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WHAT WE CAN LEARN BY GOING BACK TO SCHOOL

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KEY TAKEAWAYS

Expectations for the back to school shopping season are low, and this season may only be flat versus last year.

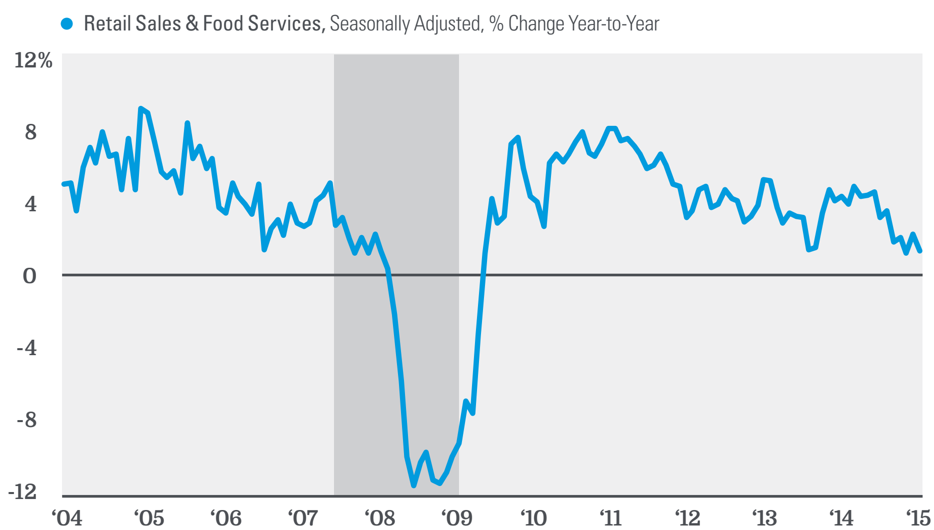
Several consumer spending tailwinds suggest the consumer discretionary sector may be poised to outperform through year-end.

The summer has flown by and some children are already going back to school this week. The back to school shopping session is considered the second most important selling season for retailers (after the Christmas/winter holidays), which we think is a good reason to check in on the health of the U.S. consumer and provide our latest thoughts on the consumer discretionary sector. Expectations for this season are low, but several consumer spending tailwinds suggest the sector may be poised to outperform over the rest of the 2015.

BACK TO SCHOOL RETAIL OUTLOOK

Our outlook for back to school shopping season (mid-July through mid-September) is not particularly strong. In fact, the National Retail Federation (NRF) forecasts that sales during this year's back to school period may actually decline slightly this year (which we believe may be overly pessimistic) largely due to less spending on electronic devices. Broad retail sales, which increased just 1.4% year over year during the latest month (June), have been slowing [Figure 1], and suggest a relatively modest back to school season. In July, retailers' sales growth (a subset of much broader government-reported retail sales) has been tepid, according to

1 RETAIL SALES HAVE SLOWED IN RECENT MONTHS



Source: LPL Research, Haver Analytics 08/07/15

Shaded area indicate a recession

Thomson Reuters data (reported +0.2%). The government's retail sales report for July is due out this Thursday (August 13, 2015).

But a survey conducted by the NRF in June indicated that a higher percentage of people expect to spend more this year (as opposed to less or the same) than last year, relative to the same survey results last year. Among college students, 29% expect to spend more this year than last, compared with 23% of responders in 2014. Among K–12, 29% expect to spend more this year than last, compared to 24% last year. The consumer is getting some help from lower gas prices, still low interest rates, and positive—though lessening—wealth effects from higher stock prices and rising home values.

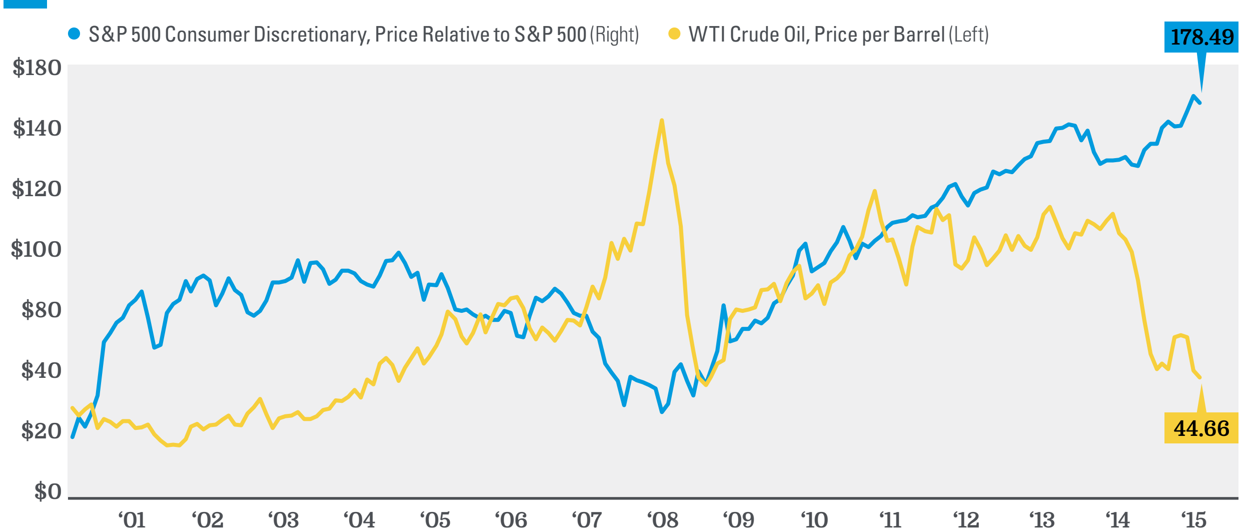
Electronics categories (smartphones, tablets, laptops, etc.) have been gaining an increasing share of parents' shopping budgets in recent years and will again be a key factor in determining whether this season meets expectations. As those of you with children know, consumer electronics have become an increasingly important part of back to school shopping. While strong product cycles last year in the smartphone and tablet areas present difficult comparisons to grow off of, exceeding last year's spending may still be doable.

CONSUMER DISCRETIONARY VIEW

Does a tepid back to school outlook mean the retailers or the broad consumer discretionary sector are a sell here? We don't think so. We see the following factors as supportive of the sector in the near term:

Lower oil prices. Relative performance of consumer discretionary has shown inverse correlation to oil prices [Figure 2]. This factor, which certainly contributed to the sector's strong performance in 2015, is gaining intensity as oil prices retest lows from earlier this year. Lower prices at the pump should continue to provide support for consumer discretionary spending during the ongoing summer driving season. Although a big oil price bounce that could cause sector performance to reverse is possible, we believe it will take a while for oil prices to break out of the current

2 CONSUMER DISCRETIONARY SECTOR HAS HISTORICALLY PERFORMED WELL WHEN OIL PRICES FALL



Source: LPL Research, FactSet 08/07/15

Indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

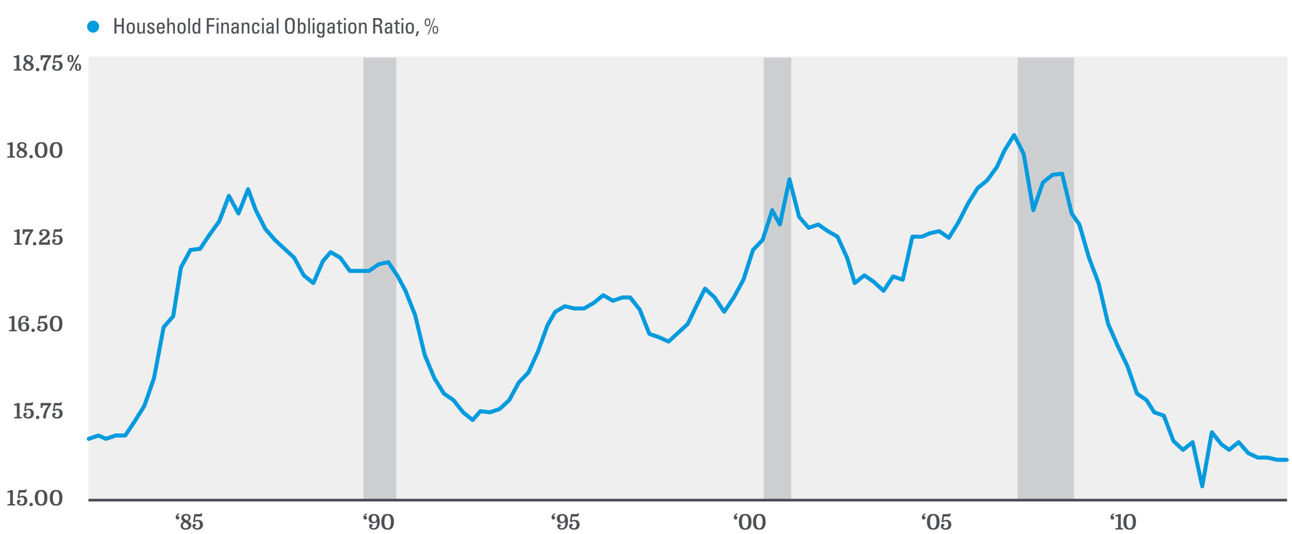
range and return to the $60s. See our *Weekly Market Commentary*, "The Bright Side of Cheap Oil," January 12, 2015, for more on this relationship.

Consumers are in good financial shape. In addition to the positive wealth effects cited earlier, consumers are benefiting from low interest rates and debt reduction efforts since the end of the financial crisis. Figure 3 shows that the financial obligation ratio for households (ratio of financial obligations to disposable personal income) is near 30-year lows. This ratio essentially measures how much of a burden debt and other regular non-discretionary payments are for consumers (rent/mortgage payments, car loans and leases, credit cards, property taxes, etc.) when expressed in terms of the income that consumers have available to spend. Steady, though certainly not spectacular, job gains add to what is generally a favorable picture for consumers in support of further gains in consumer spending.

Solid sector profit growth. The consumer discretionary sector is on track to produce among the best earnings growth of all equity sectors during the second quarter of 2015 (12%, second only to financials at 21%), and a bigger upside surprise (5%) than the S&P 500 for the quarter (trailing energy, healthcare, and financials slightly). The biggest drivers of the strong earnings performance were autos (lower gas prices), internet and catalog retail (shift to online spending), and household durables (recent strength in housing market). In addition, the sector's forward estimates have been among the most resilient; since June 30, 2015, full-year 2015 and 2016 earnings estimates for the sector have both inched higher.

Economic expansion may still have a ways to go. The early years of the economic cycle are typically best for the consumer discretionary sector, which outperformed the S&P 500 by a sizable margin coming out of downturns in 1991, 2001, 2003, and 2009–2010. But the sector has had several good mid- to late cycle years, including 1997–1999 and 2006, and has outperformed two-thirds of the years during which there was no recession, dating back to 1990. Given we expect the current economic expansion to be a long one, with perhaps several more years to go, we believe it is reasonable to expect the sector to continue to perform well for the rest of the year.

3 CONSUMERS' DEBT OBLIGATIONS ARE AS LOW AS THEY HAVE BEEN IN DECADES



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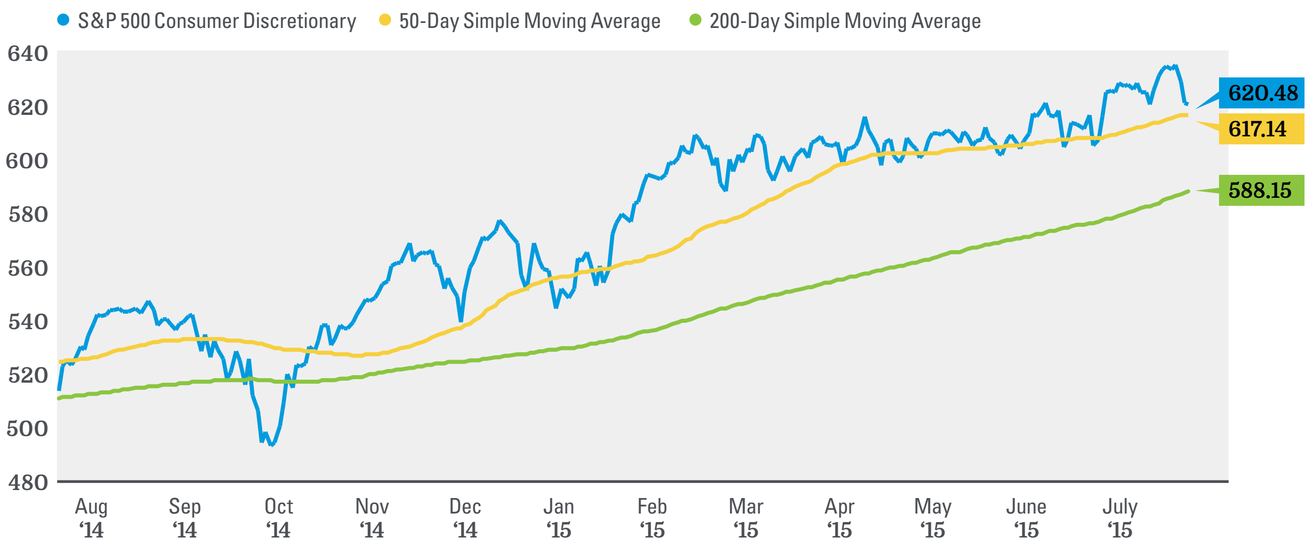
Strong technical momentum. Based on the consumer discretionary sector index's position above its 50- and 200-day simple moving averages, the positive slope of those moving averages, and the series of higher highs and higher lows exhibited on the price chart, the strong technical momentum continues [Figure 4]. The sector also has delivered consistent relative strength versus the S&P 500 over the past year, another positive technical indication.

These factors push us to the positive side of the consumer discretionary debate, but there are some risks worth noting. The sector's relative valuations are slightly above the long-term historical average. In addition, the media industry (25% of the sector) has struggled mightily this earnings season with customers "cord cutting" and shifting to digital media consumption, presenting a near-term risk to the sector.

CONCLUSION

Expectations for the back to school shopping season are low, and this season may only be flat versus last year. But several factors—including low oil prices, consumers' solid financial condition, and the likelihood that the current economic cycle lasts several more years—suggest the sector may be poised to outperform over the rest of the 2015.

4 **CONSUMER DISCRETIONARY SECTOR EXHIBITING STRONG TECHNICAL MOMENTUM**



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IMPORTANT DISCLOSURES

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Technical analysis is a methodology for evaluating securities based on statistics generated by market activity, such as past prices, volume and momentum, and is not intended to be used as the sole mechanism for trading decisions. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns and trends. Technical analysis carries inherent risk, chief amongst which is that past performance is not indicative of future results. Technical analysis should be used in conjunction with fundamental analysis within the decision making process and shall include but not be limited to the following considerations: investment thesis, suitability, expected time horizon, and operational factors, such as trading costs, are examples.

INDEX DESCRIPTIONS

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.

DEFINITIONS

A simple moving average (SMA) is a simple, or arithmetic, moving average that is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods. Short-term averages respond quickly to changes in the price of the underlying, while long-term averages are slow to react.

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