Sector Strategy

May 2012

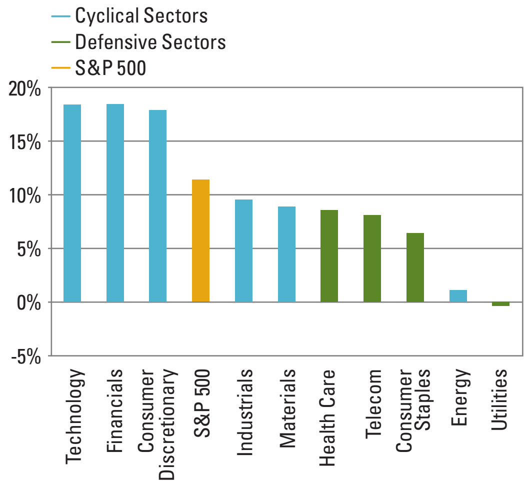
Toning Down Cyclicality

The Big Picture

- Continue to favor cyclical sectors, but with more balance based on our cautious macro view.
- Favor business spending driven Industrials and Technology sectors.
- Lowered view of resource sectors reflects volatility around China theme.

- We continue to favor **cyclical sectors.** With the exception of Consumer Discretionary, we believe cyclicals are attractively valued relative to the broad equity market and to defensive sectors.
- While we continue to under-emphasize **defensive sectors,** those sectors led the market in April 2012 and are likely to outperform in a potential stock market pullback. Accordingly, we have become less positive on the cyclical sectors in recent weeks, while we are becoming slightly more constructive on Consumer Staples.
- Our downgraded views of the **Energy and Materials sectors,** to neutral, as noted in the *Portfolio Compass* dated May 2, 2012, reflected heightened volatility surrounding the China-driven growth theme and loss of momentum from a technical perspective.
- Our views on **Technology and Industrials** remain positive. Technology, the top performing S&P 500 sector year-to-date, has benefited from outsized gains for its largest constituent, solid earnings results, attractive valuations, and powerful mobility product trends.
- Our positive outlook for **domestic business spending,** and expectations for only a modest slowdown and easier monetary policy in China, support our positive view of the globally-focused Industrials sector, as well as Technology.
- Despite the resurgence of the **Financials sector** in 2012, our view remains cautious. The sector has benefited from strengthening balance sheets, dividend increase announcements, better economic data and, until recently, signs of stabilization in Europe. Our growth outlook is lackluster and regulatory pressures are intense.
- The **Energy and Utilities sectors** are down year-to-date. Depressed natural gas prices and related earnings weakness have weighed on the Energy sector. Utilities weakness has been driven by several factors, including the market's increased preference for cyclical investments, the lack of earnings growth, correlation to natural gas prices, and high valuations.

1 Strong 2012 So Far for Cyclical Sectors



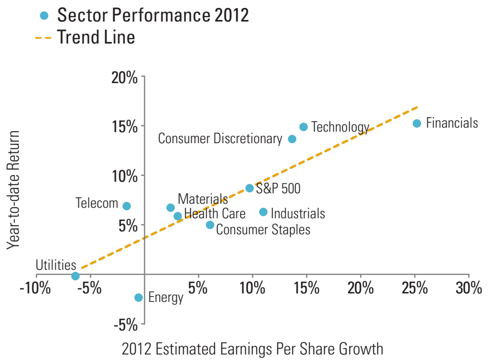
Source: FactSet, LPL Financial 05/09/12

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

Performance Review – Earnings Driving Stock Prices

In 2011, company fundamentals, or more specifically earnings growth, had little correlation to stock market performance as the defensive sectors with the least favorable growth prospects performed best, while the cyclical sectors generally lagged. This year has been a different story. As Figure 2 illustrates, earnings growth is driving stocks this year as the fastest earnings growth is being rewarded by investors with the highest year-to-date returns.

2 Earnings Driving Stock Prices



Source: FactSet, LPL Financial 05/09/12

Scatter graph depicts expected 2012 earnings per share growth on the horizontal axis and returns year-to-date on the vertical axis.

Figure 2 shows expected 2012 earnings per share growth on the horizontal axis and returns year-to-date on the vertical axis.

This shift in market sentiment has been driven by many factors. First, in the U.S., economic data has improved and reduced the odds of a recession. Second, policy makers in Europe have made progress toward resolving the debt crisis, evident in lower sovereign bond yields in peripheral European countries and improved Financials sector returns. Third, corporate profits have continued to grow at a solid pace. Profits have been an important driver of stock returns, for economically sensitive sectors in particular, as higher stock prices have not been accompanied by meaningfully higher valuations in terms of forward price-to-earnings (P/E) multiples. These factors have been evident in improved performance of the more cyclical sectors that are enjoying the fastest growth such as Technology.

Momentum for Cyclicals Slowed in April 2012

The momentum for the stock market overall and the cyclical sectors, however, has started to fade in April and early May 2012 after a very strong first quarter. A series of consistently positive economic surprises in the first quarter has been followed by more disappointments since then. The risks associated with Europe have risen following recent elections in France and Greece, which have been accompanied by renewed weakness in peripheral European bond markets. In addition, earnings growth has slowed from the strong growth reported for the fourth quarter of 2011 in January and February 2012 and may not provide as much support for stocks going forward. These factors have contributed to a moderate market pullback since early April along with strong performance by defensive sectors, while most cyclical sectors have lagged. The one exception is Consumer Discretionary, which has gotten a lift from resilient first quarter consumer spending, better-than-expected retail sales increases, and falling energy prices.

As the critically important November 2012 presidential and congressional elections approach, policy will be an increasingly important driver of sector performance. In this edition, for each sector, we look at some of the policy issues investors should be watching. Please see the *Weekly Market Commentary* dated May 7, 2012, for additional insights.

All Eyes on November Elections

As the critically important November elections approach, government policy will play a big role not only in determining the direction of the stock market but also for specific equity sectors. The Health Care sector is an obvious example as the Supreme Court evaluates the Affordable Care Act (ruling due out in June 2012), a politically divisive issue where likely Republican presidential candidate Mitt Romney and other key Republican leaders have expressed a desire to repeal the law.

Key Sector Policy Impacts as Elections Approach

- **Health Care.** The Supreme Court ruling on the Affordable Care Act due out in June will have wide-ranging ramifications on the sector.
- **Financials.** We may see a relief rally in the Banks in the legislative-sensitive Financials sector in the event of a favorable November for the Republicans.
- **Energy.** Regulations on drilling would be more favorable as would EPA regulations under more Republican leadership in 2013.

3 S&P 500 Sector Snapshots

Consumer Discretionary	Tepid income growth, elevated valuations are concerns but resilient consumer spending, a stabilizing housing market, retail sales, and confidence are encouraging.
Consumer Staples	Seasonality and easing input cost pressures are supportive; likely outperformer in a potential market pullback due to its defensive nature.
Energy	The sector is the worst-performer year-to-date with a 3% decline. Cooling Mideast tensions and heightened global growth concerns have pushed crude oil below $100 while depressed natural gas prices have also weighed on sector performance.
Financials	Strong start to 2012 on strengthening balance sheets, dividend increases, better economic data and, until recently, signs of stabilization in Europe.
Health Care	Preference for cyclical sectors steers us away from Health Care, though we continue to find Biotech attractive; important Supreme Court ruling on Affordable Care Act due out in June.
Information Technology	One of the top performing sectors in 2012 on strong earnings, attractive valuations, and powerful mobility trend (smart phone and wireless-enabled tablet boom).
Industrials	Business spending growth, a key driver of earnings growth, slowed in Q1 2012 but is likely to pick up again over the balance of the year; likely the fastest earnings grower in the first quarter of 2012.
Materials	Still expect only a modest slowdown in China, but near-term overseas risks have risen some in recent months.
Telecom	Rich valuation, and sluggish growth are among chief concerns, although Q1 earnings upside is noteworthy.
Utilities	Among the worst-performing sectors in 2012 on weak earnings, shift toward cyclicals, depressed natural gas prices.

Our accompanying individual sector profiles are delivered individually or as a full analysis. Our sector views are outlined in *Portfolio Compass,* published on a bi-weekly basis. The *Compass* highlights the three components of our investment philosophy — fundamentals, valuation and technical analysis — for equity sectors as well as equity, fixed income and commodities asset classes. For more details on our macroeconomic and market views, please refer to our *2012 Outlook* publication and our weekly market and economic commentaries.

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.

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

Healthcare Sector: Companies are 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 manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Also, companies that provide commercial services and supplies, including printing, employment, environmental and office services, or provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Manufacturing Sector: Companies engaged in chemical, mechanical, or physical transformation of materials, substances, or components into consumer or industrial goods.

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.

Technology Software & Services: Includes 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, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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

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

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

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing is subject to substantial fluctuation and potential for loss.

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.

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

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

RES 3697 0512
Tracking #1-068768 (Exp. 05/13)