2012 Outlook Abridged

Meeting in the Middle

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

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

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

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

- ✓ **Soft sentiment and hard data find middle ground.** We expect the U.S. economy to grow about 2%, which is below the consensus forecast, while emerging markets post stronger growth and Europe experiences a mild recession. U.S. gross domestic product (GDP) is likely to produce below-average growth of about 2% in 2012, supported by solid business spending and modest, but stable, consumer spending.
- ✓ **Stocks supported by converging outlook for earnings growth.** The U.S. stock market is likely to post an 8–12%* gain, supported by mid-to-high single-digit earnings growth when the pessimistic outlook for profits reflected in the markets rise to converge with a slide in the lofty expectations for earnings projected by Wall Street analysts. Stocks may receive a boost from a slight improvement in valuations from the current 20-year low as confidence returns that the business cycle will continue.
- ✓ **Government and corporate bond yield gap narrows.** The performance gap between government and corporate bonds reverses in 2012 with corporate bonds outperforming as they post modest single-digit gains as interest rates rise and credit spreads narrow. Bond yields may be volatile within a 1.7–3% range, but we expect them to rise over the course of the year, with the yield on the 10-year Treasury ending the year around 3%. Ongoing economic growth will help to normalize interest rates as will a continuation of Federal Reserve (Fed) policy, stable inflation and tightening fiscal policy. The wide gap between yields on government bonds and those of other borrowers is likely to converge some in 2012.
- ✓ **Major policy-driven events will converge on the financial markets in 2012.** We believe a mild recession emerges in Europe, in contrast to the consensus forecast for continued growth, and the debt dilemma continues to grab headlines and move markets, while the outlook for growth and financial stress in China will also garner attention from investors. In addition, the 2012 elections in the United States are likely to hold major consequences for investors. The key fight this election is over those in the middle. The party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in the federal budget policy since World War II.

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

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

LPL Financial

Investing in 2012

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

Fixed Income Investing in an Environment of Rising Interest Rates

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

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

- High-Yield Corporate Bonds: We believe the best opportunities for fixed income investors remain in higher-yielding, more economically sensitive bonds, in particular high-yield bonds. Corporate bond valuations, both investment grade and high yield, still reflect a very high probability of recession; something that we believe only has a one-in-three chance of taking place. The high-yield bond sector reflects an expected surge in defaults, which we believe is unwarranted. Furthermore, we believe the impact of credit contagion from Europe is much less than feared. Corporate bond credit quality is solid with substantial cash balances in corporate America, coupled with strong profit growth supporting interest payments and continuing a low default rate.
- Municipal Bonds: We continue to find municipal bonds attractive for 2012. Top-quality municipal bond yields exceed those of Treasuries and have led to some of the most attractive valuations since spring 2009. However, the now lower level of yields suggests a slower pace of performance going forward and investors should temper expectations. We expect a mid-single-digit return for Municipal Bonds in 2012. A repeat of 2011's high-single-digit return, which was fueled by panicky valuations at the start of 2011 and higher yields, is unlikely.
- Emerging Market Debt: Among global bonds, we find Emerging Market Debt attractive but would avoid foreign bonds, which contain exposure to Japanese and European government bonds. We still expect emerging market (EM) economic growth to be two or three times stronger than that of developed

countries and find market concerns over a recession among emerging market countries as vastly overstated. While we find a greater opportunity in High-Yield Bonds, EM Debt valuations remain attractive—offering a greater than 3% yield advantage to comparable Treasuries.

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

Stock Market Investing in a Sluggish Global Economy

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

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

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

- Commodity Stocks: The stocks of commodity producers are well positioned heading into 2012 due to their exposure to fast-growing demand from emerging market economies as well as their cyclicality. Very stimulative U.S. monetary policy, a weak dollar and emerging supply constraints in several key commodities, including copper, should also be supportive. We believe these stocks will perform well if China's growth stabilizes (a soft landing) after deliberately slowing in the past couple of years. Commodity stocks are trading at below-average historical relative valuations despite the favorable, middle stage of the U.S. business cycle that has historically favored these stocks along with strong growth prospects in emerging market countries.

- Small- and Mid-Cap U.S. Stocks: We expect Small- and Mid-Cap U.S. stocks can provide attractive returns for investors in 2012. Smaller capitalization companies tend to perform better after the economy emerges from mid-cycle soft spots and credit markets improve. We expect Small and Mid Caps to benefit from increased merger and acquisition activity in 2012 due to the significant amount of cash, north of $1 trillion, on non-financial company balance sheets. Potential headwinds include less exposure to fast-growing emerging market economies. We believe Mid Growth is particularly well positioned due to the concentration in cyclical sectors.
- Emerging Markets: We see attractive return potential in 2012 for Emerging Markets as economic growth far exceeds that of the developed world. In addition, monetary policy is becoming more positive with central banks beginning to reverse course and cut interest rates. We see China averting a hard landing, growing in the 8–9% range rather than 5–6% as some fear. Emerging market economies in aggregate should only slow marginally in 2012 and still grow at about a 6% pace. A weaker US dollar may add to attractive Emerging Market returns in 2012.

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

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing may involve risk including loss of principal.

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

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

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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

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

The 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.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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.

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.

The prices of small cap stocks are generally more volatile than those of large cap stocks.

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