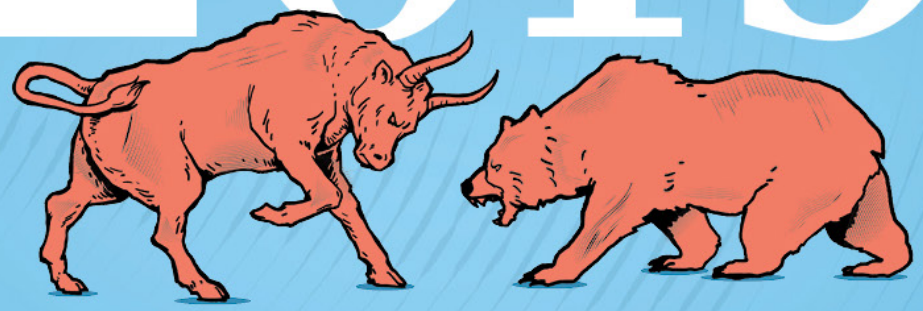
LPL RESEARCH

OUTLOOK 2019



FUNDAMENTAL

HOW TO FOCUS ON WHAT REALLY MATTERS IN THE MARKETS

CHART BOOK

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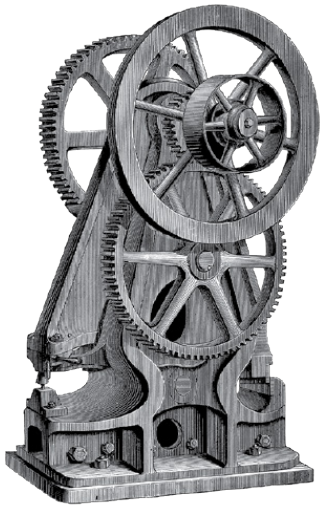
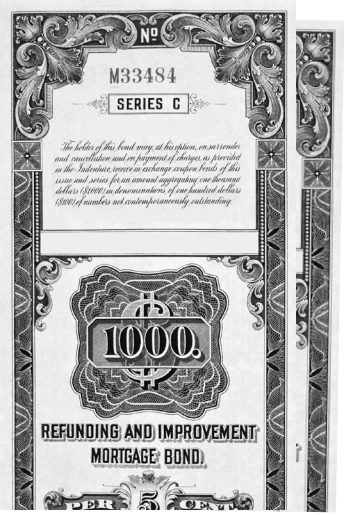


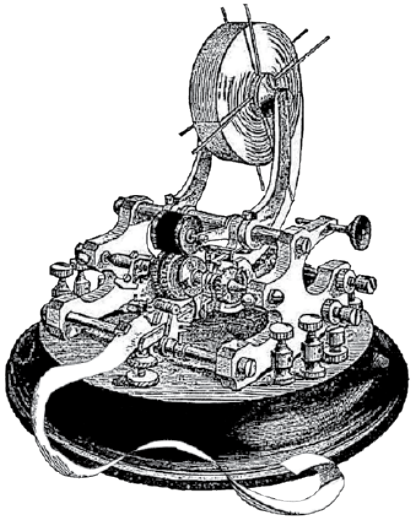
2.5–2.75% U.S. GDP GROWTH

Consumer spending, business investment, and government spending should provide continued support for gross domestic product (GDP) growth of 2.5 – 2.75%.



FLAT RETURNS FOR BONDS

A rising rate environment may prove challenging for bonds, and we expect flat returns for the Bloomberg Barclays U.S. Aggregate Bond Index.



8–10% RETURNS FOR STOCKS

Expectations for still solid corporate profits and steady economic growth support our forecast of 8–10% returns for the S&P 500 Index.

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At A Glance

NEW AND NOTEWORTHY Your book club may thank you for these recommendations in 2019.	CLASSICS Don't count out these timeless tales; these investments should provide a solid background to portfolios.	OUT OF PRINT Might have to wait for the next edition; these investments aren't gaining traction yet.
U.S. Stocks: Superior economic and profit growth and fiscal stimulus provide an edge over developed international equities.	**Small Caps:** Tax reform benefits starting to fade and cycle is aging, but domestic focus may help early in 2019.	**U.S. Defensive Stocks:** Less economically sensitive sectors may offer lower return potential amid solid economic and profit growth.
Value: Economic growth tailwind and attractive relative valuations compared with growth may help buoy value stocks.	**Intermediate-Term High-Quality Bonds:** Offer some potential diversification while avoiding the rate risk of long-term bonds.	**Growth Stocks:** After a sustained period of strong performance compared with value, the growth stock rally may be due for a pause.
Cyclical Stocks: Solid economic growth may support economically sensitive sectors.	**Bank Loans:** Still potentially attractive for strategic investors, but high issuance, weaker investor protections raise some concerns.	**Developed International Stocks:** Growth in Europe has slowed while political challenges are rising.
Emerging Markets: Strong growth, attractive valuations, and potential U.S.-China trade agreement may help emerging market equities outperform.	**High-Yield Bonds:** May be supported by further economic growth, but we prefer a combination of equities and high-quality bonds.	**Developed International Bonds:** Valuations remain very rich and declining central bank accommodation may create a challenging environment.
Investment-Grade Corporates: Economic growth may help credit-sensitive bonds; added credit risk provides incremental yield.		**Long-Term High-Quality Bonds:** With rates expected to rise, the diversification benefit does not adequately compensate for added rate sensitivity.
Mortgage-Backed Securities: Yield benefit relative to rate risk remains attractive among high-quality options.		

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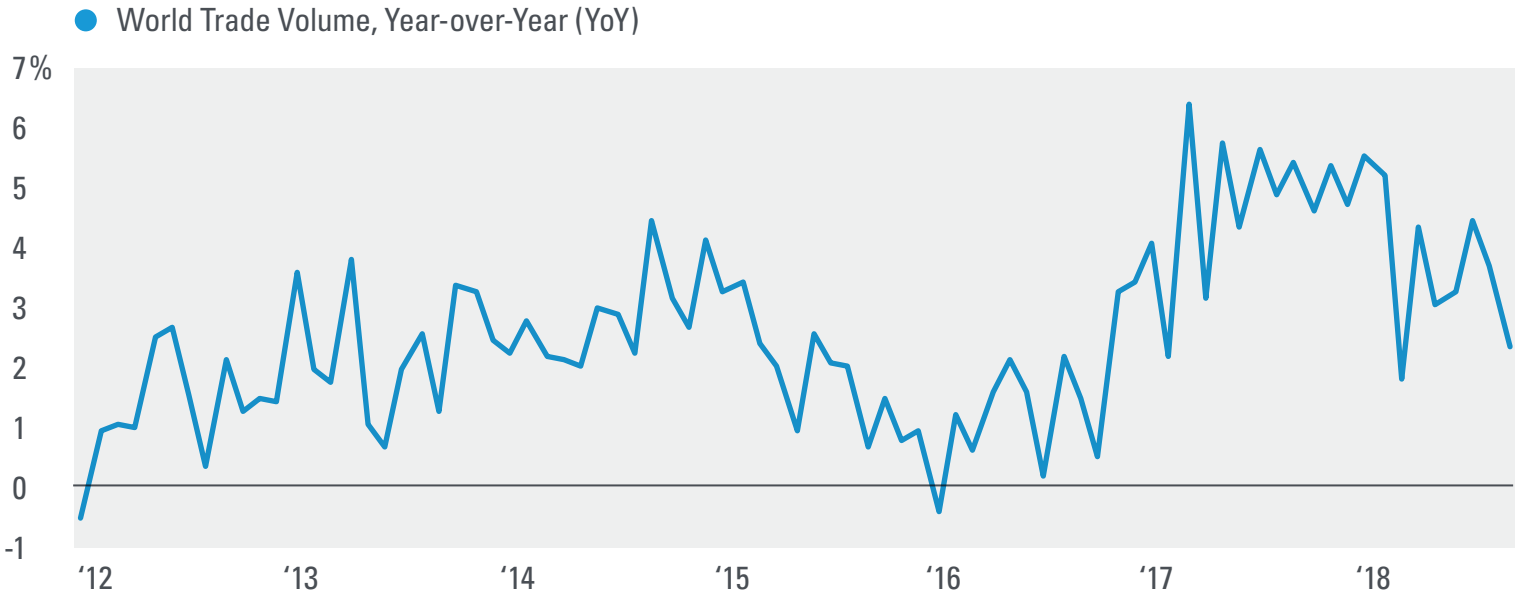
TRADE ACTIVITY HOLDING UP DESPITE TENSIONS



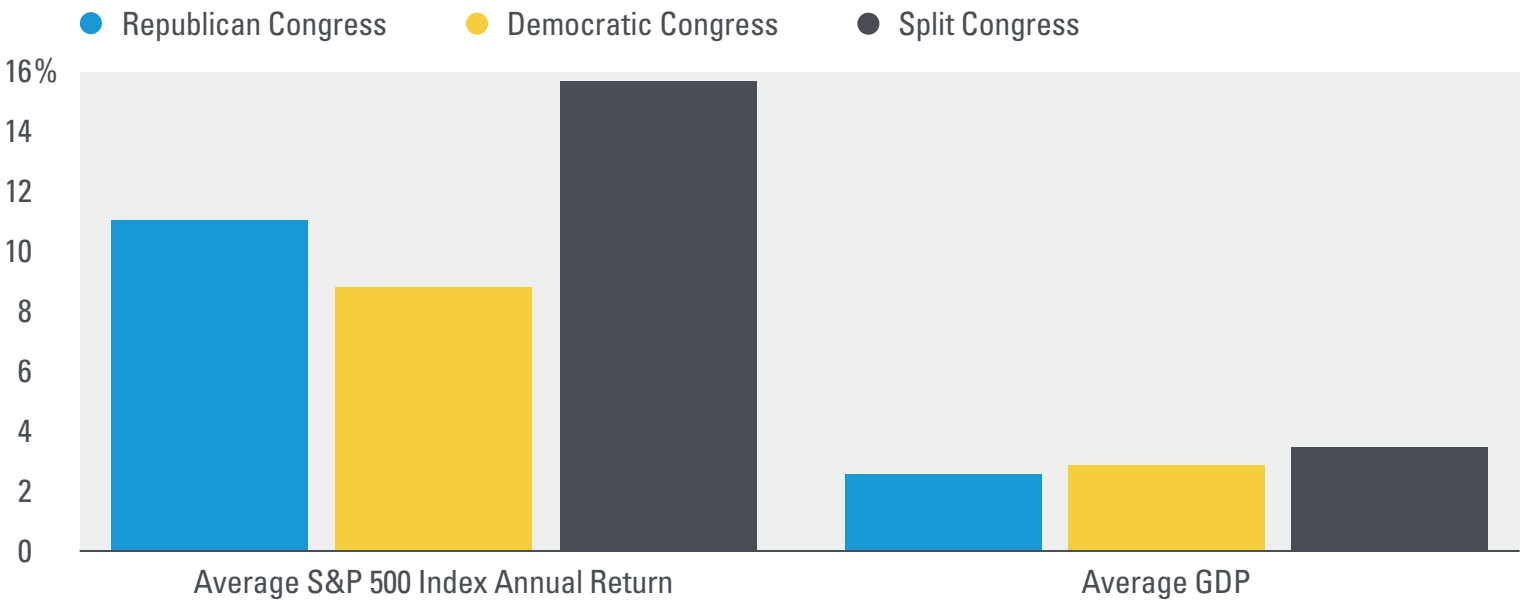
Source: LPL Research, CPB Netherlands Bureau for Economic Policy Analysis 11/30/18

Trade will likely continue to make headlines in 2019. Though tariff talks and trade tensions with China remain, progress has been made with South Korea, Japan, Mexico, Europe, and Canada, which supported positive market sentiment in the third quarter of 2018. Moreover, the conclusion of the recent G20 summit in Argentina resulted in a sort of "trade truce" whereby the U.S. and China committed to working on a more lasting trade resolution within the next few months. Although tariff threats may seem scary, trade represents a small portion of the overall economy and the fiscal measures should more than offset the potential negative impact of tariffs in 2019.

Even though we expect a resolution, if it takes longer than expected to reach an agreement, then it's possible that continued trade discussions could further weigh on market sentiment. The ongoing uncertainty could have a greater impact, potentially slowing the pace of business spending or the rate at which fiscal stimulus will take effect. However, despite all the attention given to tariffs, world trade has been growing at a steady pace.

HISTORICALLY, A REPUBLICAN PRESIDENT WITH A SPLIT CONGRESS IS POSITIVE FOR ECONOMY AND STOCKS

Performance Under a Republican President Based on Congress Makeup



Source: LPL Research, Bloomberg 11/30/18

Data are from 1950–2017.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

Considering the Federal Reserve's (Fed), likely path for interest rates and how that may influence the economy and markets, the onus is on federal legislators to support the durability of the current economic expansion. The setting of fiscal policy, whatever the party leadership, is always complicated, and there will always be some policies that raise concerns among market participants.

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ECONOMIC FORECASTS

REAL GDP (YoY %)	2017	2018 (EST.)	2019 (LPL EST.)
U.S.	2.2%	2.9%	2.5–2.75%
Developed ex-U.S.	2.4%	2.1%	1.9%
Emerging Markets	4.7%	4.7%	4.7%
Global	3.7%	3.7%	3.7%
U.S. ECONOMIC DATA			
Inflation (YoY%)	2.1%	2.4%	2.25–2.5%
Unemployment	4.4%	3.7%	3.6%

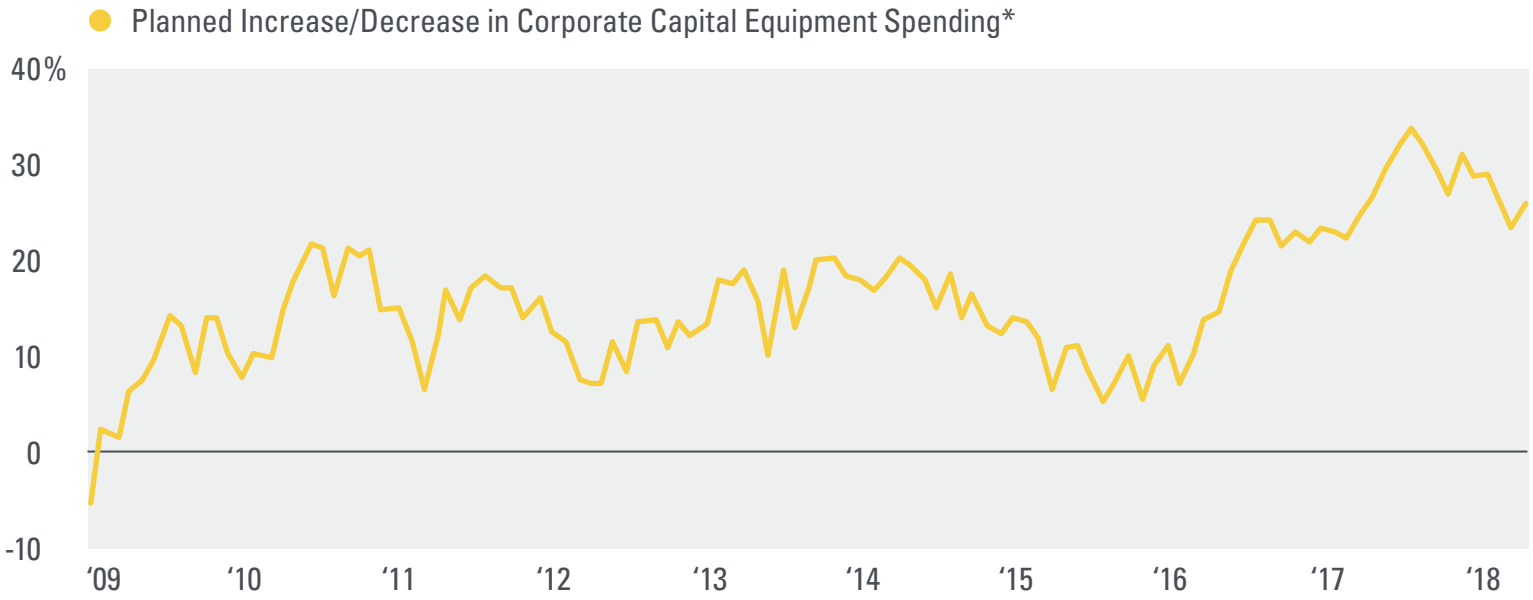
Source: LPL Research, Bloomberg, International Monetary Fund (IMF) 11/30/18

2018 GDP based on IMF estimates; 2018 inflation and unemployment based on Bloomberg-surveyed economist consensus given year-to-date data; 2019 economic data and U.S. and global GDP estimates are LPL Research forecasts. Other GDP estimates are IMF projections. Inflation is measured by the Consumer Price Index.

Estimates may not develop as predicted.

Fiscal stimulus did its job in 2018, with the U.S. economy growing at an average of 3.3% over the first three quarters, compared with the expansion average of 2.3% GDP growth. While we believe expectations should be lowered in 2019, we continue to expect that the ongoing impact of fiscal stimulus will be readily apparent. We are looking for GDP growth of 2.5–2.75% in 2019, supported by consumer spending, business investment, and government spending.

BUSINESSES STILL SHOWING PLANS FOR ROBUST SPENDING

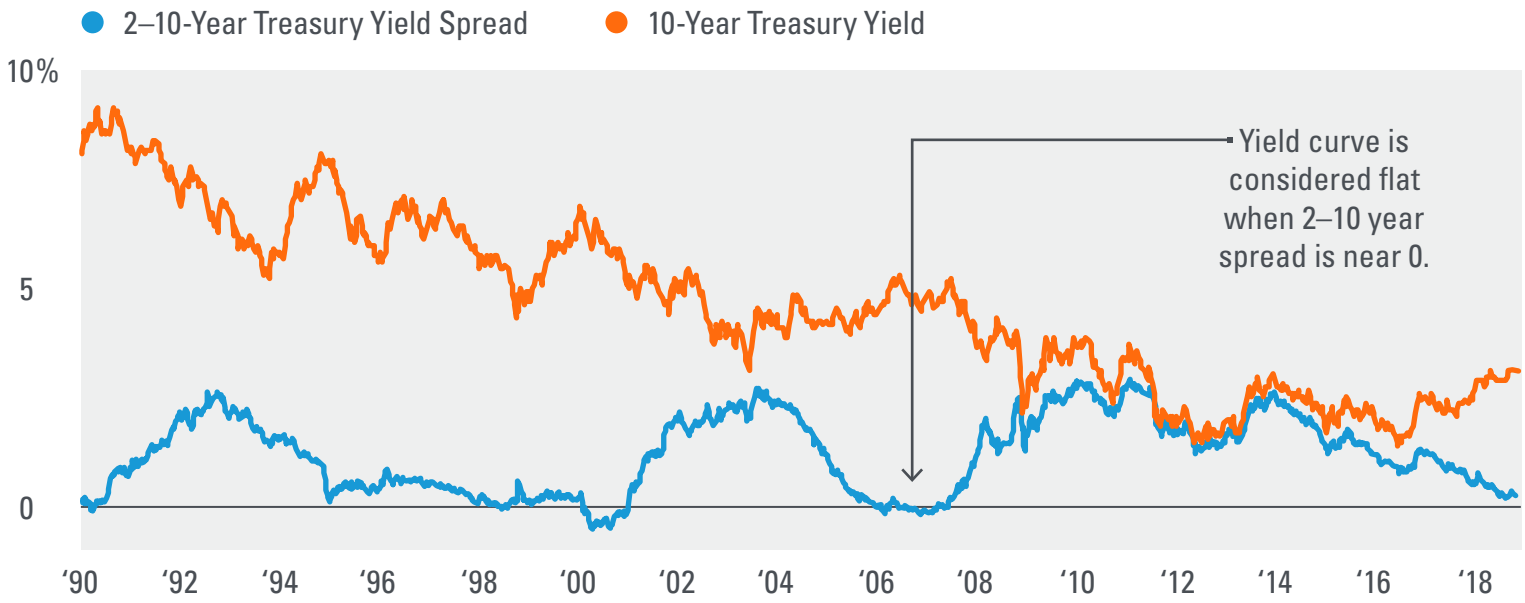


Source: LPL Research, Strategas Research Partners 11/30/18

*Based on regional surveys. Above 0 indicates more respondents are expecting increases than decreases in the next 6–12 months.

Despite periodic slowdowns, business spending was robust in 2018. If this trend persists, it's possible the cycle may elongate even further. Surveys suggest that business spending may grow at a solid rate of about 7% in the year ahead, such that early signs of a slowdown could prove to be temporary, per the Institute for Supply Management's manufacturing Purchasing Managers' Index. High business confidence should support increases in capital equipment purchases.

YIELD CURVE MAY STAY FLAT DUE TO HIGHER TRENDING RATES



Source: LPL Research, Federal Reserve 11/30/18

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. Past performance is no guarantee of future results.

Investors' obsession with the flattening U.S. Treasury yield curve dominated headlines for much of 2018. A flattening yield curve occurs when short-term rates are rising faster than long-term rates, which may eventually lead to an inverted yield curve, where short-term rates are higher than long-term rates. Historically, this has been a negative signal for the U.S. economy, often providing an early warning of an eventual recession, which is why the yield curve has been garnering so much attention recently.

We believe these concerns were overstated given the positive economic environment. We do expect both short- and long-term rates to gradually rise in 2019, keeping the yield curve somewhat flat. However, if that continues to occur in the context of solid economic growth and modest inflation, we don't think a flat yield curve should be read as a signal of rising recession risk.

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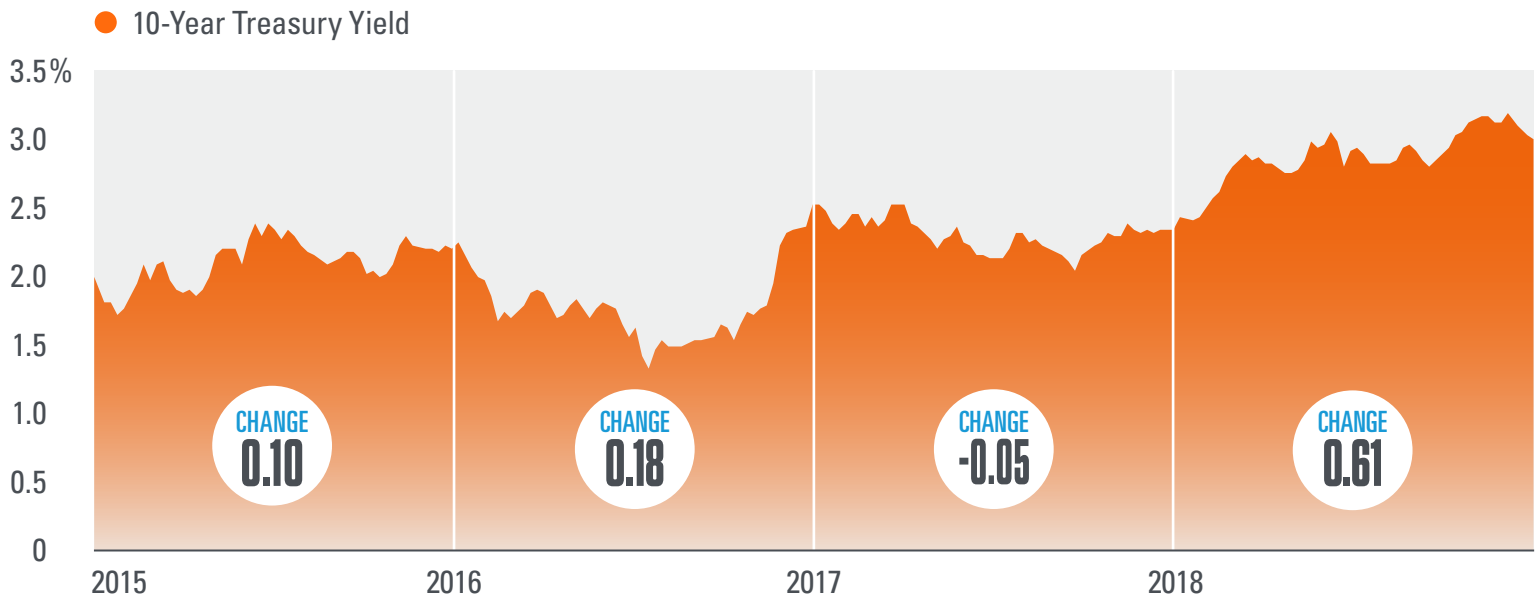
ALTHOUGH RATES ARE CLIMBING, INCREASES HAVE BEEN GRADUAL



Source: LPL Research, Federal Reserve 11/30/18

The yield on the benchmark 10-year U.S. Treasury jumped roughly 60 basis points (0.60%) in 2018 (as of 11/30) from 2.40% to 3%. Market interest rates moved higher as economic growth gained traction and inflation measures approached the Fed's target for price stability. In addition, the rising federal budget deficit caused Treasury auction bidders to demand higher yields for the risk they were taking, particularly since the Fed, with the end of quantitative easing (QE), was no longer backstopping the U.S. Treasury market.

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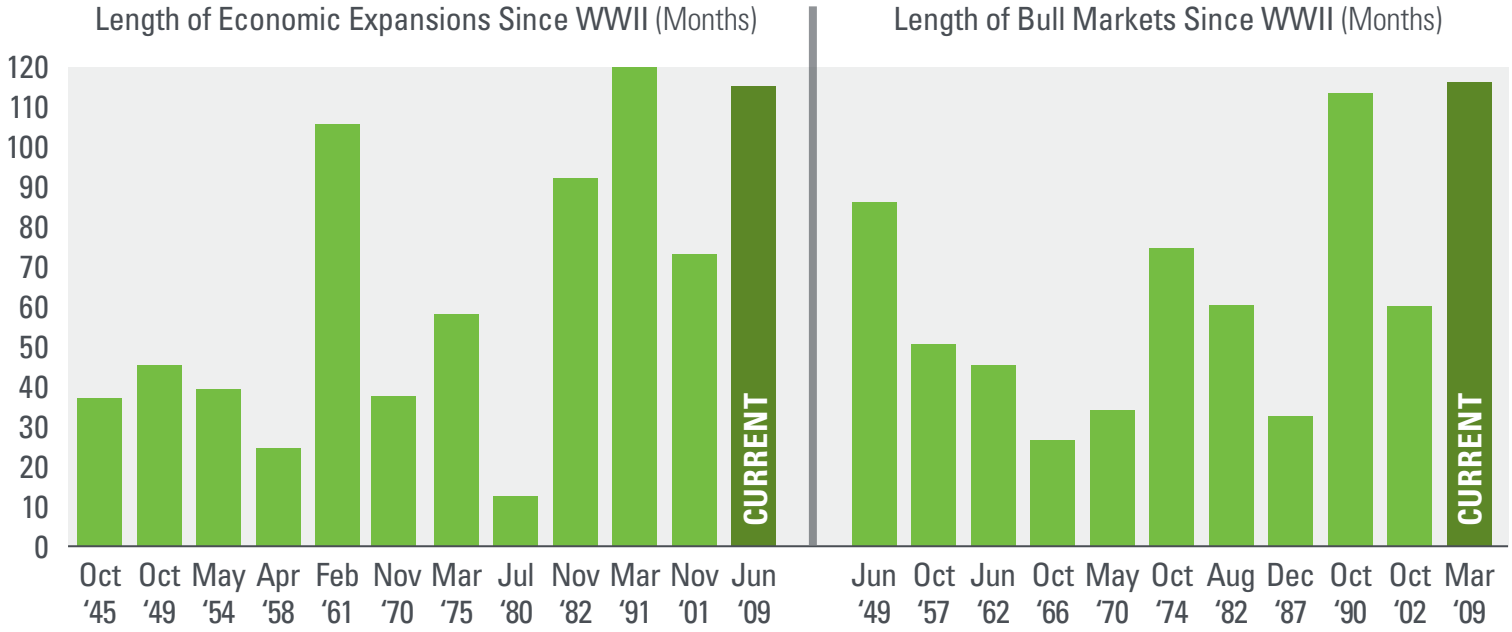
ECONOMIC EXPANSIONS AND BULL MARKETS



Source: LPL Research, NBER, FactSet 11/30/18

Economic expansions are based on GDP growth, bull markets on S&P 500 Index returns.

The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1945 incorporates the performance of predecessor index, the S&P 90.

The current bull market* is officially the longest in history, and the economic expansion is quickly approaching that milestone as well—it'll be the longest expansion ever as of May 2019. So what does age have to do with it? Considering that on average the typical bull market and expansion last approximately 5 years, reaching the 10-year mark is quite a feat. But for those who are concerned that the cycle has gone on too long, there is some interesting context to consider. Assuming the start of the current bull market began after the lows achieved in March 2009, then it is the longest in duration, but not magnitude. Please note: Chart is dated as of 11/30/18.

* Based on the 19.8% maximum decline from 09/20/18 to 12/24/18, by the most widely used definition of a bear market, as of 12/29/18 the bull market is ongoing.

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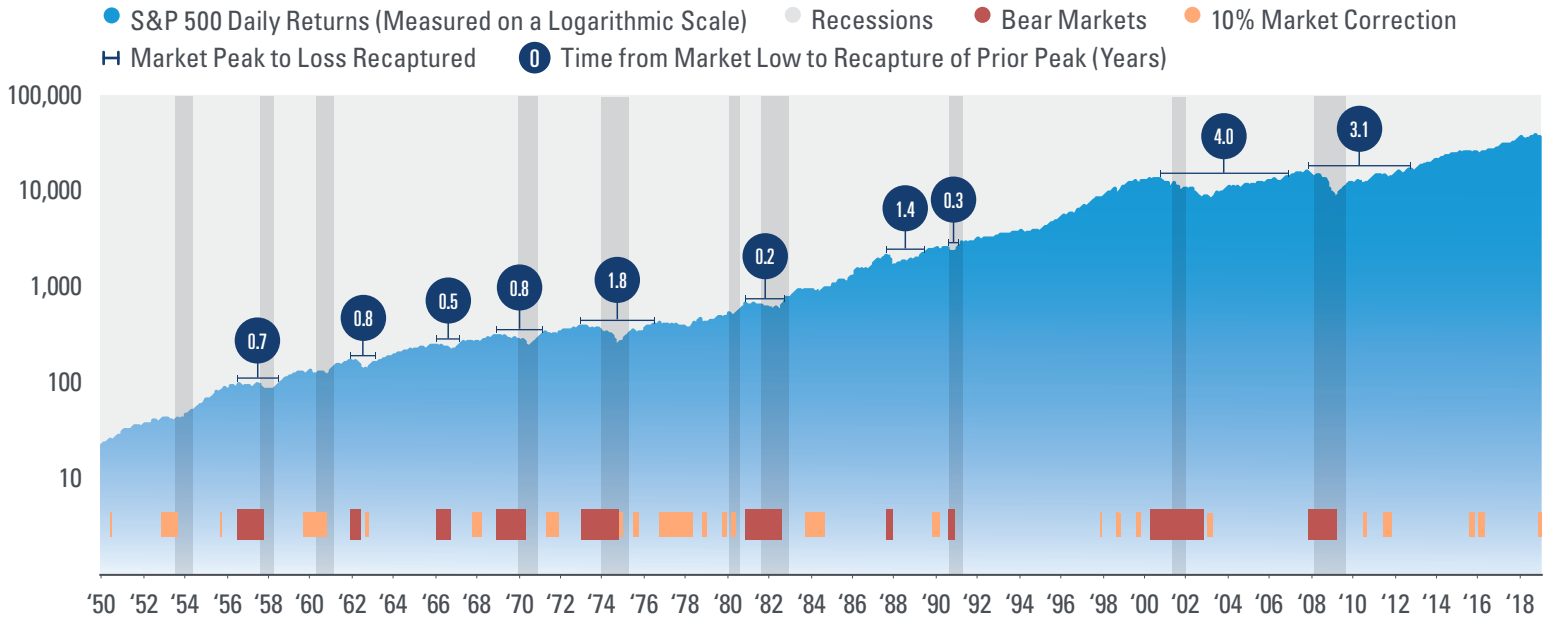
A SNAPSHOT OF STOCK MARKET HISTORY

The S&P 500 has taken an average of a little less than 1.5 years to recover from a bear market.



Source: LPL Research, Bloomberg 12/31/18 (Note: Chart has been updated since release of *Outlook 2019* publication.)

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

The blue graph represents the index's total return, including both price changes and dividends. Historically, there's been a long-term pattern of market gains, and in fact, even very volatile periods appear less dramatic at this scale. This pattern is not just magic—it's had a firm basis. Stocks ultimately represent ownership of a small slice of corporate profits, and corporate America has been able to grow its profits over the years as the economy has expanded, and occasionally contracted during periods of recession. This has resulted in a trajectory that has included peaks and valleys—a few higher or deeper than others—but that over the long term has advanced.

But what about those bear markets (declines of 20% or more) and less extreme but still meaningful corrections (declines of 10% or more)? Bear markets and even corrections do cause real economic damage, but should also be viewed in relation to the history around them and the long-term performance of the market. Past recessions accompanied by bear markets have certainly felt worse than they look here, but that's the point—sometimes our emotional reactions to market changes overwhelm the broader perspective a longer-term view can provide.

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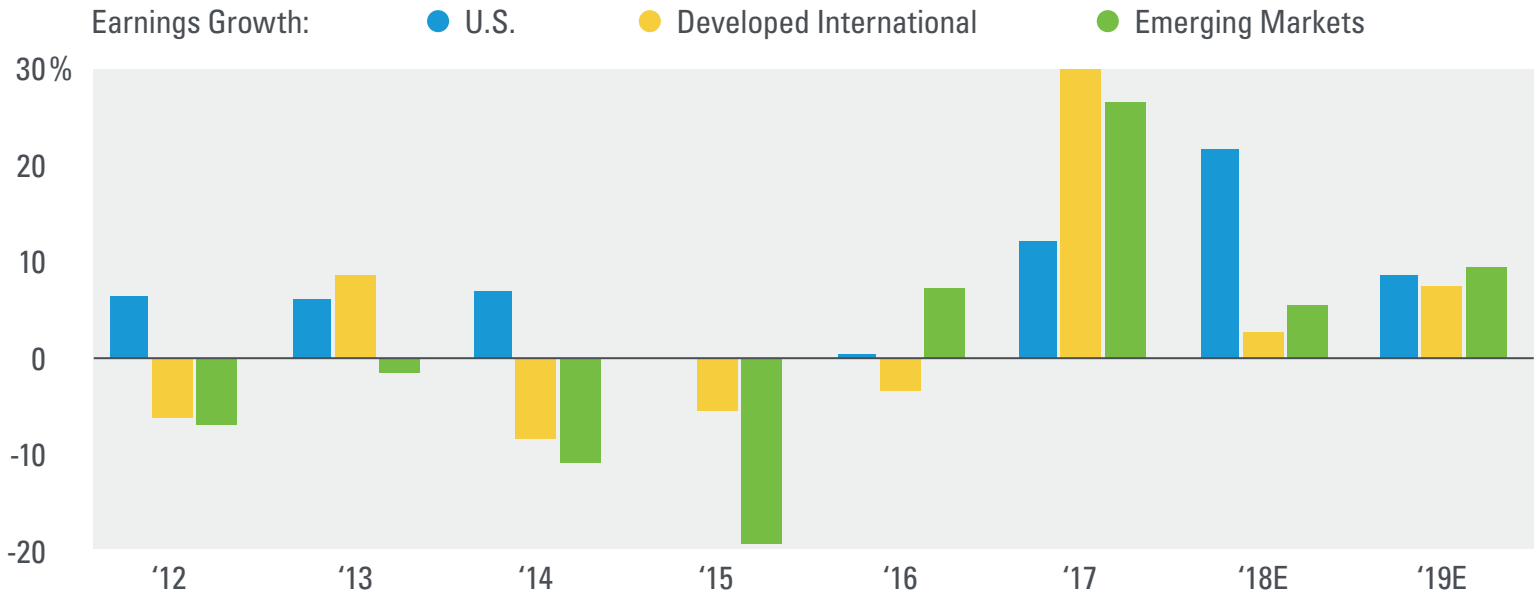
U.S. AND EMERGING MARKETS LEAD EARNINGS GROWTH



Source: LPL Research, FactSet 11/30/18

Indexes: S&P 500 (U.S.), MSCI EAFE (developed international), MSCI EM (emerging markets).

Estimates may not develop as predicted.

All indexes are unmanaged and cannot be invested into directly.

We favor emerging markets over developed international equities for their solid economic growth trajectory, favorable demographics, attractive valuations, and prospects for a U.S. trade agreement with China, with a bias toward emerging Asia. Growth in Europe has been slowing and may struggle to reach even 2% in 2019, while growth in Japan is also lagging, despite stimulus and corporate reform efforts. GDP growth in China and broader emerging markets is likely to more than double the pace of developed international economies in 2019, and we believe political uncertainty is actually higher in Europe than in emerging markets. Please note: Chart is dated as of 11/30/18.

IMPORTANT DISCLOSURES

Please see the *Outlook 2019: FUNDAMENTAL: How to Focus on What Really Matters in the Markets* for additional description and disclosure.

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. Our recommendations are subject to change at any time based on market and other conditions. Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

All 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. All performance referenced is historical and is no guarantee of future results.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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

Rebalancing a portfolio may cause investors to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential illiquidity of the investment in a falling market. The prices of small cap stocks are generally more volatile than large cap stocks. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

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

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. Bond yields are subject to change. Certain call or special redemption features may exist, which could impact yield.

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.

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.

Municipal bonds are subject to availability and change in price. Interest income may be subject to the alternative minimum tax (AMT). Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, they are subject to market and interest rate risk and capital gains tax could apply.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

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

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

DEFINITIONS

Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to 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.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Such changes usually affect securities inversely and can be reduced by diversifying (investing in fixed-income securities with different durations) or hedging (e.g. through an interest rate swap).

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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.

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.

INDEX DEFINITIONS

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. The modern design of the S&P 500 stock index was first launched in 1957. All performance back to 1928 incorporates the performance of predecessor index, the S&P 90.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS) (agency and non-agency).

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the United States and Canada.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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