Weekly Market Commentary

July 1, 2013

Mid-Year Outlook

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

The performance of the markets is likely to converge in the second half of the year on a path that likely holds modest gains. The return of volatility will also be a key characteristic of the second half of 2013 as markets follow a path with ups and downs.

Join the Conversation
@LPLResearch
#LPLResearchMYO

The investment landscape for the first half of 2013 has proven to be a tough one to navigate. And this is likely to continue through the second half of this year. There is a lot of rocky terrain and potentially some surprises ahead that investors need to prepare for.

The performance of the markets is likely to converge in the second half of the year on a path that likely holds modest gains. The return of volatility will also be a key characteristic of the second half as markets follow a path with ups and downs.

Rather than a single path emerging, the paths of least resistance for the economy and markets diverged in the first half of 2013. The different markets took all three paths.

- Stocks took the bull path as investor confidence rose when the worst of the fiscal cliff outcomes was avoided and the Federal Reserve's (Fed's) bond-buying program continued. This helped to lift stock valuations and prompted individual investors to put money into the market at the strongest pace in years, according to flows into domestic stock funds tracked by the Investment Company Institute (ICI).
- Commodities asset classes took the bear path on weakening economic data around the world and as tax increases and spending cuts sunk in here in the United States, Europe's recession broadened and deepened, and China's growth slowed. Copper, wheat, and gold futures—to name just a few—all plunged during the first half of 2013.
- Bonds took the base path with the year-to-date return of the Barclays Capital Aggregate Bond Index remaining between +/-2% through much of the first half, as a volatile 10-year Treasury note yield ranged between 1.6% and 2.6%.

Rather than a single path emerging in the first half of 2013, the paths of least resistance for the economy and markets diverged. And the magnitude of disagreement among the markets that we observed has been rare. This divergence is unlikely to continue in the second half. Instead, the markets are likely to converge in a second half that likely holds modest—but volatile—gains for investments such as stocks, bonds, and commodities.

LPL Financial Research's second half outlook is composed of:

- The **U.S. economy**, as measured by real gross domestic product (GDP), will continue to grow at about 2% supported by housing, as well as consumer and business spending, offsetting the drag from government spending cuts. Inflation remains tame, but rises modestly from the recent 1% pace. The European economy remains in recession in the second half, but it may begin to show some improvement late in the year. China's growth remains around 7%. This may support demand for raw materials.
- The **Federal Reserve** has communicated that it will begin to slow its bond-buying program, known as "QE" (quantitative easing), in the fall of 2013. The slowing will be dependent upon the economy meeting the Fed's forecast, and the program is expected to end by mid-2014 as the unemployment rate falls to about 7%. The Fed will maintain zero interest rates throughout the remainder of this year and next.
- The **fiscal cliff** and sequester had only a small measurable effect outside of government jobs and spending in the first half and may also remain benign in the second half. The budget is improving this year and will for the next few years, according to the Congressional Budget Office, so the debt ceiling debate in the second half may not be much of an issue for the markets.
- We expect low single-digit returns for the broad **bond market** in the second half, resulting in flat returns for the year. Given our expectation of stabilization in bond yields, we expect interest income to offset price declines and result in low single-digit returns for high-quality bonds in the second half of 2013. Still-high bond valuations, stabilization in Europe's economies, and a gradual reduction in QE might result in a further, but modest increase in bond yields in the second half. Slow but steady growth, combined with rising yields, favors corporate bonds over government bonds.
- The **stock market** goes from a gallop to a grind higher as stocks end the year modestly higher, from current levels on the S&P 500 Index, after a strong first-half gain of about 13%. The gains are primarily driven by mid-single-digit earnings growth, aided by record-breaking share buybacks, wide profit margins, and contained labor costs. Those gains come with a substantial uptick in volatility, however, which may present opportunities. Soft global economic growth and a strong dollar favor U.S. over international stocks.

The second half of 2013 may act as a bridge to a new path for policy, the economy, and markets: the aggressive stimulus from the Fed over the past five years is likely to begin to fade, the government may shrink as a portion of the U.S. economy to the lowest levels in a decade, the economic drag from higher taxes and spending cuts implemented in the first half of 2013 starts to diminish, and corporate profit margins may reach all-time highs. The four-year-old recovery in the economy and markets is unlikely to be the end of the path, but instead a new beginning that may refresh the pace of growth in the coming years.

But a word of caution—we are not out of the woods yet. There is no clear or easy trail in the second half of 2013. The markets and global economy remain in uncharted territory with geopolitical, monetary, and fiscal policy at significant crossroads. Despite a recovering housing market and improving job growth, sluggish economic growth persists and creates uneven footing and potential hazards ahead.

To help you plan for what lies ahead, you can access our full *Mid-Year Outlook 2013: Investors' Trail Map to the Markets* here:

Scan the QR Code with your mobile device to go directly to the link.*

It can provide you with what you need to know before you go and check before you trek. ■

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.

Investing in specialty market and sectors carry additional risks such as economic, political or regulatory developments that may affect many or all issuers in that sector.

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

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

Corporate bonds are considered higher risk than government bonds, but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer, coupon rate, price, yield, maturity, and redemption features.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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

*Please note, you need to have downloaded a free or paid QRC Reader application to your mobile device prior to attempting to scan.

Precious metal investing is subject to substantial fluctuation and potential for loss. Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors.

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). Members of ICI manage total assets of $11.18 trillion and serve nearly 90 million shareholders.

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.

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 Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

RES 4234 0713

Tracking #1-179919 (Exp. 07/14)