LPL FINANCIAL RESEARCH

Mid-Year Outlook

2009

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LPL Financial

Chapter 1

Forging Ahead on a Road to Recovery

Every year LPL Financial Research compiles its Outlook for the following year to let investors know where we believe the markets are heading and how to best position portfolios. The heightened uncertainty generated a wider range of possibilities for 2009 than for most years. As a result, we presented three scenarios for 2009, our base case, a bear case, and a bull case. In our Mid-Year Outlook we provide you an in-depth view on the remainder of 2009.

In the first six months of 2009 we have experienced immense efforts to repair our economic system following the unprecedented events in the last months of 2008. During these six months we have witnessed the bankruptcy of the big U.S. auto makers, the dramatic 25% or more swing in the stock market*, and unprecedented government intervention in the capital markets. As the first half draws to a close, early signs of stability in the markets and the economy have emerged.

Back in December we published our outlook on how the markets would forge ahead, falter, or sharply rebound. Our most likely scenario, the base case, has proven to be on track. But what can we expect for the latter of 2009? Will our base case unfold, or are there factors that could derail it? With six months of experience behind us, we now offer you our perspective on how our base case is tracking, and what new opportunities and challenges lie ahead.

What is on the horizon?

- We continue to believe that the economy will emerge from recession in the second half of 2009. The sharp decline in first quarter Gross Domestic Product (GDP) at an annual rate of 5.5% will likely be followed by a more modest decline in the second quarter. We expect positive quarter-over-quarter readings on GDP in both the third and fourth quarters of 2009.

** The stock market as measured by the S&P 500*

- Inflation, which was not a concern during the first half of 2009 when deflation was the issue, appears poised to rise by the end of the year. The year-over-year change in inflation, measured by the Consumer Price Index (CPI), has dipped to -0.7% at the midpoint of the year. We expect it to rebound out of negative territory to between 0% and 1% by year-end.
- We expect the stock market, as measured by the S&P 500 Index, to post a calendar year return in the mid-teens, as the volatile first half of the year transitions to more consistent improvement in earnings and sentiment over the second half. We anticipate the year-end S&P 500 close to be around 1000–1050. After a wild ride, the stock market, as measured by the S&P 500, ended the first half of the year with a mid-single digit gain that places the index about halfway back from the March low to our year-end return target.
- We expect the bond market, as measured by the Barclays Aggregate Bond Index, to post a return in the mid- to high-single digits range. The flat total return on the bond market so far in 2009, as measured by this index, hides major shifts under the surface. While Treasury Bonds suffered as yields climbed, narrowing corporate bond spreads boosted returns in corporates and helped to offset the rise. Less movement in Treasury yields in the second half, as we expect will be the case, will help bring positive total returns for the year.
- Alternative "volatility" strategies performed well in the first half of the year, aided by the high volatility in both stocks and bonds. However, these strategies are likely to underperform opportunistic and long-only strategies as volatility subsides in the second half of 2009.

While strong cross-currents remain in the financial markets, growing evidence points to an improving economic backdrop, healing credit environment, and emerging willingness of investors to take increased risk in their stock and bond investments. Key gauges of financial market stress have shown marked improvement. In fact, measures of stress in the corporate bond market (reflected in the Baa-rated bond credit spread*) and lending among banks (indicated by the TED spread**) have moved back to pre-crisis levels. Since stress in the credit markets was the key driver of the recession and bear market, improvement in these areas is critical to a successful recovery.

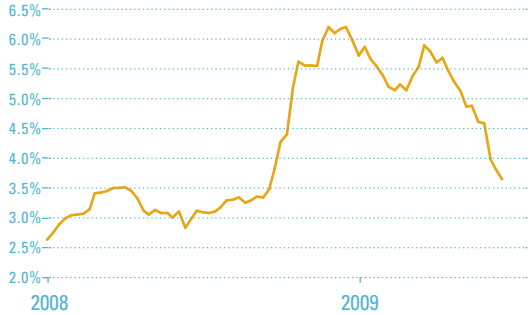
The economy remains fragile. Yet, robust fiscal and monetary policies have helped lead the way to an improved economic backdrop that continues to favor the unfolding of our base case forecast as we initially presented it at the end of last year. The market will likely continue to see volatility in the second half of 2009, we expect overall an upward-trending market, continued economic improvement, and a transition from recession to recovery as our base case forecast plays out.

**The credit spread is the yield on corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Baa-rated bonds are the lowest quality bonds that are still considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum. This spread has narrowed as conditions have improved.*

***The TED Spread measures the difference between the 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. A decline in this spread indicates liquidity is improving. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system.*

Corporate Bond Market Risk Spread Declines

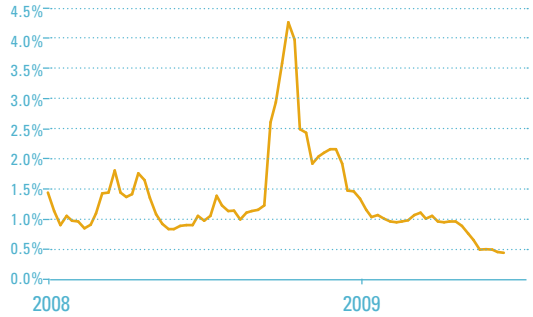
Baa-Rated Corporate Bond Spread



Source: LPL Financial, Bloomberg, Data as of 06/19/09

Interbank Lending Risk Spread Declines

TED Spread



Source: LPL Financial, Bloomberg, Data as of 06/19/09

The market will likely continue to see volatility in the second half of 2009, we expect overall an upward-trending market, continued economic improvement, and a transition from recession to recovery as our base case forecast plays out.

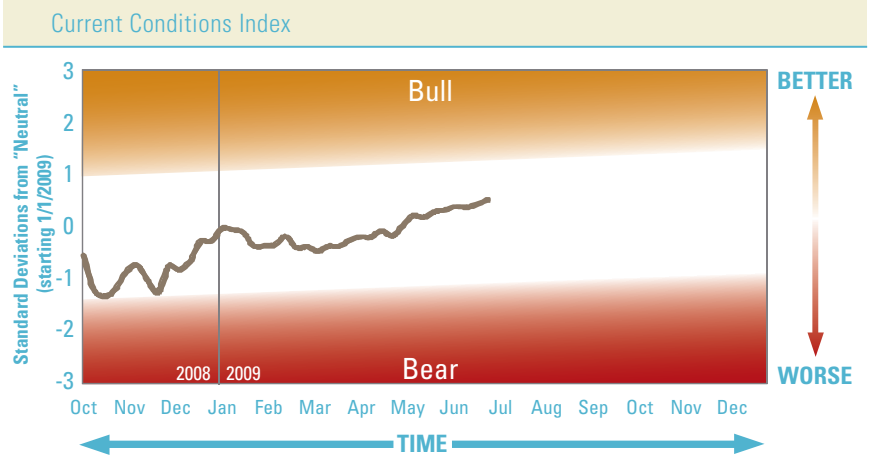
How has the CCI Been Performing?

Most of the 10 components of the index are in positive territory for the year. Measures of stress in the credit markets have shown the most improvement (Baa Spreads in the corporate bond market and the TED Spread for lending among banks). The VIX*, a key gauge of stress in the stock market has also subsided notably since the start of the year. Deterioration can be measured in first time filings for unemployment benefits (initial jobless claims) and slumping demand for housing (mortgage applications). In general, the other components have all improved since the start of the year. Notably shipping rates have risen as demand has picked up (this rise has also been seen in trucking and rail traffic). Also, despite little change in the low level of consumer confidence this year, retail sales rebounded during the last full week of June back to the slight rise relative to the same period last year that has been the norm over the past few months.

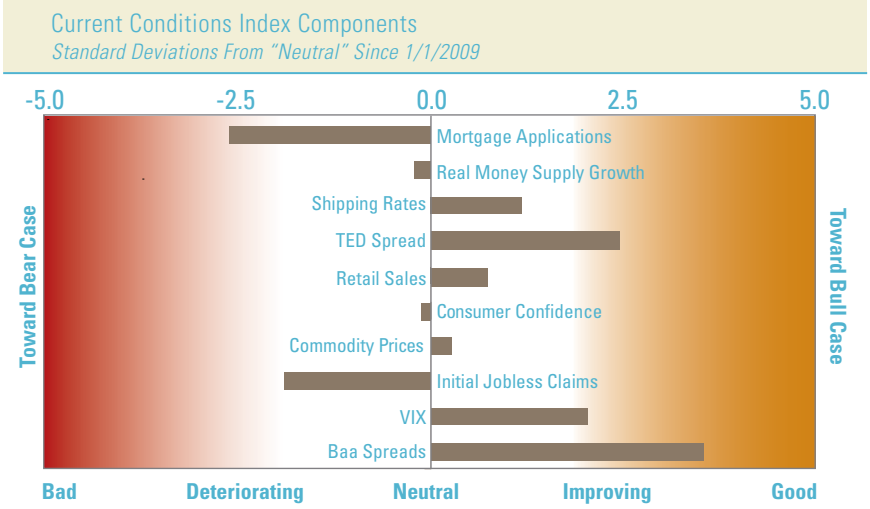
LPL Financial Current Conditions Index

How are the economy and markets performing?

The LPL Financial Current Conditions Index advanced to 0.6 during the past week continuing the advance that began at the beginning of March. It is possible that the pace of gains in the index may soon begin to moderate as the impact of the GM bankruptcy, higher gasoline prices and interest rates, and rising legislative and geopolitical uncertainty weigh on the economy and markets. The index reflects current conditions aligned with our base case outlook for modest gains in the stock and bond market in 2009.



Source: LPL Financial, Data as of 7/1/09



Source: LPL Financial, Data as of 7/1/09

**The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market based estimate of future volatility. While this is not necessarily predictive it does measure the current degree of fear present in the stock market.*

Chapter 2
Breaking Down our Outlook

The U.S. economy endured a difficult first half of 2009, with the broadest measure of economic activity, GDP, declining at a 5.5% annualized rate in the first quarter of 2009 after an annualized 6.3% drop in the fourth quarter of 2008. In early spring however, "green shoots" began to emerge in the economy, suggesting that the worst of the recession was over. A good way to illustrate the improvement is to look at changes in two major components of the U.S. economy: consumer spending and business spending.

THE ECONOMY

Where We Have Been

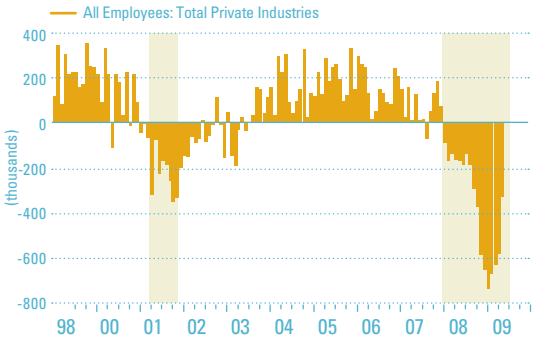
The "green shoots" first appeared in consumer spending, which accounts for about 70% of GDP. The stabilization of consumer spending in the first half of the year occurred despite further deterioration in the labor market. In addition, the consumer found some relief as the housing market—there has never been a tighter link between the consumer and housing—also showed signs of stabilizing after a three-year slide.

Business spending (about 10% to 15% of GDP) has stopped falling in June 2009, aided by the $787 billion fiscal stimulus plan that helped to jump-start investment. The Fed implemented a regime of quantitative easing (see sidebar on the next page) in the first half of 2009, aimed at combating the deflation that gripped the economy. As a result of weak demand for goods and services and a big slowdown in business spending, businesses spent most of the first half of 2009 shedding unwanted inventories. The $787 billion fiscal stimulus package passed by Congress in February put into place $250 billion in direct aid to individuals and states and $200 billion to improve the nation's infrastructure. Although only a fraction of the $450 billion in spending from the fiscal stimulus bill was actually spent in the first half of 2009, the bill did help to jump-start business capital spending toward the end of the first half.

Green Shoots Start to Take Root

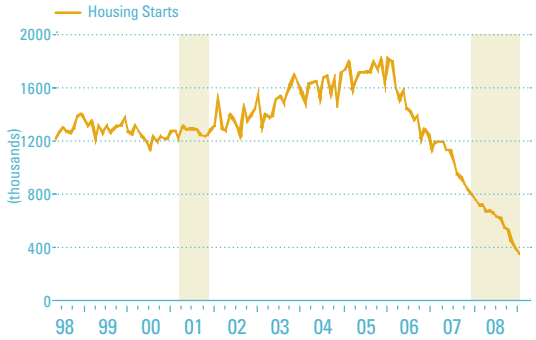
In sharp contrast to the first half of 2009, when we saw negative GDP growth and negative inflation (deflation), we think the second half of the year will bring both positive GDP growth and positive readings on inflation. We are upgrading our outlook for the economy, as measured by real GDP growth, and now expect real GDP growth to be positive in both the third and fourth quarters. We expect that the deflation that gripped the economy in the first half of 2009 will give way to very mild inflation in the second half of the year. Specifically, we expect that producer and commodity price inflation will continue to heat up throughout the remainder of 2009, fueled both by

Labor Market Began to Stabilize in First Half of 2009



Source: Bureau of Labor Statistics/Haver Analytics, Data as of 6/16/09

Housing Market Begins to Stabilize After Three Year Slide

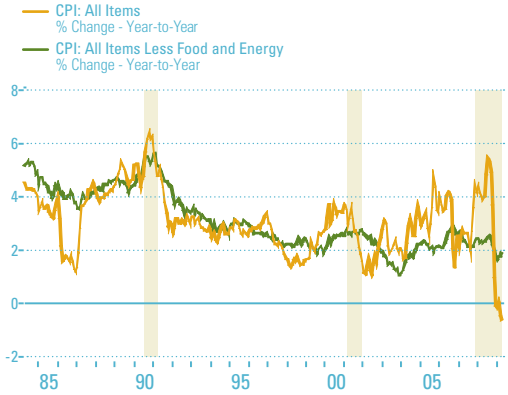


Source: Census Bureau/Haver Analytics, Data as of 6/16/09
(Shaded areas in charts indicate recessions)

Quantitative Easing

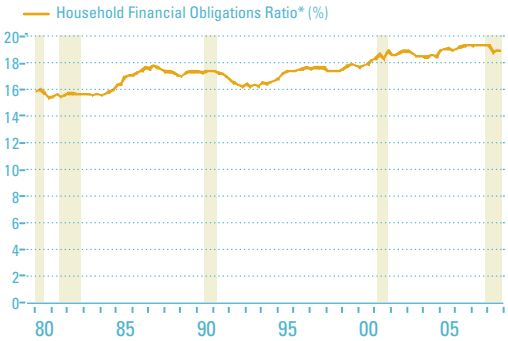
In an effort to combat deflation and avoid mistakes made during the Great Depression, the Fed began the year by aggressively expanding the money supply. It then stepped up those efforts in mid-March, announcing that it would purchase an additional $1.2 trillion of Treasury, Agency, and Agency Mortgage-Backed Securities. The Fed is likely to buy more of all three types of securities during the second half of the year to help hold mortgage rates down. However, the Fed must begin soon to prepare the markets for an "exit strategy" from this quantitative easing policy.

Headline Deflation Likely to End by Q409; Core Inflation Stable



Source: Bureau Labor Statistics/Haver Analytics, Data as of 6/16/09

Financial Obligations Ratio Near Long-Term Average



Source: Federal Reserve Board/Haver Analytics, Data as of 6/16/09

(Shaded areas in charts indicate recessions)
* This ratio is total household debt cost relative to total household income. More details on page 7

China's continued strong recovery and the effects of the Fed's quantitative easing regime. In general, solid productivity growth, muted wage growth, and excess capacity in the U.S. and abroad will help to contain prices of finished consumer goods.

We expect that the "green shoots" that began to emerge in the first half of 2009 will take root in the second half, led by a rebound in both consumer spending (70% of GDP), and business capital spending (10-15% of GDP). Consumer spending will be lifted by further stabilization in both the housing and labor markets. We expect the pace of job losses, as measured by the monthly nonfarm payroll job count, to diminish noticeably by the end of 2009, with monthly job gains likely in early 2010. The unemployment rate has already moved above our initial forecast, and we now expect the unemployment rate to peak at around 10% late this year or in early 2010. The leading indicators of employment, including jobless claims, overtime hours worked, and employment at temporary help agencies began to turn the corner in the middle of the second quarter, setting the stage for continued improvement in the labor market over the remainder of 2009. However, we are monitoring the ongoing restructuring in the auto industry as a threat to this forecast.

We expect business spending will continue to benefit from the $787 billion fiscal stimulus package, a restocking of inventories, and a pickup in auto production. In addition, we expect the Fed to accommodate corporate borrowing by maintaining a near zero Federal funds rate, which should help to foster business spending.

Support for the Revised GDP Forecast

We believe real GDP growth will turn positive in the third quarter, aided by the combined impact of:

- An uptick in auto production
- A restocking of inventory
- A lagging impact of low Fed funds rates and huge money supply growth, and
- A stabilized housing market. (We now expect residential construction or housing starts to begin to add to GDP growth by the fourth quarter.)

These positive impacts will more than offset the effects of ongoing consumer balance sheet repair, tepid exports, and the drag from a continuingly weak labor market.

In addition to the catalysts above, the full impact of the $787 billion fiscal stimulus package will begin to be felt in the third and fourth quarters. Of the $250 billion allocated to spending, only about $45 billion has been spent, leaving more than $200 billion in the pipeline. On balance, according to the nonpartisan Congressional Budget Office (CBO), the stimulus legislation will contribute to an increase in GDP of between 1.4% and 3.8% by the fourth quarter relative to the CBO's baseline forecast.

Risks and Opportunities

There are both risks and opportunities for our economic forecast, including the risk that consumers will forgo spending in favor of continuing to pay down debt, that rising mortgage rates will cut short the housing recovery, and that out-of-control government spending will cause Treasury yields to soar and the dollar to sink.

Deleveraging

A prevalent concern among investors is that the process of consumer balance sheet repair, or de-leveraging (paying down existing debt or not taking on any new debt to finance purchases), will persist through the remainder of 2009 and beyond, knocking the wind out of any economic recovery. While it is true that the level of consumer debt (75% of which is mortgage debt) relative to incomes is near all-time highs, the cost of carrying the debt (debt cost as percent of income) is near its long-term average.

Rising Mortgage Rates

After hitting 40-year lows in early 2009, mortgage rates have risen by 80 basis points (0.80%) to near 6%, threatening any recovery in housing. In response, mortgage applications, which soared in early 2009, have tapered off. However, even with the recent rise in mortgage rates, housing affordability (the ability of a family with the median income to afford the median priced house) is still at 40-year highs. In addition, surveys of home buying intentions show that more than 75% of people think now is a good time to buy a home, close to an all-time high.

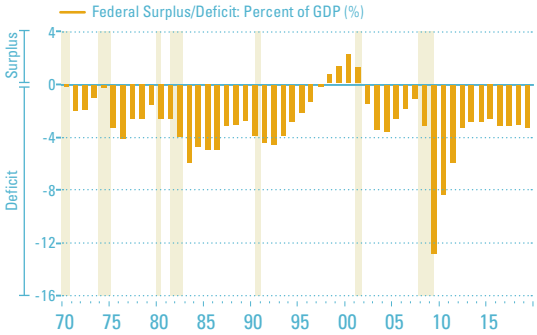
Budget Deficit

Until very recently there has been no serious talk of a deficit reduction in Washington, but the ability to finance the deficit is likely to continue to be a concern for financial markets. The budget deficit for fiscal year 2009 (ending on September 30) is headed to $1.75 trillion, or 12% of GDP. Deficits often grow as a share of GDP during recessions due to increased spending on programs like jobless claims and the impact of lower tax revenues from individuals and corporations. This time around, the increase in the deficit was exacerbated by the spending related to the Troubled Asset Relief Program (TARP) and the $787 billion stimulus package. Both the nonpartisan CBO and the Obama Administration's Office of Management and Budget (OMB) currently project that as the economy recovers, the deficit will begin to decline as a percent of GDP in the next few years. Increasingly, investors may begin to fear that Congress and the Administration will address the rising deficit solely via tax increases. While the announcement by President Obama in June 2009 calling for a return to "pay-as-you-go" budget rules is a step in the right direction on spending, a serious debate at the national level needs to occur in order for the budget deficit to return to a more sustainable, long-term track. In the near term, there is hope that the budget debate will be a key issue in the upcoming 2010 Congressional mid-term elections.

Fed Publishes the Financial Obligations Ratio (FOR)

We think this measure, which connects the debt level to the actual cost of carrying debt, is far more meaningful than simple debt-to-income levels. The FOR is currently at 18.9% versus the long-term average of 17.4%. There are two ways the FOR can drop: through deleveraging or higher incomes. While interest rates may rise and push up the cost of servicing debt, most household debt is long-term and at fixed rates so it changes very slowly over time. Furthermore, it is unlikely interest rates will get back to the average of the past 30 years (the 10-year Treasury averaged over 7% and mortgage rates were close to 10%). Accordingly, we do not believe the deleveraging over the next two years will be nearly as painful as the level of household debt might suggest.

Budget Deficit as a Percent of GDP Soared Due to Recession and Lack of Spending Restraint



Source: Office of Management and Budget/Haver Analytics, Data as of 6/16/09 (Shaded areas in chart indicate recessions)

The PAYGO (or pay-as-you-go) budgeting rule required that new federal spending or tax changes do not add to the federal deficit. Any new proposals (spending or tax) had to be "budget neutral" or offset with savings derived from existing funds. PAYGO was first enacted in 1990 and expired in 2002. In June 2009, the Obama Administration called for the reintroduction of PAYGO rules.

THE STOCK MARKET

Stocks' Wild Ride

Stocks had a wild ride in the first half of 2009. The stock market fell sharply during the first two months of the year and then rallied back to end the first half of the year with low- to mid-single digit gains as economic conditions improved.

On February 10, the day Treasury Secretary Geithner disappointed the markets by unveiling an unclear Financial Stability Plan, the stock market began a month long 25% decline that culminated in a March 9 low of 676 for the S&P 500. Fortunately, the previously enacted policy actions began to bear fruit by early March. These actions were primarily focused on the hard hit Financials sector, which led the stock market in its journey lower:

- The Fed stepped in to provide capital in the interbank system.
- The alphabet soup of programs known as the TARP, TAF, PDCF, and others were launched to make short-term capital available for banks.
- The FDIC established guarantees for some bank debt to ensure banks had access to longer-term capital.
- Many large banks received direct capital injections in exchange for preferred shares.
- Some banks received government insurance against losses in potentially bad assets.
- The FDIC increased bank deposit insurance to avoid a run on the banks.

Most stock markets around the world followed the same basic pattern as the United States. However, there were stark differences in performance by the end of the first half.

- Emerging Markets posted gains of greater than 40% as their superior balance sheets, exposure to rising commodity prices, and increasing raw material demand from China offered an attractive combination of both offensive and defensive characteristics.
- Developed foreign (Large Foreign) stocks were up 11%, boosted by sharp declines in the US dollar.
- Growth stocks outperformed Value stocks by a wide margin, largely due to strength in the top performing Information Technology sector.
- U.S. Large- and Small-Cap stocks posted similar mid-single-digit gains.

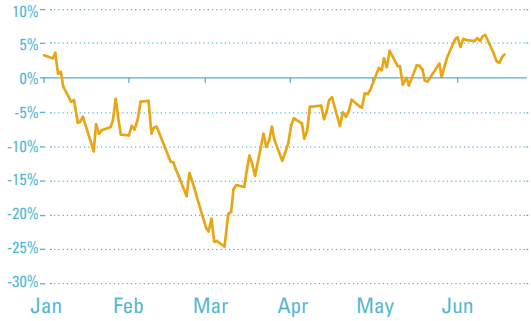
Outlook Unchanged

Our outlook for stock market performance remains unchanged from what we presented in the Outlook for 2009: "*The stock market, as measured by the S&P 500, posts a return in the mid-teens, as a volatile first half of the year gives way to more consistent improvement in earnings and sentiment in the second half. We anticipate the year-end S&P 500 close to be around 1000-1050.*" In addition, we expect continued outperformance by Emerging Markets and Growth stocks and believe Small-Cap stocks will outperform Large Caps as they have since the low on March 9.

Over the long-term, earnings are the most important driver of stock market performance. Historically, stock price performance closely tracks expectations for earnings. The median forecast by Wall Street analysts for

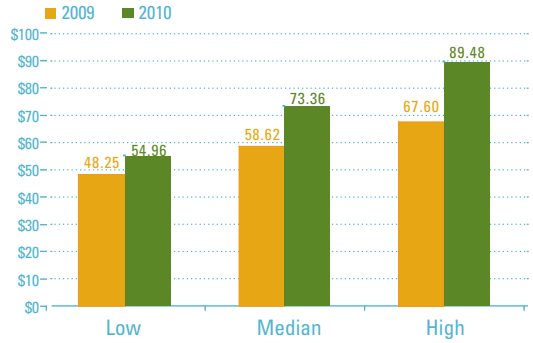
Stocks' Wild Ride

S&P 500 Index Year-To-Date Total Return



Source: Bloomberg, LPL Financial Research, Data as of 6/19/09
The S&P 500 is an unmanaged index which can not be invested into directly. Past performance is no guarantee of future results.

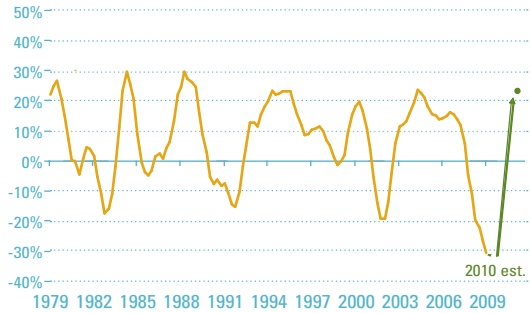
S&P 500 Earnings per Share Analyst Consensus Forecasts



Source: FactSet Research Systems, Thomson Financial, LPL Financial

Average Post-Recession Rebound for S&P 500 Profits Expected

Year-Over-Year Change in Four Quarter Sum of S&P 500 Earning Per Share



Source: LPL Financial, FactSet Research Systems, Data as of 6/24/09

each company in the S&P 500 results in a share-weighted estimate for the index of about $59 in 2009 and $73 for 2010. Over the next 12 months, earnings are expected to be close to $66, resulting in a forward price-to-earnings ratio (P/E) of 14.

Given the wide range of analyst estimates, it is worth looking at the best and worst projections—as seen by Wall Street analysts—for the profits of the companies in the S&P 500. To collect this data, we have taken the highest and lowest analyst estimate for each company to derive the bull and bear cases for the S&P 500. (Please see the chart on page 8.)

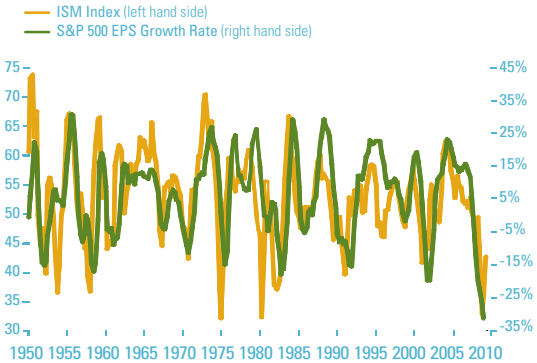
- The bull case, using the highest estimate for every company, is $68 in 2009 and $89 in 2010.
- The bear case, using the lowest estimate for every company, is $48 in 2009 and $55 in 2010.

In general, the median estimate of earnings for each of the companies in the S&P 500 has stopped falling and actually started to rise slightly as the first half of the year comes to a close. We now believe this consensus is a reasonable forecast for both 2009 and 2010. If the 2010 analyst consensus estimate of $73 and the current next 12-month P/E of about 14 hold at year-end 2009, the S&P 500 would end the year at about 1000. That outcome would be in line with our base case forecast for a modest gain for stocks in 2009.

The 25% expected gain in earnings in 2010 implied in the consensus analyst estimates is in line with the typical rebound from prior recessions. Encouragingly, the best leading indicator for U.S. profits, the Purchasing Managers Index from the Institute for Supply Management (ISM) is moving higher. After bottoming at the end of last year, the ISM index has moved up steadily in the first half of 2009. This indicator bodes well for profit growth in the second half of 2009.

ISM Index Points to a Turnaround in S&P 500 Earnings Growth

Year-Over-Year Change in Four Quarter Sum of S&P 500 Earnings per Share and Institute for Supply Management PMI Index



Source: FactSet Research Systems, Thomson Financial, Bloomberg, LPL Financial, Data as of 6/24/09

Risks and Opportunities

There are both risks and opportunities in the second half for investors in the stock market, including the risk of a retest, the return of inflation, the changing geopolitical environment, and the rise of protectionism.

Retest

While the stock market may have bottomed on March 9, bear markets of this magnitude nearly always pull back after an initial relief rally. Such a "retest" is often the result of lingering uncertainty over the potentially negative unintended consequences of policy actions. Of the bear markets since 1950, 10 of 11 retested. A pause in the momentum and a decline in daily volatility are part of a healthy bottoming process that builds a base for a sustainable advance. While there is the risk of a pullback, we believe a consolidation or retest of the rally should be seen as an opportunity to increase stock market exposure in light of the improving market and economic conditions.

Of the bear markets since 1950, 10 of 11 retested. A pause in the momentum and a decline in daily volatility are part of a healthy bottoming process that builds a base for a sustainable advance.

Inflation

Inflation measures are currently slightly negative, and given abundant global labor and manufacturing capacity we do not expect inflation to rebound much before late in the fourth quarter of 2009. However, when inflation does begin to rise, the Fed may be in a difficult position to contain it. Interest rate hikes might hurt the still fragile banks by raising their cost of funding. Also, the Fed may be unable to promptly sell the Mortgage-Backed Securities and other troubled debt securities that it is in the process of buying to boost the

Regulatory Impacts?

While earnings are likely to be the most important driver for the stock market, there are other factors looming that will impact the stock market. The second half of 2009 will bring legislative and regulatory initiatives creating heightened uncertainty for business leaders and investors surrounding health care, climate change, financial regulation, and labor with the ability to affect the business climate in many sectors of the stock market. While there is likely to be a lot of debate and bills introduced, we do not expect major initiatives to be passed or significant changes to occur in 2009.

Protectionism and the Stock Market

Great Depression: In 1930, the Smoot-Hawley Tariff imposed an effective tax rate of 60% on thousands of products and materials imported into the United States and resulted in a round of retaliatory protectionist actions around the world. If not the primary cause of the Great Depression, the Smoot-Hawley Tariff certainly made a bad situation much worse. In September 1929, the Smoot-Hawley Tariff bill reached the Senate, the same month stock prices peaked. On October 23, 1929, opponents to the tariff suffered a major setback, and it appeared that the tariff act would most likely pass into law. On that same day, the Dow Jones Industrial Average dropped more than 5% during the last hour of trading, beginning the stock market crash of 1929 that reached its climax a few days later on October 29.

October 1987 Crash: By early October 1987, protectionist fears had mounted. The increasing likelihood of protectionist legislation was on the rise, owing to the worsening trade deficit. Treasury Secretary James Baker threatened to break the Louvre Accord and allow the dollar to fall further if Germany did not loosen its tight fiscal policy that was weighing on U.S. exports. And, then-new Fed chairman Alan Greenspan made statements welcoming a further 30% reduction in the value of the dollar. The combination of soaring deficits and fears of protectionist currency devaluation pushed interest rates up above 10% and sparked a stock market crash on October 19, 1987.

money supply without risking destabilizing the credit markets. The result may be the potential for inflation to rebound more forcefully than market participants currently expect. It is too early to determine whether inflation is a likely to be a big problem for investors in late 2010 or 2011 as excess capacity is absorbed. However, investors can take steps now to both profit and protect from rising prices. We recommend exposure to the stocks of commodity producers, which can provide a great offense (as investors benefit from rising prices) and defense (as investors benefit from a hedge in their portfolios if the risk of inflation proves to be a bigger problem).

Changing Geopolitical Environment

Geopolitical events have been reasserting an influence on the markets after a brief honeymoon period while foreign leaders assessed the new U.S. administration and the world's leaders focused exclusively on the global financial crisis. Adding to the stresses of the global recession, the uncertainty introduced by anticipated and unforeseen upcoming geopolitical events may help to keep a lid on stock prices in the coming months. However, there may also be events that have a positive effect on markets. For example, a global stock market rally took place on Monday, May 18 when the ruling Congress Party emerged victorious in India. If the hard-line nationalist main opposition party had won, Indian restraint against Pakistan would not be assured in the event of another large-scale militant attack like the one that took place in Mumbai in November 2008. With the surprisingly strong showing by India's ruling party, India is staying on the sidelines and looking to the United States to manage Pakistan's jihadist problems. However, geopolitical hot spots that might negatively affect markets in the second half of 2009 are likely to include North Korea, Iran, Russia, and Afghanistan.

Protectionism

The stock market typically reacts negatively to the potential for protectionist legislation—in fact, fears of protectionism were important elements in the stock market crashes of 1929 and 1987. There is a strong tendency for each nation to favor their domestic industries in the fiscal stimulus packages being introduced around the world. An open-market structure is critical to our base case outlook for the financial markets in 2009. While stocks have not reacted negatively to the latest signs of protectionism, the increasing frequency of actions could begin to weigh on markets.

THE BOND MARKET

The Eye of the Storm

The credit crisis was at the center of the market meltdown in September of 2008, and rebuilding and supporting the credit market was at the heart of the federal government's efforts toward overall recovery in our economy during the first half of this year. The Fed played a large part through its implementation of programs designed to support liquidity and cap yields of U.S. Treasury notes. Federal Reserve support measures ultimately influenced two very different responses within the bond market.

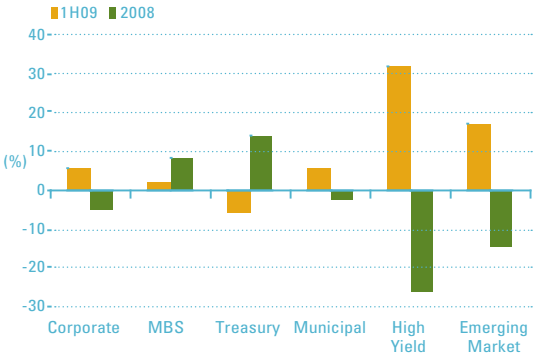
A Tale of Two Bond Markets

Bond performance varied a great deal between government bonds and non-government sectors. Credit sensitive bonds such as Corporate and High-Yield Bonds outperformed Treasuries by a wide margin through the first half of 2009. Improving liquidity and "less worse" economic data helped restore some normalcy to credit markets. Emerging Market Debt (EMD) also benefited from a strong policy response. The G20 group of finance ministers and central bank governors agreed to triple the resources of the International Monetary Fund (IMF) to $750 billion and included a line of credit for EMD issuers. The added resources greatly reduced liquidity risk.

The Municipal Bond market also outperformed Treasuries noticeably benefiting from improved liquidity and government support efforts. A drop in supply was perhaps the most significant factor as the Build America Bond (BAB) program, which emanated from the Obama Administration's stimulus package, shifted a great deal of states' and municipalities' funding needs over to the broader taxable market. To be sure, Municipal Bonds benefited from several factors including strong investor inflows, cheap valuations, and the prospect of higher future tax rates, but alleviating the supply overhang was most important.

On the other hand, high quality government bonds underperformed on a global basis as high valuations proved difficult to sustain in the face of massive new issuance to support liquidity measures. Treasury bonds, in particular, lagged noticeably so far in 2009, after a record 2008. Although, the broad bond market as measured by the Barclays Aggregate Bond Index is roughly unchanged year-to-date through mid-June, it masks very different sector performance as well as a reversal of 2008 performance as the chart at the right illustrates.

Bond Sector Total Returns



Source: Barclays Capital, LPL Financial, Data as of 6/12/09

Corporate: *Barclays Corporate Index*

MBS: *Barclays Fixed Rate Mortgage-Backed Securities Index*

Treasury: *Barclays Treasury Index*

Municipal: *Barclays Municipal Bond Index*

High Yield: *Barclays High-Yield Bond Index*

Emerging Market: *Barclays US Dollar Emerging Market Bond Index*

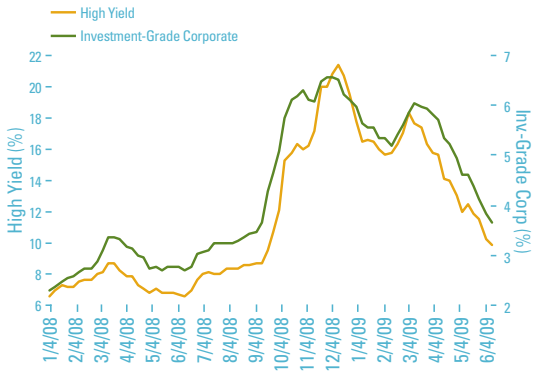
Gradual Improvement for Remainder of Year

We expect bond market total returns to come in at the low end of our mid- to high-single digit return forecast. The increase in Treasury supply proved more troublesome than expected and pushed the 10-year Treasury yield to 3.8% (through June 19), up by 1.6 percentage points since the start of the year. This yield increase exceeded the upper end of expectations factored into our initial base case scenario. However, the yield spread narrowing among Corporate Bonds and Mortgage-Backed Securities (MBS), reflecting the improvement in credit sectors, exceeded our expectations, as investors moved quickly from lower yielding cash and Treasuries to the better opportunities further out on the risk spectrum.

Focus on Sector Allocation and Intermediate-Term Bonds

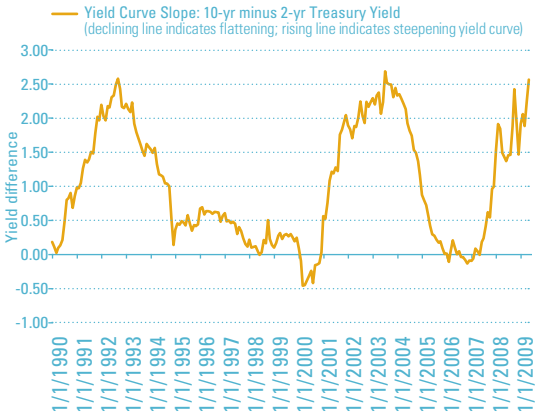
We expect the divergence between government bonds and non-government sectors to continue but at a slower pace. We remain focused on Intermediate-Term Bonds and believe sector allocation, such as to Corporate Bonds, offers better value than trying to time interest rate movements. The pace of the rise in Treasury yields during the first half of 2009 is not sustainable absent clear signs that either the Fed will increase interest rates or inflation will accelerate; we do not expect these signs over the balance of 2009. Furthermore, the wide gap between yields on short- and long-term debt means the yield curve remains near historically steep levels and significant yield pick up can be obtained with intermediate bonds.

Corporate Yield Spreads Narrowed Throughout First Half of '09



Source: Barclays Capital, LPL Financial, Data as of 6/12/09

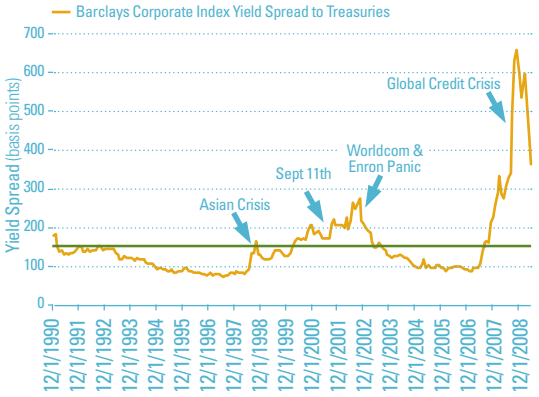
A Steep Yield Curve Favors Intermediate Bonds



Source: Bloomberg, LPL Financial, Data as of 6/12/09

Investment-Grade Corporate Bonds remain our favorite sector within the bond market, even after their impressive start to 2009.

Corporate Yield Spreads Still Wide by Historical Comparison



Source: Barclays Capital, LPL Financial, Data as of 6/12/09

Investment-Grade Corporate Bonds remain our favorite sector within the bond market, even after their impressive start to 2009. Although yield spreads have contracted to 3.6 percentage points above Treasuries (through June 15), they remain above the 2.7 percentage points peak of the WorldCom and Enron fueled corporate panic of 2002. Outside of Financials, fundamentals for most corporate issuers are better than in 2002. The new issue market came back to life in the first half, but issuance has slowed recently and is expected to remain light through the summer. The supply/demand backdrop is favorable, as reinvestment needs should be more than sufficient to absorb new issuance.

Similarly, High-Yield Bonds have enjoyed a great start to 2009, but yield spreads to Treasuries remain wide. The average yield advantage of 9.6% above Treasuries (through June 15) is roughly in line with the current level of defaults. Although Moody's expects the default rate to increase to 13.8% in the fourth quarter, this forecast has been reduced by 2% since the start of the year. High-Yield Bonds have also benefited from stimulus legislation, which postpones taxes for companies doing debt exchanges. Successful debt exchanges have enabled issuers to extend maturities and restructure debt, and this trend is likely to continue. Furthermore, we believe High-Yield Bonds may benefit as yield-seeking investors rotate from Investment Grade to High Yield during the second half of 2009.

However, we do expect the pace of Corporate Bond improvement to slow over the second half. Although many issuers are actively engaged in de-leveraging and repairing balance sheets, much of the gains this year have come from better liquidity and investors taking advantage of overly cheap valuations. Further spread contraction will likely need to be accompanied by better underlying credit metrics. We believe this will occur, but gradually.

We still find Municipal Bonds attractive, but as with Corporate Bonds, expect the pace of improvement to slow. New issuance is running at its slowest pace since 2006, and provides a favorable supply backdrop, unlike the backdrop in 2008. Over a longer-term horizon, the prospect of higher tax rates in 2011 will also provide support. Municipal valuations remain attractive by historical norms.

We continue to underweight Treasuries, where supply has proven more burdensome than anticipated; to be sure, a reversal of safe-haven buying and higher inflation expectations have also played a significant role in higher yields. Bond dealers remain capital constrained, and new Treasury supply has led to higher yields in the absence of investor demand.

Risks and opportunities

There are both risks and opportunities in the second half for investors in the bond market, including rising Treasury yields, wider yield spreads, and rating downgrades.

Rising Yields

A greater than expected rise in Treasury yields is a risk to continued unfolding of our base case. As we expected, credit sensitive sectors such as Investment-Grade Corporate and High-Yield Bonds, as well as Emerging Market Debt, have so far been more than able to absorb the rise in Treasury yields as average yields from these sectors have actually declined. But should Treasury yields rise steadily, whether from supply pressures, higher inflation, stronger economic data, or sooner than expected Fed rate hikes, then

interest income and price appreciation in non-Treasury sectors might not be able to fully offset the rise in interest rates. In this case, bond market returns might be less than we expect for the year.

Wider Yield Spreads

For the Corporate Bond sector, weaker than expected earnings could lead to wider yield spreads. In the High-Yield Bond market, a greater than expected rise in the default rate could pressure yield spreads wider there as well. Either event could lead to government bond outperformance, as could a renewal of safe haven buying.

Rating Downgrades

In the municipal market, credit quality concerns appear to be the primary risk. States and municipal balance sheets remain under pressure due to the recession. Due to the composition of today's municipal market—with many special purpose financing vehicles and corporate-backed issues—it is possible the default rate may ultimately surpass that witnessed in the Great Depression. However, we believe the tax-free high-yield market is priced for this rate of defaults and that high-grade bonds—particularly highly rated general obligation and essential service revenue bonds—should weather the storm. Ratings downgrades may occur for select issuers, but we believe defaults will likely be confined to below investment grade issuers.

Will Foreigners Stop Buying U.S. Treasuries?

Despite concerns, evidence indicates foreigners have actually increased purchases of U.S. Treasuries recently and will likely remain steady buyers. Supporting factors include:

Treasury and Fed data: The Treasury International Capital System (TICS), which reports U.S. asset purchases with a two-month lag, showed March was one of the strongest months on record for Treasury purchases as foreign institutions were net buyers of $29 billion. April purchases slowed to $17 billion but were still firmly positive. More recent data from the Fed showed foreign central banks' holdings of U.S. Treasuries held in custody at the NY Fed increased 7% from the end of March through the end of May. Demand remained strong with another $18 billion bought during the week ending June 10.

Auction participation: Foreign demand at Treasury auctions increased steadily from late May through June corroborating NY Fed data. Indirect bidders, a group that includes foreign central banks, increased buying at auctions culminating in taking down more than 60% of 2-, 5-, and 7-year notes sold during the last week of June. Indirect bidder participation for the auctions was among the highest ever recorded.

Qualitative factors: For the biggest holders of Treasuries, China and Japan, Treasury purchases help maintain stable exchange rates which in turn support exports to the U.S. Foreign central banks subsidize their domestic economy by buying Treasuries in an attempt to maintain stable exchange rates to support exports. If Treasury purchases slow in the future it might simply be in response to slower export growth. The U.S. Treasury market is also the deepest and most liquid in the world. There is simply no practical alternative to U.S. government securities for investing large reserves.

Chapter 3

How to Invest for the Second Half of 2009

With the economy in the midst of its long climb from recession to recovery, investment opportunities for the second half of 2009 are in transition. While 2008 and the first part of 2009 warranted the prudent strategy of employing risk aversion, for the remainder of 2009 it is equally important to consider opportunistic risk taking. While many tough days certainly remain for the economy, the backdrop has improved and the forward-looking market appears poised to begin recouping its 2008 losses.

While we believe that it is the time to shift from risk avoidance to risk taking, a cautious and deliberate reintroduction of risk into portfolios is a sensible strategy. Many aspects of the economy still remain sluggish or are even still worsening, albeit at a slower rate. But what the current environment does illustrate is that the risks are now, for the first time since late 2007, leaning more towards reward than danger. There are several opportunities in each investment type.

Bond Opportunities

During most recessions and subsequent stock market downdrafts, bonds in general hold up well and thus offer diminished return opportunities during the recovery period. However, this recession has been vastly different. Given that the problems in the economy first emerged in the housing and credit markets, spread-related fixed income, including Corporate Bonds, fell nearly in line with stocks. As a result, coming out of this recession, there are better opportunities to reap above average rates of return with less risk than stocks from more aggressive fixed income asset classes.

When the credit markets froze up in the second half of 2008 and investor concerns regarding the ability of companies to pay interest and repay principal spiked, yield spreads skyrocketed as investors demanded compensation in the form of large premiums over low risk investments, like Treasuries. But as the global economy continues to improve and the credit markets continue their healing process, yield spreads for more aggressive fixed income strategies will likely continue to fall as prices rise, presenting an attractive environment for fixed income investments.

The yield advantage of Investment-Grade Corporate Bonds over Treasuries has fallen dramatically from its all-time highs near the start of the year. However, there is plenty of room for improvement, further boosting total returns, since yields on Investment-Grade Corporate Bonds are still well above historic average levels. While Investment-Grade Corporate Bonds remain solid investment options, perhaps the best risk/reward potential lies in the even more aggressive fixed income arena, as High-Yield Bonds, Emerging Market Debt, Non-Agency Mortgages, Preferred Stocks, and Bank Loans still trade at yield spreads well above historic levels and present attractive return opportunities. We suggest using lower risk fixed income instruments, such as cash, Treasuries, Agency Mortgages, and Foreign Sovereign Debt, as a source of funds to allocate to these aggressive bond opportunities.

Stock Opportunities

In general, the stock market remains poised for continued improvement, despite the spirited rise from March through June 2009. The stock market is most often forward-looking. It typically bottoms or begins to rally six to nine months ahead of the end of a recession. In fact, coming out of recession market bottoms, there are fewer places better to invest than stocks. In fact, stocks, as measured by the S&P 500 Index, have provided better return opportunities relative to traditional bonds and cash during the market's recovery period. In each of the last six major recessions, stocks have posted returns, on average, almost triple that of bonds and over six times more than cash in the year following the low point for stocks.

The stock market remains poised for continued improvement. In fact, coming out of recession market bottoms, there are fewer places better to invest than stocks.

PERFORMANCE SINCE THE MARKET CLOSING LOWS FOR PREVIOUS RECESSIONS ONE YEAR LATER

Market Low	Stocks*** (%)	Bonds*** (%)	Cash*** (%)
05/26/1970	43.55	16.85*	6.12
10/03/1974	34.59	9.21*	6.75
08/12/1982	57.73	21.91	8.82
10/11/1990	26.69	15.84	6.83
10/09/2002	29.46	4.61	1.32
03/09/2009	34.17**	2.22**	0.06**

Source: FactSet, Haver Analytics, and LPL Financial

*Denotes the use of 50% Dow Jones Corp Bond Index and 50% GFD - US 10-Yr Gov. Bond Index

**Denotes period from 3/09/2009 through 6/17/2009

***Stocks are represented by the S&P 500 Index, Bonds by the Barclays Capital Aggregate Index, and Cash by 30-day T-Bills

Indices are unmanaged and can not be invested into directly. Past performance is no guarantee of future results.

However, given the strong rise in the stock market since its lows on March 9, 2009, the question remains: Does this recovery still have the potential to continue upward? Despite the S&P 500 rally of about 36% from the low of 676 on March 9 through June 17, 2009, it has only recovered 27% of the total decline from its peak level of 1552 hit in October 2007. Although outcomes varied widely, in previous post-recession recoveries, stocks rebounded from their low point to within about 19% of the previous market high during the following year, on average. If the stock market follows this pattern, the S&P 500 would have to rise to about 38% above the current (as of June 17) level. As such, stocks appear poised to benefit in the second half of 2009 as economic data and market conditions continue to improve.

Although outcomes varied widely, in previous post-recession recoveries, stocks rebounded from their low point to within 19% of the previous market high during the following year, on average.

Alternative Investment Strategies

Looking forward as the recovery in the equity and credit markets continues, alternative investment strategies are positioned to help diversify portfolios and lower future volatility. Furthermore, the dislocation in credit and equity markets has created attractive values and spreads that provide opportunities in several alternative asset classes.

Managed Futures: As trends in currencies and commodities begin to stabilize in the second half of 2009, Managed Futures are well positioned to help offer diversification benefits and also to deliver solid, but volatile, absolute returns.

Distressed Debt: The combination of rising default rates and forced selling by hedge funds, pensions, and other institutional investors left Bank Loans and other Distressed Debt selling at huge discounts to the underlying value of the discounted cash flows of the investment. While distressed values have improved, along with most categories of credit, rising default rates will likely provide opportunities within Distressed Debt during the second half of 2009.

Long/Short (Long-Biased): So far in 2009, successful long/short managers have been able to move in or out of key asset classes or sectors effectively. As the fundamentals begin to improve for the stock market during the second half of 2009, long/short managers have the potential to see greater success in both the long and short side of their portfolios. Additionally, those managers who are biased long (meaning they have more long than short positions) will tend to do better because they are fully exposed to the markets.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

STOCK MARKET REBOUNDS QUICKLY AFTER TROUGH

Peak	Peak to Trough Decline	Trough	Gain One Year From Trough	% Needed to Get Back to Peak
11/29/68	-36.1%	5/26/70	43.6%	+9.0%
1/11/73	-48.2%	10/3/74	34.6%	+43.4%
11/28/80	-27.1%	8/12/82	57.7%	-13.0%
8/25/87	-33.5%	12/4/87	22.8%	+22.5%
7/16/90	-19.9%	10/11/90	26.7%	-1.4%
3/24/00	-49.1%	10/9/02	29.5%	+51.9%
Average	**-35.7%**		**35.8%**	**+18.7%**
10/9/07	-56.8%	3/9/09	33.3%*	+71.9%*

*through 6/17/09 Source: Bloomberg, LPL Financial
Returns are total returns of the S&P 500.
Indices are unmanaged and can not be invested into directly. Past performance is no guarantee of future results.

Commodities

Within stocks, those investments that benefit from the return of customer and business demand for goods and services, as well as those that typically benefit from an improving inventory cycle, are usually the first to advance. During the dramatic contraction in global economic growth in the fourth quarter of 2008, diminished global demand led to a sharp reduction in the production of goods, causing the prices of raw materials, better known as commodities, to plummet. The price of oil fell from a high near $145 per barrel to a low in the $30s, while other energy, industrial metals, and agriculture commodities also fell sharply. However, as consumer and business demand begins to return, so does the demand for commodities. We believe this increase in demand makes commodity-sensitive strategies attractive. Another area that is likely to benefit from strengthening commodity prices is investments in commodity rich regions of the world, with particular emphasis in Emerging Markets.

Sectors

Cyclical sectors, such as Technology, Consumer Discretionary, and Materials tend to benefit most in the early stages of a market recovery. Their direct ties to the improving outlook for and purchasing power of consumers and businesses makes them likely outperformers during the second half of 2009. In addition, Small and Mid Cap stocks tend to be beneficiaries of the market shifting from risk aversion to risk taking, as we anticipate the improving economy in the second half of 2009 will best reward smaller companies that are more economically sensitive and benefit from a thawing of capital markets that help to fund smaller company growth engines.

REITs

Commercial real estate faces multiple challenges including tight credit conditions, rising vacancy rates, and falling rental rates. While a lack of transactions makes it difficult to place an accurate value on real estate, we estimate that commercial prices have declined about 25% to 30% since their peak. Both traded and non-traded REITs have reduced dividend payouts to help minimize the impact of the current situation on the long-term value of the REIT.

Risks

With an emerging recovery on the backbone of such a fragile, yet healing, economy, many risks remain that could derail the base case, including market disconnection and a market run-up. While we continue to believe strongly in our base case, watching for mounting risks and maintaining a well diversified portfolio^ is the best defense against portfolio risks.

Market Disconnection

Perhaps the biggest concern might be that the market and the economy disconnect. In the early stages of the economy's healing, the market has rebounded sharply. The preponderance of the evidence points to a continued gradual improvement of economic conditions, as the benefits of the massive stimulus and monetary policy actions around the globe take hold. However, the market runs the risk of being more selective in what it gets excited about. If this risk plays out, the market could disconnect from the improvement in the economic backdrop and demand more than just gradual improvement to reward investors. If this happens, more aggressive strategies like Stocks or High-Yield Bonds may underperform despite an improving economic backdrop.

Market Run-Up

Another risk to watch for is the possibility that the economy improves too fast in its recovery, which puts pressure on continuing market gains. While the impacts of the economy on the market are often discussed, there are also market impacts on the economy. Should this balance become too extended, markets could have negative impacts on the still fragile economy and cause problems. One example of this effect is the price increases in Energy commodities in the first half of the year that resulted in soaring gasoline prices approaching $3 per gallon. As a result, Americans are paying approximately $1 billion a day in gasoline versus the $600 million per day at the start of the year. This "tax" on American consumers could limit spending and have negative impacts for the economy.

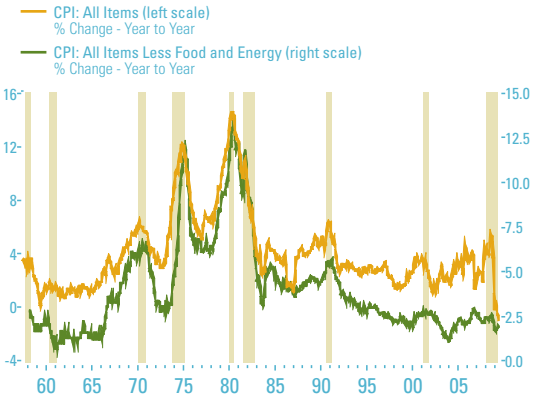
^ There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Chapter 4

Repeat of 1970's Inflation?

High rates of inflation have negative consequences for consumers and investors. As prices rise, consumer purchasing power is eroded. Inflation can be a potent negative for financial assets, since it erodes the purchasing value of future cash flows. The destructive consequences of high and rising inflation have been witnessed many times across the globe and were most recently experienced by the United States in the late 1970s and early 1980s. Recently fears have risen that inflation may make a big comeback with negative consequences for all.

We View a Return to '70s Style Inflation as Unlikely



Source: Bureau of Labor Statistics/Haver Analytics,
Data as of 6/17/09 (Shaded areas in chart indicate recessions)

Specifically, there is widespread concern that "quantitative easing", massive federal deficits, a weaker US dollar, policy mistakes, or the economic recovery itself will lead to a sharp increase in inflation in late 2009 and beyond. We do not take that view, and suggest instead that deflation (a general decline in prices) is a bigger risk than inflation in 2009 and early 2010. We also make the case that while there are a few similarities between the economic and policy backdrop today and in the run up to the 1970s and 1980s era inflation, on balance the backdrop is much less inflationary today. Noting the differences leads us to conclude that when inflation does return, it will not be anything close to the sharp increase in prices seen in the 1970s and early 1980s, when headline inflation was in the 10% to 14% per year range and core inflation (headline inflation less food and energy) was between 8% and 12% per year. We believe policy mistakes are the biggest risk to our view.

Lots of Money with No Place to Go

As previously noted in the Economic Outlook section of this report, the Fed embarked on a regime of quantitative easing (see sidebar on page 6 for details) in order to combat the threat of deflation brought on by the global economic slowdown that began in mid-2008. Quantitative easing has resulted in an explosion in money creation that could potentially lead to an uptick in inflation. For example, the monetary base was up more than 100% year-over-year in May 2009, a record gain. There is also concern that

flooding the market with cheap dollars will erode the value of the US dollar and lead to higher inflation. The challenge of removing quantitative easing is addressed in the policy mistakes section below.

A Vastly Different Economic and Policy Backdrop

Many of the fears of an uptick in inflation revolve around the economic and policy backdrop today that in some ways echoes the run-up to the high inflation environment of the 1970s and early 1980s. While some of these comparisons are valid, on balance the economic and policy backdrop today is far less "inflation friendly" than the economic and policy backdrop in the late 1960s and early 1970s that fostered the rise in inflation.

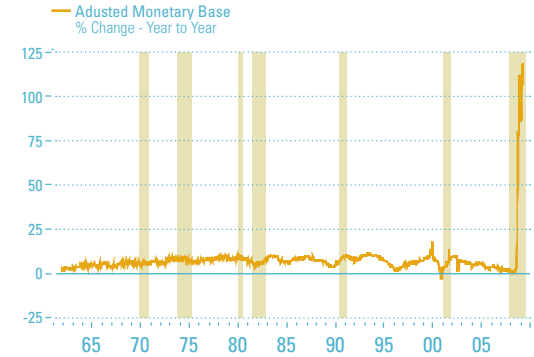
Inflation remained low throughout most of the early- to mid-1960s, but began to creep up during the next 10 years before exploding higher in the mid-1970s through the early 1980s. Some attribute the rise in inflation to the heavy spending on the Vietnam War and President Lyndon Johnson's Great Society programs. We certainly can draw parallels to today, where government spending as a share of GDP has risen from 18.5% at the end of the 1990s to 21.0% in 2008, the highest since the early 1990s.

However, many of the other factors that likely contributed to the surge in inflation in the 1970s and early 1980s are not present today:

- Union membership had a potent impact on wage growth. As a percent of the workforce, membership has fallen from close to 25% in the late 1960s to around 10% today.
- In the 1960s and early 1970s, wages were often tied to inflation rates via cost of living adjustments (COLAs), which created a "wage price spiral". COLAs are far less prevalent in today's labor market.
- The United States went off the gold standard in 1971, and allowed the US dollar to float, which boosted inflation expectations in the early 1970s.
- Today, the Fed has built up nearly 30 years of inflation-fighting credibility. It had virtually none in the 1960s and 1970s.
- Explicit inflation targets exist today in some countries, and are being seriously discussed by the Fed. Explicit inflation targets were non-existent in the United States and very rare elsewhere in the late 1960s and early 1970s.
- Long-term inflation expectations in the United States are low and have been relatively stable over the past 15 years; in the late 1960s, inflation expectations were higher than they are today, and rising.
- High inflation often leads to even higher inflation, as it reinforces expectations. Over the past 5 years, core inflation has averaged 2.2% and has been decelerating for more than 25 years; in the late 1960s, core inflation averaged close to 4.0% and was already accelerating.
- Productivity has been quite strong in the past 15 years. In contrast, productivity was much weaker through the inflationary period from the mid-1960s through the early 1980s.

A key reason why we do not think a severe bout of 1970s-style inflation is in the cards for the U.S. economy in the years to come is excess capacity of both labor and capital in the global economy. The emergence of China as an economic power has been a big factor in the creation of excess capacity. In addition, the dynamics and composition of the U.S. and global economies

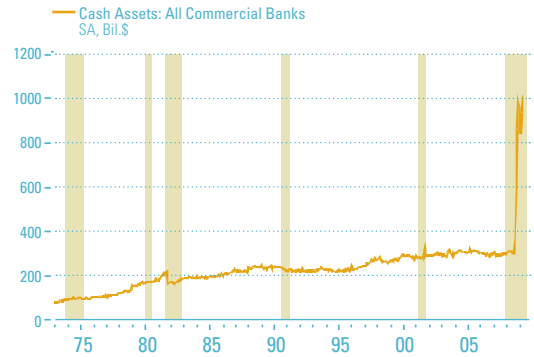
The Monetary Base is Soaring…..



Source: Federal Reserve Board/Haver Analytics, Data as of 6/17/09
(Shaded areas in chart indicate recessions)

A key reason why we do not think a severe bout of 1970s-style inflation is in the cards for the U.S. economy in the years to come is excess capacity of both labor and capital in the global economy.

But the Banks are Hoarding the Cash, Not lending It

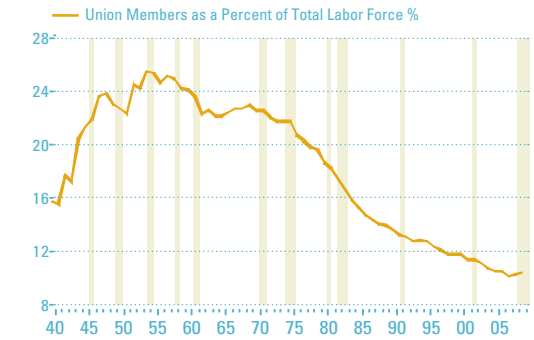


Source: Federal Reserve Board / Haver Analytics, Data as of 6/17/09
(Shaded areas in chart indicate recessions)

Hoarding the Cash

Missing here is what is actually happening to the money being "created" by the Fed's actions. In order for additional money supply to cause inflation, it must be put into use in the economy. For the most part, the money is not making its way into the economy, and is therefore not likely to cause inflation. The reason these money multipliers are collapsing and money is not making its way into the system is simply that banks are hoarding the cash that is being created rather than lending it out. For example, the money multiplier, the ratio of the money supply to the monetary base, has contracted sharply over the past few months. Thus, in our view, the data suggests that the quantitative easing program the Fed and other central banks are engaging in is merely offsetting the deflationary impact of contracting credit availability. It is filling the void that was created when the financial system nearly collapsed and the expansion of private capital ground to a halt last fall. We also note that quantitative easing in the United States has not led to any pickup in long-term inflation expectations measured by surveys or markets.

Union Membership as a Percent of the Labor Force is at an All-Time Low



Source: Haver Analytics, Data as of 6/17/09
(Shaded areas in chart indicate recessions)

today are vastly different—and far less inflation friendly—than they were in the late 1960s and early 1970s. In short, the starting point for inflation matters, and in that regard, we are at a much better starting point today than in the late 1960s.

- Capacity utilization, which measures the percentage of U.S. factories' production capabilities being utilized, hit a new all-time low in May of 2009 at 65%. The global recession has dampened utilization, but even during the past five years, capacity utilization averaged about 78%. By comparison, during the late 1960s, capacity utilization averaged 88%, resulting in higher prices rather than additional output.
- The economy is much more global today than it was in the late 1960s. Capital and labor flow much more freely over international borders than they did in the late 1960s and early 1970s, which helps to eliminate the bottlenecks that can lead to inflation pressures. For example, before the global recession hit in mid-2008, trade (exports plus imports) accounted for about one-third of U.S. GDP, more than three times its portion in the late 1960s.
- Wages account for about 70% of business costs. In the latest 12 months, wage growth is running at a 2.2% pace and decelerating. In the late 1960s, wage growth was running at more than 6%, and was accelerating.

Additionally, focusing on cyclical trends, inflation usually declines well after the end of a recession, especially after global recessions. With headline consumer prices already in deflation territory, this supports our view that only mild changes in prices are likely over the next year or so.

Is a Policy Mistake Possible?

In our view, the risk of policymakers making a mistake on monetary, fiscal or economic policy is the biggest threat to our thesis that inflation will not begin to soar after the recession ends. The key to avoiding any policy mistakes is that the Fed (and other central banks) properly time and execute reversal of their monetary stimulus efforts—although missteps in fiscal and economic/regulatory policies might also play a role.

In removing the quantitative easing, the Fed faces the dilemma that if it acts too soon to remove the stimulus, it risks derailing the recovery before it becomes self-sustaining. On the other hand, if the Fed waits too long to remove the stimulus, the money it created will find its way into the economy eventually, and lead to a quick return of inflation.

The good news is that most of the Fed's quantitative easing program can be unwound, and some of the program is self correcting. That is, when the market no longer needs it, the program will stop. It is also reassuring to see that the Fed has been talking publicly about the exit strategy from quantitative easing since early in 2009, and they are likely to continue talking about it during the rest of the year.

From a regulatory perspective, the risk is that heavy handed regulation will hamper the United States' strong productivity growth, which has been a lynchpin keeping labor inflation and inflation expectations low for the past 25 years.

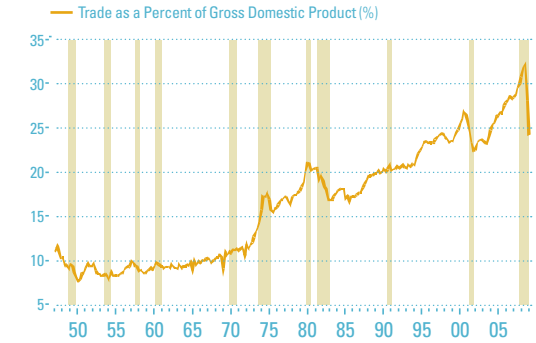
The Deficit

On the fiscal and economic/regulatory front, the risk is that the massive budget deficits in the United States lead to higher inflation. On this front, the link between deficits, inflation, and debt is loose and unclear, at best. For example, after World War II, the debt-to-GDP ratio in the UK ballooned to more than 200%, and inflation did not surge. The debt-to-GDP ratio in the United States fell consistently through the 1960s and 1970s, even as inflation accelerated. It is also encouraging that the Obama Administration and other G-8 leaders have already begun preparing markets for the removal of stimulus when the time is right.

Another concern on government policy is the risk that governments will simply adopt inflationary policies to pay down debt. Our view here is that this course of action is unlikely to be pursued and that any attempt to pursue this policy would be readily transparent in the marketplace, lead to an increase in real interest rates, and make debt problems even worse.

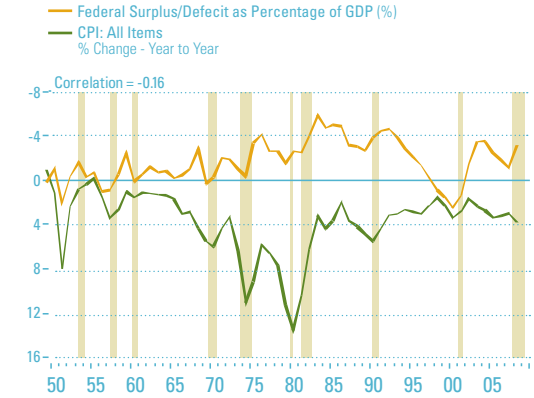
LPL Financial Research will continue to monitor all of the factors which influence the economy and markets and share the information and any shifts in our outlook with our daily and weekly communications. In particular, the *Current Conditions Index, Weekly Market Commentary, Weekly Economic Commentary,* and *Bond Market Perspectives* communications provide up-to-date checks of these factors and discuss where we are on a Road to Recovery.

U.S. has a Much More Global Economy Today



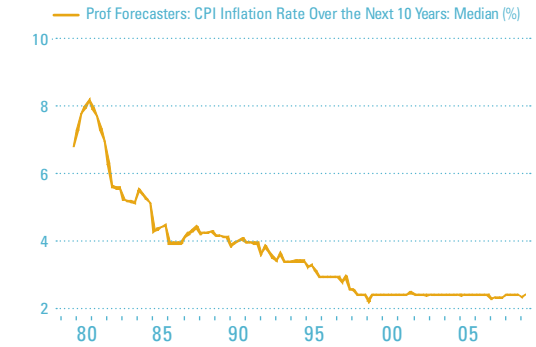
Source: Haver Analytics, Data as of 6/17/09
(Shaded areas in chart indicate recessions)

There is Only a Very Loose Relationship between Budget Deficits and Inflation



Source: OMB, BLS/Haver, Data as of 6/17/09
(Shaded areas in chart indicate recessions)

Long-term inflation expectations in the United States are low and have been relatively stable over the past 10-15 years



Source: Federal Reserve Bank of Philadelphia/Haver Analytics
Data as of 6/30/09

Outlook At A Glance: Mid-Year Update

WHAT ARE THE BEST OPPORTUNITIES NOW?

MORE ATTRACTIVE	LESS ATTRACTIVE
▪ Commodity Sensitive Strategies ▪ Emerging Markets ▪ Small Cap Stocks ▪ Mid Cap Stocks ▪ Cyclical Sectors (Information Technology, Consumer Discretionary, Materials, Industrials) ▪ Preferred Stocks ▪ Investment-Grade Corporate Bonds ▪ High-Yield Bonds ▪ Bank Loans ▪ Emerging Market Debt ▪ Non-Agency Mortgages ▪ Managed Futures ▪ Distressed Debt ▪ Long/Short	▪ Defensive Sectors (Consumer Staples, Utilities) ▪ Treasuries ▪ Agency Mortgages ▪ Cash ▪ Volatility Strategies

	BASE CASE	BEAR CASE	BULL CASE
PORTFOLIO CONSTRUCTION - Relative to Strategic Weights			
	Trim alternative asset classes, neutral to slight overweight to stocks and neutral to bonds	Underweight stocks ▪ Overweight alternative asset classes ▪ Overweight conservative bonds and cash	Overweight stocks ▪ Underweight bonds ▪ Underweight alternative asset classes
EQUITIES			
FORECAST	S&P 500 posts a low-teens return ▪ S&P 500 2009 EPS expected to be about $59 ▪ S&P 500 2010 EPS expected to be about $73 ▪ P/Es stay at about 14	The S&P 500 posts a sharp decline ▪ S&P 500 EPS to plummet another 20% ▪ P/Es go to 8 by year-end	The S&P 500 posts a large gain ▪ S&P 500 EPS growth increases to above 20% ▪ P/Es rise above 15
MARKET CAP	Underweight Large Cap ▪ Small Cap stocks will benefit from easing credit conditions and less international exposure	Overweight Large Cap ▪ Large Caps are more defensive than Small Caps ▪ Underweight cyclicals	Overweight Small Cap, slight underweight of Large Cap ▪ Small Caps outperform during the beginning of the business cycle and offer more market beta
STYLE	Slight preference for Growth relative to Value; preference to cyclicals regardless of style ▪ Preference for early- and mid-cyclical investments favors Growth	Overweight Growth relative to Value ▪ Defensive Growth stocks hold up better	Move to a greater allocation to Growth ▪ Overweight cyclicals ▪ Underweight defensive ▪ Overweight high beta*
U.S. VS. INTERNATIONAL	Overweight U.S. and Emerging Markets relative to Developed international (Large Foreign) ▪ Developed international markets are lagging the U.S. and the Emerging Markets in terms of policy stimulus and growth ▪ Deeper linkages between banks and businesses will cause the international recovery to be slower and weaker than the U.S.	Overweight U.S. relative to Developed International (Large Foreign) and Emerging Markets ▪ International and Emerging Market stocks are less defensive than U.S. ▪ Key value sectors like Financials negatively impacted by lingering financial panic	Overweight Developed International (Large Foreign) and Emerging Markets relative to U.S. ▪ As investors move away from the safe haven of the U.S., the dollar return on international investments rises

	BASE CASE	BEAR CASE	BULL CASE
FIXED INCOME			
FORECAST	High Quality Bonds return mid- to high-single digits for the year ▪ High Quality Corporate Bonds and Mortgage-Backed Securities outperform U.S. Treasuries ▪ Municipal Bonds remain cheap to Treasuries but continue to improve in second half of 2009	High Quality Bonds return low- to mid-single digits for the year ▪ Treasuries continue outperformance relative to Corporate Bonds and Mortgage-Backed Securities ▪ Municipal Bonds underperform Treasuries and municipal yields rise on credit quality concerns	High Quality Bonds return high-single digits for the year ▪ Corporate Bonds lead performance by wide margin and Treasuries lag among domestic sectors ▪ Municipal Bonds outperform Treasuries and get added boost late in 2009 on prospects of higher tax rates
DURATION	Remain duration neutral ▪ Better risk-reward opportunities are available in sector bets than in interest rate bets	Lengthen out duration ▪ Lower yields and rising prices are more pronounced for longer maturities	Shorten duration ▪ Focus on more eclectic fixed income sectors, not duration
SECTOR	Favor Corporates, Agencies, Preferred Stocks, and MBS over Treasuries ▪ We begin to shift focus on to High-Yield Bonds over the second half of 2009 ▪ Yield advantages in spread sectors are notable	Favor Treasuries ▪ Explicit government backing is necessary ▪ Avoid High-Yield Bonds, Investment-Grade Corporate Bonds, and Preferred Stocks	Favor High-Yield Bonds, Investment-Grade Corporate Bonds, and Preferred Stocks ▪ Emerging Market Debt looks attractive ▪ Quickly improving credit markets favor higher beta spread product ▪ Avoid Treasuries
U.S. VS. INTERNATIONAL	Favor Emerging Market Debt, which looks attractive ▪ We are neutral on U.S relative to Developed Foreign debt.	Favor U.S. over International ▪ More uncertainty remains with what foreign banks will have to do	Favor International over U.S. ▪ Unhedged outperform hedged due to dollar weakening ▪ Increase allocation to Emerging Market Debt on improving outlook for commodities and greater investor appetite for risk
ALTERNATIVE INVESTMENT MUTUAL FUND STRATEGIES			
FORECAST	Volatile markets prevail through the first half ▪ Alternative strategy mutual funds continue to help mitigate volatility through the first part of the year, but may underperform as the economy improves	Volatile markets prevail throughout the year ▪ Alternative investment strategies continue to outperform relative to equities, but underperform relative to fixed income	Volatility subsides ▪ Equity markets rally ▪ Alternative investment strategies underperform relative to equities but provide opportunities relative to fixed income
POSITIONING VOLATILITY: *Covered Call, Managed Futures, Global Macro* RISK MANAGEMENT: *Long/Short, Market Neutral, Absolute Return* OPPORTUNISTIC: *Distressed Debt, REITs, Commodities*	As the healing process in the economy continues, we recommend migrating to opportunistic strategies positioned to take advantage of opportunities that were created by the weak economy, such as Distressed Debt. Also begin to consider opportunistic economically sensitive strategies such as Commodities	Volatility and risk management strategies provide greatest relative outperformance throughout the year ▪ Continue to avoid economically sensitive opportunistic strategies, such as REITs and Commodities	Overweight opportunistic strategies; underweight volatility and risk management strategies ▪ Overweight opportunistic strategies such as Distressed Debt ▪ Overweight to opportunistic, economically sensitive strategies such as REITs and Commodities

*Beta: Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile that its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

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.

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

Stock investing involves risk including loss of principal.

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

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.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

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

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 funds shares is not guaranteed and will fluctuate.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potentially illiquidity. There is no assurance that the investment objective will be attained.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Investing in mutual funds involves risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Mid capitalization companies are subject to higher volatility than those of larger capitalized companies.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the option.

An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fed seeks to preserve the value of your investments at $1.00 per share, it is possible to lose money investing in the Fund.

The Barclays Aggregate Bond Index is composed of securities from the Barclays Government/Credit Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index.

The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size.

Covered Call mutual fund strategies typically hold a long portfolio of stocks and then sell calls. Some covered call strategies then buy puts to further protect against downside risk. The net result is a portfolio that is correlated to the broader markets, but with significantly less volatility and increased risk due to the use of derivatives.

Global Macro funds use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical managed futures fund. Historically, the benefit of global macro has been solid long-term returns with very low correlation to equities and fixed income securities.

Long/short funds focus on managers who go long and hedge against the market through options or shorting equity securities with the goal of outperforming the market while limiting volatility. These funds tend to have a higher correlation to equities than other alternative strategies and, therefore, are most appropriate for more aggressive portfolios.

Consumer Discretionary: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Healthcare: Companies in two main industry groups: Healthcare equipment and supplies or companies that provide healthcare-related services, including distributors of healthcare products, providers of basic healthcare services, and owners and operators of healthcare facilities and organizations. Companies primarily involved in the research, development, production and marketing of pharmaceuticals and biotechnology products.

Industrials: Companies whose businesses: (1) Manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery, (2) Provide commercial services and supplies, including printing, employment, environmental and office services, (3) Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Information Technology: Technology Software & Services, including companies that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services and technology Hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Materials: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Telecommunications Services: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

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