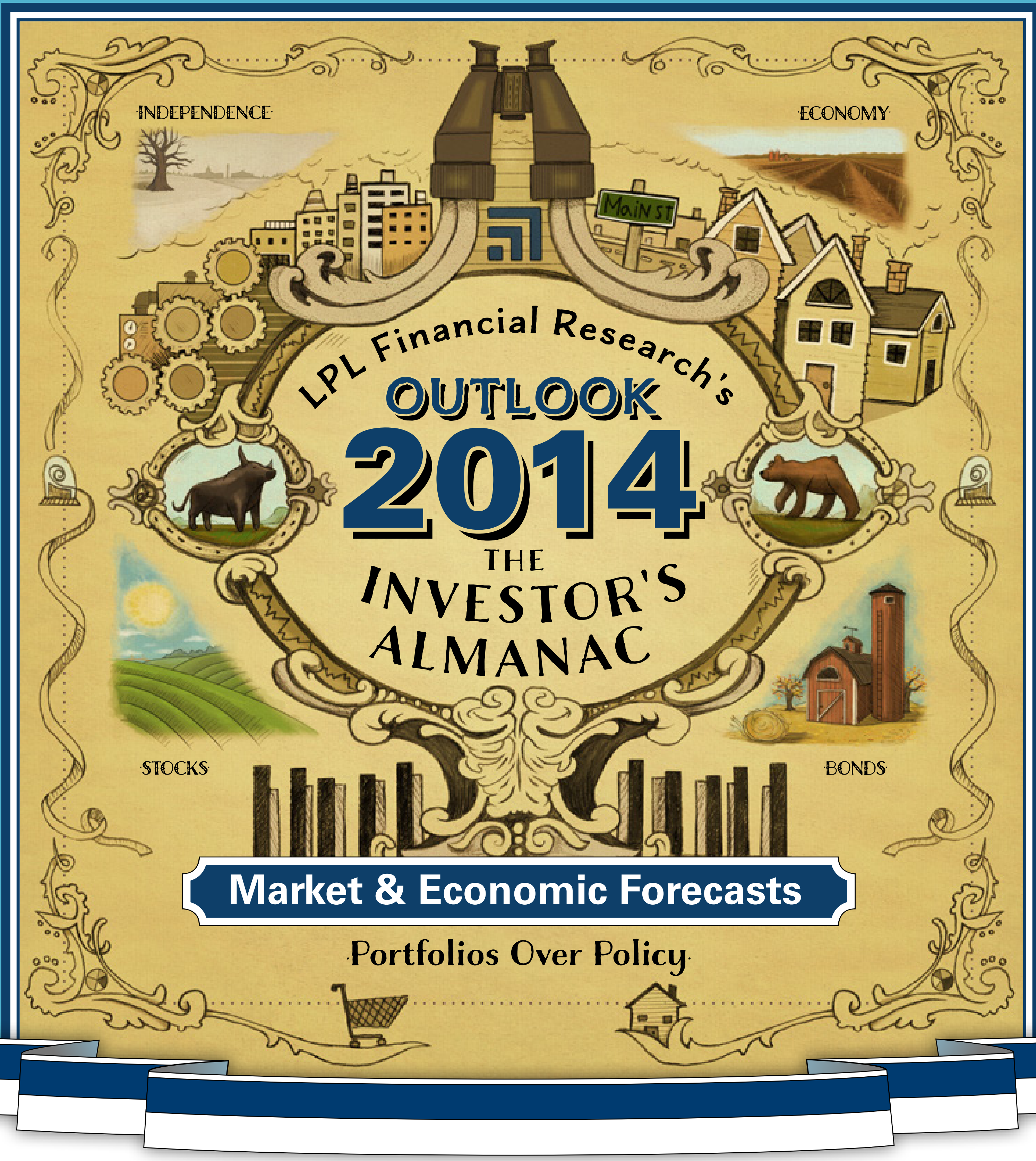


LPL Financial

THE INVESTOR'S

Portfolios Over Policy

A farming almanac is an annual publication containing a guide for the coming year and a forecast of the times and statistics of events and phenomena important to growing. Farmers' almanacs have been a source of wisdom, rooted in the core values of independence and simple living, for American growers for over 200 years. In LPL Financial Research's *Outlook 2014: The Investor's Almanac*, we seek to provide a trusted guide to the coming year filled with a wealth of wisdom for investors.

In 2014, portfolios are likely to enjoy more independence from policymakers than in 2013, when the markets and media seemed to obsess over policymakers' actions both here and abroad. This could be seen throughout 2013, during the government shutdown and debt ceiling debacle, the Federal Reserve's (Fed) mixed messages on tapering its aggressive bond-buying program, the bank bailout and elections in Europe, and the unprecedented government stimulus referred to as "Abenomics" in Japan, among many other examples.

In the year ahead, there are many reasons investors can return to the basics of growing and preserving their portfolios and spend less time gauging the actions of policymakers, including:

- After two "clean" lifts to the debt ceiling since 2011, which ensured any risk of default on Treasury obligations was avoided, we are unlikely to see concessions in exchange for a third increase in 2014 — making a high-stakes fiscal battle unlikely.
- The Fed is likely to begin to taper its bond-purchase program, known as quantitative easing (QE), in the first half of 2014, signaling a commitment to reducing its presence in the markets and transitioning to a post-QE environment.
- Europe is emerging from recession, which means less need for direct life support from the European Central Bank (ECB) or painfully austere fiscal policy as deficit targets are eased.

ALMANAC

The economy and markets becoming more independent of policymakers while growth accelerates is likely to bolster investor confidence in the reliability and sustainability of the investing environment.

Key components of our 2014 outlook:

- Stronger U.S. economic growth emerges from fertile soil, accelerating to about 3% in 2014 after three years of steady, but sluggish, 2% growth. Our above-consensus annual forecast is based upon many of the drags of 2013 fading, including U.S. tax increases and spending cuts, the European recession, and accelerating growth from additional hiring and capital spending by businesses.
- The stock market may produce a total return in the low double digits (10–15%). This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10% and a rise in the price-to-earnings ratio (PE) of about half a point from just under 16 to 16.5, leaving more room to grow. The PE gain is due to increased confidence in improved growth allowing the ratio to slowly move toward the higher levels that marked the end of every bull market since World War II (WWII).
- Bond market total returns are likely to be flat as yields rise with the 10-year Treasury yield ending the year at 3.25–3.75%. Our view of yields rising beyond what the futures market has priced in warns of the risk in longer-maturity bonds now that conditions have turned for the bond market.

In 2014, there may be more all-time highs seen in the stock market and higher yields in the bond market than we have seen in years as economic growth accelerates. The primary risk to our outlook is that better growth in the economy and profits does not develop. That risk is likely to be much more significant than the distractions posed by Fed tapering and mid-term elections. In our almanac, we forecast a healthy investment environment in which to cultivate a growing portfolio in 2014.

LPL Financial Research's

OUTLOOK 2014

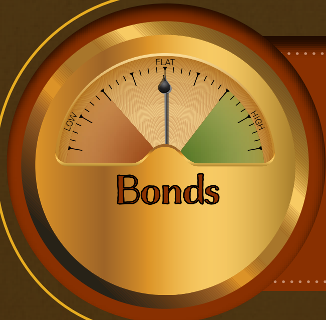
At A Glance

3% Growth

As economic drags fade and global growth improves, the U.S. economy may accelerate to its fastest pace in nearly a decade.

10-15% Returns

This slightly above-average annual return forecast is rooted in our expectations for high single-digit earnings growth and a modest rise in the PE.



Flat Returns

Interest rates will move higher and bond prices lower in response to improving economic growth eroding return from yield.

Guide to Growing and Preserving Your Portfolio

Sowing Seeds

Consider adding some of these to your growing portfolio

- International (Developed Market) Stocks
- Emerging Market Stocks
- U.S. Small Cap Stocks
- Bank Loans
- Emerging Market Bonds

Full Bloom

Ensure plenty of portfolio space for these

- U.S. Large Cap Stocks
- Cyclical Stocks
- Intermediate-Term Bonds
- High-Yield Bonds
- Investment-Grade Corporate Bonds
- Municipal Bonds

Harvest Time

Consider reaping these that are not in season

- Defensive Stocks
- High-Quality Bonds
- Long-Term Bonds
- International (Developed Market) Bonds
- Cash

Source: LPL Financial Research 11/26/13

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

Operation Twist is the name given to a Federal Reserve monetary policy operation that involves the purchase and sale of bonds. "Operation Twist" describes a monetary process where the Fed buys and sells short-term and long-term bonds depending on their objective.

How to Invest

Look for these How to Invest planter tags for strategies to cultivate your portfolio in the 2014 environment.

Investor Independence

The 20-year cycle starts to turn in 2014, as the overarching trend is one of investors becoming more independent from policymakers.

Taking a look back at recent history, it would seem that policymakers dictate to the markets how to move. Examples from the past few years include:

- The U.S. Fed bent the yield curve to its will by driving the yield on the 10-year Treasury from 4% to as low as 1.6% through a commitment to bond purchases.
- The Bank of Japan communicated its intention to generate some inflation and, in response, the yen weakened by 25%.
- The ECB drove bond yields down in troubled peripheral countries—such as the drop from 16% to 6% in Portugal that took place in just months—without having to actually do much more than state its intention to support Eurozone member debt.

20-Year Cycle

This may seem normal, but it has not always been this way. Instead, history reveals times when markets have driven policymakers to action rather than the other way around. In fact, a look back to the events of 20 years ago can attest to the power of portfolios over policymakers:

- The date "Black Wednesday" refers to September 16, 1992, when the markets forced British policymakers to withdraw the pound from the European Exchange Rate Mechanism after they were unable to maintain its price target. The unrelenting market pressure was driven by market participants like George Soros who made over £1 billion by betting against the currency.
- The term "bond vigilantes" refers to the market participants that drove the yield on the 10-year U.S. Treasury from 5.2% to 8.0% from October 1993 to November 1994, over concerns about federal policymakers' overspending. In response, policymakers, including Treasury Secretary Rubin, President Clinton, and Congress, made efforts to reduce the deficit.

Highlighting the impact the market held over policymakers 20 years ago, President Clinton's political adviser James Carville said at the time: "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." However, that era of markets dominating policymakers was not normal either. In 1973, 20 years earlier, the cycle was reversed, and the Organization of the Petroleum Exporting Countries (OPEC) policymakers dominated the direction of the world's markets and economy with the first oil embargo.

So perhaps, another 20-year cycle of policymaker dominance of the markets has peaked. The next 20 years could mark a turn back toward markets leading policymakers as the Fed commits to reducing its presence in the market by tapering bond purchases in 2014, and significant new policy initiatives are unlikely in a mid-term election year.

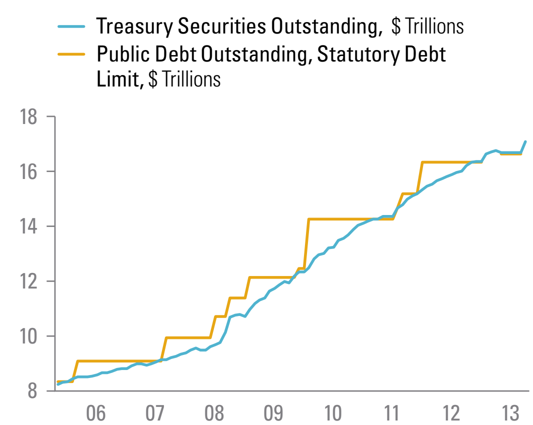
Weary of Washington

Washington will still gather some attention from investors. After all, deadlines have been set early in 2014 for hitting the debt ceiling and the funding of the federal government, coinciding with primary season for the mid-term elections. But we think there is unlikely to be a reprise of the brinkmanship and economic disruption that threatened to take the United States to the brink of disaster.

The January 15, 2014 date for funding the government in the 2013 debt ceiling deal was chosen because that is the date of the next round of automatic sequestration spending cuts. These cuts kick in unless Congress scraps the cuts mandated by the Budget Control Act of 2011 or enacts other specific cuts to bring the spending subject to sequestration down to the required $967 billion cap for 2014. The amount of the spending cap in the October 2013 deal was frozen temporarily for three months at the fiscal year 2013 level of $986 billion. The Senate and President Obama want to raise the cap from $986 billion while Republicans want to keep it, but ease cuts on defense spending. In any case, the market impact may be muted since the 2014 required cuts only total another $19 billion, and there may be discussions of eliminating them and even rescinding some of the 2013 budget cuts, resulting in potential economic upside. Importantly, we are unlikely to see tax increases or major spending cuts as part of closing the gap, as talk shifts from how to deal with the cuts to how to improve growth.

The October 2013 deal lifted the debt ceiling until February 7, 2014 [Figure 1]. Of course, the Treasury would still be able to use "extraordinary measures" to stay below the ceiling beyond February 7, especially with tax receipts strong approaching April 15. The debt ceiling has now been lifted twice since the August 2011 debacle without any spending cuts or other policy changes attached to it, making it less likely another push for changes in early 2014 would be worth the political and economic cost of a showdown. In 2013, Republicans saw enough negative impact on polling results to make them wary of another showdown in an election year. It is worth noting that 87 House Republicans voted in favor of the October 2013 deal when only 17 votes were needed to pass the legislation, reflecting wide Republican support for a bipartisan solution to future debt ceiling debates.

1 U.S. Debt Ceiling Likely to Be Lifted Again in 2014



Source: LPL Financial Research, U.S. Treasury, Haver Analytics 11/15/13

Active Investing

The rise in volatility may be a good thing for investors seeking opportunities. Active managers have tended to outperform the indexes when the markets are more volatile. In fact, the average U.S. large cap active manager has historically outperformed the S&P 500 most of the time during periods of heightened volatility, defined by the VIX being more than 2 points above its 3-year average. That compares to outperforming just 38% of the time when market volatility is lower, as measured by the Morningstar U.S. Large Cap Blend category.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive it does measure the current degree of fear present in the stock market.

Focus in 2014

As investors become increasingly independent of policymakers in 2014, they may focus more on the reliability and sustainability of growth and key emerging trends in the investing environment.

- **Good news is good news.** Investors will be paying even closer attention to signs that growth is picking up from a weak 2013, as measured by gross domestic product (GDP) and profits, as the Fed signals a desire to taper its bond-buying program. Another year of 2% GDP growth, along with ongoing bond buying from the Fed, will not be enough to drive improvement in the stock market and corporate bond spreads in 2014. A better pace of growth must develop. Investors will be watching key measures of economic activity and durability such as the Institute for Supply Management (ISM) Index and the labor market. Unlike in 2013, when strong economic reports often disappointed investors looking for more support from the Fed, strong economic data are likely to be greeted with a positive response from investors in 2014.
- **Growth scares drive volatility.** Unlike 2013, when clashes among policymakers drove market volatility, investors may drive more market volatility in 2014 as occasional "growth scares" may emerge, as economic activity may not accelerate in a straight line. 2013 has seen the lowest volatility during this business cycle, as measured by a maximum peak-to-trough decline in the S&P 500 of only 5.7%—the smallest of any year since 1995. Historically, as the business cycle passes the midway point, stock market volatility tends to rise from its low point. The year 2013 may have marked that low point in volatility, with the U.S. economy now likely to be passing the midpoint of the four-and-a-half year old business cycle.
- **Emerging growth trends, like the energy renaissance, shift power back to markets.** The United States is poised to overtake Russia as the world's largest non-OPEC producer of oil and natural gas in 2014—a shift that may erode the influence of policymakers in state-controlled, petroleum-rich nations in favor of market forces. The U.S. energy boom has helped refiners to export more fuel than ever, with sales abroad hitting a record 3.8 million barrels per day (according to the Energy Information Administration) as U.S. refiners use cheaper, locally-obtained crude to produce gasoline, diesel, and jet fuel to sell to overseas customers.

We believe 2014 marks a return to a focus on the fundamentals of investing rather than reading the tea leaves in policy statements or assessing the veracity of politicians' threats. As investor confidence becomes built upon an economy standing on its own rather than on extraordinary policy support, it may bolster investor belief in the reliability and sustainability of the investing environment, leading to another year of gains for stocks and rising interest rates in the bond market.

Fertile Soil for the Green Shoots of Stronger Growth

As economic drags fade and global growth improves, the U.S. economy may accelerate to its fastest pace in nearly a decade.

LPL Financial Research forecasts economic growth, as measured by real GDP, to accelerate from the 2% pace of recent years to 3% in 2014. This marks our first above-consensus annual forecast on GDP in many years. As of mid-November 2013, the Bloomberg-tracked consensus estimate by economists for 2014 is 2.6%. If achieved, the 3% pace of GDP growth in 2014 would be the best performance for the U.S. economy since 2005, when the economy posted a 3.4% growth rate. While a strong growth rate in comparison to the past 10 years, the 3% growth rate would simply equal the average pace of real GDP growth since the end of WWII.

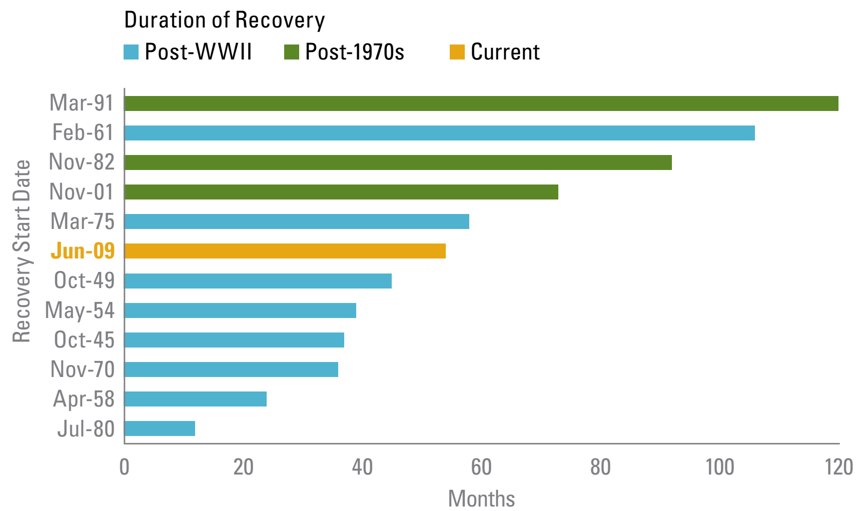
Global GDP growth is also likely to accelerate in 2014. Economists' consensus forecast expects a pickup from around 3% in 2013 to 3.6% in 2014. Beyond the United States, the major contributors to this growth rate are also likely to enjoy a better pace of growth in 2014:

- Europe will likely eke out a modest gain in GDP after emerging from a double-dip recession in 2013.
- China's growth should stabilize in the coming year after slowing during the last few years.
- Japan will likely record its third consecutive year of GDP growth for the first time since the mid-2000s.

A Longer Growing Season

If the U.S. economy grows at our expected 3% pace in 2014, it will be the end of year six of the twelfth economic expansion since the end of WWII. The current recovery is already the sixth longest expansion and would only have to last until at least mid-2014 to become the fifth longest [Figure 2].

2 The Current Economic Expansion Is the Sixth Longest Post-WWII Recovery



Source: LPL Financial Research, National Bureau of Economic Research 11/15/13

The current economic expansion has already lasted 54 months, and in 2014, may surpass the average expansion since the end of WWII, which is 58 months. Looking back over the past 50 years, the average expansion has been 71 months. On that basis, the current recovery has another two years to go (2014 and 2015) just to get to "average."

The best comparison, however, may be the three economic expansions since the end of the inflationary 1970s, a period that has seen the transformation of the U.S. economy from a domestically focused, manufacturing economy to a more export-heavy, service-based economy. In general, this economic structure is less prone to inventory swings that drove the shorter boom-bust cycles of the past. On average, the last three expansions — the ones that began in 1982, 1991, and 2001 — lasted 95 months, or roughly eight years. Using those three expansions as the standard, the current economic expansion is merely at its midpoint. The rather tepid pace of this expansion relative to prior expansions that lasted this long also supports the idea that we are close to the middle of the expansion, rather than the end.

Small Risk of Recession

Most, but not all, recoveries end when the imbalances within the economy that have built up over time grow too big to sustain. Examples of these imbalances can include overinvestment in housing or technology, excessive consumption, or too much debt, among others. Currently few, if any, material imbalances have begun to emerge, as the economy continues to struggle to normalize after the Great Recession of 2008–09, the worst economic downturn since the Great Depression of the 1930s. In fact, the strength in the forward-looking economic data captured in the Index of Leading Economic Indicators suggests just a small chance (10–15%) of a recession over the next few years.

While these data suggest low odds of recession in the United States in the next few years, a recession is not completely out of the question. For example, a major mistake by policymakers (fiscal or monetary) at home or abroad could cause a recession. In addition, a geopolitical event, such as a terrorist attack that disrupted economic activity over a wide area for a long period of time would likely lead to a recession, as would a large-scale natural disaster. Finally, a sharp and swift spike higher in consumer energy prices—similar to what the U.S. economy experienced in the early 1970s and mid-2000s—would also raise the odds of recession.

Drags on Growth Fading

Several factors have caused the current expansion to be lackluster, even after such a severe recession. Major components of GDP—government spending, business spending on equipment and buildings, and consumer investment in housing—have badly lagged the average post-WWII expansion and have acted as a drag on economic growth in the United States. The factors that contributed to the weakness in recent years include strained balance sheets, poor business confidence that contributed to a weak labor market, banks' unwillingness to lend after billions of losses in the housing bust, and a weak global economic backdrop comprised of a lingering recession in Europe and a slowdown in China and other emerging markets. Fortunately, most of these uncertainties should fade in 2014.

In addition, growth in 2013 was stifled by tax increases and spending cuts that added a material drag to the economy. The impact of the sequester, the fiscal cliff, and defense cuts reverberated throughout the economy in 2013, and these should fade quickly in early 2014, especially if Congress can come together to offset, or at least dampen, the sequester that is set to hit the economy on January 15, 2014. On balance, government spending should be less of a drag on growth in the next four years than it was in the first four of the expansion, when government spending added to growth in only three of 16 quarters. In 2011, 2012, and the first three quarters of 2013, weakness in government spending (federal, state, and local) subtracted about 0.5% each year from GDP growth. Just adding that 0.5% back to GDP in 2014 would, in addition to better global growth, result in +1% and help the U.S. economy achieve 3% growth in 2014 [Figure 3].

However, some drags may remain, including:

- The impact of the Affordable Care Act;
- The increased regulatory burden in the financial sector and its impact on bank lending and loan growth;
- The long-term outlook for the federal budget; and
- The mid-term elections in Congress.

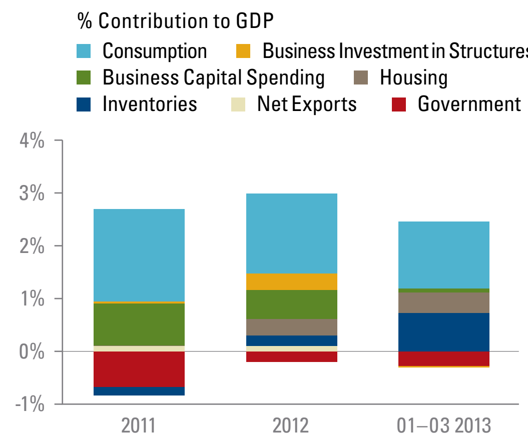
While these may keep growth from rising to 4% or above, we see the decreasing impact of drags as a positive for growth in 2014.

Yellen Enters as Fed Exits

Given our forecast for the economy, we expect the Fed to begin tapering its bond-buying program in the first half of 2014 and exit the program altogether by the end of the year. Therefore, 2014 is likely to mark a year of transition for the Fed in many ways—the immediate impact being a less direct role in the markets. After tapering its bond buying, we expect the Fed to remain on the sidelines and keep short-term interest rates near zero well into 2015.

We expect the current Vice Chairwoman of the Fed, Janet Yellen, to succeed Ben Bernanke on January 31, 2014, as Chairwoman of the Fed and the Fed's policymaking arm, the Federal Open Market Committee (FOMC). While this may have little impact on the decision to taper QE in 2014, it is a very

3 Government Acted as an Economic Drag on GDP in Each of the Past Three Years



Source: LPL Financial Research, Haver Analytics 11/15/13 significant change as it relates to the long-term balance of policy between the Fed's dual policy goals of full employment and low-and-stable inflation. The Fed has been focused primarily on inflation over the past three decades. Chairman Volker brought inflation down from the double digits in the early 1980s, then Chairman Greenspan continued that legacy and helped keep inflation stable in the 1990s, and then Chairman Bernanke sought to avoid deflation, or falling prices, in the late 2000s. The change in leadership at the Fed may mark a longer-term shift in focus toward improving employment. This may mean short-term rates remain low for an extended period while longer-term rates rise — not just in 2014, but for years to come.

The change in leadership is not the only change at the Fed in 2014, but the other changes are likely to have little impact on the focus of Fed policy. The makeup of the FOMC shifts each year on a preset schedule, with the presidents of the regional Fed banks rotating on and off the FOMC as voting members. In 2014, the FOMC will lose two members who were in favor of an earlier tapering of the bond-buying program and hike to interest rates: Esther George of Kansas City and James Bullard of St. Louis. However, they will be replaced by two members with similar views: Charles Plosser of Philadelphia and Richard Fisher of Dallas. Likewise, two members who favor a slower approach to removing the extraordinary economic stimulus by the Fed will rotate off as voting members in 2014: Eric Rosengren of Boston and Charles Evans of Chicago. But they will be replaced by two voting members with like perspectives: Sandra Pianalto of Cleveland and Narayana Kocherlakota of Minneapolis.

Yellen's credibility, and that of the Fed itself, are on the line as the Fed exits its direct role in the markets. Increasingly, emphasis will be on the guidance the FOMC provides as it contemplates increasing interest rates in future years.

Stocks Have Room to Grow and Produce Solid Gains

Our analysis, informed by history and attention to cycles, suggests 2014 holds double-digit gains for investors and a return to the fundamentals of investing with a focus on earnings and valuations.

We forecast a low double-digit gain of 10–15% for U.S. stocks in 2014, as measured by the S&P 500 Index. This forecast for a slightly above-average annual return is rooted in our expectations for high single-digit earnings growth and a modest rise in the PE ratio. Additionally, we expect similar performance for international stocks.

An improvement in economic growth to an average 3% pace in 2014 should drive solid profit gains and boost confidence in the durability of growth. Importantly, GDP does not have to be booming to produce solid gains in the stock market, as 2013 can attest. In fact, there is little relationship between the magnitude of GDP growth and stock market performance. Strong GDP can be a sign of an overheating economy that may be due for a recession, and weak GDP may be discounted by the stock market ahead of an actual turnaround. Since WWII, U.S. GDP of plus or minus 1% around the long-term average of 3% has produced an average gain of 16% in the S&P 500 and produced a positive return 83% of the time.

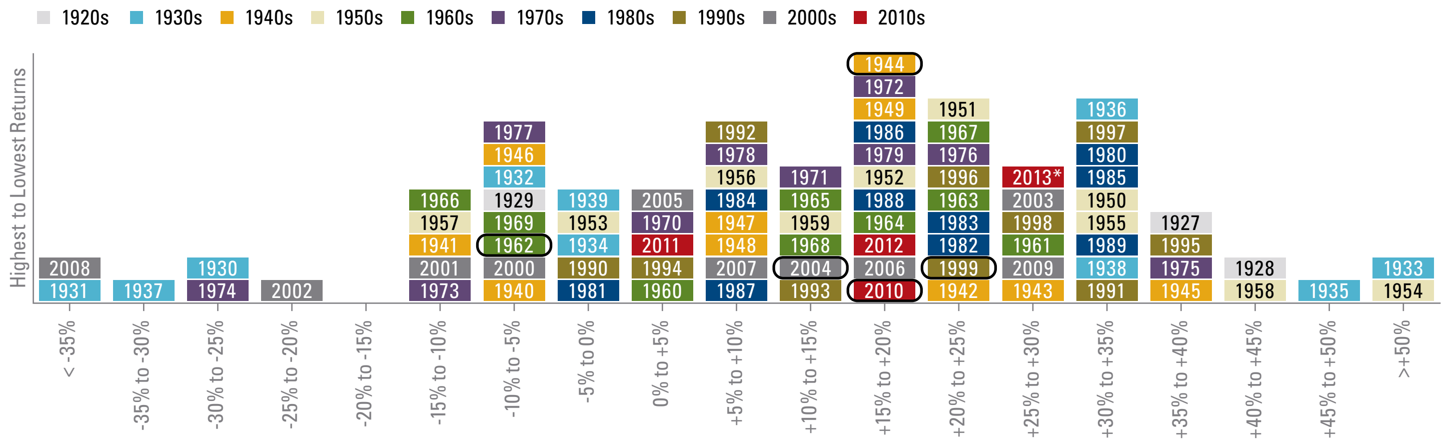
The risk to our forecast is from growth disappointing our expectations, not from policymakers derailing the recovery. A key lesson from 2013 is that the stock market and economy can overcome many challenges by policymakers, including the fiscal cliff tax increases, the sequester spending cuts, the Fed tapering concerns, and the shutdown and debt ceiling brinkmanship. But a better pace of growth must materialize; just more bond buying by the Fed is not enough to lift valuations from current levels to propel further gains.

U.S. Stocks

We foresee above-average total returns for U.S. stocks in contrast to below-average total returns for bonds.

4 Strong Years for Stocks Are Historically Followed by More Strong Years

S&P 500 Annual Total Return 1927-2013*



Source: LPL Financial Research, Bloomberg data 11/14/13
*2013 Year-to-Date Total Return Through 10/25/13

Note: Circles denote the year following 25–30% returns.

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

Cyclical Stocks

Accelerating earnings growth and a steeper yield curve over the course of 2014 favor cyclical companies regardless of growth or value style. Defensive value sectors that are interest rate sensitive, such as telecom and utilities, may suffer as interest rates rise, and defensive growth sectors like consumer staples may suffer headwinds from a rising dollar as the Fed winds down its bond-buying program.

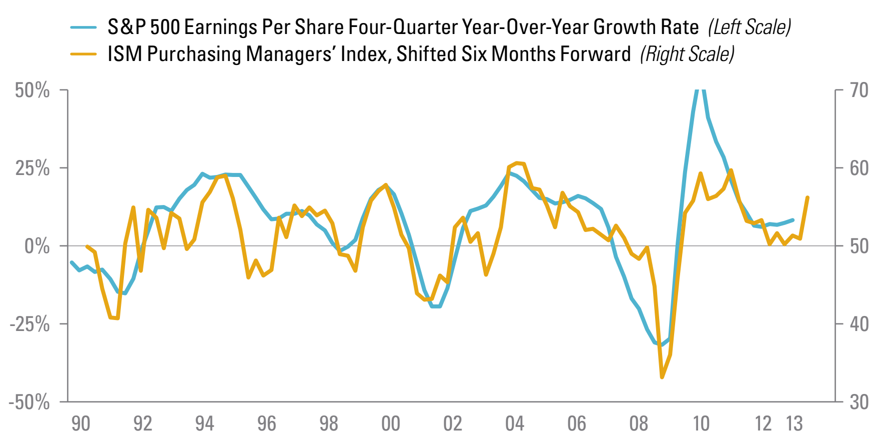
Looking Back

Some may fear an outsized gain in the stock market during 2013, is surely to be punished with losses in the coming year. However, historically after a one-year total return in the 25–30% range, the S&P 500 has followed it up by more solid years of gains. In fact, the average return in a year following a 25–30% gain was 12%, and stocks posted a double-digit gain in four of the five occurrences (the exception was 1961's gain of 26.9%, which was followed by a loss of 8.7% in 1962) [Figure 4]. In fact, most of the years were actually followed by several years of strong gains, as was the case in 1943, 2003, and 2009.

Earnings Growth

We expect more businesses will benefit from the improving trend in global economic data, which should help boost confidence in future earnings growth. Most notably, the widely followed ISM Purchasing Managers' Index has a solid track record of forecasting earnings growth in coming quarters [Figure 5]. This indicator suggests a rebound from the sluggish performance of earnings and revenues in 2013.

5 Reliable Earnings Indicator Pointing Higher



Source: LPL Financial Research, Bloomberg Data, Thomson Financial 10/11/13

Given 3–4% global GDP and inflation of 1–2% in 2014 driving sales growth for S&P 500 companies of about 5%, in conjunction with the benefit of ongoing buybacks and profit margin expansion, we expect earnings per share (EPS) growth of 5–10% in 2014. From our perspective, Wall Street analysts' consensus estimate for earnings growth of 11% in 2014 may again be too high, since it would require a combination of even stronger economic growth and profit margin expansion beyond what are already record levels.

Valuation Expansion

With only about 5% earnings growth in 2013, but a 26% gain in the S&P 500 Index (not including dividends) through mid-November 2013, it was clearly a year driven by rising valuation, as the rise in the PE did most of the lifting of the index. We expect the PE for the S&P 500 to continue to rise in 2014, though not as much as in 2013.

The rise in valuation in 2013 to about 16 was primarily a reversal of the PE contraction in 2011 and 2012, as the PE fell from around 15 at the end of 2010 to 13 in 2011 and ended 2012 at about 14. As the risk of a return to recession subsided and confidence in the durability of growth improved, the PE returned to average, as the economy kept growing despite all of the hits it took from fiscal cliff tax increases, sequester spending cuts, European bank bailouts, and Fed tapering concerns, among many others.

As the economy accelerates in 2014 and earnings grow more rapidly, the PE is likely to rise further. Alternatively, if economic growth falters and earnings do not move higher, we would expect a modest drop in the PE and a decline for the stock market, despite more bond buying from the Fed. The market has become increasingly more sensitive to growth over policy. And it is the direction of growth, much more than magnitude, that matters. Remember that the Fed's third round of bond buying, or QE3, announced in September 2012, failed to boost stocks until January 2013, when growth started to improve after the fourth quarter of 2012's GDP growth rate of just 0.1%.

While stock indexes like the S&P 500 have hit all-time highs, the stocks are not currently valued at the levels that have marked the end of bull markets in the past. The PE for S&P 500 companies using EPS over the past four quarters stands at about 16 as 2013 draws to a close. This is below the 17–18 PE where every secular and cyclical bull market has ended since WWII (with the exception of the late 1990s that ended much higher). We expect the PE for the S&P 500 to end 2014 around 16.5—a level last seen in 2005 and 2006. A rise of half a point seems reasonable based upon last year's experience as risks receded and our expectation for growth to improve in the coming year. The rise in valuation contributes 0–5% to our 10–15% return forecast.

The Bull Continues

While stocks reacted negatively in 2013 when interest rates shot up sharply on fear of a premature end to the Fed's bond-buying program, in general, stocks can go up even when bond yields rise—as we expect them to in 2014. Bull and bear market trends over the past 63 years reveal that the environment we foresee is most like that of the 1950s, when stocks were in a bull market while bonds and cash were in bear markets [Figure 6]. While the current market combination is rare, it is not unheard of—nor has it been a fleeting or fragile combination. For nearly the entire decade of the 1950s, stocks remained in an upward-trending, secular bull market while bonds and cash were mainly in a bear market.

Small Cap Stocks

Historically, an environment of improving growth and rising valuation has tended to benefit smaller company stocks over their larger company peers. But tempering this, to some degree, is the fact that they do not have as much exposure to improving foreign sales as larger companies.

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

Source: LPL Financial Research, Bloomberg data 08/26/13

The S&P 500 and the Barclays Intermediate-Term Government Bond Index are unmanaged indexes, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Index performance is not indicative of any particular investment. Past performance is no guarantee of future results.

Bond yields may continue to rise in the coming years as the Fed ends the bond-buying program and GDP growth and inflation accelerate, maintaining the bear market for bonds. At the same time, the Fed may likely keep cash yields pinned down, with no interest rate hikes likely for at least a year or two, maintaining the bear market for cash. However, we are likely to avoid the ugly triple-bear markets of the late 1970s, where soaring inflation weighed heavily on stocks, bonds, and cash.

Broadening Growth

Nowhere were the effects of the Fed's message on tapering felt more acutely in 2013 than in the world's emerging markets (EM). The MSCI Emerging Market Index is down 4% for the year through mid-November 2013 compared with a more than 25% gain for U.S. stocks. Much of that weakness came following the Fed's May 22, 2013 communication on its intention to taper its bond-buying program, with EM stocks falling about 15% during the following month. In addition, many EM currencies depreciated as investors pulled their money—echoing the start of the currency crises in Mexico in 1994 and Asian emerging markets in 1997, which were devastating to EM investors.

Similar to the environment that preceded the July start of the 1997–98 Asian financial crisis, U.S. economic growth has prompted the Fed to consider reducing monetary stimulus. The Fed's talk of tapering draws a comparison to the Fed rate hike of March 1997. Then, as now, the threat of reduced global liquidity created a headwind for emerging market countries and acted as a weight on the relative performance of EM stocks versus U.S. stocks.

However, unlike 1997, these countries have not been creating debt-fueled bubbles in their economies. And their smaller deficits, larger foreign currency reserves, debt denominated in local currency, and flexible exchange rates are positives likely to help avoid another emerging market crisis.

Chasing Returns

While corporations are again likely to remain buyers of their stocks in the coming year, 2014 may finally be the year individual investors, as a group, begin to buy stocks in contrast to the net selling they have done since the bull market began nearly five years ago. The five-year trailing annualized return for stocks has been weak, especially compared to bonds, in recent years. However, as 2014 gets underway, the one-, three-, and five-year trailing annualized returns for the S&P 500 will all be in the double digits for the first time this business cycle. Our analysis of history shows that it is the five-year return that individual investors tend to chase, based on net inflows to U.S. stock funds. As of March 6, 2014, five years from the bear market low in the S&P 500 — even assuming no additional growth in the stock market between now and then — the five-year annualized return may have exceeded bonds' 5% return by 20%. This may prompt many investors to reconsider the role of stocks in their portfolios, especially as interest rates rise and bond performance lags.

With long-term interest rates remaining historically low, corporate earnings likely to grow in the high single digits, job growth improving, and inflation remaining below 3%, conditions are ripening for stocks to reward investors in 2014.

Emerging Market Stocks

With important crisis-mitigating mechanisms in place, the outlook for EM stocks turns on prospects for global growth, which are improving. Also, the weakness in EM stock prices in 2013 has led to attractive, below-average valuations. As 2014 matures, the stocks of companies in more emerging market countries may become increasingly attractive.

International (Developed Market) Stocks

We recommended U.S. over international stocks in 2013, but the tide is turning and some international exposure is warranted in 2014. Better economic growth in developed foreign markets, notably Europe, should lift earnings growth. Earnings growth in Europe has been negative for much of the past five years, with only a brief period of growth in late 2010 and 2011. The prospects for earnings gains in 2014 similar to those of the United States should help to lift international stocks. European valuations are in line with their average discount to the United States and may rise modestly with U.S. valuations.

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

Time to Harvest Yield as Rates Rise for Bonds

As economic growth accelerates and the policymakers at the Fed reduce its direct impact on the bond market in 2014, higher interest rates will likely be the result. In this environment, high-quality bond returns may be flat.

Intermediate-Term Bonds

Long-term bonds provide too much interest rate risk to be attractive in 2014. While short-term bonds offer the least interest rate risk, their low yields make them less attractive. We believe that intermediate-term bonds possess a better combination of interest rate risk mitigation and reward in the form of yield under a range of outcomes.

Interest rates are likely to continue to move higher and bond prices lower in response to improving economic growth. This growth will likely prompt the tapering of bond purchases by the Fed and increase the likelihood of a Fed rate hike in the middle of 2015. Bond valuations remain expensive compared to historical averages, measured by low inflation-adjusted yields. Tapering will mark the first step in a return to normal for bond prices and yields. We see a defensive investment posture in the bond market focused on less interest rate sensitive sectors as the most prudent way to invest in 2014. Conditions for the bond market have turned after a long period of solid gains, suggesting investors focus on picking up the interest payments that drop from bonds. Investors should no longer expect growth in principal value that boosted total returns for many years.

Historically, longer-term bond yields have tended to track the change in GDP growth when unleashed from Fed actions. Stronger economic growth can drive interest rates higher on the potential for higher inflation as demand picks up and greater desire for borrowing elevates the cost of funding. Our expectation for a 1% acceleration in U.S. GDP over the pace of 2013 suggests a similar move for the bond market. This would prompt a rise in the yield on the 10-year Treasury from around 2.75% as of mid-November 2013 to about 3.25% to 3.75% in 2014.

On the Horizon

While investors may see the Fed end direct involvement in the bond market in 2014 as the bond-buying program comes to a close, the Fed may make its presence felt again in 2015 with a series of rate hikes. The expectation for rate hikes in 2015 may also lead to rising pressure on bond yields in 2014.

Each period of Fed interest rate hikes is different, but by evaluating key metrics such as short-term Treasury yields, the shape of the yield curve, and inflation-adjusted yields prevalent at the start of prior Fed rate hikes, we can approximate the trajectory of yields in 2014 as the market braces for a potential interest rate hike in 2015.

Given the Fed's current guidance for a mid-2015 start to interest rate hikes, supported by our outlook for stronger GDP and job growth in 2014, we may expect at least an 18-month path of reduced Fed involvement in the bond market from around the start of 2014 to mid-2015. This reinforces the fundamental case for the 10-year Treasury yield rising by 0.5% to 1.0% as yields rise to more "normal" valuation levels that would translate to a 10-year Treasury yield at the end of 2014 of 3.25% to 3.75%. Total returns may be roughly flat under that scenario [Figure 7].

It is possible that yields could increase by 1% to 3.75% should inflation-adjusted yields return to more normal levels. Under that scenario, high-quality bond total returns would be negative, as indicated by Figure 7. We see a move of this magnitude as less likely unless the markets expect an earlier start to Fed rate hikes. Instead, we think it is more likely the Fed may wait longer than mid-2015 to raise interest rates, which supports a more fundamentally driven and modest rise in yields.

The primary risk to our bond market outlook is that yields rise less than our forecast due to:

- **Disappointing growth.** Slower-than-expected growth may reinforce the low inflation environment and delay the timing of eventual Fed rate hikes—both of which are positives for bond prices. Should the economy grow at a slower pace than anticipated in 2014, bond prices may similarly prove more resilient.
- **Low inflation.** Inflation is an enemy of bondholders since it makes fixed payments worth less over time. While it is likely to pick up modestly in 2014, fortunately, it is likely to remain historically low. Bond valuations may therefore remain historically expensive. The lower the pace of inflation, the less bond yields will need to rise in response.
- **Fed delays.** Our interest rate forecast is based upon the Fed gradually tapering bond purchases in 2014 and market participants' expectation for a potential interest rate hike in June 2015. If these are pushed back, yields may rise less than our base forecast, and bond prices may prove more resilient. Low single-digit returns may result if it becomes clear the Fed may wait longer than mid-2015 to raise interest rates.

Stay in the Middle

The risk of losses from rising interest rates affects longer-term bonds the most. The reason that longer-term bonds are more susceptible to interest rate risk is because they have a long future stream of interest payments that do not match the higher and rising current rates, and so the bond price must be discounted to compensate for the change in interest rates.

Among high-quality bonds, we prefer intermediate-term bonds, which possess far less interest rate risk compared to long-term bonds [Figure 8]. The yield curve remains relatively steep today. A positive factor for intermediate-term bonds is that they occupy the steepest portion of the yield curve. A yield curve is a chart of bond yields from the shortest-maturity

7 We Expect Flat High-Quality Bond Returns in 2014

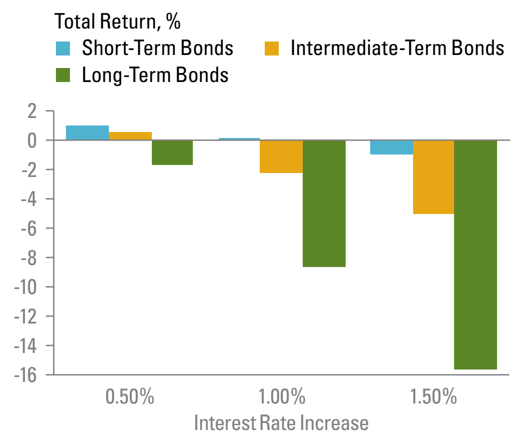
Change in Bond Yields, %	-0.50	-0.25	0.00	0.25	0.50	0.75	1.00
Total Return, %	6.1	4.7	3.4	2.0	0.6	-0.8	-2.2

Source: LPL Financial Research, Barclays Aggregate Bond Index data 11/08/13

Scenario analysis returns assume one-year holding period, no reinvestment of interest income, and a parallel shift in the yield curve.

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.

8 Interest Rate Risk Remains Concentrated Among Long-Term Bonds



Source: LPL Financial Research, Barclays Aggregate Bond Index data 11/08/13
Chart shows one-year total return for Barclays 1-3yr Gov/Credit Index, Barclays Aggregate Bond Index, and Barclays Long-Term Gov/Credit Index. Returns reflect parallel shift of the yield curve, no reinvestment of income, and one-year holding period.

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.

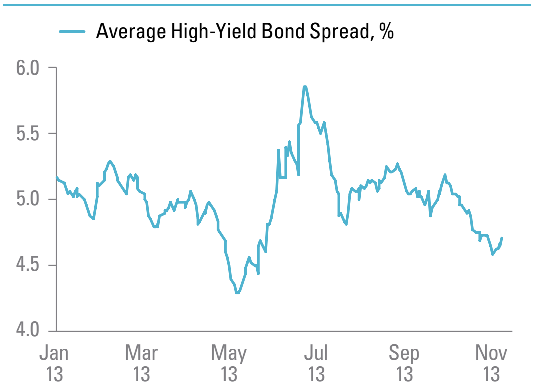
High-Yield Bonds and Bank Loans

High-yield bonds and bank loans are two sectors that have historically proven resilient and often produced gains during periods of rising interest rates. In 2013, both sectors were among the leaders of bond sector performance during a year of higher interest rates.

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.

Bank loans are loans issues by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risks including interest rate, credit, market, and default risk.

10 High-Yield Bond Valuations Are More Expensive Compared to the Start of 2013



Source: LPL Financial Research, Barclays High-Yield Index 11/08/13

Yield Spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

issues to the longest-maturity ones. The steepest point is that which offers the biggest increase in yield per additional increase in term.

Intermediate-term bonds have the ability to generate modestly positive returns despite a fair rise in interest rates. Importantly, given their position on the yield curve, intermediate-term bonds can also provide some defensive properties to a portfolio [Figure 9]. Intermediate-term, high-quality bond returns turn negative with a 1% rise in interest rates—just above the high end of the most likely range we expect for intermediate-term bonds in 2014. However, they can produce mid-single-digit gains if interest rates are unchanged or even decline slightly—driven by disappointing economic growth or a negative event causing investors to take a temporary defensive stance. In that event, intermediate-term bonds may provide a gain, offsetting losses in the event of a stock market pullback—a key reason for holding bonds in a portfolio.

9 Intermediate-Term Bonds and a Steep Yield Curve Offer Defensive Properties

	Total Return Based on Change in Treasury Yields, %			
Maturity	-0.25%	0.00%	0.50%	1.00%
4-Year	3.0	2.3	0.8	-0.6
5-Year	4.0	3.0	1.1	-0.9
7-Year	5.3	3.9	1.1	-1.6
10-Year	6.6	4.6	0.6	-3.2

Source: LPL Financial Research, Bloomberg 11/08/13

Total returns assume one-year holding period, no reinvestment of interest income, and a parallel shift in the yield curve.

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.

Harvesting Yield

A rising interest rate environment presents a challenge to bond market investors. Investors must seek to minimize interest rate-driven losses and at the same time focus opportunistically on sectors that have traditionally produced gains during rising rate environments.

Domestic Bonds

High-yield bonds and bank loans are potentially attractive bond sectors for 2014. Deteriorating credit quality and rising defaults are the key risks to investors in these lower-rated bonds, but we believe these risks will be manageable in 2014 as growth picks up. The global speculative default rate was a low 2.8% at the end of October 2013—well below the historical average. Moody's forecasts a low default environment to persist through 2014, a forecast we agree with given the limited number of maturing bonds in 2014. In addition to a low default environment, both high-yield bonds and bank loans remain supported by good fundamentals. Company leverage has increased over recent quarters, but the cost to service that debt remains quite manageable with interest coverage near post-recession highs.

High-yield bonds and bank loans are likely to produce low- to mid-single-digit returns in 2014. We expect high-yield bond spreads will end the year unchanged to 1% higher in 2014, in response to modest credit deterioration and rising rates. Yield spread widening accompanied by our expectation that bond yields overall may finish 2014 0.5% to 1.0% higher leads to a low- to mid-single-digit total return expectation. High-yield bond valuations are more expensive heading into 2014 compared with the start of 2013 [Figure 10]. As 2014 progresses, yield spreads may increase as investors begin to demand greater compensation for a potential increase in defaults in 2015. Bank loans may also be impacted by investors bracing for higher defaults, but less than high-yield bonds due to their shorter-term nature and higher seniority.

Among high-quality bonds we favor investment-grade corporate and municipal bonds. Investment-grade corporate bonds are likely to be impacted by rising interest rates but still yield, on average, 1.3% more than comparable Treasuries. We also find municipal bonds attractive, favoring intermediate-term rather than traditional long-term municipal bonds. The attractive valuations of intermediate-term municipal bonds may act as a buffer against rising interest rates.

International Bonds

Emerging market debt (EMD) is another way to add higher income-generating bonds to portfolios. In general, EMD issuers have lower debt burdens and stronger economic growth than their developed market peers. In addition, valuations are attractive as 2013 winds down with an average yield spread of 3.5% to comparable Treasuries, near the upper end of a four-year range. However, not all EMD issuers are alike. In the face of relatively sluggish global demand in recent years, some emerging market countries have relied on extraordinary liquidity provided by the world's central banks to grow their economies at the cost of running current account deficits as they increasingly borrow to import more than they export. As global credit conditions tighten and developed market bond yields rise, some EMD issuers have suffered as investors find more attractive yields in more financially secure markets. As these EMD issuers adjust to the lessened liquidity provided by central banks, they become increasingly attractive.

Developed international bond markets are less attractive. Europe's economic woes continue, despite modest improvement in 2013. Sluggish economic growth may help support higher-quality European government bonds, such as Germany's, by keeping a lid on interest rates. But the lack of growth in peripheral European countries may weigh on broader international bond markets. In Europe, large debt burdens remain and have worsened in recent years, with European government debt reaching 96% of GDP. Valuations are unattractive, especially among more troubled European nations.

Opportunities in a Less Liquid Market

Like 2013, 2014 may also provide investors with opportunities created by volatility. In 2013, the 10-year Treasury yield fell as low as 1.6% and also rose as high as 3.0% — a remarkably wide range given the steady and sluggish pace of economic growth and lack of abrupt changes by the Fed. Although these movements may seem dramatic in a historical context, they may become the norm as recent financial regulations discourage traditional market-making firms from participating in the bond market. As a result, these less liquid markets can experience sharp swings up or down and temporarily take prices and yields beyond levels warranted by fundamentals. Tactical investors may harvest opportunities that could arise in a low-return, volatile market. This may be experienced more dramatically in less liquid markets, such as emerging market debt and municipal bonds, among others.

Investment-Grade Corporate Bonds

In a rising rate environment, interest income can be a buffer against price declines associated with rising interest rates. The higher yield of investment-grade corporate bonds, which remain supported by good credit quality fundamentals, may therefore be able to provide better protection than Treasuries.

Municipal Bonds

On a long-term basis, municipal bond valuations remain attractive as top-quality municipal bond yields often exceed those of comparable-maturity Treasuries. A favorable supply-demand balance also persists, as tight budgets suggest new issuance may only marginally offset the amount of maturing debt, leading to stagnant overall market growth.

International Bonds

Emerging market debt is increasingly attractive in 2014, but we remain cautious on developed foreign bond markets given weak growth and unattractive valuations.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

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

Municipal bonds are subject to availability and change in price. They are subject 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. Municipal bonds are federally tax-free, but other state and local taxes may apply.

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

Is Washington Washed Up?

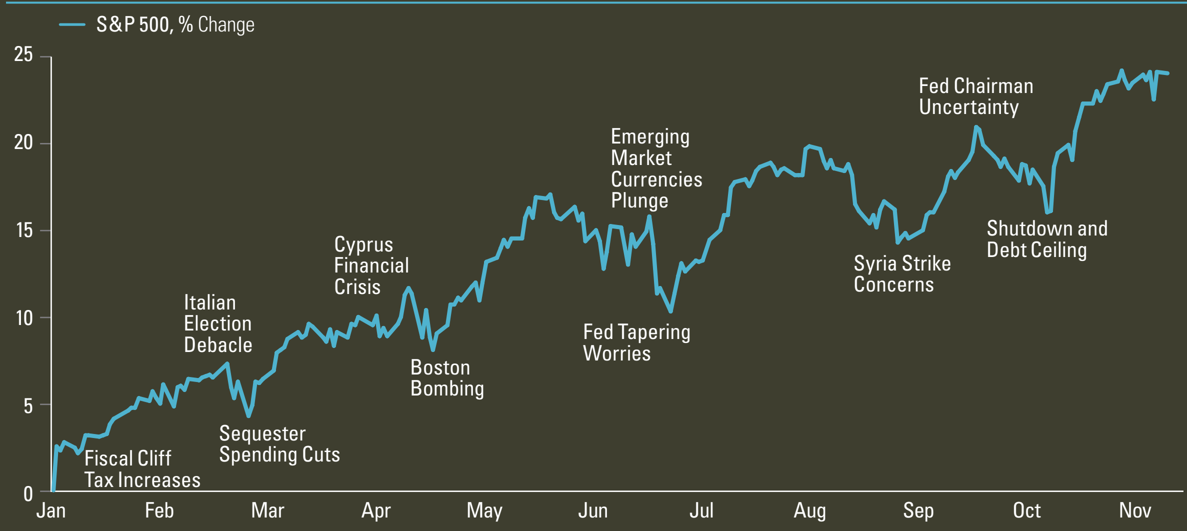
When we take a look at weather forecasts, such as those in farmers' almanacs, we do not often consider any bias by the source of those forecasts. But maybe we should. It turns out that when it comes to weather forecasting, it is common to find low-probability outcomes consistently overestimated by forecasters. For example, according to a study at Texas A&M "when TWC (The Weather Channel) forecasted a 0.2 (20%) chance of precipitation for the same day, precipitation occurred only 5.5% of the time."

The well-known bias of weather forecasters to exaggerate fears of negative, low-probability outcomes, such as the likelihood and amount of snowfall, also often appears in the forecasts of non-weather-related issues. We saw this bias in the media over the antics in Washington, D.C., fixating on the threat of a default on U.S. Treasury debt during the debt ceiling discussions, or a return to recession due to the impact of the sequester spending cuts. This bias could also be seen in events beyond the United States' borders in the exaggerated attention devoted to the threat of another financial crisis stemming from the Cyprus bank bailout, the risk of the outcome of the Italian elections plunging the Eurozone debt markets into chaos, and the risks of a strike on Syria turning into a major geopolitical military engagement.

Of course, the probabilities of those outcomes were very low, and the markets did not dwell on those potential outcomes. Market participants tuned them out, and the S&P 500 moved steadily higher throughout the year without experiencing more than a 6% pullback at any point [Figure 11]. We believe it will be safe in 2014 to again tune out much of the antics in Washington, D.C. as the mid-term elections turn up the volume but not the impact.

The LPL Financial Research forecast: In the near-term, Washington may be washed up when it comes to driving the markets.

11 The Stock Market Overcame Many Challenges in 2013



Source: LPL Financial Research, Bloomberg data 11/26/13

The S&P 500 is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

IMPORTANT DISCLOSURES

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

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

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

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

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

BEHIND THE SCENES

ABOUT THE CREATION OF *OUTLOOK 2014*

The folksy images and colorful palates of farmers' almanacs make them immediately identifiable as Americana. They have become part of the American cultural heritage and a nostalgic symbol denoting independence and a simpler life. The illustrations we created for our almanac are mindful of these principles, as we envision a return to the basics of growing and preserving portfolios in the year ahead, making the iconic visual metaphor of a farmers' almanac beautifully suited to our *Outlook 2014*.

We pride ourselves on having a unique Outlook that stands out—reflecting our independent thinking and commitment to core investment values. We hope you enjoy reading our *Outlook 2014: The Investor's Almanac* as much as we enjoyed creating it.

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