Weekly Market Commentary



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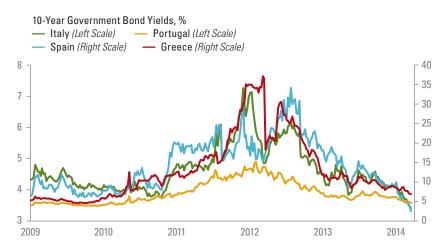
Highlights

The ECB made a big bet last week that the Eurozone economy is picking up fast enough to avoid the need for any further stimulus. We are not so sure. Until some key catalysts emerge, the risks to stocks in Europe may outweigh the rewards.

Europe's Big Bet

Bond yields have fallen this year, but they began to rebound in the United States in the latest week as the glass-half-empty bond market realized the all-time high stock market may have it right. But this was not the case in most of Europe. The ongoing decline in European government bond yields continued last week and is striking when considering how fast they were rising two years ago. What a difference a couple of years can make. The 10-year Italian and Spanish bond yields dropped to near all-time lows at the end of last week, while Greece's 10-year—once over 35%—fell below 7% [Figure 1]. Problem solved? Not exactly.

1 What a Difference a Couple of Years Can Make



Source: LPL Financial Research, Bloomberg data 03/10/14

Past performance is no guarantee of future results.

(Portugal, Italy, Ireland, Greece, and Spain) and thought deserving of their double-digit borrowing rates, could now be believed to be among the GAUDS (Germany, Austria, United Kingdom, Denmark, and Switzerland) and their low single-digit yields. As we have highlighted several times over the past two years, bond yields have receded as the risk of financial crisis has

passed. But the situation in Europe is slowly transforming into an economic

The countries once derided in the financial press for overspending PIIGS

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

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



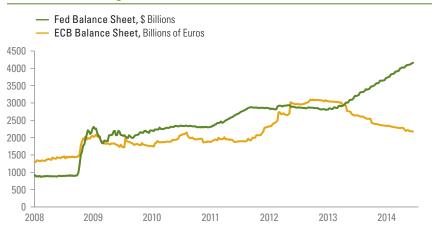
crisis in the form of a potential lengthy stagnation. We had anticipated Europe could shake off this risk and produce better growth this year—and it still may—but the risk of a setback rose last week.

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The risk can best be seen in prices. Central bankers around the world, including the U.S. Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of Japan (BOJ), have a clearly stated goal of 2% inflation, to motivate spending and lift wages while leaving a buffer above zero when growth inevitably slows again. While the inflation rates in the United States and Japan are just below that and rising, the pace of inflation in the Eurozone has been under 1% since October 2013 and is still decelerating.

Last week, rather than making a move at its meeting to cut rates or take other actions, the ECB took a gamble that the economic momentum in the Eurozone may be self-sustaining enough to turn prices higher on its own. The status quo announcement was accompanied by the release of the ECB's forecast for inflation in the coming years, showing it expects inflation to remain below 2% through 2016. Not only has the ECB refrained from any new stimulus, it has been outright shrinking the bonds on its balance sheet for over a year now, in contrast to the Fed, which is just starting to slow the growth in the bonds on its balance sheet by tapering its pace of bond buying [Figure 2].

2 ECB and Fed Taking Different Paths



Source: LPL Financial Research, Bloomberg data 03/10/14

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Higher inflation is necessary for the Eurozone to avoid what Japan has experienced—a high debt and pension burden coupled with flat inflation and economic growth for much of the past two decades. The problem for Europe is an elevated risk of economic stagnation, a rise in the value of the euro hurting exports, and very low rates of inflation making it very hard for countries to address their debt and pension problems. Despite years of austerity in the form of tax hikes and spending cuts, Eurozone government debt-to-GDP (gross domestic product) has risen to a record 93%, up 4% from a year ago, according to Eurostat, the official statistics office of the European Union (EU). Higher inflation is necessary

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for the Eurozone to avoid what Japan has experienced—a high debt and pension burden coupled with flat inflation and economic growth for much of the past two decades.

We remain hopeful that in 2014 Europe can overcome its weaknesses and have a better chance for returns competitive with U.S. markets than last year. Here are the catalysts we are looking for to turn more positive on European stocks:

 Lower expectations for earnings growth – The current earnings expectations are likely to be disappointed. The consensus of analysts' estimates for European company earnings are for 12.2% growth in 2014. This seems high given prospects for only about 1% GDP growth, especially

Personalizing the Challenges

Many of the Eurozone's problems are structural. Although some challenges are posed in peripheral economies like Italy, a core country like Germany is not immune from its own challenges as it seeks to rebalance its dependence on exports. While this can be illustrated with statistics, it may be helpful to personalize the structural challenges facing the Eurozone with an example.

If you are 21, you are unlikely to buy a car in Italy:

- You can't get a job The unemployment rate is a record 43% for those under 25, and in the south of Italy it has soared past 50%.
- You can't get a loan More European banks have been tightening lending standards than have been easing them every quarter since the start of the financial crisis, according to the ECB's quarterly Euro Area Bank Lending Survey.
- You can't afford gas At the current price of 1.7115 euro/liter, the cost of gas is equivalent to \$9 a gallon.
- You can't get insurance About 1 in 15 Italian cars are involved in a claim each year, according to the Italian Insurance Association, ANIA. This is twice as many as France, which has a similar number of drivers. Each claim was much higher as well, resulting in very high premiums.

As a result, though it has shown recent signs of picking up, the 12-month average of new car registrations in Italy is now the lowest since data started being recorded.

If you are 21, you are unlikely to buy a car in Germany:

- You have a job Germany youth unemployment is a very low 7.6%.
- But you prefer to save, not spend The German savings rate is 10% (compared to 4% in the United States).

As a result, the 12-month average of new car registrations in Germany has been flat for years.

3 Car Buying Slumping in Europe



Source: LPL Financial Research, Bloomberg data 03/10/14

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The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

- compared with the consensus for the United States, which now aligns with our outlook for 8.8% earnings per share growth for the S&P 500.
- Lower valuations Although European stocks usually trade at a discount to U.S. stocks due to a different sector mix and slower growth, at a forward price-to-earnings (PE) ratio of 13.3, compared to 15.8 for the S&P 500 Index, the discount is not sufficiently pricing in the greater risk of economic stagnation.
- Inflation picking up back above 1% and rising A key sign that the risk of deflation is receding.
- ECB action If the euro moved toward \$1.45 or longer-term inflation expectations fell, it may prompt a move by the ECB to reduce the risk of stagnation, which markets would welcome.
- Loan demand picking up Signs that business loans are increasing, rather than the declines indicated in the surveys, would be a welcomed sign that the bridge is being made between recapitalizing the banks and getting them lending again.

Despite inflation being in the ECB's "danger zone" and rising debt burdens, the ECB made a bet last week that the Eurozone economy is picking up fast enough to avoid the need for any further stimulus. We are not so sure. Until some of the above catalysts emerge, the risks to stocks in Europe may outweigh the rewards.

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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 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.

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