays Treasury Index by 0.7%. A repeat may be unlikely, but the example is still valid in our view to illustrate the incremental difference MBS may potentially make given few attractive opportunities.

Investment-grade corporate bonds are another way to reap added interest income but, on average, that market possesses greater interest rate sensitivity. Combining MBS with investment-grade corporate bonds can help offset potential interest rate risk while still maximizing sources of income in today's market. Investment-grade corporate bonds also may benefit from the economic improvement we anticipate over the second half of 2016. With an average yield spread of 1.4% above comparable Treasuries, just above the 1.3% 20-year average, investment-grade corporate bond valuations are roughly fair to slightly more attractive than Treasury alternatives.

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

Mortgage-backed securities are subject to credit, default, 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, market and interest rate risk.

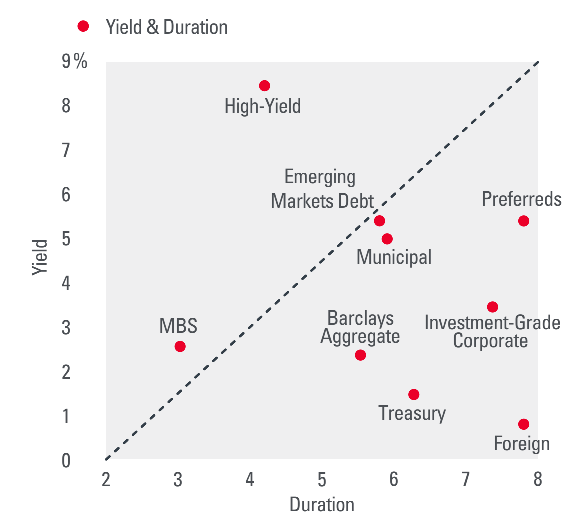
Taxes and Municipal Bonds

The presumptive Democratic candidate has hinted at higher tax rates for top earners, which may boost the allure of municipal bonds. In the event of a Republican sweep, tax cuts may be proposed, which would erode the attractiveness of municipal bond income. We view the latter outcome as less likely and believe the prospect of higher taxes lurks in the background independent of the presidential election. States such as Illinois and Pennsylvania have been pondering tax increases while the city of Chicago already passed a significant tax increase. State and local government revenue has begun to slow in 2016 after a multi-year rebound following the 2007–2009 recession.

Following a sluggish start to the year and a second quarter 2016 rebound, we find municipal bond valuations fair to slightly expensive on a near-term basis. Still, average AAA-rated municipal bond yields are only slightly below their Treasury counterparts, suggesting investors are not fully pricing in the tax-exemption of municipal interest income. An increase in tax rates, although still highly uncertain, would provide a possible tailwind to municipal bond prices and may cause the sector to richen further versus high-quality taxable alternatives.

Additionally, the favorable supply-demand backdrop for municipal bonds remains largely intact. State and local government revenue has improved steadily since the end of the last recession but, unfortunately, expenses have grown almost equally with revenue. States and municipalities therefore have had, and will likely continue to have, limited capacity to issue new debt for infrastructure and other civic projects. Among high-quality bonds we continue to find slightly better value among municipal bonds.

13 MBS OFFER RELATIVELY MORE POTENTIAL YIELD FOR A GIVEN LEVEL OF INTEREST RATE RISK



Source: LPL Research, Barclays, BofA Merrill Lynch, JP Morgan, Citigroup 06/30/16

Asset class data shown are represented by the indexes listed in the Disclosure section.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It 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.

Past performance is not indicative of future results.

How to Invest: Bonds

Interest rate risk has diminished but a strong first half of 2016 and still higher valuations create a challenging investment environment. Amid historically low yields, intermediate bonds, with an emphasis on mortgage-backed securities and investment-grade corporate bonds, provide diversification benefits and a favorable trade-off between yield and interest rate risk. Municipal bond valuations have also richened in 2016, but the tax-exempt benefit of municipal bonds is still not fully accounted for in current prices and they remain attractive on a long-term basis compared to high-quality taxable alternatives.

Above-average yields and fair valuations on high-yield bonds can aid income generation and return. We avoid developed international bonds, which have benefited greatly from extraordinary central bank policy moves. Lower yields and higher valuations relative to U.S. counterparts, coupled with currency risk, offer limited value.

Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

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.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

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 rates rise. Interest income may be subject to the alternative minimum tax. Federally tax free but other state and local taxes may apply.

BEYOND THE HYPE

If we had to emphasize one mantra of investing, it would be the importance of maintaining a long-term perspective. We must keep our emotions in check and strive to block out the hype—the noise that can distract us from these long-term goals. The "hype" on everyone's minds right now is of course, the 2016 presidential election, and that cannot be ignored. If this were a debate and LPL Research was behind the podium, the question we'd be asked by many is: How will this election affect the markets? Our first response: it's not about election years, or even political parties—but about investing for the long run. Nonetheless, there are some historical election year patterns that may be worth watching.

The Economic Factor: Income Growth

INCOME GROWTH PATTERN FAVORS WIN FOR DEMOCRATIC PARTY

Income growth is one way to gauge the impact of the economy on election results, as this measure captures the impact of several key factors, including the unemployment rate, inflation, and wage growth. In the year leading up to the election, inflation-adjusted, after-tax income growth of about 3–4% appears to be the threshold for the incumbent party to win. As of June 30, this measure is currently growing in the 3–3.5% range, suggesting that the incumbent Democratic Party will win just over 50% of the two party vote in November's election.

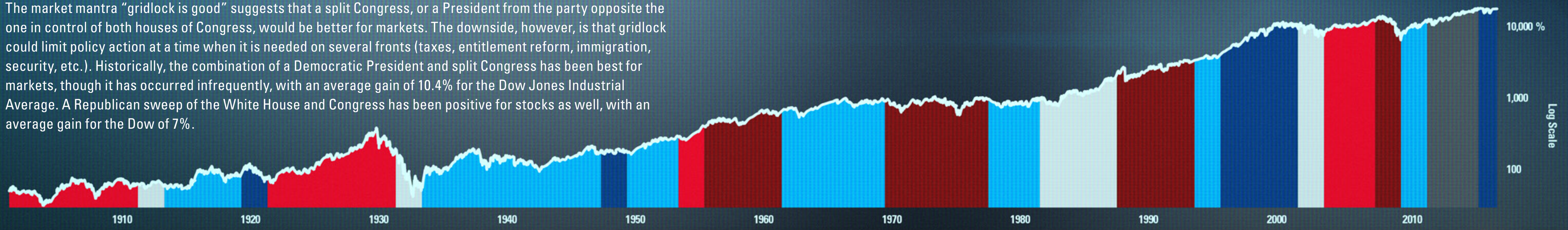
Source: LPL Research, Bloomberg 06/30/16

The History of Political Regimes

STOCK MARKET PERFORMANCE UNDER PRESIDENTIAL AND CONGRESSIONAL PARTY COMBINATIONS

Dow Jones Industrial Average Performance by Political Regime

The market mantra "gridlock is good" suggests that a split Congress, or a President from the party opposite the one in control of both houses of Congress, would be better for markets. The downside, however, is that gridlock could limit policy action at a time when it is needed on several fronts (taxes, entitlement reform, immigration, security, etc.). Historically, the combination of a Democratic President and split Congress has been best for markets, though it has occurred infrequently, with an average gain of 10.4% for the Dow Jones Industrial Average. A Republican sweep of the White House and Congress has been positive for stocks as well, with an average gain for the Dow of 7%.



Political Regime	% Gain/ Annum	% of Time
Democratic President, Democratic Congress	7.2	34.7
Democratic President, Republican Congress	8.6	9.8
Democratic President, Split Congress	10.4	3.5
Republican President, Republican Congress	7.0	22.6
Republican President, Democratic Congress	2.4	19.1
Republican President, Split Congress	-4.3	10.5

Source: LPL Financial, Bloomberg, Ned Davis 06/30/16

The Dow Jones Industrial Average Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Potential Wins for Stocks & Bonds

PRESIDENTIAL CYCLE PATTERN SUGGESTS VOLATILE SUMMER AND LATE-YEAR RALLY

S&P 500 Performance by Presidential Cycle Year

Source: LPL Research, FactSet 06/30/16

Study covers 16 election cycles back to 1952.

TREASURY YIELD TRENDS DURING AN ELECTION YEAR ARE SIMILAR TO THOSE OF ANY GIVEN YEAR

Average 10-Year Treasury Yield, Cumulative % Change

Source: LPL Research, Bloomberg 06/30/16

Yield data from 12/31/63 through 12/31/15.

Election years have been strong for stocks, especially excluding the anomaly in 2008 (the worst year of the Great Recession), with gains averaging near 10% and positive returns in a solid 87% of years. The election year pattern for stocks suggests volatility may persist through the summer months until markets have more clarity on the candidates and their platforms. Once that clarity arrives, often before the election itself, stocks have typically staged a late-year rally.

The path of bond yields during a presidential election year is very similar to the historical pattern for any given year. The seasonal tendency is for yields to decline starting in late October through November; but during election years, the tendency is for an increase in Treasury yields. The path of Treasury yields is slightly higher during election years (compared to the average year) due to the frequency of Fed rate hikes.

Taking these historical patterns into consideration, and given the current environment, suggests that we will remain in a similar policy and stock environment as we've seen in recent years.

*Income growth is measured as the inflation-adjusted, after-tax personal income growth during the 12-month period prior to the election. In 1964, 1972, 1980, 1984, 1996, 2004, and 2012 an incumbent was running for a second term after a change in party in the previous election.

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

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.

An effective presidential campaign strategy requires staying focused on reaching the White House and avoiding the short-term distractions that don't contribute to that effort. Similarly, in investing, protecting against short-term thinking and focusing on longer-term goals is key. Above all, however, having a trusted campaign manager (and financial advisor) along with a well-planned strategy can help set you up for success.

Sticking to a long-term investing plan has never been more difficult. We're constantly exposed to attention-grabbing stories that may be harmful for long-term planning; and gravitating toward stories that confirm our preconceptions can make the distraction even bigger. The natural tendency to expect recent trends to continue (called recency bias) can lead us to chase performance and buy at the wrong times. Even the election itself presents a potential bias; whether we favor the person (or political party) in the White House may influence our optimism regarding the economy and markets, which could lead to counterproductive investment decisions.

Distractions aside, what's most important is to start with the decisions that can have the largest impact on meeting financial goals. Working toward financial goals is a campaign. While the candidates are aimed at securing the votes they need, LPL Research offers some campaign strategy tips to help long-term investors as they seek financial success in navigating these increasingly volatile times.

Our Six-Point Plan to Financial Success

1. Hit the Campaign Trail Early

When it comes to reaching financial goals, time is much more important than rate of return, thanks to the power of compounding. Figure 14 demonstrates this concept by looking at 10-, 20-, 30-, and 40-year investing periods. An investment of $10,000 per year, earning 5% per year, would result in a future value of $1,207,998 after 40 years. Considering that same investment of $10,000 per year, the final column in the table shows the annual return that would be required over the shorter time periods (of 10, 20, or 30 years) in order to reach that same future value of $1.21 million.

If you have been fortunate enough to save for much of your life to meet your financial goals, thank the financial advisor or family member who set you on that path, because investing for 40 years at a relatively conservative 5% per year is roughly equivalent to investing for 10 years at 51% per year, and that 5% rate is much easier to achieve. Starting early has certainly provided significant added returns.

What about those who did not start early? Rather than regretting not getting an early start to investing, it's important to seize the moment and be early relative to the future. Some retirement savings may not be drawn on for many years, and investing for children or grandchildren can stretch the timeline—and compounding benefits—even further.

14 TIME MAKES A BIG DIFFERENCE IN THE RETURN NEEDED TO REACH FINANCIAL GOALS

Number of Years	Invested per Year	Return	Future Value	Annual Return Needed to Equal 40-Year Future Value
40	$10,000	5%	$1,207,998	5.0%
30	$10,000	5%	$664,388	8.3%
20	$10,000	5%	$330,660	16.4%
10	$10,000	5%	$125,779	51.3%

Source: LPL Research 06/30/16

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

2. Stay on Message, Stay Diversified

Politicians need to stay on message when swaying voters, and investors need to remain committed to the key determinants of long-term investment success, which include the powerful risk and return driver of diversification. Although spreading investments across asset classes in portfolios has not contributed to performance in recent years, we all know not to put all of our eggs in one basket. Concentrating investments in a limited number of investment ideas and themes is a risky strategy for long-term investing. This is why the axiom that the only free lunch in investing is diversification rings so true—because diversifying, over time, can help mitigate risk without sacrificing return.

Just because investing only in large cap U.S. stocks may have been the best strategy over the past few years does not mean it will be going forward. The recent diversification drag is the longest such stretch since the late 1990s. After that, diversification enjoyed one of its strongest runs ever. A diversified portfolio (as constructed in Figure 15) outperformed the "nondiversified" S&P 500 in 9 out of 11 years from 2000–2010. Although diversification has detracted in four out of the past five years, a reversal in this diversification trend may be approaching.

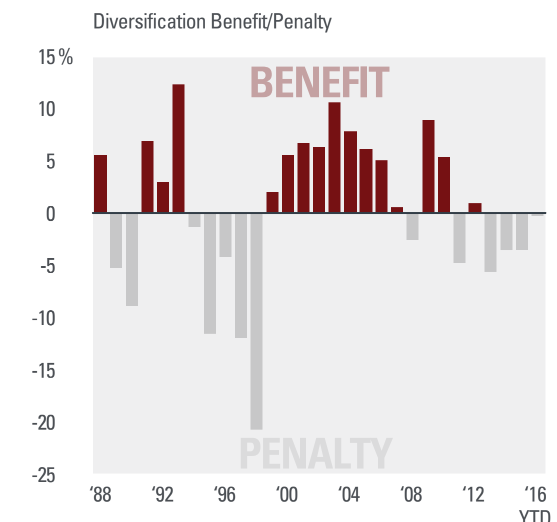
Diversification's contribution to investment performance is cyclical. We have identified some factors, including market volatility, that seem to have some predictive ability to signal when diversification will and will not work. However, we would suggest that timing these trends is not best served for the long-term investor. What we can control is our holding period—there are no term limits on investing. The longer the time frame, the more likely diversification is to boost returns, suggesting diversification may not just reduce volatility in the coming years but may also add to returns. Our message remains the same and we believe in diversification over the long term.

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

3. Get Ahead of the Story, Don't Chase Performance

Buying into an up market is the comfortable thing to do; just as when the market is down, we want to get out and cut our losses. But when it comes to investing, sometimes the comfortable strategy isn't the most prudent one. Making the comfortable decision amidst market volatility usually translates into buying at the peak and selling at or near the lows. A herd mentality and recency bias combine to throw a big obstacle in

15 DIVERSIFICATION BENEFITS ARE CYCLICAL AND MAY BE POISED TO REVERSE



Source: LPL Research, Zephyr, FactSet 06/30/16

Diversification benefits are based on the difference between the return for the S&P 500 and a portfolio of 30% the S&P 500, 20% the Russell 2000 Index, 20% the Russell Midcap Index, 10% the MSCI EAFE Index, 10% the FTSE NAREIT All Equity REITs Index, and 10% the MSCI Emerging Markets Index, rebalanced monthly. Rolling periods use monthly returns from 01/01/88 to 05/31/16. This analysis is for illustrative purposes only. Results would have been different had different indexes or time frames been used.

Indexes are unmanaged index and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is not indicative of future results.

front of us. Investors who focus on the big picture and maintain an even keel through the market's ups and downs, whether through self-discipline or with the help of trusted financial advice, tend to generate potentially better investment performance over the long term. Even seasoned investment professionals fall victim to these biases, but they acknowledge them and put processes in place to manage them.

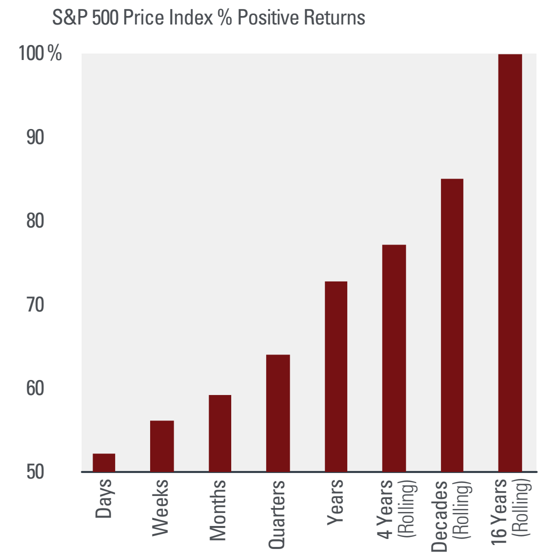
These biases can work in the other direction too. The stock market has done virtually nothing for the past year and a half, causing some to expect similar lackluster performance going forward. Of course, the truth is that no one can predict what stocks will do with any degree of certainty from one year to the next. However, we do know that assuming the flat stock market over the past 18 months will repeat for the next 18 months is just as unlikely. Rather, patience is required to help ensure we are invested enough to pursue the attractive returns that the markets have delivered over many decades.

Consider Alternative Points of View: How to Invest in Alternative Strategies

Alternative investment strategies can play an important role in a portfolio, especially given the current level of volatility. There are a few areas that may be particularly attractive. By definition, these types of investments are typically structured to be uncorrelated to traditional investments; in many cases their returns will be as much a function of decisions by the investment managers as overall market conditions.

Precious metals can be a valuable asset class during periods of currency uncertainty; increased intervention by central banks also generally makes gold more attractive. Managed futures programs may also benefit from sustained upward trends in metals prices as well as downward pressure on interest rates. Long/short equity strategies also appear attractive, as they provide some exposure to equity markets while limiting downside volatility. We also think that MLPs are attractive given their high yields and relative stability in energy prices. We are very cautious with respect to arbitrage-based strategies that rely on leverage. Given very low interest rates, the use of leverage may result in a high degree of risk with relatively low return potential.

16 **LIKELIHOOD OF POSITIVE RETURNS INCREASES OVER LONGER TIME FRAMES**



Source: LPL Research, Bloomberg 06/30/16

Data are from 01/01/61 through 12/31/15.

4. Be Patient, It's More Than Just the Next 4 Years

Investment returns can vary a lot depending on the holding period, especially for riskier asset classes such as stocks. It can take time for something that works a majority of the time to work most of the time. For example, over the past 50 years, based on daily data, the S&P 500 has been positive only 53% of the time. But over longer periods, the likelihood of positive performance improves dramatically as the holding period elongates [Figure 16]. In fact, while stocks are only up around a coin flip day-to-day, we have never seen a 16-year period when stocks didn't achieve a positive rate of return.

For performance that varies a lot, like stock returns, what happens over several months, quarters, or even years may tell you little about what might happen over the longer run. Of course, even longer periods are uncertain and can be influenced by changing economic and financial conditions.

The message here is that patience and a focus on the long term can dramatically improve your chances of success. It's more than just about the next 6–12 months—or a 4-year term—it's about consistent participation and a commitment to an investment plan for the long run.

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.

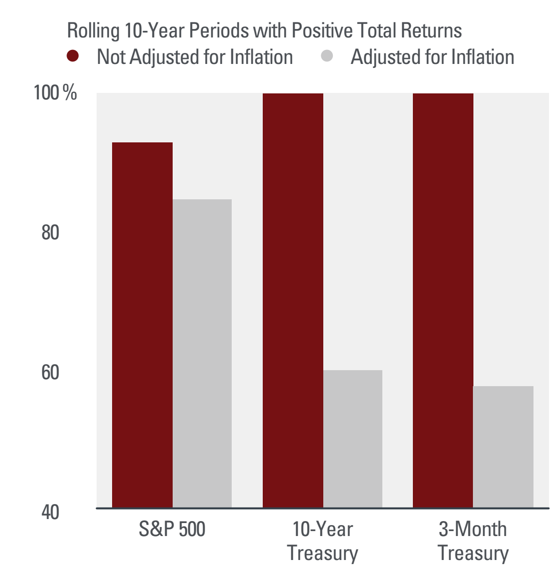
5. Avoid Political Biases

Many emotions and biases work against investors trying to stick to their long-term plans. But perhaps none of those biases are more emotional than politics. But key supporters can originate where you may least expect.

People care about politics, and whether the candidate that a particular investor favors is in office may influence how that individual feels about the economy and markets, which could lead to poor investment decisions. For example, Republicans may have been slower to invest in 2009 after President Barack Obama was elected and missed out on attractive returns; or some Democrats may not have participated in the 2003–2007 bull market when George W. Bush was in the White House.

Separating political views from investment decisions can be very difficult. But over the long term, the economic cycle and market fundamentals (corporate profits, inflation, interest rates, valuations, etc.) are far more important drivers of stock market performance than politics. Politics can have short-term impact, no doubt, and can have outsized impact on certain industries and sectors; but in general, a focus on the long-term economic and market fundamentals will help you achieve your investment goals.

17 **RETURN LEVELS CAN BE AN IMPORTANT FACTOR IN BEATING INFLATION**



Source: LPL Research, Federal Reserve, U.S. Bureau of Labor Statistics, Aswath Damodaran (New York University Stern School of Business) 06/30/16

Data are as of year-end 2015.

6. Organize a Fundraiser, Inflation Decays the Value of Cash

In today's low interest rate environment, getting a positive return from savings after inflation to maintain—or better yet, increase—purchasing power is difficult. Inflation is often the enemy of savers and investors because it inconspicuously eats away at the value of savings and investments alike. After taking into account the impact of inflation, cash is among the most punitive investments.

Investors should be wary of holding too much cash, but more so, understand that cash has difficulty keeping its value after adjusting for inflation. The annual return for the U.S. 3-month Treasury, a proxy for the return of cash, has never been negative over any rolling 10-year period dating back to 1937 without adjusting for inflation; but after adjusting for inflation it has been negative in 42% of all rolling 10-year periods, and every year from 2009 to 2016 [Figure 17]. Being positioned to at least maintain the purchasing power for money set aside for the future is a prudent minimum initial goal (inflation has averaged a little over 3% annually since WWII, but has been lower since the start of the Great Recession). Striving for higher returns that best fit your risk objectives is the best way to beat inflation over the long run, even if those returns are below long-term averages.

A Winning Platform

The road to long-term financial goals is filled with many potholes and road blocks. We can all fall victim to the many behavioral biases that can impede our progress toward our long-term goals. We hope our campaign strategy can help you stick to your long-term investment strategy and achieve your investment aspirations.

Over these past seven years, one of the best, but also most befuddling, bull markets in history may have made us feel like the financial markets are not functioning properly, and there's a need to change something to "make investing great again." But even though a changing world presents important new challenges, having the right advice that helps maintain a focus on the big picture, execute a good plan, and stay patient, brings out the ways that "investing has always been great." We think you have the winning platform already: invest early and often, stay diversified, be patient through the ups and downs, protect against your biases, and remember that too much cash is a punitive long-term investment.

ELECTING TO INVEST

Voting is far more than just entering a booth every four years to pull a lever, push the button, or fill in the bubbles on each ballot. Furthermore, presidential elections are rarely even about a particular person—someone we have likely never met. Rather, voting is simply supporting a preferred candidate's platform that best represents each voter's personal beliefs, convictions, and values. In other words, elections are about casting a vote that is essentially every individual American's investment in our collective future. Voting represents, in that short time we are alone in that booth, a casting of our hopes for a better future for our country, our family, and ourselves. It's the one time every four years when we transform from people to citizens, from our day-to-day routines to a democracy.

Yet, despite the importance of this investment and what it represents for our future, a shockingly small number of Americans ever enter the voting booth. The Center for the Study of the American Electorate found that only 57.5% of eligible voters cast a ballot in the 2012 presidential election, and forecasts are that even fewer voters will turn out this year. It is certainly understandable the many reasons why almost half of Americans don't show up to vote, as navigating the crowded parking lot, waiting in long lines, and the hassle of taking time out of our busy lives to make a trip to the polls is just inconvenient. But, perhaps more than anything, what keeps most Americans from the voting booth is the belief that their vote doesn't count.

Equally alarming is that almost one-third of Americans have no savings for retirement and only half of Americans invest in the stock market at all. Although there are many individual reasons behind this trend, one is undoubtedly the concern over market volatility and the fear that another Great Recession could be around the corner.

Whether it is the distress that one vote doesn't matter or the concern over the impact of short-term market volatility, it is fear that keeps many people from fully participating in both elections and investing. But the simple fact is, that although it is unlikely that your individual checked-off ballot will be the deciding vote in this presidential election, it is equally unlikely than any down market day—or even year—will derail a long-term investor's financial plan. The reality is that what makes a democracy work is that all of our votes matter, not any one ballot in particular. And in investing, the same is true; it is the collection of market days that combine to create what Albert Einstein coined as the most powerful force on Earth: compounding. Thus, elections and investing are both fueled by consistent participation.

So as we all (or more likely, half of us) enter the polling stations in our neighborhoods this November and transform our towns into communities, for just one day we should revel solemnly and introspectively over how important and influential our decision to participate really is. Equally, as markets move up and down, it is patience, adherence to our investment plan, and a decision to participate that will be the hallmarks for investment success and the fulfillment of our investment in our future.

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