# Weekly Market Commentary

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## The Second Half

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### Highlights

Our outlook over the second half of 2012 remains on track based on the beliefs we laid out in our *2012 Outlook.*

We continue to believe that the U.S. economy will grow about 2%, the U.S. stock market is likely to post an 8–12%* gain, and corporate bonds will outperform government bonds as they post modest single-digit gains.**

The issues facing investors in the second half of 2012 may not be so dramatic or as prone to disappointment as they may at first seem.

In the first half of the year, investors focused on the need for capital by European banks. In the second half, all eyes will turn to the U.S. capitol and the upcoming elections.

Our outlook over the second half of 2012 remains on track based on the predictions we laid out at the end of last year. We continue to believe that:

- The U.S. economy will grow about 2%,
- The U.S. stock market is likely to post an 8–12% gain, backed mainly by earnings growth, and
- Corporate bonds will outperform government bonds as they post modest single-digit gains.

In our *2012 Outlook,* we stated that the party that emerges in control following the November 2012 elections will forge the decisions that will represent one of the biggest shifts in federal budget policy since World War II. In the second half of the year, the elections will become an increasingly potent driver of the markets and determine whether our expectations for the year are on target.

The connection between the economy and the election can most clearly be seen through the historical relationship between income growth and election results. Inflation-adjusted, after-tax income growth of about 3–4% appears to be the threshold for incumbents to get 50% of the popular vote [Figure 1]. Above 4% the incumbent gets re-elected; below 3% and the challenger wins. Between 3–4% a lot of other factors come into play, making it close.

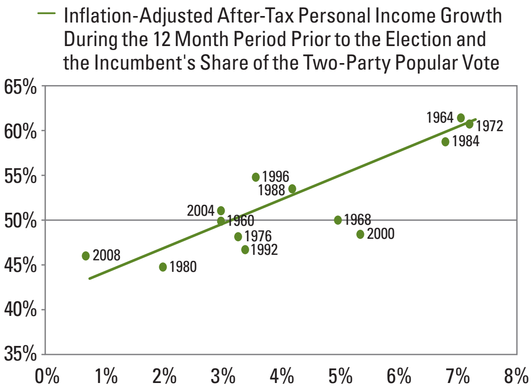
As we start the second half, this measure is about 1%, suggesting that President Obama faces an uphill battle for re-election. While other factors may have a bearing on the election, income growth and related job creation may be the key measures by which the presidency will be judged.

No matter which party controls the White House, the changes in Congress may have a dramatic impact on the second half of the year. The election may result in both chambers being controlled by the same party. The Republicans will likely retain control of the House, but they could also take the Senate.

Markets are likely to welcome the prospect for one party—whichever it is—being in control of Congress. Historically, markets have struggled most of the time under a split Congress [Figure 2]. A Congress that can act promptly, get bills to a vote on the floor, work on them in conference between the



### 1 Income Growth Above 3–4% Is the Key to Getting Re-Elected




Source: Bloomberg, LPL Financial 04/02/12

Note: In 1964, 1972, 1980, 1984, 1996, and 2004, an incumbent was running for a second term after a change in party in the previous election.

### 2 Dow Jones Industrial Average Performance by Political Regime

| Political Regime | Annualized Performance | % of Time |
|---|---|---|
| Democratic President/ Democratic Congress | 7.3% | 35.8% |
| Democratic President/ Republican Congress | 9.6% | 9.0% |
| Democratic President/ Split Congress | 9.2% | 1.2% |
| Republican President/ Republican Congress | 7.0% | 23.4% |
| Republican President/ Democratic Congress | 2.2% | 19.8% |
| Republican President/ Split Congress | -4.0% | 10.8% |

Source: Bloomberg, Ned Davis, LPL Financial 06/20/12

The Dow Jones Industrial Average Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

chambers, and bring them swiftly to the president's desk would be a dramatic change to the last year-and-a-half of gridlocked government. After all, Congress writes the laws. A Congress that is able to work together is critical after what happened with last year's debt ceiling debacle and debt downgrade.

Congress has the potential to move from gridlocked to unlocked in 2013. This matters a lot to investors because the 2013 budget is going to have the biggest impact of any budget in decades, even if no action is taken in Washington. The fiscal headwind composed of tax increases and spending cuts already in the law total well over $500 billion, or 3.5% of Gross Domestic Product (GDP). The U.S. has never experienced a deficit cut by more than 2% of GDP that did not end in a recession.

Last week's Supreme Court ruling upholding the Affordable Care Act (ACA) makes a budget deal this year to avert the fiscal headwind less likely since the Republicans now have less to offer Democrats to extend the expiring tax cuts. If the ACA had been struck down, there would have been more room for negotiation. However, in the second half of this year, the markets may begin to move higher as they price in a major budget deal taking place after the elections in early 2013, which would restructure these changes to be less of an economic drag. The risk that a deal does not happen, and a return to recession may be looming in 2013, should keep markets from posting exceptional gains in 2012.

This has been a major period of global political change. Twelve of the 17 Eurozone governments have collapsed or been voted out over the past two years. And votes in Germany and Italy are coming in 2013. In the second half of this year, Europe is likely to lay the groundwork toward a further financial integration. But leaders are unlikely to agree on details that would immediately alleviate pressures. And that means the concerns over the fate of some Southern European countries may linger and drive volatility.

In the second half of 2012, the issues facing policymakers here and abroad are daunting. However, the issues facing investors may not be so dramatic or as prone to disappointment as they may at first seem. Remember that in the first half of the year:

- Greece defaulted,
- Spain needed a bailout,
- Iran thwarted deadlines on its nuclear program,
- China's economy slowed to the weakest pace since the recovery began three years ago, and
- Total U.S. Federal debt-to-GDP crossed over 100%.

Yet the world did not end, a crisis did not erupt, and U.S. stocks and bonds actually posted gains.

We remain committed to our forecasts for gains this year, given our assessment of the developments and their likely impact in the second half of 2012. ■

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. All indices are unmanaged and cannot be invested into directly.

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.

*LPL Financial Research provided this range based on our earning per share growth estimate for 2012, and a modest expansion in the price-to-earnings ratio. Additional explanation can be found in our *2012 Outlook*.

** Please reference the *2012 Outlook* for our perspective surrounding this.

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.



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