LPL FINANCIAL RESEARCH

Outlook 2013

The Path of Least Resistance

Contents

LPL Financial

The Path of Least Resistance

In 2013, many different forces will combine to influence the direction of the markets to follow the path of least resistance leading to modest single-digit returns in the U.S. stock and bond markets.* The path for the year may be set at the end of 2012, or in early 2013, as critical decisions are implemented:

- Washington will likely finally rise to the challenge of this self-imposed crisis and form the compromise between the parties that will meet the least resistance—extending some of the Bush-era tax cuts and cancelling some of the scheduled spending cuts. However, going down this path risks delaying progress toward a more permanent solution that makes the government's finances sustainable.
- The Federal Reserve (Fed) is likely to continue its bond-buying program of quantitative easing (QE). This open-ended QE is the path of least resistance among Fed decision makers and one which will buy the Fed more time to determine if more aggressive monetary policy easing is needed or if the economy can withstand a lessening of stimulus.
- Major hurdles to further European integration overcome in 2012 set the stage for progress toward a tighter fiscal, economic, and banking union. A high degree of resistance to splitting apart counterbalanced with strong stances against unconditional support is likely to keep Europe on a middle path toward slow continued integration.
- The U.S. economy faces the weakest global economic backdrop since the Great Recession of 2008–09 heading into the looming fiscal drag of tax increases and spending cuts. These forces are only partially offset by the benefits of Fed stimulus, the positive consumer wealth effect driven by the rebounding housing and stock markets, and the lifting of business uncertainty as the budget decisions are resolved. The combination is likely to result in a path leading to flat-to-weak growth for the U.S. economy.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

*Equity market forecast is for the S&P 500 Index and is based upon a low-single-digit earnings growth rate supported by modest share buybacks combined with 2% dividend yields and little change in valuations. Bond market forecast is for the Barclays Aggregate Index and is based upon <1% rise in rates, with price declines offset by interest income.

Our base case path is supported by our view that key decision makers will find it is better to determine a way to overcome an avoidable and unnecessary economic recession, buy time to actually propose and vote on competing long-term fiscal visions, and do something to help restore confidence in Washington's ability to govern. Ideally, this could help maintain investors' appetites for U.S. equities and Treasuries. For the markets, the path of least resistance is likely to include modest single-digit returns for stocks as sluggish profit growth dampens stronger gains, but prices are supported by low valuations and improving clarity as uncertainties begin to fade. Bond yields may rise only slightly, restrained by sluggish growth and a Fed committed to keeping rates low, leaving returns to be limited to interest income at best.

However, there are paths that differ from this base case outcome: a bear path where the consequences of fiscal contraction damage confidence as well as the economy, and a bull path where an historic opportunity to address the U.S.'s long-term fiscal challenges is embraced and leads to sustainable solutions. Which of these three is the path of least resistance is likely to be determined by the end of the first quarter of 2013.

1 Calendar of Events That Impact the Path Taken

Mid-Nov to Jan 2	"Lame duck" session
Late December	Debt ceiling reached: Treasury will use "extraordinary measures" to extend this date until February/March 2013
December 31	Fiscal cliff: Bush tax cuts expire, 2% payroll tax cut expires, extended unemployment benefits and "doc fix" end*
January 2, 2013	Sequester goes into effect: A series of prearranged across-the-board cuts to spending agreed to in August 2011
January 3, 2013	New Congress sworn in
January 21, 2013	Inauguration day
Feb/Mar 2013	Debt ceiling reached
Feb/Mar 2013	Possible ratings downgrades
March 31, 2013	Possible government shutdown as temporary funding expires

Source: LPL Financial Research 11/26/12

* Medicare physician reimbursement

The Base, Bull, and Bear Case Paths

The hard-fought election will likely be followed by more fighting in a divisive and bitter "lame duck" session in Congress running through year-end 2012. The stakes are high as those on Capitol Hill seek to mitigate the budget bombshell of tax increases and spending cuts, known as the fiscal cliff, due to hit in January 2013. The two parties have very different visions of what a deal should look like. Failure to reach a compromise in the coming months could lead to a recession and bear market for U.S. stocks in early 2013.

However, a deal is in the best interest of those on Capitol Hill. The Republicans have a lot of items that are important to them to lose in foregoing a deal with Democrats: the Bush tax cuts would expire and the looming spending cuts hit defense spending hard while not really impacting the big entitlement programs (such as Social Security, Medicare, Medicaid, and the Affordable Care Act). To avoid being blamed for a return to recession on their watch, Democrats may only need to compromise on extending the middle-class tax cuts, which President Obama already communicated his support of during his campaign, and delaying the impact of some of the spending cuts. The path to a deal may not be a straight line, but is the outcome we view as most likely and upon which we base our expectation of modest returns for stocks and bonds—with no bear or bull market—in 2013.

While a deal may be likely, there are risks for investors. In October 2012, with the S&P 500 having risen back to within 10% of all-time highs, markets seemed confident that the Senate Democrats would quickly find a compromise with House Republicans to avoid going over the fiscal cliff. However, a compromise may be hard to reach. Recall that the gridlock in Washington was no help to markets in 2011, as the unwillingness to compromise on both sides of the aisle led to the debt ceiling debacle in August 2011, which sent the S&P 500 down over 10% in a few days despite the ultimate approval of the increase to the debt ceiling. A bear market and recession could be looming if policymakers choose this path.

Despite the risks, there is room for guarded optimism. If there ever were a time to enact long-term fiscal discipline, now is that time. The United States' large and unsustainable budget deficits helped push total U.S. debt over 100% of Gross Domestic Product (GDP) in 2012. Previously unmentionable as part of the "third-rail" of politics, wide-reaching bipartisan proposals have been unveiled to put the United States back on a path to fiscal sustainability. A long-term solution of permanent changes to tax rates and entitlement programs as well as ending the battles over the debt ceiling could emerge in 2013. This path would be welcomed with a bull market and lift the uncertainty plaguing business leaders and investors alike.

The battle is likely to result in a compromise that averts the worst-case outcome, but the negotiations themselves, coming on the heels of hard-fought election battles, may drive market swings. Fortunately, the lowest valuations for stocks in 20 years may help to limit downside and create potential investment opportunities. Which of these three paths will prevail is largely driven by the compromise—or lack thereof—in Washington.

The Paths of 2013

Depending upon the path taken, certain areas of the markets will perform differently than others.

Source: LPL Financial Research 11/26/12

Based on our assessment of market conditions, fundamental, technical, and valuation analysis and the backdrop of the situation in Washington, D.C.

There is no assurance that the techniques, outcomes, or strategies discussed are suitable for all investors or will yield positive outcomes. The purchase of certain securities may be required to effect some of the strategies. Investing involves risk including possible loss of principal.

The Base Path
The Compromise

The negotiations will center on which expiring tax cuts to extend and which discretionary programs to shield from spending cuts in an effort to avert a recession. Each party has different priorities, but both face the same realities. A compromise is likely to be struck either in the lame duck session in December 2012 or early in 2013. As a result, we believe this is the most likely path with a 55–65% likelihood.

2 DJIA and Congressional Control Since 1901: *Markets Don't Like Gridlock*

Party	Annualized Return %	% of Time
Democrats	5.5%	55.4%
Republicans	7.8%	32.2%
Split	-3.1%	12.4%

Source: Ned Davis Research 11/19/12

The Dow Jones Industrial Average (DJIA) is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Much depends on the ability of a divided Congress to work together to craft a deal. Since 1901, the Dow Jones Industrial Average has fallen an annualized -3% during the 12% of the time that featured a split-party Congress, according to Ned Davis Research [Figure 2]. Returns were much better when the control of Congress was in the hands of one party or the other. Gridlock may weigh on the markets in 2013.

Our best guess is that there will be a move to mitigate the impact of the fiscal cliff from 3–4% to roughly 1.0–1.5% of GDP in 2013. Most likely, Congress will pass a short-term deal in December 2012 that will:

- Extend the Bush tax cuts for the middle class (but not the wealthy);
- Let the payroll tax cut expire;
- Delay the sequestered spending cuts to defense and non-defense programs; and
- Deal with the other typical year-end items, such as the Alternative Minimum Tax and Medicare physician reimbursement, as well as the likely extension of unemployment benefits.

The effect of these changes would be to reduce the drag on the economy to a more manageable 1.0–1.5% from the current 3–4% while at the same time taking a meaningful step toward fiscal discipline (although still leaving a huge budget deficit for 2013).

This path leads to very sluggish GDP, on the border of a recession, and an accompanying weak earnings picture as well. In 2013, the real challenge to being able to forecast stock market performance is not finely tuning a forecast for the path of the economy or earnings; it is trying to gauge the move in valuation, or price-to-earnings ratio. This makes 2013 very different

from the past several years when stocks tracked earnings growth. Since the end of the first quarter of 2009, when four-quarter trailing earnings made their low point during the Great Recession, earnings per share for S&P 500 companies have risen 83% (through mid-October 2012). Similarly, from the end of the first quarter of 2009 through mid-October 2012, the total return of the S&P 500 has also been 83%. That one-to-one relationship between earnings and market performance may not continue as a new phase emerges in the maturing economic cycle.

In 2013, the real challenge to being able to forecast stock market performance is not finely tuning a forecast for the path of the economy or earnings; it is trying to gauge the move in valuation.

Valuations Can Be Key Driver of Stocks

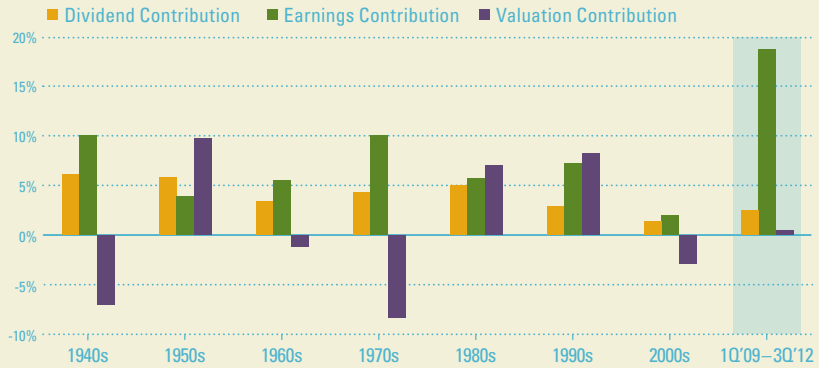
We can divide the drivers that make up the return on investing in the stock market into three components: the dividend yield, the growth in earnings, and the change in valuation.

When referring to the valuation of the stock market, we mean the price-to-earnings ratio. This measures the S&P 500 price index level, or price per share, to the earnings per share of the companies in the index. Over time, investors have been willing to pay more or less per dollar of current earnings generated by companies. Historically, this has been the most volatile component of stock market returns.

Although stock market cycles do not fall neatly into decades, to illustrate the changes in valuations over time, it is useful to look at market history by decade. Stocks rose every decade from the 1940s through the 1990s. While earnings and dividends demonstrated a stable trend of growth across time, valuations have varied widely. Valuations acted as a drag on returns in the 1940s, 1960s, 1970s, and 2000s, and boosted returns in the 1950s, 1980s, and 1990s. The net impact of changes in valuations over the very long term has been close to zero, but for shorter time periods the changes can be quite meaningful. In fact, during the 1980s and 1990s, the valuation expansion made up nearly half the total return of the S&P 500.

Since the first quarter of 2009, as the recession troughed, the S&P 500 Index is up about 83% (through mid-October 2012) as are earnings per share, uncharacteristically accounting for nearly all of the rise in the stock market. Valuations now stand in line with the lows of 2008–09, after falling throughout the 2000s, while earnings per share have reached all-time highs [Figure 3].

3 Drivers of Total Returns Come From Different Sources: *Recently Earnings Have Been the Primary Driver*

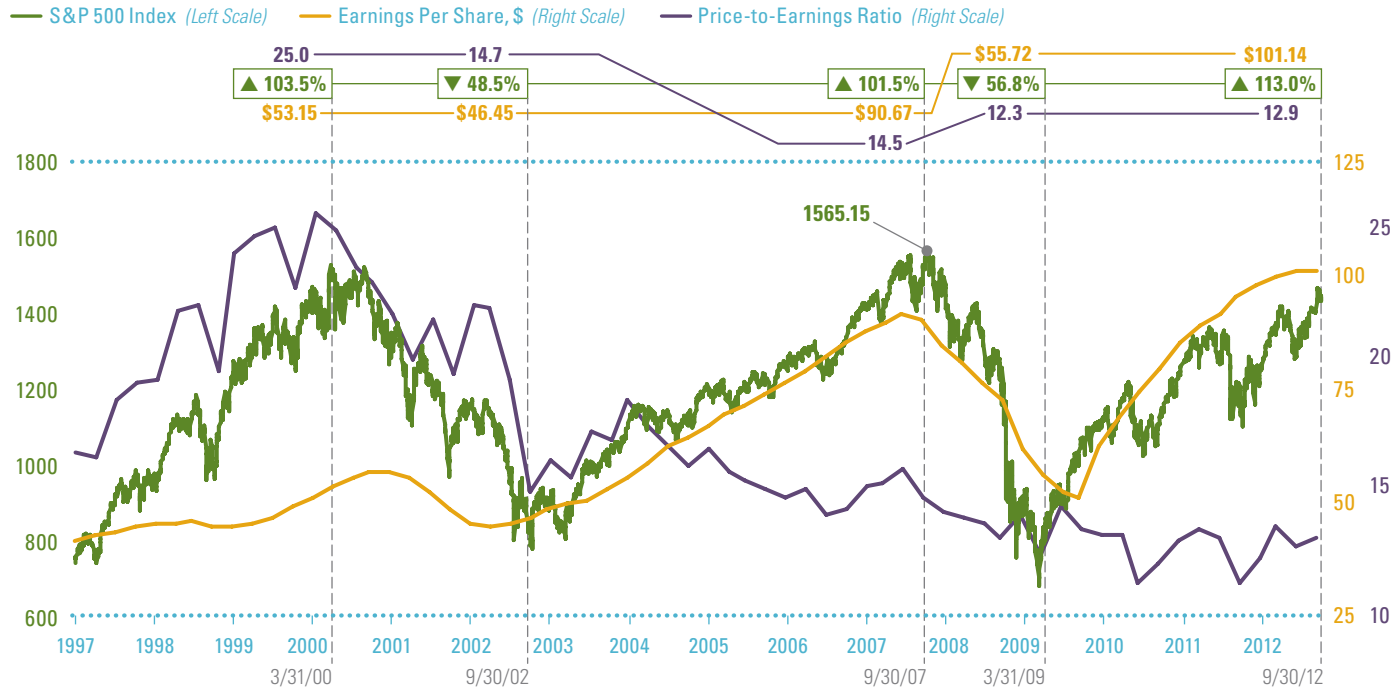


Source: LPL Financial Research, Thomson Financial, Standard & Poor's, Bloomberg 11/26/12

Lame Duck

The "lame duck" session of Congress refers to the time between the congressional elections and when the newly elected Congress convenes. Ironically, according to the *Oxford English Dictionary*, the term was first used in 18th century London to describe someone who cannot meet his financial obligations, or a defaulter. The first recorded use of lame duck to describe politicians was in the 1860s. The 20th Amendment of the U.S. Constitution—ratified in 1933—is often called the Lame Duck Amendment. The Amendment shortened the time between the election and swearing in/inauguration of a new Congress/President. The 20th Amendment moved the start of the new session of Congress and the Inauguration date of the President from March 4, to January 3 and January 20, respectively.

4 Back at the Top of the S&P 500 15-Year Range



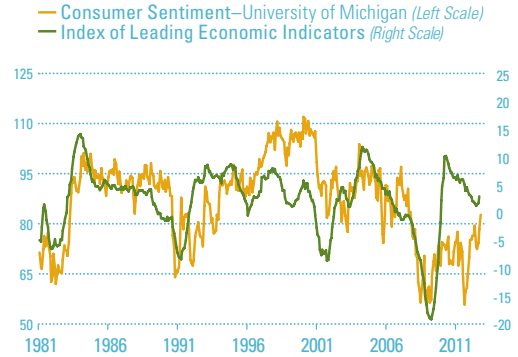
Source: LPL Financial Research, Thomson Financial, Standard & Poor's, Bloomberg 10/08/12

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

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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 a lower P/E ratio.

5 Facts and Feelings Have Almost Reconnected and a Crossover May Occur



Source: LPL Financial Research, Bloomberg 11/12/12

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

The University of Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The MCSI uses telephone surveys to gather information on consumer expectations regarding the overall economy.

Past performance is no guarantee of future results.

At just over $100, earnings per share for S&P 500 companies are now double what they were at the peak of the market in 2000. It is interesting to note that at the bottom of the market decline in early 2009, earnings per share were still greater than they were at the peak of the market in 2000. However, the most commonly accepted measure of the value of stocks, the price-to-earnings ratio, is half of the lofty level it reached when the S&P 500 Index first neared 1500 in the year 2000. When stocks most recently reached the low of the 15-year range in the first quarter of 2009, the price-to-earnings ratio was 12.3. Since then it has not risen much and currently stands at about 12.9, below the two prior market bottoms [Figure 4].

In 2013, it will likely be the change in valuation that drives most of the performance of stocks, and the sentiment shift and willingness to take on risk reflected in that movement will be meaningful for bonds as well. The direction of the markets in 2013 may be more about feelings than facts. The theme we described in our *2012 Outlook* was Meeting in the Middle; it referred to the re-connection between facts and feelings likely in 2012, as hard economic data and soft consumer sentiment found middle ground, lifting stocks. As anticipated, consumer sentiment and economic data did re-converge in 2012. In 2013, consumer sentiment could actually improve more than the economic data on prospects for a brighter future, resulting in the lines in Figure 5 crossing over each other. The last time sentiment rose above the economic data in a meaningful way was in 1996, as a Democratic President was

re-elected to a second term and worked together with House Republicans. Valuations rose sharply during this period, led by the technology sector.

How to Invest in the Base Path

Stocks

The aggregate price-to-earnings ratio for S&P 500 companies could rise as the United States takes a step—albeit a small one—toward fiscal discipline. While earnings may be relatively flat in 2013, share buybacks and dividends may provide some support, and the price-to-earnings ratio could rise a small amount resulting in low-single-digit gains. Wall Street analysts are likely to lower their current double-digit expectations for profit growth in 2013, but since valuations already reflect a flat outlook for profits, this may not weigh on the market.

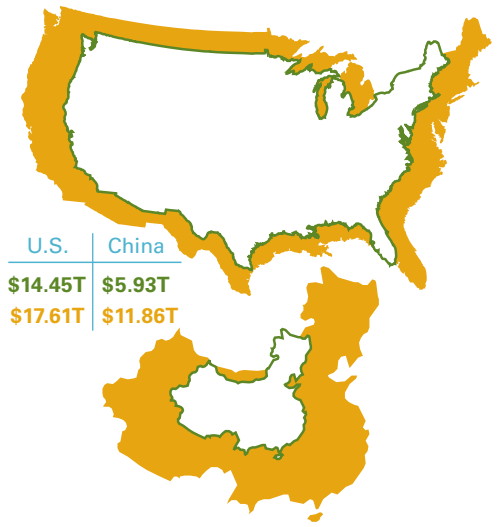
Stock investing involves risk including loss of principal.

The first half of 2013 may be better than the second half, as optimism about legislative momentum may turn to concern again as we approach year-end and face another battle over extending the tax and spending cuts. It is possible that stocks could post double-digit gains early on, only to see those gains fade back to the low single digits.

Style and cap beneficiaries may evolve during the year. Yield will matter in such a modest return environment, but the potential for a rise in the price-to-earnings ratio favors growth asset classes slightly over value ones. A cyclical growth bias in the first part of year may then turn to a defensive yield bias as momentum fades. This applies to style, sector, and capitalization: the characteristics of growth, cyclical, and small may give way over the course of the year to value, defensive, and large.

International exposure may be warranted. The international picture will have an impact on relative performance, particularly China and Europe. Normally, U.S. stocks outperform during periods when the price-to-earnings ratio rises since major foreign stock markets have more of a value bias, in general. But relative performance depends upon not only U.S. policy moves, but also on those of Europe and China. Europe has a number of big milestones just ahead. It still appears that the Eurozone is becoming more tightly integrated rather than spiraling apart. While growth in the economy and profits may be lackluster in 2013, optimism that there is a long-term solution may boost European markets—as it has during the second half of 2012. Price-to-earnings ratios are compressed in Europe, but not as much as one might think since earnings have also been falling. Looking to the emerging markets, the trajectory of China's growth is very important [Figure 6]. China is undertaking big infrastructure initiatives, cutting reserve requirements, lowering interest rates, and experiencing a leadership transition in late 2012 that should favor better growth in 2013. We may also see India and Brazil turn the corner. For the time being, the pro-growth policies implemented in China in 2012 have not resulted in a re-acceleration of growth, but they seem to have at least paused the decline in the third quarter of 2012. Initiating allocations to Europe and increasing exposure to emerging markets, as data begin to suggest policy measures are taking effect, are likely to be beneficial to portfolios in 2013.

6 China's Growth Plan Takes China From 40% to 67% of the Size of the U.S. Economy



Source: LPL Financial Research, World Bank 11/12/12

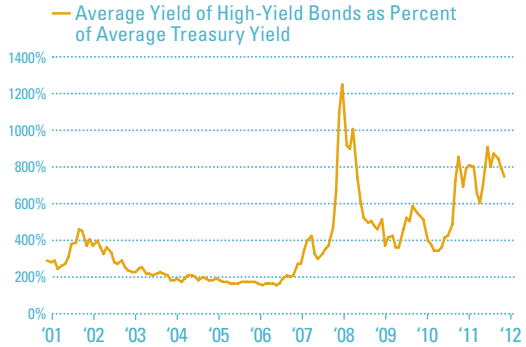
Note: Assumes continued 2% GDP growth rate for United States and stated 2020 target for China.

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

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.

High-yield bonds still benefit from good credit quality metrics, and valuations are attractive in a low-yield world.

7 Although Yield Spreads Have Contracted, High-Yield Bonds Still Stand Out in a Low-Yield World



Source: Barclays index data, LPL Financial Research 11/19/12

Average yield of high-yield bonds is 7x greater than average Treasury yield.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free, but other state and local taxes may apply.

Mortgage-backed securities are subject to credit, default risk, 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, 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.

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.

Bonds

We expect a low- to possibly mid-single-digit total return for high-quality bonds along this path. Sluggish economic growth, a Fed that will keep interest rates low, and muted inflation are likely to limit weakness on high-quality bond prices and limit upward pressure to interest rates. Interest income is likely to offset modest price declines over the balance of 2013, as Fed bond purchases are likely to continue and motivate investors to consider higher yielding segments of the bond market. Additionally, intermediate-term bonds are likely to provide the best reward per unit of risk under this relatively benign outcome for bond investors.

Municipal bonds' lower interest rate sensitivity and better yields, as well as improving housing-related tax revenue may help their performance relative to Treasuries. Municipal bonds remain attractively valued relative to Treasuries and are likely to exhibit greater resiliency compared to Treasuries. The attractive valuations are likely to buffer prices against a modest rise in interest rates. The prospect of higher taxes may also benefit municipal bonds as the tax-exempt interest income becomes more attractive. While a potential change in the taxation of municipal bond interest remains a legislative risk, this will not materially alter taxable-equivalent yields and the attractiveness of municipal income.

Treasuries may underperform as investors begin to anticipate the longer term beneficial impacts of the government's more sustainable fiscal footing as a result of a fiscal-cliff comprise. High valuations embedded within Treasuries will begin to erode in response and lead to lower prices and modestly higher yields.

Mortgage-backed securities (MBS) are likely to outperform due to higher yields, lower interest rate sensitivity, and continued Fed purchases. Yields may drift higher, but not much. The yield curve may steepen slightly, favoring short-term bonds. MBS may benefit from their shorter-than-average duration, combined with some additional lift from the Fed's bond buying, along with some spread narrowing.

Corporate bonds, despite lackluster growth in profits, may again be a winner. Corporate credit quality metrics have peaked, but companies in general have high cash balances, high interest coverage, and relatively low leverage—all of which support corporate bond valuations. The relative performance gain for corporate bonds will likely again be all about yield.

High-yield bonds may likely be a winner among fixed income sectors as investors remain focused on yield [Figure 7]. Like investment-grade corporate bonds, high-yield bonds still benefit from good credit quality metrics, and valuations are attractive in a low-yield world. Furthermore, defaults are likely to remain notably below their historical average. Very few bonds mature over 2013, thanks to companies taking advantage of low interest rates and refinancing near-term maturities into longer term debt. The lack of maturing bonds will help keep defaults low and support high-yield bond prices.

The Bear Path

Going Over the Cliff

The lack of any compromise over the sequester spending cuts during the past year, the unwillingness to embrace any of the proposed bipartisan reforms (from the Simpson-Bowles commission and so-called Gang of Six) and perhaps, most importantly, the debt ceiling debacle of August 2011 have taught us not to expect our leaders to always see the value in expedient compromise over grand gestures and winning political points. As a result, we must place a meaningful probability of taking this path at about 25–30%.

Under current law, the federal government is scheduled to implement a fiscal tightening of a scale not seen since 1947. It is attributable to over $500 billion in tax and spending cuts, equivalent to 3–4% of GDP [Figure 8]. The most recent similar occurrence was a 3% fiscal tightening in 1969 that presaged a recession later that year following robust growth of 5% in 1968—it was also accompanied by a 36% decline in the stock market. Thus, unless mitigated by an act of Congress, we expect the fiscal cliff would lead the United States into recession and a bear market in 2013.

Recently, markets may have become too complacent that Washington, D.C. will quickly find a compromise on extending some of the Bush tax cuts and other actions to avoid going over the fiscal cliff into a recession in 2013. However, if the United States goes over the fiscal cliff, the markets will come under heavy selling pressure because there will be no way to know how long the stalemate will last. It may be that one or both sides have to come under the heavy political pressure associated with widespread tax increases and a weaker economy before they are willing to compromise.

A compromise may be harder to reach than the market seems to think.

If no deal can be reached, it is possible that this could produce a technical default on the debt and trigger a prioritization of payments and a massive overnight cut to federal spending. Only slightly less awful is merely kicking the can down the road a month or two at a time. If Congress and the White House reach an agreement on the debt ceiling only on a short-term basis requiring numerous short-term deals, none of which would lead to major deficit reduction, the lack of confidence in this outcome would in all likelihood result in a downgrade by all three credit rating agencies, and investors would likely sell and seek safety.

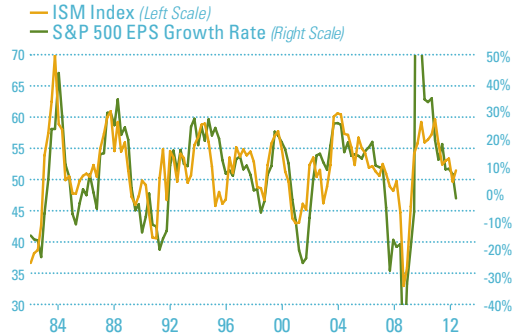
If the bear path is taken in 2013, we can expect a recession, but not a deep one since there are positives to fiscal austerity and the lack of excesses.

8 The Fiscal Cliff ($ billions)

Expiration of Bush tax cuts for middle income earners	102
Expiration of Bush tax cuts for high income earners	42
Payroll tax cut for workers	85
Alternative minimum tax "patch"	103
Debt ceiling annual spending sequester	54
Expiration of extended unemployment insurance	34
Medicare tax of 3.8% on investment income from the Affordable Care Act	18
Medicare physician reimbursement	10
Other provisions scheduled to expire	65
Total	**513**
Total as % of estimated 2013 GDP	**3–4%**

Source: LPL Financial Research, Congressional Budget Office, Office of Management and Budget 11/26/12

9 Manufacturing Activity Impacts the Stock Market



Source: Institute of Supply Management, Haver Analytics, LPL Financial Research 11/26/12

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Past performance is no guarantee of future results.

If this is the path taken in 2013, we can expect a recession, but not a deep one since there are positives to fiscal austerity. Also, over just three-and-a-half years of modest economic growth, we have not seen the buildup of excesses, such as a technology or housing bubble. The Congressional Budget Office expects the economy to shrink by -1.3% in the first half of 2013 before rebounding and growing 2.3% in the second half, when the impacts begin to dissipate.

We expect the economic backdrop in this environment to be consistent with a mild recession, as rising taxes hurt consumer spending, delay business hiring, and impact corporate capital spending. The sequestration portion of the fiscal cliff would crimp government spending, and in some cases, business capital spending, while the cuts to Medicare payments to doctors and the end of extended unemployment benefits would directly impact personal incomes and spending. Inflation would remain muted, and the unemployment rate would push closer to 9.0% from 8.0% in late 2012. The Fed may attempt to provide more stimulus to offset the impact of the fiscal cliff. These actions, along with the rising unemployment rate and slightly lower budget deficit, could apply further downward pressure to interest rates and keep them very low for most of the year. All areas of the economy would likely be impacted by the uncertainty surrounding the resolution of the fiscal cliff, as consumers, businesses, and governments at all levels are likely to postpone, or in some cases cancel, economic decisions as we head down this path.

Earnings per share for S&P 500 companies will probably decline between 5% and 15%. With earnings in the third quarter of 2012 roughly flat with where they were a year earlier, it is unlikely to take much of a retrenchment in confidence and spending to result in outright earnings declines. For example, a drop in manufacturing activity, measured by the Institute for Supply Management (ISM) Purchasing Managers Index, from currently around 50 into the low 40s would be consistent with a 5–15% drop in earnings per share [Figure 9].

The Threat of a U.S. Downgrade

The downgrade of the U.S.'s long-term credit rating by Standard & Poor's (S&P) in August 2011 following the debt ceiling debacle shook investors' confidence. The downgrade contributed to the sharp, double-digit decline in the stock market—though it had little impact on the bond market.

Scarred by its slowness to react to the U.S. housing debt meltdown in 2008, S&P was quick to use this opportunity to demonstrate its more proactive stance on such a widely watched issue. But with two of the three major rating agencies, Moody's and Fitch, maintaining their ratings on the United States, the overall rating remains AAA. All it would take is one of them to downgrade and the United States would lose its AAA status.

How likely is this in 2013? Let's look at what Moody's and Fitch have had to say. Moody's specifically has noted that a deal in the lame duck session is not necessary. In fact, it could be detrimental:

> *"...$1.2 trillion in further deficit reduction has already been legislated through automatic spending caps if no agreement is reached, failure by the committee to reach agreement would not by itself lead to a rating change." – Moody's 11/01/11*

Essentially Moody's is implying that there will be meaningful spending cuts across the board over the next 10 years, even if Congress cannot agree on fine-tuning them among programs. However, what is insinuated here is that if the cuts are averted or reduced in some way, Moody's may be forced to downgrade. It is likely at least some of the cuts get modified, so there is a significant risk of a downgrade by Moody's in 2013.

Fitch has set a higher hurdle to avoid a downgrade. In a comment this summer, Fitch stated that after the election, a multi-year deficit reduction plan would likely lead to Fitch re-affirming the U.S.'s credit rating. Fitch also reiterated what it had clearly stated earlier:

> *"Failure to reach agreement in 2013 on a credible deficit reduction plan and a worsening of the economic and fiscal outlook would likely result in a downgrade of the U.S. sovereign rating." – Fitch 11/28/11*

So, a grand compromise on long-term deficit reduction in 2013 is necessary to avoid the United States losing our AAA rating—by Moody's or Fitch or both changing their rating.

Fortunately, several reasons make 2013 a year ripe for a grand compromise. Many major taxing and spending provisions are already set to expire:

1. Bush tax cuts, payroll tax cut, and the across-the-board spending cuts to discretionary programs kick in.
2. The tax in the Affordable Care Act takes effect.
3. The debt ceiling limit will be hit again.
4. The President and Congress have the most power in the first year of their terms to forge change.

In the event of a downgrade stemming from ineffectual budget policy decision-making, U.S. stocks may react negatively. In general, stocks' losses could be bonds' gains in the short term as investors seek safety. However, it is likely that the expulsion of the United States from the club of 15 nations with the highest credit quality (including Germany, Canada, and Australia) would eventually push yields higher, impacting the cost of the United States' debt load and the United States' ability to grow and compete globally.

This information is not intended to be a substitute for specific individualized tax, legal, or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

www.youtube.com/user/LPLResearch

Please visit our YouTube page to see our series of 3-Minute Videos on a variety of timely issues such as this.

10 Large Fiscal Issues Drag Down the Market

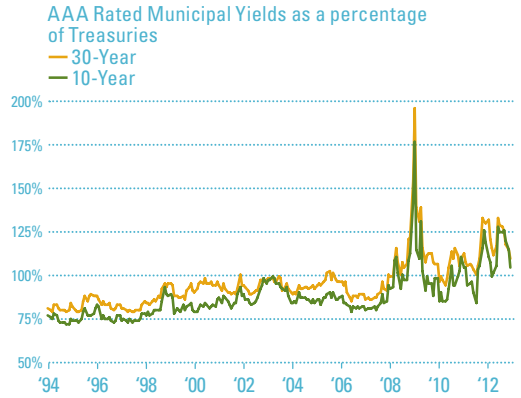
	Fiscal Drag	S&P 500 Pullback*
1947	-10.4%	-28%
1951	-2.7%	-8%
1956	-1.6%	-9%
1960	-2.1%	-13%
1969	-3.1%	-36%
1977	-1.4%	-19%
1987	-1.8%	-34%
Average		-21%

Source: LPL Financial Research, Bloomberg 10/22/12

*This is the peak-to-trough pullback associated with the fiscal drag.

The Standard & Poor's 500 Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

11 Municipal Valuations Have Improved, but Remain Attractive Compared to Long-Term History



Source: Barclays index data, LPL Financial Research 11/19/12

Stock investing involves risk including loss of principal.

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.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free, but other state and local taxes may apply.

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

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

How to Invest in the Bear Path

Stocks

Stocks underperform bonds and cash. Stocks may enter a bear market with about a 20% decline from 2012's high. This would result in a decline in the already below-average valuation, by about one point in the price-to-earnings ratio, but it also would reflect the deterioration in earnings. A 20% bear market decline is typical of years of fiscal drag on the economy. The fiscal policy drag on tap for 2013 of 3–4% of GDP (composed of tax increases and spending cuts) is the most since 1947. Since the start of 1947, there have been seven years that fiscal policy acted as a budget bombshell with an economic drag on growth of around 1.5% or more. While they have varied in magnitude, the average peak-to-trough pullback associated with those seven periods of budget bombshells was 21% [Figure 10].

Defensives outperform cyclicals. While all stocks likely post losses, defensive stocks outperform more economically sensitive, or cyclical, stocks as the earnings outlook deteriorates and a focus on safety and yield returns.

Large caps outperform small caps. Small underperforms large caps given their greater economic sensitivity and higher volatility.

International performance is similarly poor. Foreign markets typically offer no safe haven from U.S. downturns. Foreign markets may suffer similar declines to the U.S. market, given the ongoing European recession, weakest growth environment in China since 2009, and lack of a U.S. growth engine. European stocks are up so far in 2012, while corporate earnings have fallen, leaving them vulnerable to a decline.

Bonds

Safe-haven buying will likely return along the bear path and benefit Treasuries. High-quality bonds overall will benefit in response and translate into mid-single-digit returns for the broad high-quality bond market.

Municipal bonds' prices would increase, but likely fail to match Treasury gains, as has historically been the case during bouts of safe-haven buying. Despite the prospect of higher taxes, Treasuries will be more sought after due to their greater liquidity and municipal budget concerns resurfacing. Treasuries benefit from being a safe haven in a recession because of slower economic growth equating to less inflation pressure and from less issuance due to fiscal discipline. State and local general obligation credit quality would likely worsen in part because tax revenues are highly correlated with economic growth, since they are largely based on income and sales taxes. Also, spending is not as responsive since much of state and local spending is not discretionary within the current fiscal year—including items such as contracted salaries and benefits. In fact, states' spending can increase as the economy weakens as more people qualify for assistance programs. As a result, municipal budgets can quickly get out of balance. Credit weakness may cause municipal bonds to suffer relative to Treasuries as credit spreads widen [Figure 11].

MBS may be negatively impacted by a return to price declines in housing and renewed credit deterioration for households as unemployment worsens. These negatives could be partially offset by increased or continued Fed buying of MBS. However, MBS prices may see limited benefit due to prepayment concerns and their shorter average duration despite continued Fed purchases.

Corporate bonds may underperform as the earnings and economic outlook deteriorates. Yield spreads for high-grade corporate debt are likely to increase as investors demand a premium to hold it. However, yield spreads are unlikely to see anything close to 2008 levels, since issuers have greatly reduced debt and overall leverage is much lower. Furthermore, profit margins are wide, cash balances are high, and earnings per share declines are only likely to be a fraction of what was experienced in 2008–09. Although we do not expect the magnitude to be as great, high-yield bonds have underperformed higher quality bonds in every recession, and it is likely that this period would not be an exception.

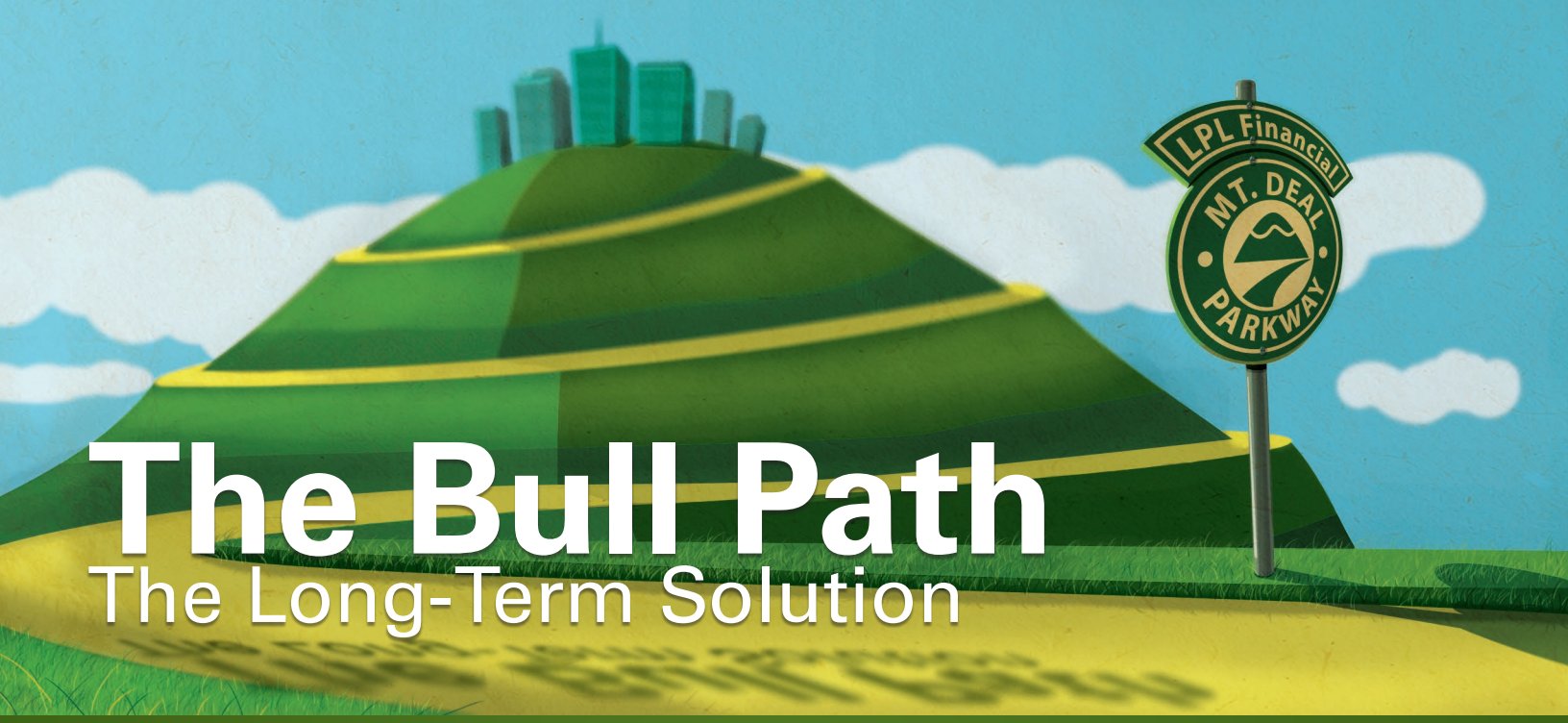
Long-term bonds outperform intermediate- and short-term bonds. This is typically the case during periods of safe-haven buying. A so-called "bull flattening" of the yield curve may result as longer term rates fall while shorter rates have limited room to decline. As the yield curve flattens, it favors longer maturity bonds that experience greater price gains than shorter term bonds.

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.

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.

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



The Bull Path

The Long-Term Solution

If there ever were a time to enact long-term fiscal discipline, now is that time. The United States' large and unsustainable budget deficits helped push total U.S. debt over 100% of GDP in 2012. Typically considered taboo by both parties, wide-reaching bipartisan proposals have been unveiled to put the United States back on a path to fiscal sustainability. We estimate a 10–15% chance that a long-term solution of permanent changes to tax rates and entitlement programs emerges in 2013.

A few drivers make the timing potentially just right for a long-term solution that goes beyond a compromise on the fiscal cliff for 2013:

- **The debt ceiling must be lifted again in the first quarter of 2013.** The lesson from the debt ceiling fight in the summer of 2011 is that a debt ceiling increase is unlikely to pass the Republican House of Representatives without being accompanied by legislation to reduce the deficit.
- **The looming threat of the United States losing our AAA credit rating.** All three rating agencies have communicated that they remain poised to downgrade the debt of the United States if substantial, long-term actions are not taken—a threat most members of Congress take seriously.
- **The spending sequester is partly composed of a nearly 10% cut to defense spending taking effect on January 1, 2013 and must be dealt with.** It is unlikely that broad and deep cuts into well-entrenched, multi-year defense programs are feasible, and the geopolitical environment will not make such an outcome palatable to those in Washington. But, neither party supports simply repealing the cuts without a deal that reduces the deficit over the long term.
- **The President and members of Congress will be in the first year of their terms.** Historically, most substantial legislative accomplishments take place in year one of the presidential cycle. Without the pressure of a looming election, policymakers are freer to take more controversial positions and focus on the long term.
- **Closing "loopholes" in the tax code requires broader tax reform.** Many politicians refer to the desire to close loopholes, or tax expenditures, in an effort to raise revenue without lifting rates at all, or as much. However, it is

Historically, most substantial legislative accomplishments take place in year one of the presidential cycle.

unlikely the votes to address the many intricacies of the tax code exist if not included in a broader bill that makes significant progress on reducing the deficit from many different areas.

Even though the efforts for a long-term solution failed in the summer of 2011, the blueprint for a potential agreement was revealed. Speaker of the House Boehner and President Obama agreed to $800 billion in tax increases over 10 years, and Vice President Biden and House Majority Leader Cantor were close to an agreement on a similar amount of entitlement spending cuts over the next decade. If the details of this agreement could be reached, and the Senate is encouraged to go along with it, it would forge a deficit reduction agreement of roughly $2 trillion (relative to current policy baseline), when combined with the associated interest savings on the national debt. It is even possible a deal to fix Social Security, similar to the plan designed by the Simpson-Bowles Commission, could be attached to the long-term solution to address the entitlement programs.

A long-term solution that reduces the deficit by over $2 trillion over 10 years (compared to current law) through raising taxes as well as cutting entitlements and defense is a bold step. However, this is why this is likely too substantial an accomplishment to hope for during the lame duck session, but two deadlines could force action: in February/March, when it is likely the debt ceiling will have to be raised, or at the end of March, when the continuing resolution funding the government expires.

A long-term solution would be bullish for equities and the economy because it would be a substantial first step toward fiscal sustainability. It would greatly reduce the risk of a crisis at some point, which is almost inevitable, given how quickly the United States is accumulating debt on an annual basis. It would provide long-term clarity on taxes and spending, and prevent annual debt ceiling fights or fiscal cliffs for at least the next few years. To the extent that these risks and uncertainties are causing businesses and consumers to stay on the sidelines, these headwinds to economic growth would be lifted—more than offsetting any fiscal drag.

The removal of uncertainty surrounding the nation's long-term deficit issues, accompanied by long-term visibility in the tax code, may provide a significant boost to consumer and business confidence, and may lead to higher economic growth, better job creation, less accommodation from the Fed, and perhaps higher inflation. Although quite dependent on the mix of revenue increases and spending cuts agreed to by lawmakers, any long-term deficit reduction plan enacted in 2013 is likely to have negative impacts on the economy in the next several years. However, it is likely to yield longer term benefits in later years via lower interest rates, increased flexibility of policymakers to respond to economic crises, and better allocation of the nation's capital.

This bull path is "risk-on" for investors as markets climb higher and head in the opposite direction of the bear path that goes over the fiscal cliff.

Ben Bernanke Urges Congress to a Long-Term Solution

"I've talked about three elements for fiscal policy. The first is to do no harm as far as the recovery is concerned, to try to avoid a fiscal cliff that would significantly damage the recovery. But second, to maintain the effort to achieve a sustainable fiscal path over the longer term. And third, to use fiscal policy effectively—to have a better tax code, to make good use of government spending programs and make them efficient and effective, and so on. So I think if Congress does all those things, the ultimate benefits would be substantial." –Federal Reserve Chairman Ben Bernanke, Speech at Economic Club of Indiana, October 1, 2012

How to Invest in the Bull Path

Stocks

Stocks would outperform bonds and cash. Though earnings may remain sluggish given the backdrop of austerity, price-to-earnings valuations could rise 2–3 points (equivalent to a 25% gain in the stock market) as confidence builds and reverses the long entrenched pessimism among individual

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Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

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investors who finally start to buy stocks again after five years of net selling, according to the Investment Company Institute fund flow data.

Cyclicals outperform defensives. While all stocks likely post gains, cyclical growth stocks that are more favorably impacted by a brighter outlook for future growth would likely outperform defensive stocks.

Small caps outperform large caps. Stocks of smaller companies outperform their larger peers as investors seek companies with faster growth opportunities and whose profits are more responsive to growth.

Domestic markets outperform foreign markets. With a key driver being the resolution of fiscal uncertainty in the United States (at least for a few years), U.S. markets would be likely to outperform their foreign counterparts as money from abroad sees the clarity and growth prospects of the United States.

Bonds

High-quality bond market total returns may be flat-to-down under this scenario, but that is highly dependent on sector and maturity exposure. High-quality bonds will weaken as the bond market looks forward to better long-term growth, but the prospects of sluggish near-term growth and the fact that the Fed will refrain from raising interest rates may limit price declines.

Treasuries experience losses as the bond market prices in improving prospects for future growth despite the better fiscal footing. The yield curve steepens and long-term bonds underperform intermediate-term bonds, which in turn lag short-term bonds.

Municipal bonds' attractive valuations and the prospect of higher taxes are key positives. However, municipal bond prices may still decline as high-quality bond prices come under pressure from rising interest rates.

MBS would benefit from prospects for further improvement in housing and homeowner credit as well as employment. However, these positives could be partially offset if the Fed slows the bond-buying program targeting MBS.

Corporate bonds would outperform as the long-term earnings and economic outlook improves, which should benefit more economically sensitive securities. High-yield bonds would lead the way followed by investment-grade corporate bonds. While spreads may narrow, rising interest rates may partly erode the total return on these securities. Also, corporate bond supply may increase as companies embrace a healthier economic outlook and seek to renew spending.

Short-term bonds outperform long-term bonds. A so-called "bear steepening" of the yield curve may occur as longer term rates rise more quickly relative to shorter term rates, which are kept in check by near-term economic weakness and a Fed that remains on hold. A greater rise in long-term interest rates relative to short-term interest rates will translate into better performance for short-term bonds.

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The Paths for Europe, Central Banks, and Geopolitics

Although Europe is still mired in recession, European stocks and bonds have performed well, and the European Central Bank appears to be standing behind Spain and Italy. Central Banks throughout Europe and the Bank of Japan will continue their currency war. Regional tensions over Iran and Syria will remain high and serve as a reminder of risks to the global economy beyond U.S. borders.

The Paths for Europe

Lately, Europe has been on a bull path. Despite its recession, European stocks and bonds have performed well. As long as markets believe the European Central Bank (ECB) will stand behind Spain and Italy, there is little reason to believe peripheral yields will shoot back up and that systemic risk will return. The ECB has made the bonds of southern European countries (and equities as well) investable again by offering to act as a buyer of the bonds of Spain and other countries if they agree to sign a memorandum of understanding (MOU) as an agreement to certain terms. Therefore, betting against southern European bonds may be dangerous.

The outlook for the Eurozone is not extraordinarily bright even if Spain follows the base path and signs the MOU—thereby agreeing to the terms of a bailout. An agreement assumes that at least Spain will have to abide by its fiscal target in the year ahead. But the ongoing recession, accompanied by new and existing austerity measures, will make meeting those fiscal targets a major challenge. If economic data suggest that Spain is unlikely to be able to meet the targets set in the MOU, investors may once again question whether the ECB will remain committed to buying the country's bonds, leaving yields to head back up and re-engage the risk of contagion. And, this will spill over to Italy, whose contribution to a Spanish bailout may equal 1.5% of Italy's GDP. Having to foot a big bill for Spain while struggling to reduce its own deficit and debt, at the same time coping with recession, may be too great a strain for the Italians. But, the alternative of denying Spain needed funds would risk a contagion that would adversely affect Italy and others.

So, what could change this to a more bearish path? One thing that comes to mind is a long delay on the part of Spain in signing an MOU. Our sense is that investors understand the political difficulties associated with an

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MOU and are willing to give policymakers sufficient time to sort them out. If, however, an official request for help is delayed too long, investors might begin to question whether a deal is possible. If investors come to the conclusion that the cost for either southern or northern European countries is apparently too high to proceed, they might infer that the ECB is unlikely to ever follow through with asset purchases. In that case, investor willingness to buy southern European bonds might diminish, the temptation to short them might increase, and risk could return again.

While these interdependencies increasingly pull the Eurozone together, there are forces that threaten to pull it apart—or at least greatly slow the pace of integration. Aside from the north-south division in the Eurozone, there is disagreement at the heart of the European Union between France and Germany. While the two countries are interested in preserving their joint leadership of the European Union, they have different long-term visions of the regional bloc. France has been pushing for the creation of a Eurobond plan for the Eurozone where countries' debts are pooled together. Conversely, Germany envisions a European Union where all member states enact strict fiscal discipline under increasing control by the European Commission. These conflicting plans will make it difficult for Europe to make substantial progress toward either of these goals in 2013.

Central Bank Paths

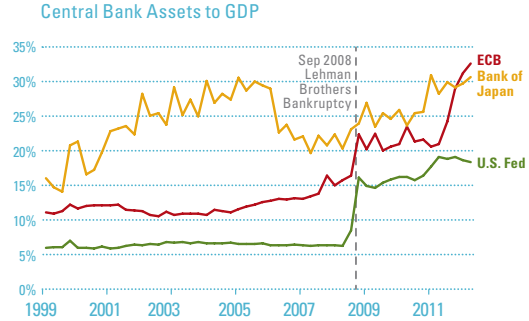
The Fed is likely to continue the third round of aggressive stimulus in the form of bond buying, known as quantitative easing, announced in September 2012. That highly anticipated move by the Fed helped stocks to rally to the highs of the year despite having S&P 500 companies issue the most warnings ahead of an earnings season in over a decade as companies lowered earnings expectations.

QE is part of the Fed's battle against recession given how weak the economy is—not to mention the threat of the impending fiscal cliff. But it is also a battle in a war against other central banks. The Fed has engaged in a massive amount of bond buying. Yet, as a percentage of the economy (GDP) the Fed's actions pale versus those of the ECB and Bank of Japan.

Since mid-2008, when the world's central banks aggressively applied stimulus through bond-buying programs and expanded the amount of assets on their balance sheets, the ECB has increased its holdings by 17% of GDP—more than doubling assets from 16% of GDP to 33% currently [Figures 12 & 13]. The ECB's balance sheet grew sharply after the collapse of Lehman Brothers in September 2008, and then jumped further as it undertook two "LTROs," or three-year loan refinance operations, in December 2011 and late February 2012. These most recent operations pumped more than one trillion euros into the banking system for the benefit of struggling Spanish, Italian, and other European banks. Other central banks have assets relative to GDP well beyond that of the Fed, especially among the emerging markets. For example, the People's Bank of China holds assets equivalent to about 25% of GDP.

Nearly all of the world's major central banks have engaged in a battle to provide aggressive stimulus proportional to the size of their economy. This similar percentage has been not merely to battle recession. It has also been to battle the currency impact of the actions by other central banks. While certainly not the only factor affecting currency values, when the central bank actions pump more liquid money into an economy, it has the tendency

12 World's Central Banks Have Aggressively Applied Stimulus



Source: Bloomberg, LPL Financial Research 10/22/12

13 Explosion in Central Bank Stimulus

Central Bank	Assets as a % of GDP		Difference
	Mid-2008	2012	
Bank of Japan	20%	31%	+11%
Bank of England	7%	21%	+14%
Federal Reserve	6%	18%	+12%
European Central Bank	16%	33%	+17%

Source: Bloomberg, LPL Financial Research 10/22/12

to weaken the currency relative to those of trading partners—unless the central banks of those trading partners are also engaging in a similar amount of aggressive actions. Those countries that have engaged in more bond buying as a percent of their GDP than the U.S. Fed have seen their currencies depreciate relative to the dollar, while those that have done less have seen their currencies rise versus the dollar [Figure 14].

The Fed's efforts are aimed at both keeping interest rates low for borrowers to stimulate economic activity and keeping the dollar from appreciating versus trading partners and risking damage to the economy from falling U.S. exports.

At the Fed meeting in mid-September 2012, the Fed communicated its intention to maintain a stimulative policy through mid-2015. The Fed is unlikely to announce a change to its stance anytime soon. Considering that it will likely take coordination among the world's central banks when the time is right to begin to rein in stimulus, lest it result in soaring currencies that may imperil recovery, it may be a very long time before the Fed feels it is able to begin to reverse the actions taken in recent years.

With the world's central banks locked in a currency war, the winner may be precious metals. Precious metals have the tendency to maintain their value relative to depreciating currencies. The latest and unlimited round of QE by the Fed may be matched by other central banks. After all, the ECB stands ready to enact its unlimited OMT, Outright Monetary Transactions, created in September 2012, just ahead of the Fed's latest announcement. This is likely to result in a favorable environment for precious metals for an extended time frame.

Geopolitical Paths

Regional tensions over Iran will remain high. Despite its continued threats, Israel is unlikely to risk a unilateral strike against Iran, and the United States is unwilling to draw a "redline" that would prompt a strike. However, the United States will continue to engage in economic warfare against Iran through sanctions. The sanctions-driven economic stresses are growing and will continue to drain its foreign exchange reserves, while Iran's struggle to manage the plunge in the value of its currency, the rial, will provide additional momentum for wider social unrest.

At the same time, Iran is watching the situation in Syria deteriorate and is trying to prevent a scenario in which the regime meltdown spills over into its borders or threatens to weaken its influence in Iraq or elsewhere in the region. All of this suggests Iran will explore a dialogue with the United States. U.S. leaders hope that coercing Iran into negotiations may allow for the extraction of major concessions on the Iranian nuclear program, but political constraints on both sides will likely prevent a resolution from developing.

Elsewhere in the Middle East, there is the potential for the U.S. special forces to intervene in Syria to secure chemical weapons stockpiles. Also in the Middle East, Israel is seeking to manage its new geopolitical reality. This rise of the Muslim Brotherhood in Egypt presents Israel with a new set of challenges on its borders. At the same time, the threat from Syria has diminished greatly. The recent rocket fire exchange with Hamas is just one example of the types of problems Israel will face in the coming years as the geopolitics in the region change.

14 Central Bank Currency War
Mid-2008–Present

Central Bank	Currency	Change in Central Bank Assets as % of GDP Relative to Change in U.S. Fed Assets	Change in Currency Relative to US Dollar
Japan	Yen	-1%	+34%
England/United Kingdom	Pound	+2%	-20%
Eurozone	Euro	+5%	-6%

Source: LPL Financial Research, Bloomberg 10/22/12

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Over the (Capitol) Hill:

A View From the End of the First Quarter of 2013

As we reach the end of the first quarter of 2013, the developments on Capitol Hill will provide much clearer visibility of the path upon which the economic and market landscape will pass over the remainder of the year. For example, by the end of the first quarter of 2013:

- The fiscal cliff issues are likely to have been resolved. Instead of a massive headwind of 3–4% of GDP, the fiscal drag for 2013 is likely to be in the neighborhood of 1.0–1.5% of GDP. If not, the U.S. economy will likely be in a recession by the end of the first quarter.
- The debt ceiling will likely have been lifted, and the rating agencies will have communicated their intention on the U.S.'s debt rating or be close to doing so.
- We will likely know if there is any follow-through on the Obama administration's new trade case against China. While the threats may deteriorate as the election fades, greater clarity will come on this important trade and currency issue by the end of the first quarter.
- The framework for any long-term solution to the U.S. fiscal challenges may be beginning to emerge.

It is worth noting that the path we start down may not be the one that we end up on. There may be many twists and turns on the way. For example, the market and economic response to a journey down the bear path could ultimately prompt a long-term deal that leads us back to the base or even the bull path. So, going over the cliff, while scary for market participants, does not mean the U.S. economy necessarily crashes on the rocks below. Even then, it is not too late for policymakers to come together and rescue the economy and investors.

Finally, while many fiscal issues may be clarified during the first three months of 2013, the opposite may be true for the Fed. The Fed will likely continue the existing bond-buying program into early 2013. However, as the year drags on, the uncertainty around Chairman Ben Bernanke's replacement when his term expires at the end of January 2014, and its impact on the direction of future policy, may weigh on the minds of investors. While Bernanke could serve a third term if nominated, it is unlikely he will. This could result in less faith in the promise to keep rates extraordinarily low past the end of Bernanke's term as chairman.

Like a zigzagging river following the path of least resistance, markets may take a volatile path as the negotiations and major events of the coming months develop into 2013. Hopefully, a straighter path is likely to emerge as the year matures and the United States becomes committed to the chosen path.

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. 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.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in specialty market and sectors carry additional risks such as economic, political or regulatory developments that may affect many or all issuers in that sector.

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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.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

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.

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 a lower P/E ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Default rate is the rate in which debt holders default on the amount of money that they owe. It is often used by credit card companies when setting interest rates, but also refers to the rate at which corporations default on their loans. Default rates tend to rise during economic downturns, since investors and businesses see a decline in income and sales while still being required to pay off the same amount of debt.

Index Definitions

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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.

Dow Jones Industrial Average (DJIA): The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors, and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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