WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

October 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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KEY TAKEAWAYS

- We expect corporate America to generate strong profit margins for at least the next several quarters, as the primary margin drivers remain largely intact.
- The S&P 500's operating margin remains near multi-decade highs on limited wage pressure, corporate efficiency, and low input costs.
- We expect strong profitability to support earnings growth acceleration in late 2015 and early 2016.

HOW LONG WILL PROFIT MARGINS CONTINUE TO DEFY THE SKEPTICS?

Profit margins may continue to defy the skeptics and remain elevated. The primary drivers of robust corporate profit margins remain largely intact, including limited wage pressure, corporate efficiency, and low input costs, and support our view that earnings growth may be poised to accelerate through year-end and into 2016. Despite a lack of revenue growth, the operating margin for the S&P 500 remains near multi-decade highs; we expect corporate America to continue to defy the skeptics and potentially generate strong profit margins over the next several quarters and likely beyond.

NEAR RECORD HIGHS

The S&P 500's operating margin remains near multi-decade highs despite several challenges. The business cycle is now more than six years old, a bit on the long side relative to history, which has led some to predict profit margin contraction. The economy has produced several years of steady job growth and the unemployment rate (5.1% in September 2015) is low, which would normally bring some upward pressure on wages and hurt margins. To an extent, margins are mean reverting, so they tend to head back to their long-term average after periods of strength such as we have experienced. Interest rates have bottomed, perhaps suggesting that borrowing costs may be poised to move higher.

Yet, despite all of these reasonable arguments for margins to contract, the S&P 500's operating margin remains near multi-decade highs [Figure 1]. We see little reason to expect much, if any, margin contraction for at least the next several quarters. We expect strong profitability to support earnings growth acceleration in late 2015 and early 2016 and provide a favorable backdrop for the stock market.

Click here for Figure 1, "Profit Margins Remain Near Record Highs Despite Energy Drag"

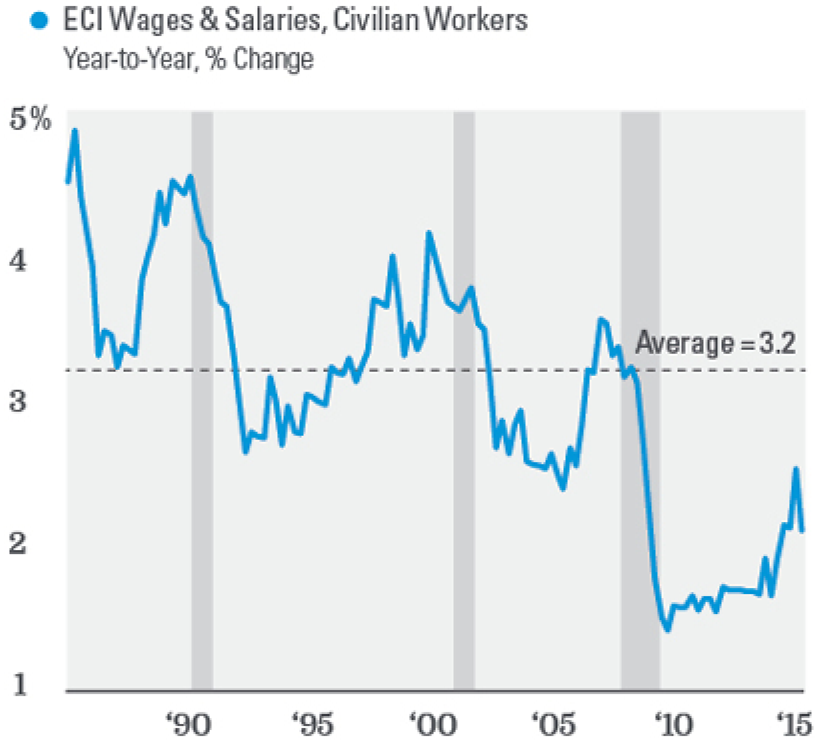
We have seen some margin contraction from multi-decade highs in recent quarters due to the energy sector downturn. Although the sector is only about 10% of the S&P 500's profits, the near halving of the sector's operating margins over the past year to below 7%, also shown in Figure 1, has been felt in overall profit margins (and also in earnings per share [EPS], with a 7% estimated impact to S&P 500 EPS estimates for the third quarter of 2015). Margins have held up quite well considering the energy sector's impact on revenue and margins.

MARGIN DRIVERS

When we break down the components of profit margins, we can see that most of the drivers of recent margin expansion remain intact. Here is a breakdown by category.

Limited wage pressure. By far the biggest component of corporate costs, the cost of labor (wages and salaries) has picked up a bit in recent years but remains well contained at around 2% growth annually, as measured by the Employment Cost Index from the Bureau of Labor Statistics [Figure 2]. This pace of wage growth is below the long-term average of over 3% during the past 30-plus years, supporting margins. The economy has produced five years of fairly steady job gains and an unemployment rate that is poised to drop below 5%, historically the Federal Reserve's (Fed) threshold for full employment; yet wages are rising slowly, except for some small pockets of strength in industries having a difficult time attracting workers with the right skills.

2 LABOR COST PRESSURES REMAIN LIMITED



Source: LPL Research, BLS, Haver Analytics 10/16/15

Shaded areas indicate recession.

The Employment Cost Index (ECI) details the changes in the costs of labor for businesses in the U.S. economy. The ECI is prepared by the Bureau of Labor Statistics (BLS) in the U.S. Department of Labor.

Why are wages rising so gradually? For one, companies still seem to lack confidence in the business cycle. There is also still some slack in the labor market that may not be captured by traditional statistics. Technology and automation have removed some of the leverage employees have to demand higher compensation. There are other reasons, but the bottom line is we do not expect wages to accelerate meaningfully from the recent pace until well into 2016, if not later.

Corporate efficiency. Companies have been doing a tremendous job controlling costs, supporting margins. Sales, general, and administrative costs (SG&A) for the S&P 500 in aggregate have, on average, increased 4.4% annually during the 2010s, compared to 6.9% in the 2000s and 7.0% during the 1990s. More widespread use of technology and automation to improve efficiency is part of the story. Offshoring, where business functions are being relocated to lower cost geographies outside the United States, is another part. The gradual improvement (rather than euphoria) in corporate confidence following the 2008-09 financial crisis is another piece of the margin puzzle. The lack of revenue growth has forced companies' hands and led them to try to squeeze more earnings growth out of a revenue base that has grown more slowly in recent years. A corporate merger boom has enabled cost synergies--2015 may break the record for dollar value of mergers and acquisitions set in 2007 at $4.29 trillion, according to data provider Dealogic.

Cost cuts are not pleasant, but this cost discipline is having the effect of propping up margins, a trend that may continue through the end of the business cycle, even if it were several years down the road.

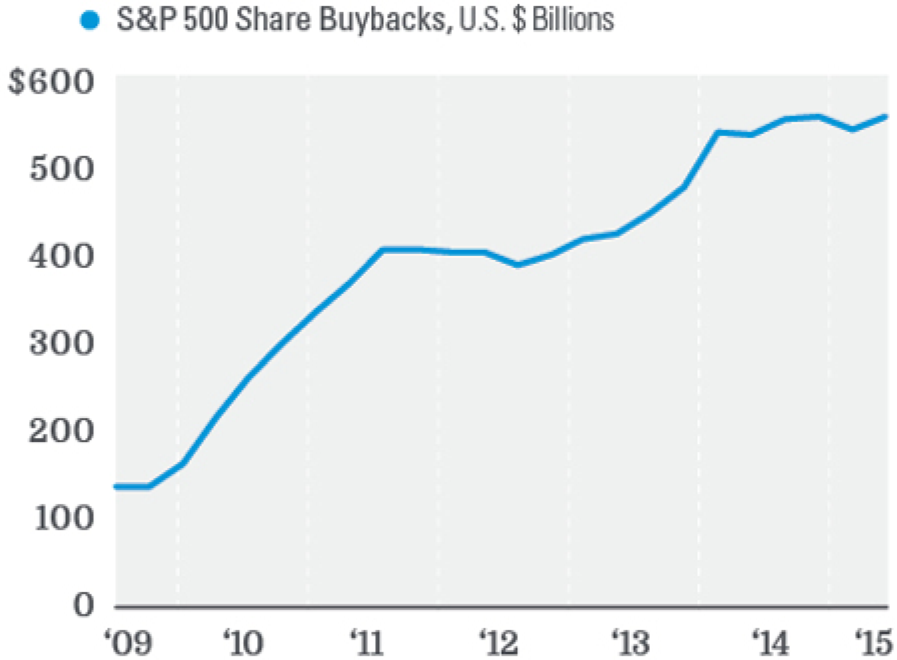
Input costs. Although a smaller portion of corporate costs, input costs have been falling for several years as commodity prices have fallen, benefiting the cost of goods sold (COGS), and therefore, margins. The Bloomberg Commodity Index is down 14% year to date, and 15% and 9% annualized over the past three and five years, respectively. While commodity prices broadly have shown signs of bottoming, we believe a large, sustained increase is unlikely to begin in the near term in the face of China uncertainty and a potentially stronger U.S. dollar.

"Below the line." The aforementioned factors explain most of the margin story, but factors "below the line" are at work here too. Operating margin represents earnings before interest and taxes relative to revenue, or EBIT margin. But earnings after interest and taxes--which translate into the bottom line (or net margin)--and EPS are also getting support from low interest expense and lower taxes. Lower interest rates have reduced borrowing costs, a benefit that will continue because corporations have extended their debt maturities. Tax obligations have been on the decline as globalization has pushed more revenue out to lower tax jurisdictions around the world.

BUYBACK BOOST

Although a capital allocation decision and not a margin driver, share buybacks are supporting EPS by reducing share counts and represent another way many companies are generating some EPS growth on weak revenue. According to Standard & Poor's data, S&P 500 EPS got a boost of 3% over the past year from buybacks alone. Although the pace of buybacks is beginning to slow and capital expenditures may be poised to take a greater share of companies' cash flow, the S&P 500 is on pace to challenge the record level of buybacks set in 2007 of $589 billion [Figure 3]. All of these factors have enabled corporate America to squeeze earnings gains from weak revenue performance in recent years.

3 RISING SHARE BUYBACKS HELPING BOOST EARNINGS PER SHARE



Source: LPL Research, Standard & Poor's 10/16/15

Trailing four quarters data.

CONCLUSION

We expect corporate America to continue to defy the skeptics and potentially generate strong profit margins for at least the next several quarters and likely beyond, as the primary drivers of strong margins remain largely intact. Despite a lack of revenue growth, thanks to limited wage pressure, strong cost control efforts, and falling input costs, the S&P 500's operating margin remains near multi-decade highs. We expect strong profitability to support earnings growth acceleration in late 2015 and early 2016 and provide a favorable backdrop for the stock market.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

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

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All indexes are unmanaged and cannot be invested into directly.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

INDEX DESCRIPTIONS

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.

The Bloomberg Commodity Index is calculated on an excess return basis and composed of futures contracts on 22 physical commodities. It reflects the return of underlying commodity futures price movements.

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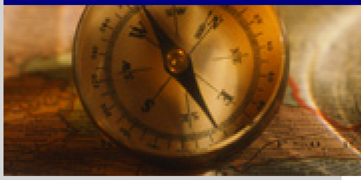


Weekly Economic Commentary | Week of October 19, 2015

KEY TAKEAWAYS

- The latest Beige Book suggests that the U.S. economy is still growing at its long-term trend.
- However, the latest assessment from Main Street suggests that the manufacturing sector is being impacted by drags from the stronger dollar, weaker oil and energy prices, and the slowdown in EM economies.
- Optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book once.

BEIGE BOOK: WINDOW ON MAIN STREET

BEIGE BOOK SUGGESTS CONTINUED MODEST ECONOMIC GROWTH

The latest Beige Book suggests that the U.S. economy is still growing at its long-term trend, but that the drag from a stronger dollar, weaker oil and energy prices, along with the slowdown in emerging market (EM) economies--most notably China--are still having a major impact on the manufacturing sector. The comments in the Beige Book also continue to indicate that some upward pressure on wages is beginning to emerge. Overall, the Beige Book described the economy as expanding at a "modest or moderate" pace in most districts. In general, optimism regarding the economic outlook far outweighed pessimism throughout the Beige Book, as it has for the past two years or so.

The Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Federal Reserve (Fed) districts. We believe the Beige Book is best interpreted quantitatively by measuring how the descriptors change over time. The latest edition of the Fed's Beige Book was released Wednesday, October 14, 2015, ahead of the October 27-28 Federal Open Market Committee (FOMC) meeting. The qualitative inputs for the October 2015 Beige Book were collected from late August 2015 through October 5, 2015. Thus, they captured the Main Street reaction to:

- The first 10%-plus correction in the U.S. equity market since 2011
- Economic and inflation data for July, August, and September 2015 that were generally softer than expected, especially in the manufacturing sector
- A 20% bounce in oil prices following a quick 30% drop in July and August
- Heightened fears of a "hard landing" in the Chinese economy

SENTIMENT SNAPSHOT

To provide a snapshot of the sentiment behind the entire Beige Book collage of data, we created our proprietary Beige Book Barometer (BBB) [Figure 1]. In October 2015, the barometer ticked down to +67 from +95 in September. Roughly half of the 28-point drop came in the three Fed districts (Minneapolis, Kansas City, and Dallas) with the most oil and gas activity. Recall that the +106 reading in July 2015 was the highest reading since April 2013, and the second-highest reading in over 10 years. While a downshift from the past few Beige Books, the +67 reading in October 2015, if sustained, suggests economic growth is running at its long-term trend, and does not indicate that an economy-wide recession is at hand.

HOW THEY WORK
BEIGE BOOK AND BEIGE BOOK BAROMETER

The **Beige Book** compiles qualitative observations made by community bankers and business owners about economic (labor market, prices, wages, housing, nonresidential construction, tourism, manufacturing) and banking (loan demand, loan quality, lending conditions) conditions in each of the 12 Fed districts (Boston, New York, Philadelphia, Kansas City, etc.). This local color that makes up each Beige Book is compiled by 1 of the 12 regional Fed districts on a rotating basis — the report is much more "Main Street" than "Wall Street" focused. It provides an excellent window into economic activity around the nation using plain, everyday language. The report is prepared eight times per year, ahead of each of the eight Federal Open Market Committee (FOMC) meetings. The next FOMC meeting is October 27–28, 2015.

The **Beige Book Barometer** is a diffusion index that measures the number of times the word "strong" or its variations appear in the Beige Book less the number of times the word "weak" or its variations appear. When the Beige Book Barometer is declining, it suggests that the economy is deteriorating. When the Beige Book Barometer is rising, it suggests that the economy is improving.

1 **DESPITE THE 28-POINT DROP, THE OCTOBER 2015 BAROMETER READING SUGGESTS ECONOMIC GROWTH IS RUNNING AT ITS LONG-TERM TREND**

- Number of Times "Strong" (and Variations of This Word) Is Mentioned Minus Number of Times "Weak" (and Variations) Is Mentioned

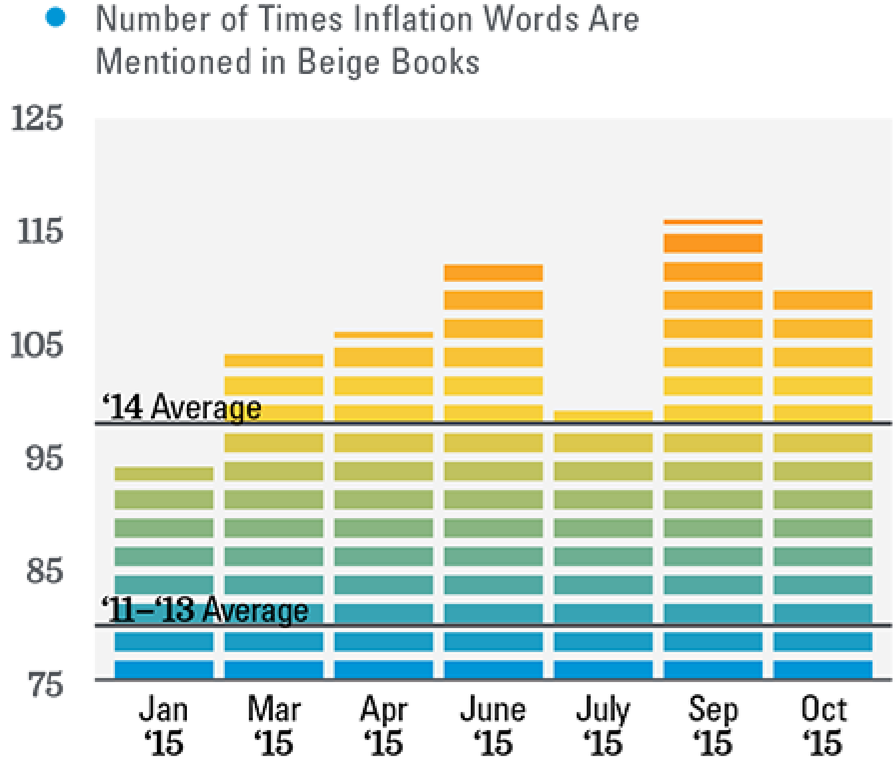
WATCHING WAGES & INFLATION

As it has over the past year, the October 2015 Beige Book noted that employers were having difficulty finding qualified workers for certain skilled positions and some reported upward wage pressures for particular industries and occupations. In the past, these characterizations of labor markets have been a precursor to more prevalent economy-wide wage increases. Indeed, for the first time in this business cycle, Beige Books released over the past 12 months contained several mentions of employers having difficulty attracting and retaining low-skilled workers, and retaining and compensating key workers.

If this trend persists over the next few Beige Books, history suggests it may not be long until Fed policymakers begin to take note of a faster pace of wage inflation in their monetary policy deliberations. However, the Beige Book would likely have to describe wage gains as "widespread" before the Fed would have to act. If the trend toward more inflation signaling words in the Beige Book persists but the economic data remain weak, at some point the Fed may still believe it needs to raise rates to stave off inflation. This is not a concern yet, but something we are watching closely.

Figure 2 shows the recent trend in the number of inflation words in the Beige Book. We counted the number of times the words "wage," "skilled," "shortage," "widespread," and "rising" appeared in recent editions of the Beige Book. In October 2015, these words appeared 110 times, similar to the 116 in September but above the 99 in July 2015. The September/October readings were the highest count so far this year. In all of 2014--when deflation, not inflation, was a concern--those words appeared, on average, 98 times per Beige Book. During 2011-13, also a period when heightened risk of deflation was evident, inflation words appeared, on average, 80 times per Beige Book. We'll continue to monitor this trend closely, as the FOMC has told markets that it will begin raising rates when it is "reasonably confident" that inflation will move back toward 2.0%.

2 SEPTEMBER/OCTOBER READINGS OF "INFLATION WORDS" WERE HIGHEST SO FAR THIS YEAR



Source: LPL Research, Federal Reserve Board 10/15/15

COMMENTS ON OIL & ENERGY STABILIZE AT A HIGH LEVEL

Oil and energy received a total of 56 mentions in the October 2015 Beige Book, in-line with the prior 3 Beige Books dating back to June 2015, but below the average of 74 mentions per Beige Book seen over the first 3 Beige Books released in January, March, and April 2015. For context, energy and oil had around 40-45 mentions per Beige Book in 2011-14 [Figure 3]. Guidance from corporate managements in the manufacturing sector, surveys of manufacturing activity, and "hard" data on manufacturing orders and shipments have been downbeat of late. However, the relative stability in the number of mentions of oil and energy in the Beige Book suggests that the worst may be over for the capital spending cuts, rig count reductions, and job losses in the oil and gas sector.

3 **CHINA, ENERGY/OIL, AND THE STRONG DOLLAR REMAIN TOP CONCERNS**

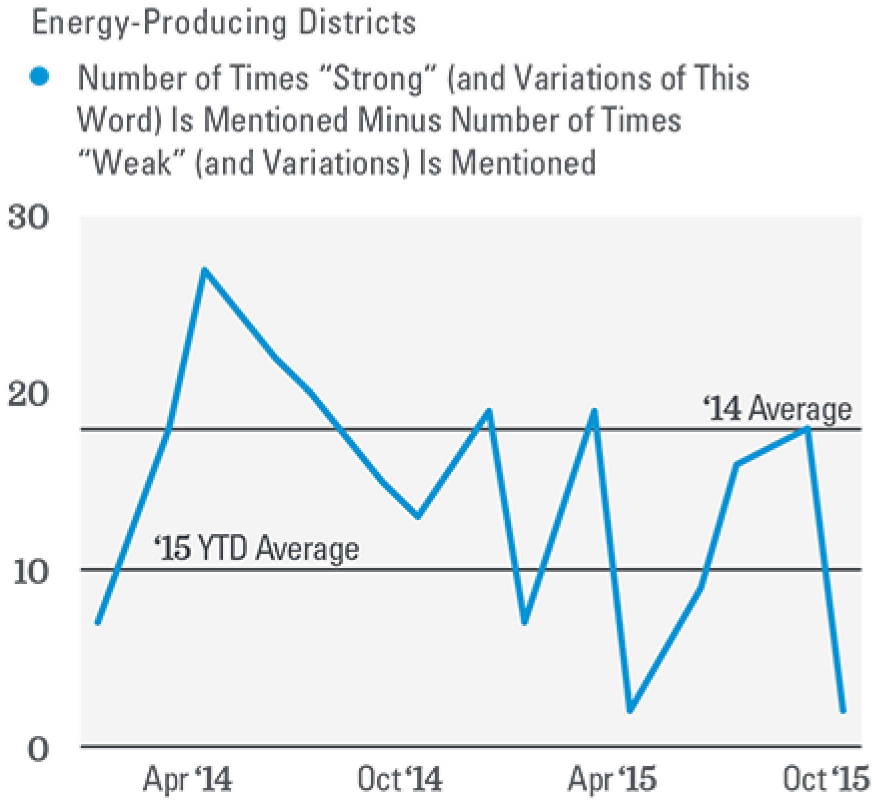
	Uncertainty*	China	Energy/ Oil	Strong Dollar
Oct '15	8	7	56	15
Sep '15	6	11	56	14
July '15	11	0	55	6
June '15	9	1	57	13
Apr '15	12	0	83	12
Mar '15	6	1	68	0
Jan '15	13	4	71	0
'14 Avg	12	2	43	1
'11–'13 Avg	21	2	46	0

Source: LPL Research, Federal Reserve Board 10/15/15

*Uncertainty/Confidence/Shutdown/Debt Ceiling/Fiscal

To better gauge the impact of lower oil prices on the economy, we recently constructed a separate Beige Book Barometer [Figure 4] for the three Fed districts with the most energy-related economic activity (Minneapolis, Kansas City, and Dallas). During 2014, the Beige Book Barometer in the energy-related Fed districts averaged +18. In the first 7 Beige Books of 2015, the barometer in the energy-related districts was just +10, a clear deceleration in activity. After a bounce from +2 in April 2015 to +18 in September 2015, the energy-related barometer dipped to just +2 again in October 2015, matching the April 2015 low. With oil prices year to date averaging around $51 per barrel--45% below the 2014 average price of $92 per barrel--and the year almost over, companies in the oil and gas sector may be throwing in the towel. In one interesting anecdote from the Beige Book on this front, contacts in Houston noted that buyer traffic and sales of high-end apartments have slowed. Still, we point out that even in places like Texas, Louisiana, and Oklahoma, energy accounts for less than 20% of gross domestic product (GDP). However, in the June, July, September, and October 2015 Beige Books, the number of weak words in the energy-related Fed districts (59) alone accounted for one-third of all weak words (171) in the entire Beige Book, indicating that the economic weakness related to the oil and gas sector is still significant.

4 **ECONOMIC ACTIVITY IN ENERGY-PRODUCING DISTRICTS DIPS BACK TO APRIL 2015 LOW**



Source: LPL Research, Federal Reserve Board 10/15/15

As was the case in the Beige Books released thus far in 2015, the October 2015 Beige Book provided many comments from all 12 Fed districts about how lower fuel and energy prices were benefiting multiple industries. In short, comments on the impact of falling oil prices are consistent with our view that falling oil prices will be a net plus for the U.S. economy as a whole, but economies in certain states could see a significant impact from the additional slowdown in drilling activity that is likely to occur over the next 6-9 months or so. (Please see our Weekly Economic Commentary, "Drilling into the Labor Market," for more details. In addition, see the Weekly Market Commentary, "Oil's Long Bottoming Process," for our latest view on oil prices.)

FADING CONCERNS/RISING CONCERNS

Uncertainty around fiscal policy has continued to fade as a concern; however, in some cases it has been replaced by uncertainty surrounding China, the drop in oil and other commodity prices, the stronger dollar, and what all these might be signaling for global growth.

Looking ahead, the fiscal concerns may pick up over the next several Beige Books if Congress doesn't act soon to address the debt ceiling and funding for the federal government. The U.S. Treasury is likely to hit its congressionally mandated borrowing limit in early November, and the funding to run the federal government is set to run out in early December.

China had 7 mentions in the latest Beige Book and 18 in the past 2 Beige Books. The 18 mentions of China in the past 2 Beige Books (September and October 2015) surpass the total number of mentions of China in all 8 of the Beige Books released in 2014 [Figure 3]. China averaged only 2 mentions per Beige Book from 2011-14. As we noted in the Weekly Economic Commentary, "China Challenge," while the Chinese economy has been slowing for more than 5 years, the news media and U.S. financial markets have only recently seemed to have taken note. As has been the case this year, most, if not all, of the mentions of China in the latest Beige Book were in a negative context, but many were also confined to the industrial or manufacturing sector. We continue to expect China to be a key topic in the Beige Book for the foreseeable future.

The concerns about a stronger dollar continued in the latest Beige Book. There were 20 mentions of the dollar in the October 2015 Beige Book [Figure 3], 15 of which were specifically about the "strong dollar," matching the count in September. To put these readings in context, the strong dollar was mentioned, on average, just 1 time per Beige Book in 2014, and got virtually no mentions in 2011-13. While the concern on the strong dollar is mainly from manufacturers, retailers who cater to overseas customers and tourism contacts in areas that traditionally attract overseas tourists (New York, Florida, Nevada, California) also cited the strong dollar as a drag on business.

OPTIMISM STILL RULES

Of the major transitory factors that impacted the economy and the Beige Book in early 2015 (dollar, oil, port strike, bad weather), only oil and the strong dollar remain as concerns. However, neither the dollar nor the other headlines has dampened the optimism on the economy, which has picked up strength in the past year or so.

In the October 2015 Beige Book, the word "optimism" (or its related words) appeared 15 times, whereas the word "pessimism" appeared just once [Figure 5]. Over the first 7 Beige Books of 2015, optimism has appeared, on average, 21 times per Beige Book, while the word pessimism has appeared a total of just 5 times across all 7 Beige Books in 2015, with 3 of the 5 mentions coming in the Dallas and Kansas City districts, who were commenting on the outlook for the oil and gas sector.

5 OPTIMISM CONTINUES TO RUN HIGH ON MAIN STREET

Mentions per Beige Book in:	Optimism	Pessimism
Oct '15	15	1
Sep '15	22	1
July '15	24	1
June '15	19	1
Apr '15	23	0
Mar '15	24	1
Jan '15	21	0
'14	30	0
'13	25	1
'09	9	5
'07	10	1

Source: LPL Research, Federal Reserve Board 09/15/15

As reassuring as it is to see that Main Street can remain optimistic despite the flow of bad news, the large number of optimistic comments in the Beige Book is not the start of a new trend: In the 8 Beige Books released in 2014, the word "optimism" appeared, on average, 30 times. In 2013, "optimism" appeared, on average, 25 times per Beige Book. In the 8 Beige Books released in 2009, during some of the worst of the financial crisis and Great Recession, the word "optimism" appeared, on average, just 9 times.

Concerns that today's economic and market environment is similar to the onset of the Great Recession and the stock market peak in late 2007 also appear to be misplaced. In the 8 Beige Books released in 2007, the word "optimism" appeared, on average, just 10 times per edition--a far cry from the 30 times per edition in the 8 Beige Books released in all of 2014 and the 21 times per edition thus far in 2015.

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

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

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

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Longevity Risk: A Key Consideration in Any Retirement Planning Strategy

Americans are living longer, and in many cases healthier lives than ever before. That's good news. But the downside of living longer is that the chance of you outliving your retirement income is becoming more and more real.

Recent research conducted by the Society of Actuaries (SOA), a leading membership-based organization for actuaries in the United States and Canada, revealed that older Americans are living longer than previously estimated. Specifically, SOA's data showed that since its last report published in 2000 the life expectancy of men age 65 has risen two years from age 84.6 to age 86.6 in 2014. Similarly, among 65-year-old women, longevity rose 2.4 years, from age 86.4 in 2000 to age 88.8 in 2014.[1]

Making Your Money Last

Because of increased longevity, managing cash flow in retirement is more critical than ever. As a starting point you should clarify your current financial situation, as well as any significant changes you expect. Two sources can provide this information:

- A net-worth statement, which provides a snapshot of your assets, debt and cash reserves.
- A monthly or annual budget, with itemized breakdowns of your income and expenses. If you haven't retired yet, it's a good idea to prepare a projected budget of your retirement income and expenses.

Even with reasonable assumptions about investment returns, inflation and retirement living costs, it is likely you will encounter unexpected changes to your cash flow over time. For this reason experts often recommend that you maintain a cash reserve to cover at least 12 months of living expenses in an interest-bearing savings account, though your needs may vary.

You will also need to check your cash flow and budget on a monthly basis in addition to conducting a comprehensive annual review of your financial situation and goals. As you monitor your finances keep the following factors in mind, as any one of them could affect your cash flow and necessitate adjustments to your plan.

- Interest rate trends and market moves may result in an increase or decrease in income from your savings and investments.
- Changes in any of the following could require you to rethink your cash flow assumptions:
    - federal, state and local tax rates and regulations,
    - Social Security or Medicare benefits or eligibility,
    - rules affecting employer-sponsored retirement benefits and private insurance coverage or
    - inflation and health care costs
- Life events such as marriage, the death of a spouse or the addition or loss of a dependent may also affect your cash flow.

Cracking Your Nest Egg

Another critical step in managing longevity risk is to determine how much you can realistically afford to withdraw each year from your personal savings and investments. You can rely on the expertise of a qualified financial professional to assist you with this task. Or, you can use an online calculator to help you estimate how long your money might last.

One strategy that many financial advisors recommend is to stay conservative and withdraw just 4% to 5% of your account balance each year. However, your annual withdrawal amount will depend on a number of factors, including the overall amount of your retirement reserves, your estimated length of retirement, annual market conditions, the expected inflation rate and your financial goals. For example, do you wish to spend down all of your assets or pass along part of your wealth to family or a charity?

No matter what your financial situation going into retirement, there are ways to potentially make what you have last as long as you need it to. Your financial advisor can help you craft, monitor and maintain a cash management plan that works for you.

[1]Society of Actuaries, press release, "Society of Actuaries Releases New Mortality Tables and an Updated Mortality Improvement Scale to Improve Accuracy of Private Pension Plan Estimates," October 27, 2014. The calculations presented are based on public mortality tables, which were developed with certain populations in mind and reflect probabilities based on averages in large populations.