LPL RESEARCH

EXECUTIVE SUMMARY

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MIDYEAR OUTLOOK 2016: A VOTE OF CONFIDENCE

At the midyear point 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.

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.** We have reduced our forecast for Fed rate hikes in 2016 from two to one, with additional rate increases next 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.
- **Second half turnarounds: oil, dollar, earnings.** Should the drags of oil prices and the U.S. dollar ease, as we expect, an earnings rebound may occur in the second half of the year.

2016 FORECASTS

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%.

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 2016, supported by steady U.S. economic growth and stability in oil prices and the U.S. dollar.

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, and below-trend economic growth translate to a more supportive backdrop for bonds globally; but we expect limited bond returns over the second half of 2016.

U.S. ECONOMY

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. Since the end of the Great Recession, the causes of (and potential remedies for) the anemic pace of economic growth have been hotly debated. Looking at the core components to GDP—productivity and labor force growth—there is some reason for optimism that productivity growth may improve; labor force growth is less flexible, as demographics and long-term secular labor trends are difficult to reverse in the short term. The Great Recession still looms large for many, but ultimately, businesses, governments, and individuals need to 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.

One point watched closely by all market participants is the anticipated path of Federal Reserve (Fed) interest rate hikes. The Fed had been adamant that it would hike rates in 2016; however, due to the Brexit-induced certainty (see more below), the messaging has become more cautious. We now expect one rate hike in 2016, although the possibility for two or even zero remains. Brexit vote aside, fundamentally it comes down to the labor market and inflation:

- The labor market could be on the cusp of a slowdown, but likely not significant enough to signal a recession. Even if job growth slowed to 150,000 per month, it may still be enough for the Fed to tighten faster than markets expect.
- 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.

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 (the so-called Brexit). This has created great uncertainty in the financial markets. Thus, we remain cautious on overseas equities. However, we will be looking to increase allocations to overseas equities, particularly in emerging markets, when there is greater political and economic clarity.

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 appetite for developed international equity markets, although the impact on emerging markets is expected to be much smaller.

STOCKS

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. A rebound in earnings would be supportive of our outlook for stock performance in 2016.

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. In addition, should oil prices stay at current levels, the commodity would show year-over-year price gains in the third quarter of 2016, a positive for the energy sector and overall S&P 500 earnings. Although not our current expectation, a prolonged Brexit-driven rally in the U.S. dollar that drags oil prices lower is a risk.

Finally, although wage pressures are starting to build, and wages are the biggest component of companies' cost structure, increases have been gradual. As long as that remains the case, we do not see modestly rising wage costs as a material threat to corporate earnings.

BONDS

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.

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.

CONCLUSION

This has been a volatile year thus far, leaving some to question the continued strength for the second longest bull market in history. But having a vote of confidence means having the belief that someone or something has the ability to succeed. 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.

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. ■

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 indexes 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.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

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.

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.

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.

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

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

The S&P 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.

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