HBK Wealth Management
Haire · Bohmer · Kilcoyne

# WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

July 2016

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.

**David Haire**
HBK Wealth Management
President
9360 Montgomery Rd.
Cincinnati, OH 45242
513-942-9700
Fax: 513-942-9701
d.haire@hbkwealthmanagement.com
www.hbkwealthmanagement.com

## In This Issue


Weekly Economic Commentary | Week of July 18, 2016

## MIDYEAR OUTLOOK 2016: BELIEVING IN THE POTENTIAL OF THE U.S. ECONOMY

### KEY TAKEAWAYS

- Looking out into the second half of the year, we expect the U.S. economy may grow between 2.0% and 2.5%.
- Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year.
- We continue to keep a close eye on the progression of labor market growth and inflation.

*This week's commentary features content from our* Midyear Outlook 2016: A Vote of Confidence, *published July 12, 2016.*

For the first half of 2016, the U.S. economy-as measured by real gross domestic product (GDP)-is on track to grow at around 2.0%. Looking out into the second half of the year, aided by a dollar tailwind, stable oil prices, steady consumer spending, record high household net worth, and a slowing, but still solid labor market, the U.S. economy may grow between 2.0% and 2.5%. But even at just over 2%, actual GDP is growing faster than potential GDP (the maximum pace the economy can grow without causing inflation), taking up slack and slowly pushing up wages and inflation. If this persists, the Federal Reserve (Fed) is likely on a path of one rate hike this year. Although the Brexit vote in late June 2016 may slightly lower U.S. GDP growth in the second half of 2016, we do not expect the U.S. to enter a recession this year.

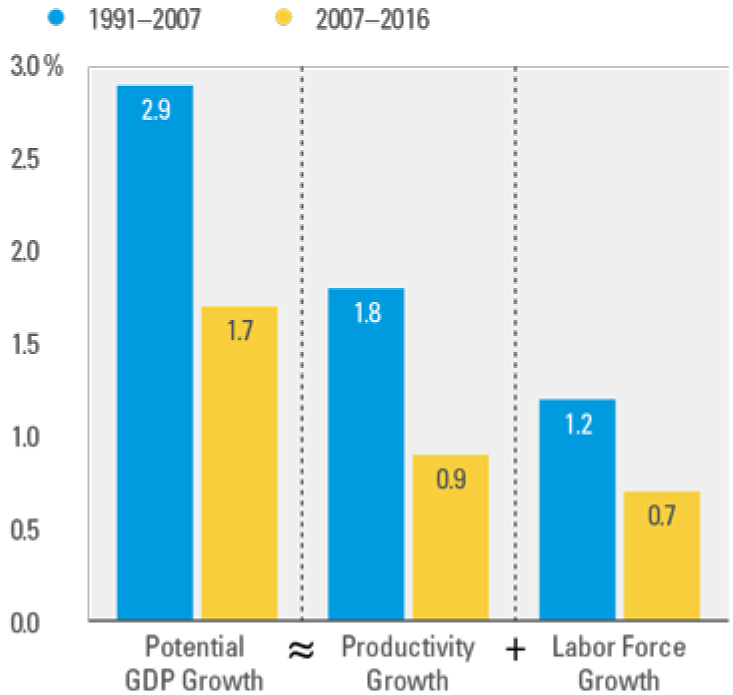
This economic recovery, now seven full years in, has been marked by a slower pace of growth than some would expect or hope for, and in some cases this pace has varied greatly across sectors of the economy and even regions in the U.S. Depending on the source, headlines range from "solid economic recovery moves forward" to "stagnant, below-trend growth persists." So, which is it? Digging into the data shows that it's probably a little bit of both, and likely lands somewhere in the middle. Although this pace of growth may be below trend, we maintain our confidence in the potential for continued U.S. economic growth in 2016.

Please see our *Midyear Outlook 2016: A Vote of Confidence* for in-depth insights on the economy, stock and bond markets, and investments for the second half of the year.

### THE BAR HAS BEEN LOWERED FOR GDP

To understand why GDP growth has recently been below the historical trend of 3%, it's important to look at its core components. The maximum rate at which the economy can grow without causing inflation (formally known as "potential GDP") is shown in **Figure 1**. The "building blocks" for potential GDP are productivity growth and labor force growth. The figure clearly illustrates that potential GDP and both of its building blocks have slowed since the onset of the Great Recession, relative to the decade and a half prior to it.

1 THE BUILDING BLOCKS OF POTENTIAL GDP, PRIOR TO AND SINCE THE GREAT RECESSION




Source: LPL Research, Organization of Economic Cooperation and Development 06/30/16

Past performance is not indicative of future results.

Since the end of the Great Recession, the causes of-and potential remedies for-the anemic pace of economic growth have been hotly debated by investors, business leaders, and policymakers alike. Productivity (as measured by output per hour worked) is slowing, not only here in the U.S., but around the world. The debate is whether the slowdown in productivity is cyclical (largely due to the nature and severity of the Great Recession), structural, or something else. That something else usually being a "measurement problem"; in a global economy that has become more service oriented and technology driven, it is more difficult to measure productivity the old-fashioned way, i.e., measuring the amount of hours of labor required to put out a particular amount of goods.

Labor force growth is the less flexible building block of potential GDP; demographics and long-term secular labor trends are difficult to reverse in the short term. There is some reason for optimism on the productivity side of the equation.

Still, improvement from the recent tepid pace of productivity will likely require, at minimum, better coordination between businesses, labor, and governments at all levels, and almost certainly more monetary and fiscal policy coordination among policymakers worldwide. Governments in the U.S. (federal, state, and local) and around the globe should be encouraging more spending on public and private infrastructure, training more existing and potential workers to be more productive in the 21st century economy, and keeping regulatory burdens low to allow businesses to thrive.

The Great Recession still looms large for many, but ultimately, businesses, governments, and individuals need to look forward and think about how to invest wisely in the future to drive renewed productivity growth. We have vast reserves of know-how. Future productivity gains will depend on how well we put them to work.

**OUR GOOD FRIEND, THE FED**

Much like the views on the pace of economic growth, there has been a consistent disconnect between the market's expectation of Fed rate hikes and the Fed's guidance on future hikes. At the start of 2016, the federal funds futures market was pricing in two 25 basis point (0.25%) rate hikes for the year, versus the Fed's December 2015 guidance that it planned four hikes in 2016. In late February 2016, the fed funds futures market didn't see a rate hike until the end of 2017. Since then, the Fed has guided markets to expect just two hikes this year. The Fed had remained adamant that these hikes will happen, until just after the Brexit vote in late June 2016, when the Fed signaled a more cautious approach for this year.

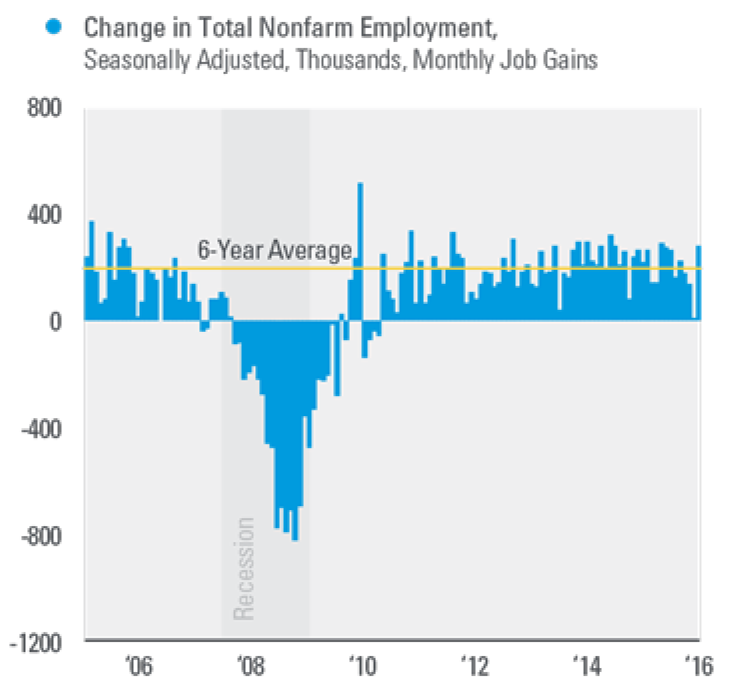
Given both the direct and indirect impacts of Brexit on the U.S. economy and financial system, we are now expecting the Fed to raise rates just once this year, potentially in December 2016. If Brexit uncertainty lingers, putting more downward pressure on the U.S. economy and inflation-and more pressure on financial conditions than we now expect-it is possible that the Fed could choose to stay on the sidelines all year. Similarly, if the impact of uncertainty around Brexit is short-lived, it is still possible that the Fed may hike rates twice this year, matching the forecast we made in November 2015. Three rate hikes by the Fed this year, which was a small possibility prior to the Brexit vote, now seems very unlikely. Brexit vote aside, fundamentally it comes down to the labor market and inflation. So what do we expect to see over the remainder of 2016?

**THE LABOR MARKET: IT ALL COMES DOWN TO TURNOUT**

The labor market could be on the cusp of a slowdown in job creation. Even after surprisingly weak job growth in April and May 2016 (averaging just 80,000 per month), over the past six years, the U.S. economy has created more than 13.6 million net new jobs, an average of between 175,000 and 200,000 per month. Over that span, the unemployment rate has dropped from nearly 10% to 4.9%, and wage inflation (as measured by the year-over-year gain in average hourly earnings) has moved from a low of near 1.5% to over 2.6%. History suggests that given where we are in the business cycle, and how far the labor market has come, a routine downshift in the labor market may be at hand. "Temporary help" jobs, a key leading indicator of future job growth, have fallen by more than 40,000 jobs in the first six months of 2016. If sustained, this suggests a slowdown in overall job creation later this year.

Market participants may view this downshift as a sign that the economy is slowing, and may even begin preparing for the next recession and next set of rate cuts from the Fed. But here's where the market and the Fed may be at odds. In a series of public appearances over the past few years, Fed officials noted that monthly job gains as low as 120,000 would still be enough to tighten the labor market, take up slack in the economy, and push up wages and ultimately inflation. Whereas the market would likely view a downshift to job creation of 120,000 jobs per month-or even 160,000 per month-as a sign of a slowing economy, and begin to worry about global growth and the onset of a recession **[Figure 2]**. Yet another disconnect between the Fed and the market to worry about.

2 FED SAYS JOBS TARGET IS 125,000–150,000; MARKET LIKELY EXPECTS MUCH HIGHER




Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 07/08/16

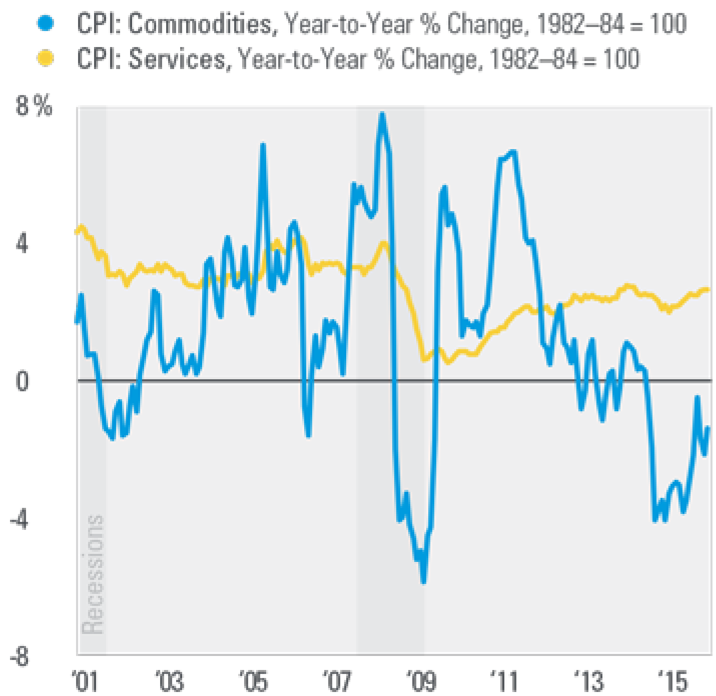
**INFLATION: BATTLEGROUND STATE**

The aftershocks of the Great Recession, plenty of global spare capacity, slower global GDP growth, and the globalization of product and labor markets have acted as restraints on inflation in recent years. However, at least in the U.S., the factors pushing inflation higher may begin to win the battle over the second half of 2016 and beyond.

The recent rise in commodity prices off the early 2016 lows increases the odds that inflation will continue to move toward the Fed's longer-run 2% target by year-end. The overall reading on the Consumer Price Index

(CPI) at midyear is running at just 1.1% year over year; but beneath the surface, CPI for services (two-thirds of CPI) has recorded a 2.7% year-over-year gain-placing it in the middle of its recent range. Meanwhile, CPI for commodities (one-third of CPI) was down 1.4% year over year in May, but for much of 2015 and early 2016 that figure was closer to down 4% **[Figure 3]**. If oil and gasoline prices stay in their recent ranges, CPI for commodities will turn positive in the second half of 2016 and push overall CPI close to 2%. By then, the Fed may have already raised rates again.

**3 IN THE U.S., FACTORS PUSHING INFLATION HIGHER MAY BEGIN TO WIN THE BATTLE OVER H2 2016 AND BEYOND**




Source: LPL Research, Bureau of Labor Statistics, Haver Analytics 06/30/16

Data for CPI are as of May 31, 2016, the most recent data available.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services, and is a commonly used measure of inflation.

While headline inflation remains low, most consumers would say that there is plenty of inflation, and they have the grocery and gasoline bills to prove it. In the 1960s, 1970s, and early 1980s, soaring inflation was a big concern in the voting booth; but today, low inflation-and the low wage increases that have accompanied it lately-are the big issues. The latest survey of consumer inflation expectations (via the University of Michigan's Survey of Consumers) revealed that consumers expected 2.3% inflation over the next 5-10 years, the lowest on record. But these days, consumers equate low inflation to slow wage growth. The good news is that those grocery prices are down nearly 1% and have been roughly unchanged for the past 18 months or so. The bad news (for politicians, at least) is that gasoline prices are up by nearly 75 cents per gallon since early this year-and if that trend continues into the summer and early fall, rising inflation could still become a key issue in the 2016 race.

*IMPORTANT DISCLOSURES*

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*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.*

*This research material has been prepared by LPL Financial.*

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Weekly Market Commentary | Week of July 18, 2016

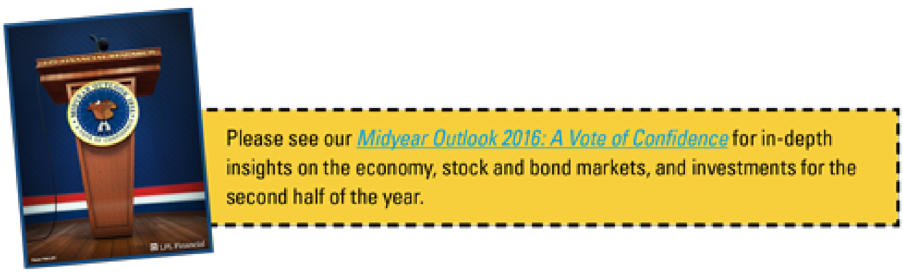
## KEY TAKEAWAYS

- We expect mid-single-digit returns for the S&P 500 in 2016, consistent with historical mid-to-late economic cycle performance, driven by a second half earnings rebound.
- Key risks include a policy mistake from Washington or the Fed, geopolitics, and a surprising pickup in inflation. Bouts of volatility are likely.
- We hope for more capital investment in the second half of 2016 and beyond.

## MIDYEAR OUTLOOK 2016: CAMPAIGNING FOR MORE INVESTMENT

This week's commentary features content from our *Midyear Outlook 2016: A Vote of Confidence*, published on July 12, 2016.

We continue to expect mid-single-digit returns for the S&P 500 in 2016, consistent with historical mid-to-late economic cycle performance. As discussed in our just released *Midyear Outlook 2016: A Vote Of Confidence*, we expect those modest second half gains to be derived from mid- to high-single-digit earnings growth over the second half of 2016, supported by steady U.S. economic growth and stability in oil prices and the U.S. dollar. A slight increase in price-to-earnings ratios (PE) above 16.6 is possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe, and begin to price in earnings growth in 2017. Low interest rates continue to provide support for stock valuations. Key risks include a policy mistake from Washington or the Federal Reserve (Fed), geopolitics including political uncertainty in Europe, and a surprising pickup in inflation that leaves the Fed playing catch-up. We expect to experience more bouts of volatility given these risks and the age business cycle.

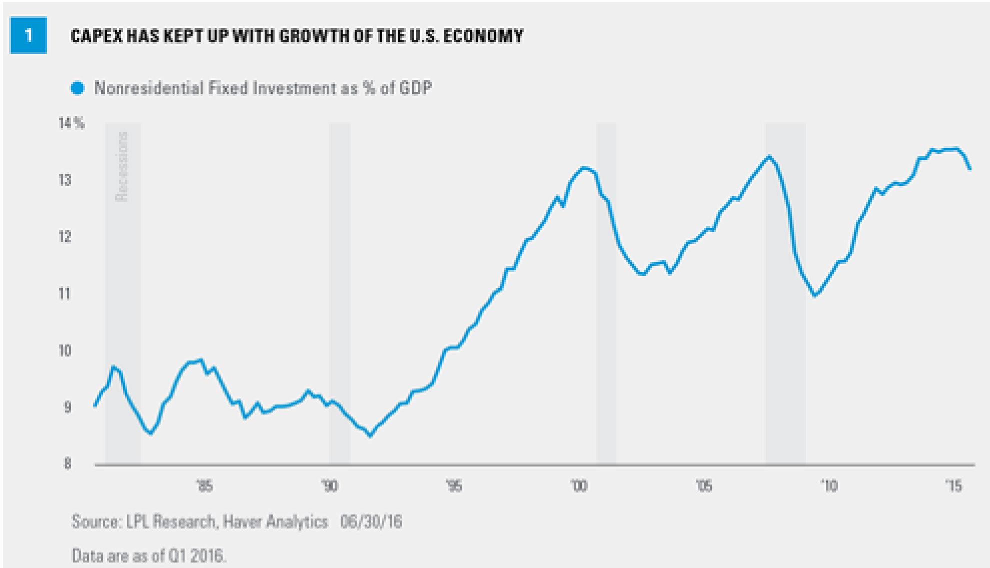



### THE ROAD TO A BETTER TOMORROW THROUGH CORPORATE AMERICA

Is corporate America investing enough in its future? A popular worry on Wall Street--and even on Main Street out on the campaign trail--is that companies are returning too much cash to shareholders and not investing enough in future growth in the form of capital expenditures (or capex).

The current economic expansion, with a 2% average growth rate since the end of the Great Recession, has been sub-par. That slow growth has coincided with below-average growth of capex. But has corporate America been underinvesting? We would say yes, but the level of investment may be appropriate for an economy exhibiting slow growth. It does not appear that capex dollars are being crowded out by other competing capital allocation decisions, and the energy downturn is a big part of the weak investment story.

Figure 1 shows that our proxy for capex (nonresidential fixed investment) remains at the high end of its historical range relative to the size of the U.S. economy. By this measure, companies are investing in property, plant, equipment, and intellectual property at an even higher rate, relative to the size of the economy, than they have historically. When considering the more than 30% reduction in energy capex since oil peaked in June 2014, the level of capex looks much better. This suggests that the level of investment may be on target given the level of economic activity. That's not great news, but it suggests that if economic growth picks up and the energy recovery continues, as we expect, capex would turn higher.




**WHERE IS CAPITAL GOING NOW?**

There are four primary potential destinations for companies' excess capital:

- Share repurchases. We do not believe that companies' desire to return more capital to shareholders through share repurchases is much of an impediment to capex. In dollar terms, share repurchases for S&P 500 companies are near record highs, with $572 billion returned to shareholders in 2015. But when measured against market capitalization to create a repurchase yield, share repurchases are below the 10-year average (3.0% versus 3.2%).
- Dividends. The total dollar amount the S&P 500 paid out in dividends in 2015 of $385 billion was an all-time high and 2016 is shaping up to be another record year. But the dividend yield on the S&P 500--the size of that dividend pie relative to the total market capitalization of the index stands at 2.1%, in-line with the 10-year average and well below the 50-year average of 3.0%. Looking at dividends another way, companies are paying out a slightly smaller portion of earnings than they have historically, suggesting dividends are not crowding out investment.
- Mergers. Buyers globally announced approximately $4.0 trillion in mergers and acquisitions in 2015, surpassing 2007 for the most on record. The environment in the U.S. remains ripe for mergers over the rest of 2016 and into 2017 with modest economic and earnings growth, low interest rates, and generally favorable credit conditions, although Brexit and U.S. election uncertainty remain wild cards.
- Debt repayment. Debt repayment was a popular destination for excess capital immediately after the financial crisis, as companies shored up weakened balance sheets and took advantage of lower interest rates to refinance existing debt and extend maturities. With those maturities extended at low borrowing rates, debt repayment is much less impactful.

We are hoping for more capital investment in the second half of 2016 and beyond, supported by these four factors:

- Stronger economic growth. More growth would lead to greater use of the economy's excess capacity, which would eventually spark more capital investment. Fiscal policy may provide a boost in 2017 as both presidential candidates favor increased infrastructure spending, although protectionist trade policies and Brexit-related uncertainty could work in the opposite direction.
- An earnings rebound. We do expect a solid rebound in S&P 500 earnings in the second half of the year even in the event of potential modest upward pressure on the U.S. dollar. More earnings would mean companies have more to invest.
- Favorable credit conditions. Credit conditions remain generally favorable with low interest rates, strong corporate balance sheets, manageable debt service costs, and generally receptive markets for debt offerings. In general, we expect these conditions to remain favorable, although we are watching developments in Europe closely.
- More confidence. The lackluster economic recovery has left some CEOs lacking the confidence to invest. U.S. elections will likely bring greater policy clarity--we have very little now--and hopefully increase corporate confidence. Prospects for a relatively smooth transition for the U.K. out of the EU would also help.

**THERE IS HOPE FOR EARNINGS**

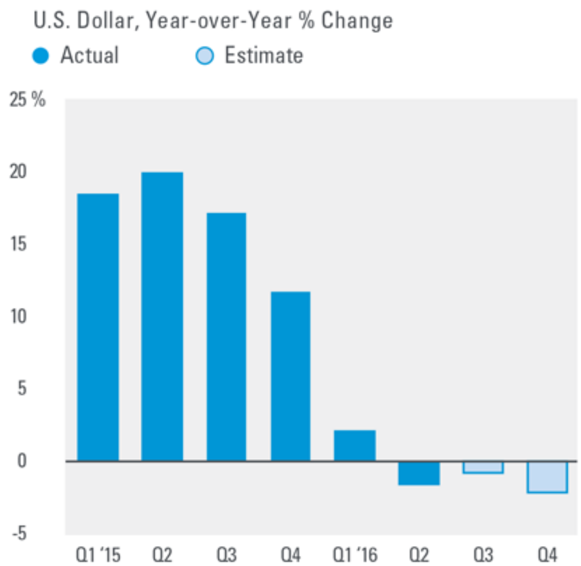
We continue to believe the conditions are in place for a solid rebound in corporate profits during the second half of 2016. After a slow start to the year, we expect 2-2.5% economic growth in the second half, as measured by gross domestic product (GDP). Nominal economic growth, which includes inflation and may exceed 4%

during the second half, is highly correlated to corporate revenue. S&P 500 revenue is expected to rise 3.6% in the second half based on consensus estimates. The recent improvement in the Institute for Supply Management's (ISM) Purchasing Managers' Index (PMI) for manufacturing, which has shown high correlation to corporate profits historically, is encouraging.

**Drags from U.S. Dollar & Oil Should Ease**

The U.S. dollar, should it remain near current levels, would be a potential tailwind for earnings in the third and fourth quarters of 2016, after representing as much as a 20% drag on foreign earnings in the second quarter of 2015 [Figure 2]. We do not expect a prolonged U.S. dollar rally as a result of Brexit, but that remains a risk to earnings in the coming months.

**2 U.S. DOLLAR HAS TURNED INTO AN EARNINGS TAILWIND**




Source: LPL Research, FactSet 06/30/16

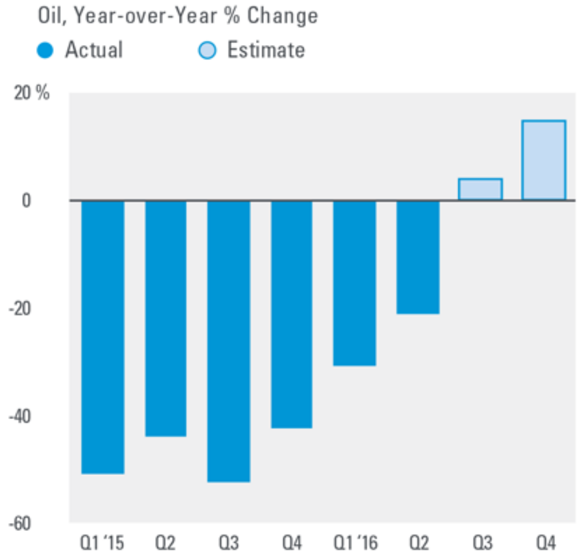
*Changes for Q3 and Q4 are based on the assumption that the U.S. dollar stays at its 06/30/16 level of 95.64 for the rest of the year.

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.

Past performance is no guarantee of future results.

Should oil prices stay at current levels, the commodity would show year-over-year price gains in the third quarter of 2016 [Figure 3]; this, along with the significant capital spending and other cost reductions undertaken by oil and gas producers, could potentially enable the energy sector to reach consensus double-digit earnings gains by year-end and propel overall S&P 500 profit margins back to near record highs. A potential Brexit-driven rally in the U.S. dollar that drags oil prices lower is a risk.

3 **OIL COULD SHOW YEAR-OVER-YEAR PRICE GAINS BY THE THIRD QUARTER**




Source: LPL Research, FactSet 06/30/16

*Changes for Q3 and Q4 are based on the assumption that oil prices stay at their 06/30/16 level of $48.33 for the rest of the year.

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.

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**Wages Remain in Check**

Finally, although wage pressures are starting to build, and wages are the biggest component of companies' cost structure, increases have been gradual. Wage inflation remains below levels of prior decades based on the government's Employment Cost Index (ECI) for wages. The most recent ECI reading in the first quarter of 2016 increased 2.1% year over year (on an inflation-adjusted basis), compared to the 30-average of 3.0%. In the June payroll survey (released July 8), average hourly earnings rose 2.6%. So far, excluding the energy sector, S&P 500 companies have done an excellent job of absorbing wage increases over the past two years. As long as wage gains remain gradual, we do not see them as a material threat to corporate earnings.

## HOW TO INVEST: DOMESTIC EQUITIES

As the economic expansion transitions from mid-cycle to the latter stages, we favor the generally less volatile and higher-quality large cap stocks, although elevated market volatility may provide opportunities to trade small and mid caps. We expect continued, though modest, economic growth to favor growth over value as markets reward those companies that can produce above-market earnings growth. An aging business cycle could mean a surprise late-year pickup in inflation, supporting the energy sector and high-yielding master limited partnerships (MLP). The latter stages of the business cycle also offer a historically attractive opportunity for healthcare investments, which are attractively valued due to the market's overly pessimistic view of political risks, in our view.

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*All investing involves risk including loss of principal.*

*Investing in MLPs involves additional risks as compared with the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLPs.*

*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.*

*Currency risk 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.*

*Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.*

*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 Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.*

*The Bureau of Labor Statistics' (BLS) Employment Cost Index (ECI) is a quarterly release which gives information on the costs of labor for businesses in the United States.*

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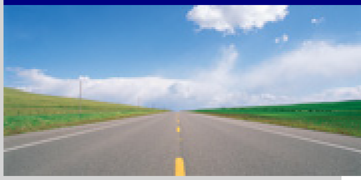

# Midyear Outlook 2016 | July 2016

Dear Valued Investor:

The recently released *LPL Research Midyear Outlook 2016: A Vote of Confidence* publication contains the guidance and investment insights to support you throughout the rest of this year. As we embark on the second half of 2016, the headlines and much of our attention will be focused on the 2016 presidential election, which can distract us with the barrage of promises and heightened political drama. Against that backdrop, however, we must strive to remain focused on our long-term investment plans.

LPL Research proposes a vote of confidence in the economy, the market, and most importantly, in our ability as investors to remain focused on our long-term goals. This is not always easy; but a vote of confidence means having the belief that someone or something has the ability to succeed. It is more than being positive or negative, a bull or a bear. It is about trusting our assessments of the opportunities--and risks--that may lie ahead, formulating a solid investment plan, and sticking with it through the ups and downs we may face in the coming months and beyond.

Our emotions were tested at the start of 2016, and again in late June. The S&P 500 had its worst start to a year ever; then, after coming back to within 3% of a new all-time high, met new opposition from the unlikely candidate of Brexit, as the United Kingdom voted to leave the European Union. Yet, two weeks after the vote on June 23 and the consequent volatility in the markets, the S&P 500 was back in positive territory--up over 4% for the year. This resilience has kept this bull market going, and the S&P 500 is expected to potentially post gains by the end of the year.

Looking ahead to the rest of 2016, LPL Research maintains confidence in its existing forecasts, with some minor adjustments. Periods of volatility are also anticipated throughout the rest of this year, but the expectation remains that we will not enter a bear market or economic recession. Here are some of the key influential factors to be watching for:

- **Federal Reserve (Fed) rate hikes.** The forecast for Fed rate hikes in 2016 has been reduced from two to one, with additional rate increases next year.
- **International growth uncertainty.** We are looking for clarity around future global growth, due to Brexit, the impact of the U.S. dollar, China's debt problem, and earnings growth in Europe and Japan.
- **Corporate America investments.** A pickup in economic growth and an energy sector turnaround may boost companies' investments in their future growth, an element that has been lacking recently.
- **Second half turnarounds: oil, dollar, earnings.** These three turnaround stories are key for the rest of 2016. Should the drags from oil prices and the U.S. dollar continue to ease, an earnings rebound may occur in the second half of the year.

The *LPL Research Midyear Outlook 2016* provides the "vote of confidence" that the current economic recovery and bull market may continue through 2016 and beyond, with the investment insights and market guidance for what may lie ahead for the rest of this year.

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

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*Bonds are subject to market and interest rate risk if sold prior to maturity. Bond and bond mutual fund values and yields will decline as interest rates rise and bonds are subject to availability and change in price.*

*The S&P 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.*

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