

# Portfolio Compass



June 11, 2014

## Navigating the Markets

The *Portfolio Compass* provides a snapshot of LPL Financial Research's views on equity & alternative asset classes, the equity sectors, and fixed income. This biweekly publication illustrates our current views and will change as needed over a three- to 12-month time horizon.

### Reading the *Portfolio Compass*

Fundamental, technical, and valuation characteristics for each category are shown by colored squares.

Negative, neutral, or positive views are illustrated by a solid black bar positioned over the color scale, while an outlined black bar with an arrow indicates change and shows the previous view.

Rationales for our views are provided beneath each category.

All performance referenced herein is as of June 9, 2014, unless otherwise noted.

\* As noted in our *Outlook 2014: The Investor's Almanac* publication.

### Compass Changes

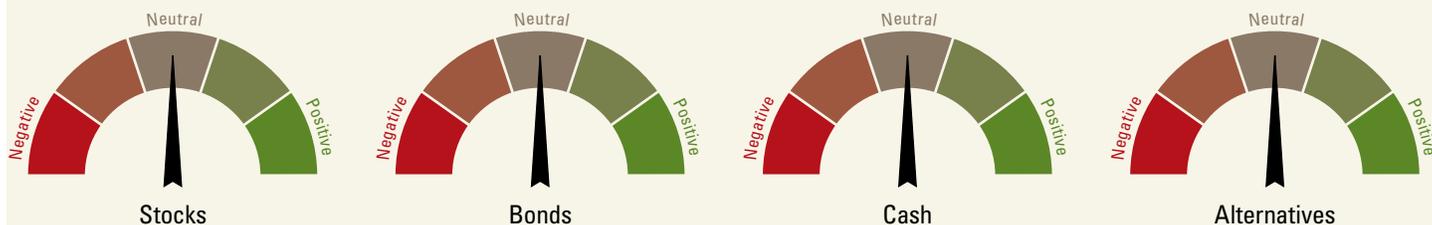
- Downgraded preferreds to neutral from neutral/positive.
- Downgraded Treasuries to negative from negative/neutral.
- Downgraded mortgage-backed securities to negative/neutral from neutral.

### Investment Takeaways

- Our 2014 stock market forecast calls for gains of 10–15%, based on our forecast for 5–10% earnings growth and modest price-to-earnings (PE) multiple expansion.\*
- We favor small caps and cyclical sectors, as we expect U.S. economic growth to improve over 2014.
- Higher valuations are still evident across the bond market, and a below-benchmark bond weighting may be appropriate.
- We have downgraded preferred securities to neutral as yield spreads contracted further.
- We have lowered our Treasuries view to negative as economic growth rebounds from a depressed first quarter and downgraded mortgage-backed securities to negative/neutral due to more expensive valuations.
- High-yield bond valuations suggest caution with yields hovering near all-time lows.
- From a technical perspective, we view the S&P 500 Index closing at new all-time highs, indicating short-term bullish price momentum.

### Broad Asset Class Views

LPL Financial Research's views on stocks, bonds, cash, and alternatives are illustrated below. The positions of negative, neutral, or positive are indicated by the solid black compass needle, while an outlined needle shows a previous view.



## Equity & Alternative Asset Classes

### Favor Small Caps as Bull Market May Continue\*

- Our 2014 stock market forecast remains for gains of 10–15%, based on our forecast for 5–10% earnings growth and modest PE multiple expansion as economic growth and the market’s confidence in that growth improve.\*
- Despite recent weakness, we continue to favor small caps for their potential to capture stock market gains this year amid potential improving economic growth in 2014 and an expected gradual increase in stock market valuations.
- We maintain a preference for growth over value, and cyclical sectors over defensives.
- We favor U.S. over large foreign, primarily due to Europe’s sluggish growth, but prospects for better growth overseas suggest a potentially more positive developed foreign equity view during the second half of 2014. Structural impediments to faster European growth remain, while Japan is on the upswing.
- Uneven growth and current account deficit challenges in several key emerging markets (EM) economies remain concerns as the Federal Reserve (Fed) and other central banks rein in liquidity, but valuations and technicals are supportive.
- Deteriorating technicals led to our recently lowered agriculture commodities view. Fundamental concerns and recent technical deterioration keep us neutral on precious metals. Crude oil (WTI) at the high end of its recent range may be poised to reverse lower.

		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Style/Capitalization	Large Growth	■	■	■				
	Large Value	■	■	■				
	We continue to favor small caps despite recent large cap strength. We maintain a preference for growth over value, but we expect 2014 to be more about cyclical versus defensive.							
	Mid Growth	■	■	■				
	Mid Value	■	■	■				
	Positive mid growth view reflects consumer-focused cyclical equity sector exposure and potential for more up-capture. Mid should benefit from continued heavy acquisition activity.							
	Small Growth	■	■	■				
	Small Value	■	■	■				
Favor small caps for potential to capture stock market gains, as we expect economic growth and stock valuations to improve in 2014, though small cap valuations and broad market volatility are risks.								
Region	U.S. Stocks	■	■	■				
	Large Foreign	■	■	■				
	Small Foreign	■	■	■				
	Emerging Markets	■	■	■				
We favor U.S. over large foreign primarily due to Europe’s sluggish growth. Uneven growth and current account deficit challenges in several key EM economies remain concerns, but valuations and technicals drive our EM view upgrade to neutral. Japan is on the upswing.								
REITs	■	■	■					
Strong YTD performance unlikely to be sustained as interest rate declines subside.								
Commodities	Industrial Metals	■	■	■				
	Precious Metals	■	■	■				
	Energy	■	■	■				
	Agricultural	■	■	■				
Deteriorating technicals led to our recently lowered agriculture commodities view. Crude oil (WTI) at the high end of its recent range may be poised to reverse lower. Precious metal risk factors include Fed tapering, low inflation, potential higher interest rates, and a strong US dollar.								
Other	Non-Correlated Strategies							
Favor long/short equity vehicles as the market rewards fundamentals and merger/arbitrate for high deal activity. Unconstrained eclectic strategies with differentiated investment styles are well suited for opportunistic allocations. Increasingly view low volatility AI strategies as bond substitutes.								

Unconstrained Eclectic strategies have a flexible investment style that does not limit the fund to a single asset class or security type.

Real estate/REITs may result in potential illiquidity and there is no assurance the objectives of the program will be attained. The fast price swings of commodities will result in significant volatility in an investor’s holdings. International and emerging markets involve special risks such as currency fluctuation and political instability. The price of small and mid-cap stocks are generally more volatile than large cap stocks. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Precious metal investing is subject to substantial fluctuation and potential for loss. These securities may not be suitable for all investors. Alternative strategies 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. Stock investing may involve risk including loss of principal.

## Equity Sectors

### Favor Cyclical Sectors in 2014 for Improving U.S. Economy

- We continue to favor the cyclical sectors for their potential to capture further stock market gains as economic growth improves.
- Our consumer discretionary view remains positive. Recent retail sales gains and the latest jobs numbers are encouraging.
- We expect improved U.S. business spending and global growth in 2014 to help industrials, including transports. During Q1 earnings season, industrials produced solid upside surprises and positive earnings revisions.
- Our positive business spending outlook and attractive valuations result in our positive technology sector bias.
- Resource sector technicals are positive, but valuations, and in the case of energy, downside risk to oil prices, temper our enthusiasm.
- Our financials view is neutral. Improving loan demand and the potential for a steeper yield curve favor regional banks, though a challenging trading, mortgage, and regulatory environment remains a concern for larger institutions.
- Our neutral health care view reflects our focus on cyclical sectors, though robust product innovation trends, a likely uptick in demand from the Affordable Care Act (ACA), and solid Q1 earnings solidify the sector's place as our favorite defensive.
- We remain cautious on telecom and utilities due to their interest rate sensitivity, though telecom valuations have become attractive. We do not expect the year-to-date utilities strength—largely driven by falling interest rates—to be sustained.

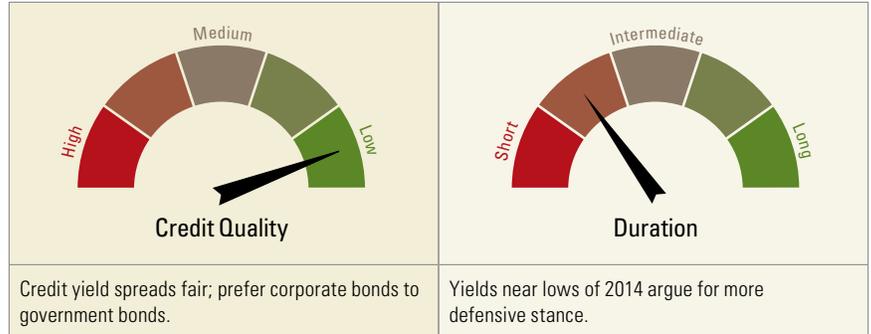
	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	S&P 500 Weight (%)	
Cyclical	Materials	■	■	■				3.5
	Technicals are positive, but we would like to see growth acceleration in China and lower valuations.							
	Energy	■	■	■				10.5
	Technical strength and positive earnings trajectory are encouraging, but we see oil as overvalued.							
	Industrials	■	■	■				10.8
	We expect a business spending pickup and better global growth in 2014; solid Q1 earnings results.							
	Consumer Discretionary	■	■	■				12.0
	Wealth effects, improving retail sales and job gains should help; valuation premium is largely gone.							
	Technology	■	■	■				18.9
Good Q1 earnings growth; positive bias on attractive valuations, positive business spending outlook.								
Financials	■	■	■				16.2	
Valuation and likely steeper yield curve offset regulatory and mortgage risk, mixed Q1 earnings season.								
Defensive	Utilities	■	■	■				3.0
	Negative view reflects interest rate risk, our preference for cyclicals, and lofty valuations.							
	Health Care	■	■	■				13.1
	Favorite defensive sector; favorable product trends and ACA—demand lift; favor biotech industry.							
	Consumer Staples	■	■	■				9.6
Input cost pressures, above-average valuations, and we prefer cyclical sectors.								
Telecommunications	■	■	■				2.4	
Interest rate and business risks remain, but valuations have fallen well below long-term averages.								

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

# Fixed Income

## Soft Start to June

- Higher valuations are still evident across the market, despite a weak start to June, with yields near year-to-date lows and yield spreads across several fixed income sectors hovering near the lowest levels of the past few years.
- Municipal bonds continue to benefit from very low supply, but issuance is expected to increase in June. We expect performance to slow after a good start to 2014. However, the sector remains attractive over the longer term.



		Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Tax-Free Bonds	Munis-Short-Term	■	■	■	[Bar chart showing negative bias]			
	Muni curve is steep, and short-term valuations are unattractive.							
	Munis-Intermediate-Term	■	■	■	[Bar chart showing neutral bias]			
	Our preferred maturity exposure, but valuations are now higher.							
	Munis-Long-Term	■	■	■	[Bar chart showing neutral bias]			
	Limited supply is a positive, but poor June seasonal trend is a near-term negative.							
	Munis-High-Yield	■	■	■	[Bar chart showing neutral bias]			
Defaults low but susceptible to interest rate risk.								

continued on next page

For the purposes of this publication, intermediate-term bonds have maturities between three and 10 years, and short-term bonds are those with maturities of less than three years.

All 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. 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 interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply. 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.

## Fixed Income (CONT.)

### Soft Start to June

- A lower-than-benchmark weighting of bonds may be appropriate. We favor a blend of high-quality intermediate bonds coupled with less interest rate sensitive sectors such as high-yield bonds.
- We downgraded preferred securities to neutral as yield spreads contracted further.
- We lowered Treasuries to negative as economic growth rebounds from a depressed first quarter, which may exert more upward pressure on yields, and downgraded mortgage-backed securities as a result of more expensive valuations.
- EM debt benefited from a drop in long-term yields and a more benign Fed, but valuations are at their most expensive level of the past 18 months and performance may slow.
- High-yield bond spreads are near 3.5%, and the average yield is hovering near an all-time low of 5%. Higher valuations suggest caution.
- Among high-quality bonds, we favor investment-grade corporate bonds due to their economic sensitivity and good fundamentals.

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

	Fundamentals	Technicals	Valuations	Negative	Neutral	Positive	
Taxable Bonds – U.S.	Treasuries	■	■	■	■	■	
	Yields are near the low end of the trading range, and additional gains are likely limited.						
	TIPS	■	■	■	■	■	■
	Low actual inflation and above-average interest rate risk are negatives.						
	Mortgage-Backed Securities	■	■	■	■	■	■
	Valuations expensive but may benefit from continued Fed purchases.						
	Investment-Grade Corporates	■	■	■	■	■	■
	Yield spread to Treasuries is below average, but credit quality is stable.						
	Preferred Securities	■	■	■	■	■	■
	Good income generator. Bank credit quality is still improving.						
High-Yield Corporates	■	■	■	■	■	■	
Valuations are expensive, but credit quality metrics are good and defaults are low.							
Bank Loans	■	■	■	■	■	■	
Attractive due to short-term nature and attractive yield.							
Taxable Bonds – Foreign	Foreign Bonds – Hedged	■	■	■	■	■	
	Yields low but possibility of ECB easing a positive.						
	Foreign Bonds – Unhedged	■	■	■	■	■	■
	Low yields, unattractive valuations, and lingering euro risks.						
Emerging Market Debt	■	■	■	■	■	■	
Yield spreads at one-year low and interest rate risk growing.							

All 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. High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of 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. International and emerging market investing involves risks such as currency fluctuation and political instability and may not be suitable for all investors. Bank loans are loans issued by below investment-grade companies for short term funding purposes with higher yield than short-term debt and involve risk. Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. government. 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. Foreign Bonds – Hedged: Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure. Foreign Bonds – Unhedged: Non-U.S. fixed income securities normally denominated in major foreign currencies.

## DEFINITIONS:

### EQUITY AND ALTERNATIVES ASSET CLASSES

**Large Growth:** Stocks in the top 70% of the capitalization of the U.S. equity market are defined as Large Cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Large Value:** Stocks in the top 70% of the capitalization of the U.S. equity market are defined as Large Cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**Mid Growth:** The U.S. mid-cap range for market capitalization typically falls between \$1 billion and \$8 billion and represents 20% of the total capitalization of the U.S. equity market. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Mid Value:** The U.S. Mid Cap range for market capitalization typically falls between \$1 billion and \$8 billion and represents 20% of the total capitalization of the U.S. equity market. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**Small Growth:** Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as Small Cap. Growth is defined based on fast growth (high growth rates for earnings, sales, book value, and cash flow) and high valuations (high price ratios and low dividend yields).

**Small Value:** Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as Small Cap. Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

**U.S. Stocks:** Stock of companies domiciled in the U.S.

**Large Foreign:** Large-cap foreign stocks have market capitalizations greater than \$5 billion. The majority of the holdings in the large foreign category are in the MSCI EAFE Index.

**Small Foreign:** Small-cap foreign stocks typically have market capitalizations of \$250M to \$1B. The majority of the holdings in the small foreign category are in the MSCI Small Cap EAFE Index.

**Emerging Markets:** Stocks of a single developing country or a grouping of developing countries. For the most part, these countries are in Eastern Europe, Africa, the Middle East, Latin America, the Far East and Asia.

**REITs:** REITs are companies that develop and manage real-estate properties. There are several different types of REITs, including apartment, factory-outlet, health-care, hotel, industrial, mortgage, office, and shopping center REITs. This would also include real-estate operating companies.

**Commodities – Industrial Metals:** Stocks in companies that mine base metals such as copper, aluminum and iron ore. Also included are the actual metals themselves. Industrial metals companies are typically based in North America, Australia, or South Africa.

**Commodities – Precious Metals:** Stocks of companies that do gold- silver-, platinum-, and base-metal-mining. Precious-metals companies are typically based in North America, Australia, or South Africa.

**Commodities – Energy:** Stocks of companies that focus on integrated energy, oil & gas services, oil & gas exploration and equipment. Public energy companies are typically based in North America, Europe, the UK, and Latin America.

**Merger Arbitrage** is a hedge fund strategy in which the stocks of two merging companies are simultaneously bought and sold to create a riskless profit. A merger arbitrageur looks at the risk that the merger deal will not close on time, or at all. Because of this slight uncertainty, the target company's stock will typically sell at a discount to the price that the combined company will have when the merger is closed. This discrepancy is the arbitrageur's profit.

**Long/Short** is an investment strategy generally associated with hedge funds. It involves buying long equities that are expected to increase in value and selling short equities that are expected to decrease in value.

### EQUITY SECTORS

**Materials:** Companies that engage 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.

**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 or the exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

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

**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.

**Technology:** 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. Technology hardware & equipment include manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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

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

**Health Care:** 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 or companies primarily involved in the research, development, production and marketing of pharmaceuticals and biotechnology products.

**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.

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

## FIXED INCOME

**Credit Quality:** An individual bond's credit rating is determined by private independent rating agencies such as Standard & Poor's, Moody's and Fitch. Their credit quality designations range from high ('AAA' to 'AA') to medium ('A' to 'BBB') to low ('BB', 'B', 'CCC', 'CC' to 'C').

**Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

**Munis – Short-term:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of less than three years.

**Munis – Intermediate:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of between 3 and 10 years.

**Munis – Long-term:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally have maturities of more than 10 years.

**Munis – High-yield:** Bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. These bonds generally offer higher yields than other types of bonds, but they are also more vulnerable to economic and credit risk. These bonds are rated BB+ and below.

**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.

**TIPS (Treasury Inflation Protected Securities):** A special type of Treasury note or bond that offers protection from inflation. Like other Treasuries, an inflation-indexed security pays interest every six months and pays the principal when the security matures. The difference is that the underlying principal is automatically adjusted for inflation as measured by the consumer price index (CPI).

**Mortgage-Backed Securities:** A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

**Investment-Grade Corporates:** Securities issued by corporations with a credit rating of BBB- or higher. Bond rating firms, such as Standard & Poor's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's investment-grade credit quality rating. 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment-grade.

**Preferred Stocks:** A class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights.

**High-Yield Corporates:** Securities issued by corporations with a credit rating of BB+ and below. These bonds generally offer higher yields than investment-grade bonds, but they are also more vulnerable to economic and credit risk.

**Bank Loans:** In exchange for their credit risk, these floating-rate bank loans offer interest payments that typically float above a common short-term benchmark such as the London interbank offered rate, or LIBOR.

**Foreign Bonds – Hedged:** Non-U.S. fixed income securities generally from investment-grade issuers in developed countries, with hedged currency exposure.

**Foreign Bonds – Unhedged:** Non-U.S. fixed income securities normally denominated in major foreign currencies.

**Emerging Market Debt:** The debt of sovereigns, agencies, local issues, and corporations of emerging markets countries and subject to currency risk.

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## 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 indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

Stock investing involves risk including loss of principal.

Preferred stock investing involves risk, which may include loss of principal.

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.

This research material has been prepared by LPL Financial.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit