LPL Financial Research

Crisis Conditions Index

April 15, 2009

2009 Outlook Scenarios

The three scenarios for 2009 we presented late last year include our base case, the scenario we believe to be most likely, a bear case or continued downturn, and a bull case or market rebound.

Base Case

The financial panic that began in September 2008 will subside in early 2009 allowing a normalization of financial markets by mid-year 2009.

Why would the base case prevail?

- Intervention policies implemented by the U.S. government begin to take effect.
- Market sentiment remains cautious through volatile January markets.
- Consumers remain cautious after a dismal 2008 holiday sales season.
- Unemployment remains relatively high through much of the first half of the year.

The base case scenario:

- The economy emerges from recession in the second half of 2009.
- Inflation turns negative early in 2009, but rises by the end of the year.
- The stock market, as measured by the S&P 500, posts a return that enters into the double digits, as a volatile first half of the year gives way to more consistent improvement in earnings and sentiment in the second half.
- The bond market, as measured by the Barclays Aggregate Bond Index, posts a return in the mid- to high-single digits range.
- In alternatives, "volatility" strategies continue to benefit returns in the first part of the year.

Bear Case

The financial panic lingers well into 2010, and financial markets do not normalize at all over the course of 2009.

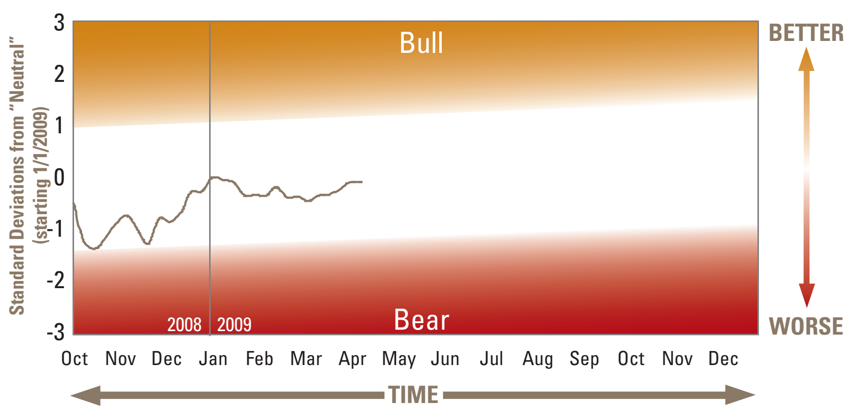
Why would the bear case prevail?

- Foreign bank failures continue without the type of intervention seen in the United States.

The LPL Financial Research Crisis Conditions Index (CCI) is an objective and transparent measure of how the conditions are evolving relative to our base, bear, and bull cases defined in our Outlook 2009 publication. This weekly index is not intended to be a leading index or predictive of where conditions are headed, but merely a coincident measure of where they are right now. We want to track the conditions in real time to aid in investment decision making. There are thousands of indicators — some lead the economy, some lag, while others merely offer a lot of statistical noise. We chose to create our own index tailored to the current environment to provide the clearest and most useful way to track how conditions are aligned with the expectations embedded in our investment recommendations.

There is a need for this type of measure since the stock market cannot be relied upon as an accurate gauge. The stock market can be a misleading guide to the underlying economic conditions. The emotions of market participants can result in an overreaction on the upside and downside. A fact-based, objective measure of conditions is necessary to understand the relative likelihood of the scenarios detailed in our Outlook 2009 publication.

LPL Research Crisis Conditions Index



Source: LPL Financial

Has Anything Changed to Our Outlook?

Much has taken place since we published our outlook in late 2008. Our outlook was based on markets responding to the introduced policy actions. The changes and delays in policy responses may have pushed out when the healing may take place in 2009 and result in a weaker first half of the year. The shorter-term environment is weaker leading to lower economic and

- Housing sales break down from the stable levels of the past year and follow the path of auto sales sharply downward.
- Increasingly aggressive forced selling by financial institutions or a major negative geopolitical event further disrupts the markets.

The bear case scenario:

- The economy lingers in a recession throughout 2009 and into 2010 with a frozen lending market.
- Stocks post another year similar to 2008, marked by a substantial decline as confidence fails to return and earnings tumble another 20%.
- Bonds return between low- to mid-single digits, with additional Treasury gains offset by price weakness in non-Treasury sectors: Corporate Bonds, Mortgage-Backed Securities (MBS), and Agency Bonds.
- The alternative investment areas of opportunity are: Long/Short, Covered Calls, Managed Futures, Global Macro, Absolute Return, and Market Neutral—all those mutual fund strategies that help with volatility.

Bull Case

The financial panic that began in September 2008 dissipates at the very start of 2009, and financial markets begin to normalize early in the year.

Why would the bull case prevail?

- Evidence of a sharp rebound in market sentiment comes in late 2008 or early 2009.
- Policy actions take effect sooner than expected.
- Falling mortgage rates help to deliver a bottom in home prices.
- The Federal Reserve injects more capital into financial institutions, and lending accelerates.

The bull case scenario:

- The economy experiences a quick rebound from the recession and a rebound in the credit markets as confidence is restored.
- Stocks rebound; both earnings and valuations snap back as a mountain of cash is returned to the capital markets.
- The bond market returns high-single digits as income and price appreciation, from Corporate Bonds in particular, more than offsets Treasury weakness.
- Most alternative strategies provide positive results but trail the strong stock market in this bullish scenario.

profit growth than we had anticipated in our base case.

- GDP in the fourth quarter was -6%, roughly in line with our expectations of being down at least 5%. We had predicted a similar decline in the first quarter of 2009. However, it now appears that the first quarter could be worse than the fourth quarter of 2008 due to a sharper reduction in inventory.
- We had expected a below consensus, mid single-digit earnings gain from 2008, but it appears earnings may now be down a mid single-digit percentage in 2009 in the low to mid-$60s.

However, with policy (TALF, mortgage modification, and other stimulus) now being implemented, the healing for the economy and earnings may begin after dipping a bit deeper. We still expect economic and profit growth to turn positive by year end.

Will We Take Action?

The index is defined relative to our outlook for 2009. The index starts at the beginning of this year at zero. Remaining on the base case path — with some volatility around an upwardly sloping trend — remains our expectation. We expect modest improvement in the indicators and the trend to move modestly higher over the course of the year. However, year-to-date we have seen some deterioration in conditions.

Looking forward, a continued downward trend into the bear case would likely result in recommended action to increase our some what defensive posture on the stock market and rein in risk in the bond portion of the portfolio. It is important to note that if the index enters the range of the bear case it does not mean our bear case for the year has been realized, just that we are on track for that bear case to be the most likely outcome.

We ran the index back over the fourth quarter of last year to provide context for the range of the base, bear, and bull cases. Looking back, early in the fourth quarter of last year the index dipped sharply down to what we would later define as the bear case for 2009. We made a shift to reduce portfolio risk at that time.

We constructed the CCI to capture many of the timely indicators we look at regularly. However, there are many other less easily quantifiable or timely barometers of the backdrop for the economy and markets that we are unable to include in the CCI. Nevertheless, these factors also affect our investment recommendations and our assessment of the likelihood of the base, bear, and bull cases defined in our 2009 Outlook publication.

How Is the Index Constructed?

To create the index we found 10 indicators that provided a weekly, real-time measure of the conditions in the economic and market environment. We then standardized these components compared to their pre-crisis 10-year average, equally weighted their standardized scores, and aligned the resulting index with zero at the start of 2009. These components capture how the conditions are evolving from a wide range of angles. Each component is important and measures a different driver of the environment. The 10 components of the CCI are described below:

1. **Initial Claims Filed for Unemployment Benefits –** Measures the number of people filing for unemployment benefits. A rise in the number of new claims acts as a negative on the CCI.
2. **TED Spread –** The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread acts as a negative on the CCI.
3. **Baa Spreads –** The yield on corporate bonds above the rate on comparable maturity Treasury debt is a market based estimate of the amount of fear in the bond market. Baa-rated bonds are the lowest quality bonds still considered investment grade, rather than high-yield. Therefore, they best reflect the stresses across the quality spectrum. A rise in Baa spreads acts as a negative for the CCI.
4. **Retail Sales -** International Council of Shopping Centers tabulates data on major retailer's sales compared to the same week a year earlier. This measures the current pace of consumer spending. Consumer spending makes up two-thirds of GDP. Rising retail sales acts as a positive for the CCI.
5. **Shipping Rates –** A measure of global trade, the Baltic Exchange compiles the Baltic Dry Freight Index which tracks the cost to ship various cargoes of raw materials on various key routes around the world. Since the supply of dry bulk ships does not change much in the short-term, the index is moved by the amount of cargo that is being traded in various global markets. A growing global economy moves more cargo which pushes up shipping rates. A rise in shipping rates acts as a positive for the CCI.
6. **Consumer Confidence –** The weekly survey of consumer attitudes by ABC News provides a gauge of the sentiment that drives two-thirds of U.S. economic growth. While we have often stressed that confidence is not a leading indicator, it is coincident and reflects the current environment. A rise in consumer confidence acts as a positive for the CCI.
7. **VIX –** 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. A rise in the VIX acts as a negative on the CCI.
8. **Money Supply Growth Less Inflation –** The year-over-year change in M2 growth adjusted for inflation is a measure of the Federal Reserve's actions to provide adequate liquidity for U.S. economic activity. A rise in the change in real M2 acts as a positive on the CCI.
9. **Commodity Prices –** While retail sales captures end user demand for goods, commodity prices reflect the demand for the earliest stages of production of goods. Commodity prices can offer an indicator of the pace of economic activity. The CRB Commodity Index includes copper, cotton, etc. A rise in commodity prices acts as a positive on the CCI.
10. **Mortgage Applications –** The weekly index measuring mortgage applications provides an indication of housing demand. With much of the credit crisis tied to housing, keeping tabs on real time buying activity can offer insight on how the crisis is evolving. A rise in the index of mortgage applications acts as a positive on the CCI.

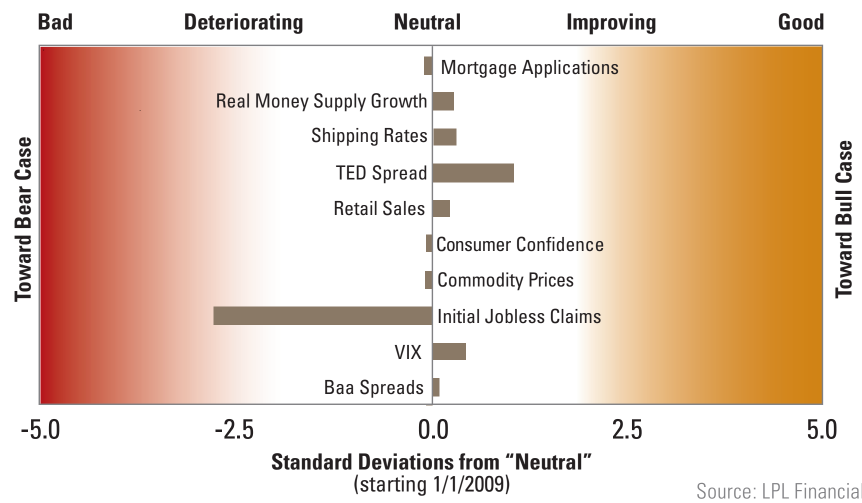
Real-Time Tracking

The LPL Financial Research Crisis Conditions Index is a weekly measure of the conditions that underpin our outlook for the markets and economy in 2009. We will publish this weekly index over the course of 2009 to provide real-time context and insight into the trends that shape our recommended actions to manage portfolios. We expect this index will become a useful tool to describe the conditions most relevant to investment decision-making in 2009.

How are the Components Affecting the Index right Now?

The LPL Financial Crisis Conditions Index was unchanged over the past week hanging on to the improvement of the past five weeks. The improvement in conditions has been mirrored in the rally in the stock and bond market. The CCI is just below where it started the year – aligned with our base case for the economy and forecast for modest gains in stocks and bonds this year.

LPL Research Crisis Conditions Index Components



Source: LPL Financial

Last week's improving components of the CCI included the VIX which has now dipped below 40 for the longest stretch since before the crisis erupted last fall. The TED Spread also reflected notable improvement reflecting ongoing policy efforts to provide adequate liquidity to the banking system. Balancing last week's improving components, was the slight slump in mortgage applications as the decline in mortgage rates paused. Initial jobless claims have stabilized, but remain the weakest component of the CCI since the start of the year.

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