WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

December 2014

Making a positive impact on as many lives as I can.

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Client Letter | "Effects of Lower Oil Prices"

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10 Stock Market Questions for 2015

With 2015 almost here, this week we pose and respond to 10 key stock market questions for 2015. Look for more on these and other topics throughout the year. We bring 2014 to a close with this *Weekly Market Commentary*. Look for our next edition on January 5, 2015. Happy New Year!

Q1: Does the drop in oil prices mean a sharp slowdown in growth is coming?

We don't think so. Overall, we estimate that the $50-plus drop in the price of WTI Crude Oil since June 2014 may boost U.S. gross domestic product by roughly 0.5%. The drop in oil has many beneficiaries, including consumers (who save about $1.4 billion for each 10 cent drop in gasoline prices), airlines, and manufacturers who benefit from access to cheaper fuel. Although some overseas economies--Russia in particular--are hurt by lower oil prices, oil importers such as China and Japan benefit. Lower oil prices will slow the U.S. energy boom and capital investment in the sector but will not stop it.

Q2: Will the Federal Reserve (Fed) end the bull market?

This is unlikely. Although the likely start of interest rate hikes in late 2015 may contribute to an increase in stock market volatility, history has shown that stocks have subsequently performed well when the Fed started to hike rates in response to better growth. During the nine economic expansions over the past 50 years, the S&P 500 has performed well around the first Fed rate hike, suggesting the Fed is unlikely to derail the market next year. The first rate hike has historically come only about halfway through economic cycles and well before bull markets have ended. (See our *Outlook 2015: In Transit* publication for details.)

Q3: Will valuations prevent U.S. stocks from a seventh straight positive year?

Valuations for the S&P 500 remain slightly above the long-term average price-to-earnings ratio (PE) of between 16 and 17 times trailing earnings, indicating a slightly expensive market. However, given that valuations have a poor record of timing market tops, and considering our positive earnings outlook, we do not expect above-average valuations to lead to an end of the bull market. As noted in our *Outlook 2015: In Transit* publication, we expect high-single-digit earnings growth to drive stock prices higher next year, supported by 3%-plus U.S. gross domestic product (GDP) growth, stable profit margins, and low interest rates, accompanied by little change in PEs.*

Q4: Is a potential European recession a risk to U.S. stocks?

Europe is teetering on the brink of another recession as the Eurozone struggles to return to reasonable growth, which leads us to favor U.S. markets over developed foreign markets, despite prospects for quantitative easing from the European Central Bank (ECB) next year. But we do not expect the continent's malaise to disrupt the U.S. stock market much, if at all, in 2015. Even without help from Europe, we expect the global economy to grow slightly faster in 2015 than it did in 2014 (when Europe helped very little). U.S. companies have managed the slowdown in Europe well thus far, helped by the relatively limited amount of revenue (about 15%) derived from the Eurozone. (See our two-part *Weekly Market Commentary,* "Don't Fight the ECB?" from September 15 and 22, 2014.)

Q5: Will EM outperform the U.S. in 2015 after underperforming for four years?

This is possible, but we would expect outperformance to come more from the latter part of the year. We continue to favor U.S. stocks over emerging markets (EM) as 2015 begins, but compelling valuations, better growth prospects, and the potential for more stimulus efforts should set up a very attractive entry point for EM next year. We would like to see evidence of sustained improvement in relative performance compared with the U.S. before becoming more positive on EM, which could come from stable oil prices and a pickup in earnings growth. (See our *Weekly Market Commentary,* "Emerging Markets Opportunity Still Emerging," from November 17, 2014.)

Q6: Will Washington help (or hurt) the stock market?

We expect the policy environment to be broadly supportive in 2015, and we believe that Republican control of Congress could have meaningful impact. We see tax reform as possible, albeit piecemeal, which the market should welcome. The Affordable Care Act (ACA) is unlikely to be repealed, but it will likely be changed, which could create investment opportunities in healthcare. Bank regulations may be eased. Energy policy may encourage faster development and more exports. And 2015 is the third year of the presidential cycle, which has historically been good for stocks. We also do not expect a disruptive debt limit fight this spring. (See our *Weekly Market Commentary,* "Favorable Policy Environment for Stocks in 2015," from December 8, 2014.)

Q7: After topping all equity sectors in 2014, will healthcare deliver again in 2015?

Healthcare has been the top-performing sector in 2014 with a nearly 30% return (according to the S&P 500 Health Care Index), and we expect another good year in 2015. The sector has benefited from robust innovation that has driven significant biotech and, to a lesser extent, pharmaceutical gains. New development and increased demand related to broader insurance coverage under the ACA have helped drive double-digit earnings gains each quarter this year and will likely do so again in the fourth quarter, based on Thomson Reuters consensus estimates. We find the sector's combination of strong earnings, technical momentum, and still reasonable valuations to be potentially attractive as the business cycle ages.

Q8: Does the sharp sell-off in energy present an attractive buying opportunity?

Despite significant underperformance, we suggest patience for several reasons. Neither OPEC nor U.S. producers have shown interest in reducing supply. The U.S. supply overhang remains significant. It will take some time for demand to respond to lower prices. Valuations are not yet compelling, given the dramatic reduction in sector earnings estimates as oil prices fell and industry capital spending plans were cut back. And from a technical perspective, after the long-standing price range between $80 and $110 failed to hold, the latest bounce has not provided enough technical evidence for us to forecast a sustainable turn in relative performance.

Q9: Will small caps stage a comeback?

We think so, but we do not expect it to be lasting. The good news for small caps is that they are more U.S. focused than their large cap counterparts and valuations have become more reasonable after recent underperformance (though they are still a bit high). Small caps should also benefit from a continued healthy credit environment, as small companies are more credit dependent. As 2015 progresses, we expect a possible leadership shift toward large caps--one that may possibly be sustained during the latter part of the business cycle.

Q10: Will active management begin to add value in 2015?

Despite several disappointing years, we expect active managers may perform better in 2015. Managers in general should benefit from improved performance from the cyclical equities that they tend to favor, and from corresponding weaker returns for the most interest rate sensitive sectors that tend to be under-owned by fund managers as bond market strength possibly abates. Potentially increased stock market volatility should help provide more opportunities. Greater dispersion among individual stocks is likely to increase the potential opportunities for active managers.

**As noted in the Outlook 2015: In Transit, LPL Financial Research expects GDP to expand at a rate of 3% or higher, which matches the average growth rate of the past 50 years. This is based on contributions from consumer spending, business capital spending, and housing, which are poised to advance at historically average or better growth rates in 2015. Net exports and the government sector should trail behind.*

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, disease, and regulatory developments.

The PE ratio (price-to-earnings ratio) is a valuation of a company's current share price compared with its per-share earnings. A high PE suggests that investors are expecting high earnings growth in the future, compared with companies with a lower PE.

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

Investing in specialty markets and sectors, such as healthcare or financials, carries additional risks, such as economic, political, or regulatory developments that may affect many or all issuers in that sector.

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.

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 reference 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.

Stock investing involves risk including loss of principal.

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 S&P 500 Health Care Index comprises those companies included in the S&P 500 that are classified as members of the GICS healthcare sector.

This research material has been prepared by LPL Financial.

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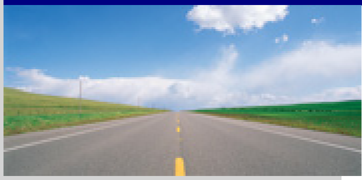

Client Letter | "Effects of Lower Oil Prices"

Dear Valued Investor,

Oil prices may be turning into the Grinch of this holiday season. Oil has dropped by more than 40% in just the past three months and contributed to volatile stock markets. LPL Financial Research does not believe the sharp drop in oil prices is a sign of significant deterioration in the U.S. or global economy. The stunning collapse does have wide-ranging impacts on the economy and markets, but LPL Research believes the risks associated with low oil prices can be manageable and that the positives outweigh the negatives.

Lower oil prices benefit the U.S. economy in a number of ways. By saving U.S. consumers tens of billions of dollars at the gas pump and in home energy bills, it is estimated that the $50-plus drop in the price of oil since June 2014 boosts U.S. gross domestic product by roughly 0.5%. That is significant, but it is important to keep in mind that U.S. consumer spending totals $12 trillion per year, and that consumers spend an average of just 4% of their incomes on energy. Still, this is a benefit to consumers, especially for those at lower income levels who spend a bigger portion of their incomes on energy.

The U.S. manufacturing sector is also a beneficiary of lower energy costs. Although not nearly as energy intensive as they used to be, industrial companies benefit from lower oil prices via lower transportation and production costs. Just a penny drop in fuel prices can save tens of millions of dollars for an airline. And lower oil and other commodity prices mean lower raw material costs.

These are all good things, but there are offsetting factors. Lower energy prices will slow--but not stop--the U.S. energy renaissance. Less U.S. energy production may mean slightly fewer energy jobs (energy jobs are about 2% of total U.S. jobs) and less business investment for future projects or expansion. The oil and gas industry drives a significant portion of business investment, so services, equipment, and infrastructure companies that service the oil producers will feel some impact.

Sharply lower oil has already impacted financial markets. The roughly 20% drop in the S&P 500 energy sector, which composes 8.3% of the S&P 500, may continue to drive increased volatility for the broad stock market indexes. The fixed income markets are also impacted, as energy composes about 15% of the high-yield bond benchmark, the Barclays High Yield Bond Index. Lower oil prices are likely to crimp profitability and may impact the ability of weaker companies to meet their debt obligations. However, it is expected that much of this negative impact is factored into market prices, and widespread defaults across the sector are not expected, should oil prices stabilize somewhere near current prices.

Most importantly, the U.S. economy is doing quite well and I think it may get a bit better in 2015, as highlighted in LPL Research's recently published *Outlook 2015: In Transit* publication. I do not believe oil's sharp decline should be interpreted as a sign that an economic downturn is forthcoming. It is very difficult to predict where oil prices are going from here, but the oil market has likely overreacted to supply pressures and should begin to stabilize over the next several months, as lower prices help buoy demand and discourage some of the higher cost production. Although the severity of the drop in oil prices has been alarming and brings some risk to markets, at this point, in terms of what it means for the economy, I believe the positives outweigh the negatives.

As always, if you have questions, I encourage you to contact me.

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