

# Outlook

# 2011



A Mix of Clouds and Sun

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# 2011

## A Mix of Clouds and Sun

Neither bulls nor bears in 2011, LPL Financial Research expects the economy and the markets will be range-bound in 2011. Bound by economic and fiscal forces that will restrain growth, but not reverse it, we believe the markets will provide modest single-digit rates of return.

**In 2011, business leaders, policymakers, and investors will play important roles in shaping the investing environment. We anticipate that:**

- **The job market will stage a comeback.** Slowing productivity gains have driven the need to bring on new workers, we believe business leaders will step-up hiring, ultimately resulting in the unemployment rate drifting lower. However, slow sales growth from tepid consumer spending will keep the pace of hiring modest. That said, we expect nearly twice the pace of job creation experienced in 2010. Economic growth as measured by Gross Domestic Product (GDP) in 2011 will be near the long-term average at 2.5–3%; however, this is below the average of 3.5–4%, which is typical at this stage of a business cycle.
- **Policymakers will deliver economic stimulus.** As 2011 gets underway, the Federal Reserve (Fed) will be in the midst of providing substantial economic stimulus—after already providing a record-breaking \$1.75 trillion in stimulus in 2008 and 2009. Later in the year, drags on

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.



growth will begin to emerge as the impact of the Fed's stimulative monetary policy begins to fade and there is a gridlock-induced shrinking of the federal budget deficit.

- **Investors will play it safe.** Inflows to riskier markets will be anemic, contributing to modest performance for both stocks and more aggressively postured bonds. We expect single-digit gains for stocks as earnings growth slows and valuations remain under pressure, and single-digit gains for bonds as yields remain range-bound.
- **Currencies will influence returns.** The currency impact on investing will be pronounced in 2011, as the currency war that began in 2010 presents both opportunity and risk. We expect a downward, volatile path for the US dollar.

Overall, 2011 will continue the economic and market volatility of 2010. The global economy remains out of balance, teetering back and forth between the soft spots that invoke a need for increasingly extended policy support and the growth spurts that provoke a desire to begin to pull back some of the record-breaking stimulus. The last time government spending comprised as much of GDP as it does today (during 1945–1960), the economy went through a period of heightened volatility driven by the swings in policy action.

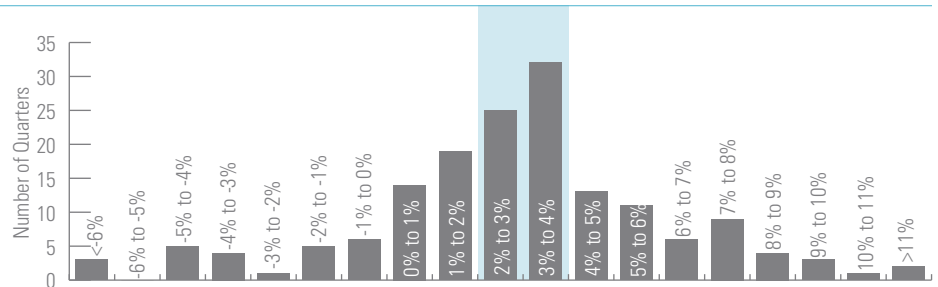
In 2011, the policy-driven themes of reflation, which is the intentional pursuit of modestly higher prices, and a broader U.S. foreign policy provide investment ideas that can thrive in a year where the performance of the major indexes is likely to be lackluster. Expected volatility, which will remain elevated, may present risks to be side-stepped and opportunities to be taken advantage of. Investors with a more opportunistic profile may benefit from a tactical approach to investing in order to find attractive opportunities when offered and successfully take profits when appropriate. Longer-term strategic investors should consider remaining broadly diversified.

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.

# 2011 At A Glance

## U.S. Real GDP Growth Rate

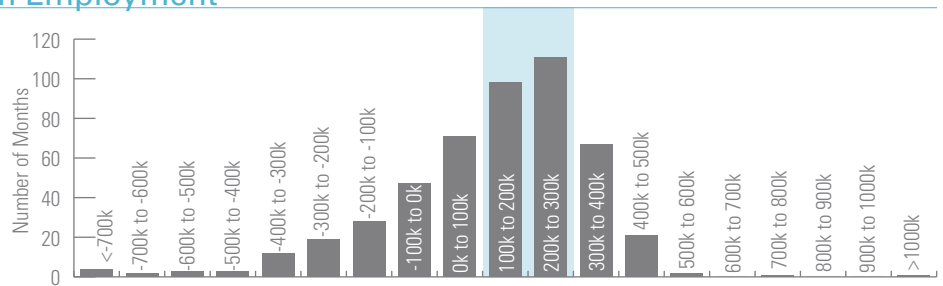
Historically, quarterly GDP growth has averaged between 2% and 4%. The recent recession led to a plunge of nearly -7% during the fourth quarter of 2008 and the subsequent recovery produced 5% growth in the fourth quarter of 2009. We expect GDP to average between 2% and 4% in 2011.



Source: LPL Financial, Bloomberg, Data from First Quarter 1970 through Third Quarter 2010

## U.S. Monthly Change in Non-Farm Employment

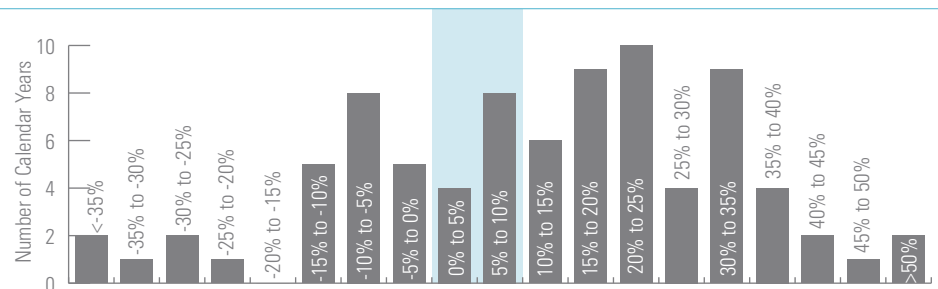
Historically, monthly non-farm job growth has averaged between 100,000 and 300,000 per month. We have recently seen extremes. For example, in January 2009, the loss was more than 700,000 and in May 2010, 432,000 jobs were created. We expect job growth to average the middle of the road 100,000 to 300,000 in 2011.



Source: LPL Financial, Bloomberg, Data from January 1970 through October 2010

## S&P 500 Annual Total Return

Annual stock market performance, measured by the S&P 500, has varied widely since the late 1920s with the long-term total return averaging around 10%. We anticipate single-digit performance for stocks in 2011.

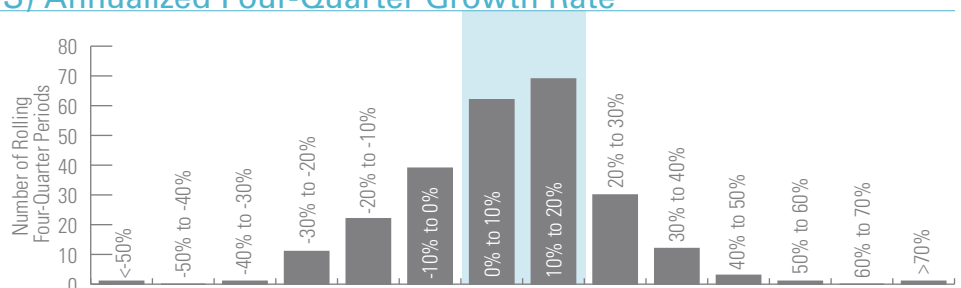


Source: LPL Financial, Factset Research Systems, Data from 1927 through 2009

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

## S&P 500 Earnings per Share (EPS) Annualized Four-Quarter Growth Rate

Four-quarter EPS growth for S&P 500 companies has recently ended up in the tails of the distribution (below -50% and above +70%). In 2011, we expect EPS to grow around 10%.

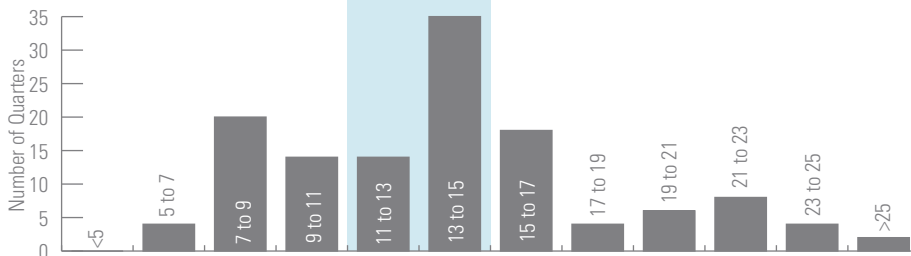


Source: LPL Financial, Factset Research Systems, Data from 3/31/49 through 9/30/10

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

After years of extremes (2008–2010) in the economy and markets, 2011 is likely to be a “middle-of-the-road” year. This is best illustrated by **highlighting** our forecasted ranges for key components of the 2011 outlook relative to their historical ranges.

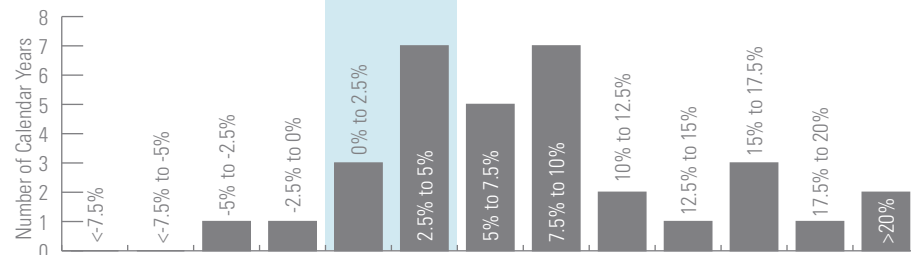
### S&P 500 Forward Price-to-Earnings Ratio



Historically, the S&P 500 forward price-to-earnings ratio, which divides the current price by the Thomson Financial-tracked analyst consensus earnings estimate for the next four quarters, has averaged 15. We expect the current below average valuations to persist in 2011.

Source: LPL Financial, Factset Research Systems, Data from Fourth Quarter 1978 through Third Quarter 2010  
The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

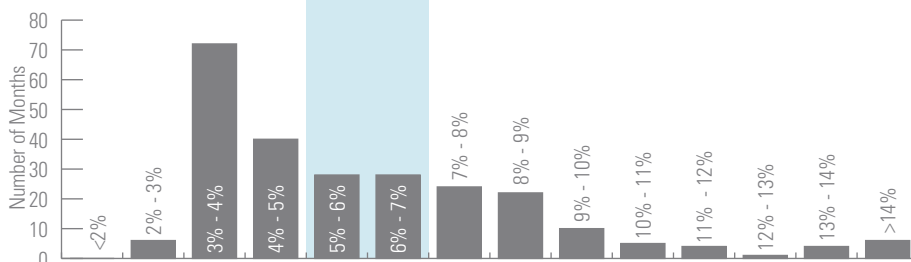
### Barclays Aggregate Bond Index Annual Total Return



The historical average total return for the bond market, measured by the Barclays Aggregate Bond Index, is about 8%. We expect below average, but positive total returns for the bond market in 2011.

Source: LPL Financial, Factset Research Systems, Data from 1976 through 2009  
The Barclays Aggregate Bond Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

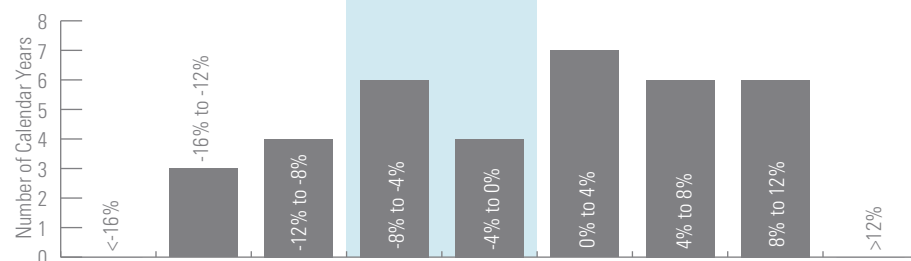
### High-Yield Bond Credit Spread



The historical average high-yield bond credit spread has been between 5% and 7%. Recent years led to record-setting extremes with spreads soaring to over 20% in November 2008, following the failure of Lehman Brothers, from below 3% in May 2007 as the credit markets peaked. In 2011, we expect credit spreads will remain near the 5% to 7% average they reached in 2010.

Source: LPL Financial, Factset Research Systems, Data from January 1990 through October 2010

### Change in Value of US Dollar versus Trade-Weighted Currencies of Major Trading Partners



Since leaving the gold standard in 1971, the dollar has depreciated by 1% a year on average. Notably, the dollar was flat in 2010, but took a wild ride as it rose sharply in the first half and fell sharply in the second half of the year. We expect the dollar to depreciate versus the currencies of major trading partners in 2011.

Source: LPL Financial, Factset Research Systems, Data from 1972 through 2009  
Major trading partners include: Australia, Canada, Japan, Sweden, Switzerland, the United Kingdom, and the Euro 11 countries.

# Economy: Neither Boom nor Bust



Economic growth in 2011 will be near the long-term average at 2.5–3%; however, this is below the average of 3.5–4%, which is typical at this stage of a business cycle. On the positive side, pent-up demand by businesses along with plenty of cash and low interest rates provide fuel for growth. In addition, the combination of the second round of quantitative easing (QE2) from the Fed and the extension of the Bush tax cuts could lift GDP significantly. However, curbing our enthusiasm are tepid consumers, slowing Chinese growth, weak bank lending, and looming government spending cuts.

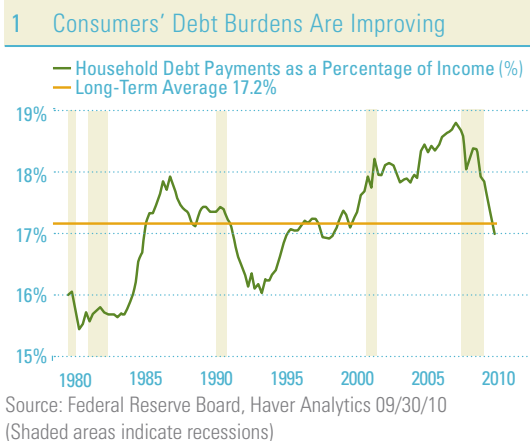
In 2011, the composition of economic growth may be very similar to 2010:

- Tepid, but positive consumer spending.
- Decelerating, but positive, business capital spending (including new hires).
- Slowing federal government, coupled with continued weakness in state and local government, spending.

## Tepid Consumer Spending

Consumer spending accounts for more than 70% of U.S. GDP. Consumer finances have been vigorously debated by market participants since the onset of the financial crisis and the “Great Recession.” Starting in the early 1990s, consumers had been on a spending spree—accelerating spending, reducing savings, and piling up debt. However, there has been a noticeable reversal of that trend the last few years as strapped consumers have been forced to address soaring debts by reducing discretionary spending. [Chart 1] This is best illustrated by the Financial Obligations Ratio (FOR), which the Fed uses to track how much of a household’s disposable income goes toward paying debt, including mortgage (or rent), credit card, lease, homeowners’ insurance, and property tax payments.

As of the second quarter of 2010 (the latest data available and reported in the third quarter), the FOR was the lowest in 12 years and is below the long-term average of 17.2%. The ratio likely improved further in the second



half of 2010. Some of the reduced debt burden is the result of defaults, but the drop in the FOR in recent quarters suggests that the combination of low interest rates, attractively refinanced mortgages, rising incomes (personal income is up 3.1% from a year ago), and less debt to service is hastening the improvement in consumers' ability to spend. Consumers have been paying down debt, increasing their spending (at a modest rate for this point in a recovery), and saving more since late 2008. We would expect this pattern to continue well into 2011, and perhaps into 2012, which means slower-than-normal consumer spending dampening economic growth, but not causing outright declines that would portend a double-dip recession.

## Better Job Growth

Jobs are always top of mind for politicians, consumers, the markets, and the Fed; but the focus on employment will hit a crescendo in 2011. Although the private sector has added back 1.1 million jobs (in the 12 months ending October 2010), nearly 8.5 million jobs were lost during the Great Recession and its immediate aftermath. At the level of monthly job growth seen over the course of the past 12 months, it would take another six and a half years to get back to pre-recession levels on the job front.

We believe that clarity on federal tax policy and continued economic growth will motivate business leaders to step up hiring in 2011 that will result in the unemployment rate drifting lower throughout the year. However, a drag on job growth will be continued difficult hiring conditions for state and local governments, which account for 17% of employment.

Historically, there has been a very close relationship between job growth and the stock market during the traditional business cycle, as the strength of the economic backdrop largely dictates similarly the direction of stock returns and the trajectory of employment. [Chart 2] However, recent economic strength, while tepid, has translated into rising stock market values, but has largely not been a big enough catalyst to stimulate sizeable employment gains. This could be the result of the uncertainty created by the rapid and sweeping legislative and regulatory reforms of 2009 and 2010, which left businesses hesitant to make capital commitments to growth, such as expanding their workforce.

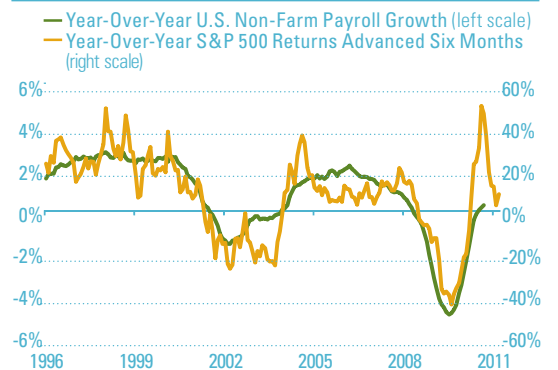
In the closing months of 2010, three of the four primary members of the President's economic team (Larry Summers, Christina Romer, and Peter Orszag) have announced their resignations. We expect Treasury Secretary Geithner may also soon depart the White House team. While this is not uncommon, it presents the opportunity to reshuffle some of the senior staff and set the stage for how the White House addresses business-related legislative efforts from the new Congress.

With the takeover of the House of Representatives by the Republicans in the 2010 mid-term elections, and GOP gains in the Senate, it is likely the sweeping legislative changes at the Federal level we have experienced over the course of 2009 and 2010 will likely slow to a crawl over the next two years. The return of gridlock in Congress is likely to mean a much slower rate and a more moderate path of legislative change. With the absence of legislative and regulatory uncertainty over the potential for major changes in healthcare costs, taxes, and other key factors, job growth may be stronger. As stability returns to the near-term legislative environment, business leaders are more likely to make the commitments to growth, including additional hiring, that drive the economy.

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### 2 Stocks Indicate Potential for Better Post-Election Job Growth

*Strong Stock Returns Tend to Precede Job Growth*



Source: LPL Financial, Bloomberg 09/30/10

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The goal of QE2 is clear: to produce economic growth that will be above trend, pull down the unemployment rate, and modestly increase the pace of inflation. It takes a while for this type of stimulus to work.

## Setting Sail on QE2

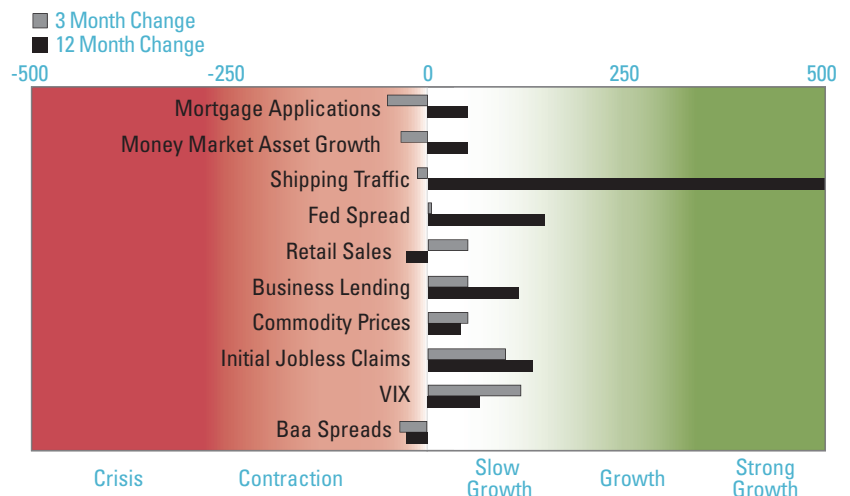
Arguably one of the most successful measures taken in 2008 and 2009 to turn the economy around was the Fed’s program of QE, so-called because it increases the quantity of money in the financial system. As 2010 draws to a close, the Fed is undertaking another round of QE, but the conditions are different this time and success in stoking growth is not assured.

One of the major themes in the economy that will drive the markets over the course of 2011 will be gauging the effectiveness of QE2 from the Fed. The Fed began QE2 in November 2010. These actions are intended to drive economic growth by prompting interest rates to remain low, businesses to borrow, and consumers to refinance debt and improve their finances. The goal of QE2 is clear: to produce economic growth that will be above trend, pull down the unemployment rate, and modestly increase the pace of inflation. It takes a while (sometimes up to a year or more) for this type of stimulus to work.

## Tracking QE2

Even before the impact of QE2 begins to show in high profile economic data, such as quarterly GDP and monthly reports on jobs and retail sales, it will manifest itself in the “high frequency” daily and weekly data. Initially, in addition to the value of the dollar, the market is likely to focus on interest rates—such as Treasury yields, mortgage rates, refinance rates, car loan rates, and credit card rates—to measure whether QE2 is creating conditions for growth. Next, markets will want to see in the weekly bank lending data from the Fed that lower rates have spurred demand for loans from individuals and businesses, and that the banking system is willing and able to provide the loans. The LPL Financial Research Current Conditions Index (CCI) provides a timely gauge of the success of QE2, by tracking shipping traffic, mortgage applications, initial filings for unemployment insurance or jobless claims, commodity prices, and retail sales, as well as five other key weekly readings on the health of the economy. [Chart 3] Finally, the markets will want to see that these actions have indeed prompted a reacceleration in economic activity measured in the widely watched monthly and quarterly economic statistics.

3 LPL Financial Research Current Conditions Index Components



Source: LPL Financial 11/24/10

Please see the page 24 for important information regarding the CCI.



## Reflation

In simple terms, the Fed balances employment and prices by seeking growth that generates the highest level of employment without causing too much price inflation. The Fed has spent much of the past 30 years determining when to attempt to slow down an economy that is growing too rapidly in order to avoid the destructive effects of high inflation. However, when inflation gets too low (often called deflation), it is a sign that growth needs a boost. The problem with deflation is that when prices fall as output exceeds demand, it can become self-perpetuating, as consumers and businesses postpone spending because they believe prices will fall further. Consumers and businesses delay buying expensive items like homes or cars because they believe these things will be cheaper in the future. As a result, spending and economic growth slows. However, it does not stop there. Businesses' profits weaken, straining their ability to pay their debts and leading them to cut production, workers, and wages. This, in turn, results in lower demand for goods, which leads to even lower prices and so on as a destructive downward spiral takes root.

QE2 can counter deflationary fears by directly inflating the money supply. All else being equal, this means that with more dollars in the system, the value of each dollar goes down and prices in dollar terms go up, resulting in a faster pace of inflation. The monthly data on inflation as well as housing prices and import prices should begin to reflect the impact of QE2 by the first part of 2011, lifting annual inflation from the current 0.6% pace (as of 10/31/10). If key measures of the economy begin to show improving growth momentum by the fall of 2011, the Fed may begin to pull back extraordinary stimulus by year-end to avoid fueling asset bubbles and inflation in 2012.

## The Risks of QE2

While the near-term impacts of QE2 are reasonably clear, the longer-term effects are not. Unlike during the financial crisis when liquidity was scarce, the benefits of adding more cash into the financial system that is already on a growth trajectory and flush with high cash balances at banks and corporations may be very limited. In addition, U.S. stimulus cash may wind up fueling emerging market growth as U.S. companies deploy the cheap cash to fuel growth in markets with lower labor costs and stronger demand. The Fed also risks undermining the lower interest rates that are essential to growth by devaluing the dollar, making U.S. Treasury bonds less attractive to the foreign investors that we are increasingly dependent upon to fund our national debt.

One of the other risks of QE2 is that too many dollars chasing too few goods may unintentionally cause "asset bubbles" here in the United States or abroad. Given the huge overhang of unsold homes, strict lending standards, and regulators' hyper-vigilance around the banking system, the risks of another residential real estate bubble are low. However, bubbles are always forming somewhere in the world and the Fed embarking on another round of QE may indeed be creating a bubble somewhere. But, the Fed has decided that the rewards of trying to revive economic growth in the United States in the near term outweigh the longer-term risk of creating another potential asset bubble.

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# Stocks: Neither Bull nor Bear



What do you call a year that is not a bull market or a bear market? 2011. We expect modest single-digit gains in 2011 for the stock market, accompanied by heightened volatility.

We believe our restrained outlook for stocks is supported by a number of factors:

- Earnings growth will be limited by sluggish revenue growth, but supported by strong profit margins. In addition, slow domestic demand for U.S.-made goods and services will be offset by faster demand from emerging economies.
- Valuations are likely to be supported by the fact that they are already well below historic averages, but constrained due to lack of demand from foreign and U.S. investors.
- Dividends may help to support demand for stocks in a low-yield environment.

## Earnings Bound

As of the third quarter of 2010, many U.S.-based companies have achieved a new record high in profits, aided in large part by the U.S. economy (measured by GDP) having already surpassed its prior peak of economic output set in late 2006. Despite sluggish economic conditions, manufacturers have begun to see greater demand for goods, which resulted in factory and plant utilization rates rising from the lowest level in its 40-year history, about 68% a year ago, to 75% during the third quarter of 2010. In addition, earnings have clearly benefitted from the Fed providing stimulus to the economy that has resulted in a weaker dollar, strong profits from international investments, and an improved environment for export growth.

While the unemployment rate has been slow to decline, that dark cloud presents a silver lining in the form of low labor costs for businesses and thus higher profits. On average, labor expenses make up about 70% of the cost of producing goods and services in the United States. The labor cost per unit of output has been falling at an unprecedented 4–5% pace, according to the Bureau of Labor Statistics. In addition, reduced interest and tax expenses are contributing to companies' bottom lines. Businesses have reduced and refinanced a tremendous amount of debt over the past year. In addition, they have a significant amount of tax-loss carry forwards made available to them by tax law changes that they are now using to minimize taxes.

Earnings, the most important driver of the stock market, have increased substantially from their recession low point and are now only about 15% below the all-time peak of mid-2007 for S&P 500 companies. The consensus of Wall Street analysts believes earnings will return to the prior peak by the end of 2011. [Chart 4] We are not as optimistic, but believe earnings will post a solid gain in 2011. Earnings are likely to rise about 10% in 2011, well below their 30% growth rate in 2010.

Our outlook for 2011 corporate profits is bound by continued sluggish revenue growth resulting from modest economic expansion in the developed markets, including the United States. While companies have been producing strong double-digit earnings gains on the back of single-digit revenue growth and significant cost reductions over recent quarters, further gains are limited. Profit margins are wide and still expanding as fixed costs are spread over more output. However, there is little room to squeeze out additional expenses particularly given that labor costs may begin to firm and halt the 5% decline in per unit labor costs seen in 2010.

## Constrained Valuations

Stock market valuations are well below average, already reflecting the concerns about the durability of economic growth. Investors appear unwilling to pay sizeable premiums for somewhat uncertain future growth, which are reflected in valuations that are poised to stay below average.

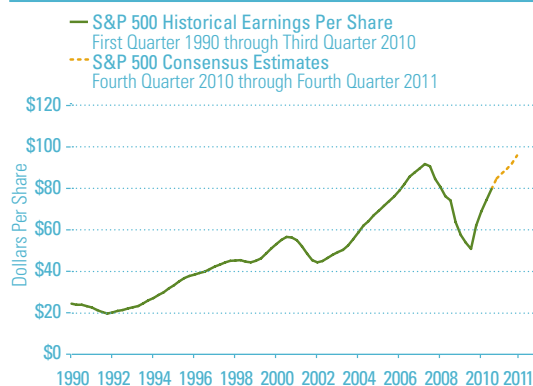
Instead, dividends may be a key theme in the stock market as investors increasingly seek yield. In 2010, the biggest flows were out of the lowest-yielding asset classes—cash and large cap U.S. stocks—and into higher-yielding asset classes, such as bonds (specifically high-yield bonds) and foreign stocks, according to the Investment Company Institute. While investors are unlikely to pay up for growth, demand for stocks is unlikely to require lower valuations. Institutions, such as endowments, pension funds, and insurance companies are seeking riskier assets, including stocks, over high-quality bonds in the current extremely low-yield environment.

## Buyers Strike

Individual investors remained net sellers of U.S. stocks during every week of the second half of 2010 (as of mid-November) despite solid gains in the U.S. stock market. However, individual investors have not been avoiding investing entirely. Interestingly, they have been putting money to work in foreign stocks and U.S. bonds—including more aggressive emerging market stocks and high-yield bonds—as they reallocate money from cash and U.S. stocks.

While individuals may have overcome, to some degree, their distrust of the sustainability of the economic recovery and policymakers in Washington, they remain skeptical of the integrity of the U.S. stock market. More than \$80 billion has come out of domestic equity mutual funds since the “flash crash” on the afternoon of May 6, 2010, according to the Investment Company Institute. If a weaker US dollar makes investing in U.S. company stocks less attractive to foreign investors and they join the American individual investor in a boycott of domestic stocks, gains in 2011 may be hard to come by.

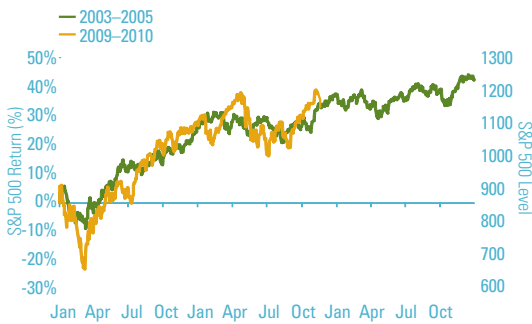
### 4 Reported S&P 500 Historical Earnings Per Share and Consensus Estimates for 2011



Source: LPL Financial, Thomson Financial 11/12/10

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

## 5 S&P 500 in 2003–2005 and 2009–2010



Source: LPL Financial, Bloomberg 11/11/10

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## Volatility

Inflows to riskier markets will likely be anemic, resulting in modest performance for stocks. We expect single-digit gains for stocks as earnings growth slows and valuations remain constrained. The path of QE2, currently scheduled to end mid-year 2011, along with the pattern of economic and earnings growth in 2011, is likely to lead to heightened volatility. In 2009 and 2010, the S&P 500 tracked the same pattern and, ironically, same levels as it did during the early years of the last business cycle in 2003 and 2004. [Chart 5] The stock market in 2011 may behave like it did in 2005, a similar point during the last business cycle, which offered investors a year of volatility within a range-bound market before closing the year with an overall 5% gain in the S&P 500.

## Beyond Borders

Returns from investing overseas benefit from a declining dollar, but foreign developed markets could suffer from even slower economic growth than the U.S., which would constrain profit growth. However, emerging markets may continue to provide a profitable mix of solid growth, strong balance sheets, and currency gains.

## The Flash Crash

On the afternoon (ET) of May 6, 2010, the major equity indices, already down more than 4% from their prior-day close, suddenly plummeted an additional 5–6% in a matter of minutes before rebounding almost as quickly to “pre-crash” levels. During the “flash crash,” the Dow Jones Industrial Average plunged about 600 points only to recover those losses within minutes. It was the biggest one-day point decline, 998.5 points, on an intra-day basis in the 114-year history of the Dow Jones Industrial Average. Against the backdrop of unusually high volatility and thinning liquidity, the trigger for the “flash crash” was a large mutual fund company initiating an automated computer sell program that had no regard for price or timing in order to sell a massive amount of S&P 500 futures contracts as a hedge to an existing equity position. While the Securities and Exchange Commission (SEC) has taken actions intended to avoid a similar event in the future, they noted that under stressed market conditions, the automated execution of a large sell order could trigger extreme price movements. While the evolution of trading and potential for intra-day breakdowns of liquidity for stocks make regular trading of specific securities on an exchange challenging for an individual, they have had little to no effect on investing through mutual funds and Exchange-Traded Products (ETPs) for a time horizon that exceeds a single day.

# Bonds: Neither Bubble nor Burst

We forecast low- to mid-single-digit gains for bonds in 2011. Yields are unlikely to plunge or soar in 2011. Despite the substantial rise in bond prices and corresponding decline in yields in 2010, our primary gauge of bond market valuation, inflation-adjusted yields, suggests that while bonds are expensive, they are not in a bubble.

## No Bond Bubble

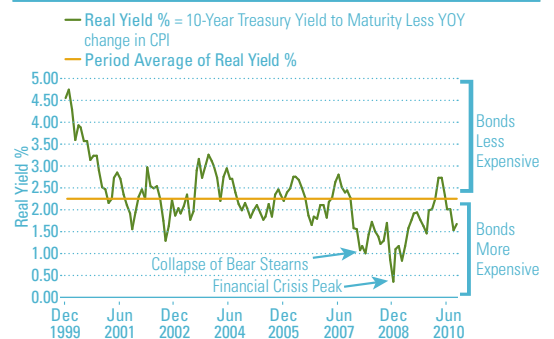
The inflation-adjusted yield of the 10-year Treasury note remains above the level following the collapse of Bear Stearns in March 2008 and well above the level witnessed during the height of the financial crisis. Furthermore, expensive valuations are supported by sluggish economic growth. As long as economic growth remains below the long-term trend of around 3%, bonds may remain somewhat expensive with inflation-adjusted yields below the average of the past 10 years. [Chart 6]

The presence of the Federal Reserve buying in the bond market with its QE2 mandate will likely limit bond market weakness. In November 2010, the Fed announced it would conduct an additional \$600 billion in Treasury purchases through the middle of 2011. Coupled with the existing reinvestment of the proceeds of the Fed's Mortgage-Backed Security (MBS) holdings, the Fed is on pace to absorb most of the net new supply of Treasuries in 2011. The magnitude of Fed purchases is therefore likely to provide support for bond prices and keep yields relatively low even as it attempts to reignite inflation.

Interest rates are unlikely to move dramatically higher in the absence of multiple Fed interest rate hikes or a rapid acceleration in inflation, neither of which we expect in 2011. However, yields may move modestly higher over the course of 2011 as economic growth firms, inflation expectations increase, and the Fed potentially begins to unwind monetary accommodation. The key word is modest, as the classic drivers of interest rates, the Fed and inflation, are likely to remain bond-friendly for most of 2011. The Bernanke-led Fed is likely to err on the side of maintaining monetary accommodation in place for longer and not risk damaging the economy with an early interest rate increase. Therefore, yields are unlikely to plunge or soar in 2011.



## 6 No Bond Bubble: Bond Valuations Are Not Extreme

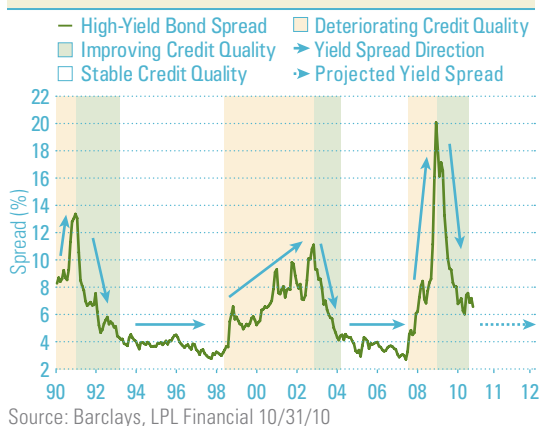


Source: Bloomberg, LPL Financial 10/31/10

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

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

## 7 The Credit Cycle



Projected Yield Spread is based on historical spread contractions.

Spread = Difference between the yield on the high-yield bond index and the yield on the Treasury bond index.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and 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.

## Riding the Credit Cycle

We continue to favor corporate bonds as stable credit quality provides a favorable backdrop for the sector. The performance of both high-yield and investment-grade corporate bonds are highly influenced by the credit cycle, which is the longer-term underlying trend of corporate credit quality. The credit cycle can be best measured by yield spreads, which increase (deteriorate), decline (improve), or remain stable over time. Changes in the credit cycle are marked by years, not months. [Chart 7]

We believe we are at the beginning of a stable stage of the credit cycle. By taking painful but necessary actions in recent years, corporations have done an excellent job of improving their balance sheets through reducing debt, refinancing loans, and cutting costs. This has sharply driven down yield spreads and pulled bond prices higher. However, eventually, further balance sheet improvement is difficult to achieve and credit quality stabilizes along with yield spreads giving way to the stable stage of the credit cycle. The stable stage has historically been the longest and, while returns are likely to lag the earlier stage of improvement where yield spreads were falling sharply, one in which we believe investors may reap solid returns in 2011.

The stable period of the credit cycle has historically been good to corporate bond investors as corporate-issued high-yield bonds have outperformed government-issued Treasuries in most calendar years. The start and end of various stages of the credit cycle do not fall precisely at the end of each calendar year, but for illustrative purposes, we show the predominant stage of the credit cycle in effect for a particular year in table 8. Although price appreciation is limited during the stable stage, the compounding of interest payments may be a powerful force for bond investors and can result in outperformance relative to lower yielding government bond sectors during a stable credit environment.

Similar to the corporate bond market, we expect stable credit quality in emerging market debt. Economic growth among emerging market debt

## 8 Stable Credit Quality Conditions Have Historically Been Good for Corporate Bonds

Improving Credit Quality Stable Credit Quality Deteriorating Credit Quality

	Total Return (%)																				YTD 2010 <sup>^</sup>
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	
High-Yield Corporate	46.2	15.8	17.1	-1.0	19.2	11.4	12.8	1.9	2.4	-5.9	5.3	-1.4	29.0	11.1	2.7	11.9	1.9	-26.2	58.2	14.4	
Treasury	15.3	7.2	10.7	-3.4	18.4	2.7	9.6	10.0	-2.6	13.5	6.8	11.8	2.2	3.5	2.8	3.1	9.0	13.7	-3.6	8.6	
Difference*	30.9	8.6	6.4	2.4	0.8	8.7	3.2	-8.1	5.0	-19.4	-1.5	-13.2	26.8	7.6	-0.1	8.8	-7.1	-39.9	61.8	5.8	

Source: Barclays High-Yield Bond Index, Barclays Treasury Index, LPL Financial 10/31/10

\*High-Yield minus Treasury return.

<sup>^</sup>YTD through 10/31/10

The Barclays High-Yield Bond Index and Barclays Treasury Index are unmanaged indices, which cannot be invested into directly. Past performance is no guarantee of future results.

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 a fund shares is not guaranteed and will fluctuate.

issuers remains among the strongest globally, and fundamental credit metrics could improve further. Although we find valuations only fair, we expect that strong growth and solid credit quality combined with our expectation for further dollar weakness may provide attractive returns for emerging market debt opportunities in 2011.

## Municipal Merits

Budget woes will continue to present a risk to the municipal market. As of September 2010, most states demonstrated higher year-over-year tax revenues. In many cases these higher revenues were anticipated and factored into 2011 fiscal budgets. This means additional spending cuts may be in the cards to balance budgets in June 2011, when 2012 budgets are solidified. Throughout much of 2011, negative headlines surrounding municipal credit quality may therefore persist and create periods of weakness. Ultimately, we believe that high-quality municipal bond defaults will continue to be rare due to the high seniority of municipal bond payments. As a result, we view this as an opportunity for creating attractive valuations for investors to consider.

Failure of Congress to extend the taxable Build America Bond (BAB) program would be a negative for the traditional tax-exempt municipal bond market in 2011. The BAB program was a key factor in limiting the supply of tax-exempt municipal bonds and creating a favorable environment for municipal bond investors over the past 18 months. If the BAB program is not extended, tax-exempt issuance would increase and may lead to weakness as the tax-exempt market braces for increased supply. However, several factors could counteract an increase in municipal supply:

- The ability of many states and municipalities to issue new debt is constrained due to budget pressures.
- Strong investor demand for municipal debt that prevailed throughout 2010 will continue in 2011 and absorb much of the increase in issuance.
- Attractive valuations and the concern over rising tax rates in the near future should spur investor interest.

The extension of the Bush tax cuts is likely, but unresolved as of this writing. In general, municipal bond valuations are now more attractive, as measured by municipal-to-Treasury yield ratios, compared to when the Bush tax cuts were enacted in 2003. While municipal bonds typically offer lower yields than comparable maturity Treasuries due to their tax-advantaged status, the yield of the tax-exempt 30-year municipal bond is now higher than that of the taxable 30-year Treasury bond. This unusual occurrence is not the result of a flight-to-quality by investors favoring Treasuries (as it was in 2008 and 2009); instead it reflects the expectation that the Bush income tax cuts will be extended rather than expire and enlarge the tax benefit of owning municipals over Treasuries. However, in the event the Bush tax cuts expire or are modified at higher rates, tax-exempt municipal bonds may benefit.

## Modest Returns

While 2011 is neither the year of a bubble nor a burst for bonds, investors should prepare for modest total returns in the low- to mid-single-digit range. Bond market performance in 2010 is on track to be at, or just above, the high-end of the range we had forecast a year ago. Now, the lower level of yields implies even lower returns going forward.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

The issuance of Build America Bonds (BABs) began in April 2009. They were authorized by the American Recovery and Reinvestment Act economic stimulus of 2009 and can be issued for qualifying infrastructure projects. They are taxable municipal bonds and are considered a category of bonds.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

# Currency: No Reason to Ignore



Currency is important in 2011. It is not just whether you own stocks, bonds, or commodities in 2011, but also the currency in which they are denominated that may be the difference between investment success and failure. The dollar has fallen over 10% against major currencies since June 2010. [Chart 9]

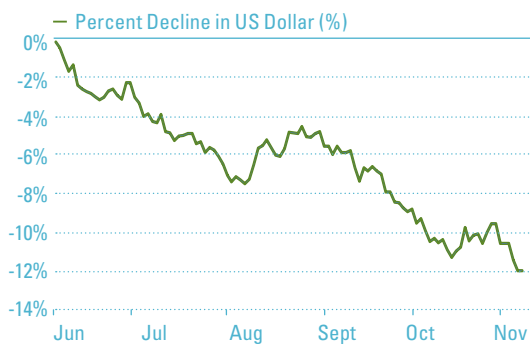
To illustrate the profound impact currency has had on investment performance, consider that from June 6, 2010 to November 5, 2010:

- Gold has risen 12.4% in dollars, but is flat in Japanese yen.
- U.S. stocks, measured by the S&P 500, have advanced 17.6% in dollars, but are flat in euros.
- The global stock market, measured by the MSCI World Index, is up 24% in dollars, but up only 2% in Swiss Francs.
- U.S. bonds, measured by the Barclays Aggregate Bond Index, have provided a 4.2% return in dollars, but are down -6.9% in British pounds.

Fears of a “currency war,” in which countries devalue their currencies to gain a trade advantage, have dominated headlines in late 2010. Brazil’s finance minister warned of “an international currency war” and called for “some kind of currency agreement.” India’s prime minister has expressed similar concerns and the governor of the Bank of England has warned of protectionism unless “the need to act in the collective interest” is recognized.

Despite these calls for action, the “currency war” is unlikely to end anytime soon. It is primarily the result of the bifurcation of world economic growth. Many developed countries see further stimulative monetary policy, which lowers interest rates and pumps more currency into the system, as a necessary response to subpar growth. In the United States, a weaker dollar is a beneficial side effect of that policy that can help boost inflation (since a weaker dollar has less purchasing power) as the Fed seeks to avoid the demand-destroying effects posed by the threat of deflation, or falling wages and prices. However, these policies create challenges for the emerging market countries where growth is currently strong, but increasingly pressured by a rising currency that threatens to reduce the global competitiveness of their exports and create a bubble in their economies as the world’s capital increasingly pours into their borders.

9 Trade-Weighted Value of US Dollar Versus Major Trading Partners



Source: Bloomberg 06/06/10 through 11/05/10



## Potential Actions

There are primarily three potential actions countries may take in the ongoing currency war.

1. **A global currency agreement.** As previously stated, we believe a globally coordinated move on exchange rates is unlikely. The framework suggested by some finance ministers for such an agreement would follow that of the Plaza Accord of 1985, when France, Germany, Japan, and the UK governments agreed to intervene to devalue the US dollar against the yen and the German deutsche mark. This devaluation was planned, done in an orderly, pre-announced manner and did not lead to a financial crisis or a currency war. Back then, the move was in response to a dramatic rise in the value of the dollar which was due to the Fed having previously hiked rates into the double-digits to curb rampant inflation. Today we face a problem that is the complete opposite, which makes the unique circumstances that led to the success of the Plaza Accord extremely unlikely to occur in the prevailing environment.
2. **More monetary stimulus around the world.** This seems to be the most likely outcome. During the end of 2010, a number of countries have already started taking steps towards more stimulus as they follow the lead of the United States. Both the Bank of Japan and Bank of England have moved toward additional QE. Nearly all of the world's major central banks are contemplating similar actions. Even the Bank of Canada, the first of the major central banks to begin rate hikes this past summer, is likely to put a halt to their actions. However, there are likely to be some exceptions among emerging markets where there are more than 20 central banks that are raising rates to prevent a further rise in domestic inflation (inflation is running in the mid-to-high single-digits in countries such as Brazil, Russia, and India). For these countries, a rising local currency is another way to slow inflation as it keeps a lid on the prices of imported goods.
3. **Emerging markets try to close the doors.** Some emerging market countries are under pressure to reduce the strength of their currencies. This may lead to longer-term risks of emerging market asset bubbles becoming inflated due to the excessive stimulus from domestic actions in addition to inflows from abroad. This is prompting some emerging market countries to impose controls on the cross border flow of capital to weaken their currencies.
  - Brazil, which has the highest real interest rates in the G-20, is seeking to restrain its currency as investors seek higher-yielding assets in emerging markets amid near-zero interest rates in the U.S., Japan, and Europe. In late 2010, Brazil imposed back-to-back tax hikes on foreigners' investments. The Brazilians' first attempt to stem the currency gains via imposing a tax on inflows failed. That move was outflanked by a similarly timed announcement from the Bank of Japan that reduced the overnight rates to a range of 0–0.1%, the lowest since 2006, prompting even more money to flow into Brazil's higher rates.
  - South Korea is also preparing further measures to counter capital inflows triggered by low interest rates overseas, such as reviving a withholding tax on foreign investors' bond holdings, and may impose further limits on currency forward trading.

## Currencies, Exports, and Trade Wars

While a strong currency is usually associated with strong economic conditions, a weaker dollar does have its advantages, especially for export-oriented companies. As the dollar depreciates versus the currency rates of trading partners, goods in the United States become more attractive as they are now priced in "cheaper" dollars and can be paid for by the appreciated currencies of U.S. trading partners. As a result, many export-focused countries are seeking a cheaper currency. However, for the United States, which continues to import more goods than we export, a weaker dollar means a compromise between a boost for the exporters, and higher costs for items imported for consumption.

- Indonesia's central bank said it plans to offer deposit rates with longer maturities of three, six, and nine months to slow the flow of "hot money" in and out of the country.
- Thailand recently re-imposed a 15% withholding tax on foreign bond holdings.

It is possible that we could see more aggressive moves if these countries become desperate to stop the appreciation of their currencies.

### How Long Will It Last?

The currency war cannot go on forever. There is a limit to the benefit of currency devaluation. President Obama has a stated goal of growing the U.S. economy by doubling U.S. exports over the next five years. The United States is already in a close race among the world's largest exporters. In order to accomplish that magnitude of an increase in global market share for the United States in such a short amount of time would likely require a further substantial devaluation of the dollar. However, that large a devaluation would hurt consumer spending—since it would push up the prices of oil and other imported goods, in addition to the interest rates consumers use to finance their spending, making everything more costly. Since consumer spending makes up about 70% of the U.S. economy, it is highly unlikely the gain in exports would offset the potential drop in consumer spending, which is many times larger. A rise in inflation and interest rates would put an end to the benefits of quantitative easing in the United States. We expect a modestly declining dollar to continue through much of 2011.

### How to Win the Currency War

In some years, currency effects can safely be ignored—2011 is not one of those years. We believe U.S. investors can be winners in the currency war through exposure to foreign currency denominated stocks, bonds, and commodity asset classes in 2011. Specifically, as a result of the incentive to weaken currency values by lowering interest rates global monetary policy will likely be more aggressive than it would be otherwise. This is good news for investors in emerging market stocks and bonds. Emerging markets benefit from the greater global demand created by stimulative monetary policy, the rising value of their commodity-based exports, and the appreciation of their currency, which boosts dollar-based investment returns. The declining value of the US dollar also pushes up the prices of commodities including precious metals.

Precious metal investing is subject to substantial fluctuation and potential for loss.

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

# How to Potentially Profit and Protect in the Year of Range-Bound Returns

With 2011 looking like neither a screaming bull market nor a raging bear market, investment opportunities will be largely driven by key market themes that will likely emerge to drive various sector and asset class returns. One unmistakable theme that should define the early part of the year is the Fed's program of reflation. Beyond reflation, having a portfolio strategy to successfully navigate volatile financial markets will be crucial in 2011.



## Investing for Reflation

The Fed has begun a program of QE, which means they will expand the supply of money in the financial system (by buying Treasury bonds in the open market) in an effort to encourage lending and economic growth. The byproduct of quantitative easing is reflation, which is the intentional pursuit of modestly higher prices (inflation). This easing monetary policy action can counter deflationary fears by directly inflating the money supply and reigniting economic growth. All else being equal, this means that with more dollars in the system, the value of the dollar goes down and prices in dollar terms go up, resulting in a faster pace of inflation.

Incorporating the theme of reflation into your portfolio may be advantageous. With the Fed's QE2 initiative having the effect of devaluing the dollar, investments that benefit from the declining U.S. currency and the resulting rise in inflation are the primary portfolio benefactors. Key positive effects of reflation are likely to be seen in commodities and precious metals, commodity-sensitive equities, emerging market equities and debt, and real estate. Treasuries may have mixed results, while the dollar and the Financials sector may be negatively impacted.

### Likely Benefits

**Commodities and Precious Metals:** Gold may be the most obvious beneficiary of the Fed's intentions. Inflation and a falling dollar tend to increase demand for gold as a way to preserve value. From a broader perspective, because most commodity asset classes are priced in US dollars, gold is not the only likely benefactor from dollar depreciation. We would expect to see improvement in the prices of other precious metals

## Reflation

### Likely Benefits

- Commodities and Precious Metals
- Commodity-Sensitive Equities
- Emerging Market Equities and Debt
- High-Yield Bonds
- REITs

### Mixed Benefits

- Treasuries

### Likely Hurt

- Cash
- US Dollar
- Financials Sector

## 10 Volatility to Continue in 2011



Source: FactSet Research Systems 01/01/10 through 11/10/10

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

Precious metal investing is subject to substantial fluctuation and potential for loss. The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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 will decline as interest rates rise and are subject to availability and change in price.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Investing in real estate/REITs involves special risks, such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk in your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index, while providing a real rate of return guaranteed by the U.S. Government.

and commodities tied to manufacturing, such as copper, lead, iron ore, coal, and, of course, oil. Besides benefiting from dollar depreciation, investing in commodity asset classes provides indirect exposure to the surging growth of emerging markets and, in particular, China. China's pace of economic growth remains well ahead of most developed countries and has resulted in strong demand for industrial commodities.

**Commodity-Sensitive Equity Sectors:** Similarly, commodity-sensitive equity sectors, such as Materials, Industrials, and Energy, stand to benefit from the Fed's reflation intentions. Energy companies' profits benefit from the increase in the price of oil, while Material and Industrial companies' business models are rewarded for their pursuit of the mining and extraction of commodities.

**Emerging Market Equities and Debt:** If the dollar weakens, gains in investments denominated in foreign currencies translate into more dollars, boosting possible returns. Within foreign investments, emerging market countries offer a more robust growth story relative to developed nations. Furthermore, emerging market stocks and bonds benefit from appreciating currencies relative to the dollar and the increasing value of their commodity-based output.

**High-Yield Bonds:** High-yield bonds may benefit as yield hungry investors are forced to take more credit risk as high-quality bond yields remain low.

**Real Estate Investment Trusts (REITs):** Reflation should benefit real estate since property prices may rise in an inflationary environment. While REITs normally offer advantages in a reflation picture, REITs with an international bias stand to benefit even more. On top of benefiting from a weak dollar, international REITs offer better valuations, higher yields, and improved fundamentals in some foreign developed nations.

### Mixed Benefits

**Treasuries:** In their reflation efforts, the Fed is purchasing intermediate-term Treasuries, benefiting these segments of the maturity curve. With higher inflation a most likely consequence, other beneficiaries are Treasury Inflation-Protected Securities (TIPS), as their principal increases with inflation. Longer-dated Treasuries, however, may struggle as longer-term inflation risks and their lack of inclusion in the Fed's purchase plan pressure these securities.

### Likely Hurt

**Cash:** As the Fed increases the quantity of dollars in the financial system, the value of the dollar is likely to fall. A falling dollar and rising inflation makes cash less attractive.

**Financials Sector:** Bank stocks may be negatively affected by the Fed's intentions. As 5- to 10-year rates move lower on Fed buying, the profit margin banks earn by borrowing short term and lending longer term narrows, crimping profits.

### Beyond Reflation

As 2011 gets underway, the reflation theme is likely to dominate market opportunities. However, as the year progresses and the Fed's actions begin to fade, new themes may emerge depending on how successful the Fed's actions are at reinvigorating economic growth. Beyond reflation, we expect volatile financial markets to persist and to intensify as 2011 muddles along.

While a long-term, strategically diversified approach works well regardless of the market environment, we believe that opportunistically focused portfolios that take a tactical approach to investing in 2011 may enhance performance. In a period of increased volatility, we believe that a more active rebalancing\* strategy that employs a tactical approach to investing may enhance performance during these periods by positioning portfolios to become aggressive when volatility presents opportunity and taking on a defensive stance when volatility suggests danger. In both market scenarios, we would focus on investments that offer a higher yield, traditionally thrive on elevated levels of volatility, and help to minimize portfolio fluctuations through increased diversification.

**Offer a Higher Yield:** We believe a higher yield may benefit portfolios by providing a consistent income component that is received regardless of price movements, helping to cushion market volatility. These strategies include High-Yield Bonds, Real Estate Investment Trusts, Emerging Market Debt, and dividend-paying stocks.

**Thrive on Elevated Levels of Volatility:** Strategies with less constrained investment mandates may thrive in the volatile period that is likely to dominate 2011. [Chart 10] In periods of high volatility, there are more opportunities for price divergence and therefore more possible investment opportunities for the nimble managers that usually characterize Opportunistic Equity or Balanced and Unconstrained Eclectic strategies.

**Increased Diversification:** With elevated volatility levels, an investment that may benefit from heightened uncertainty helps not only to potentially improve returns, but also to help reduce portfolio risk. Alternative strategies, such as those listed in the sidebar, may be potential sources of diversification and some risk reduction.

\*Rebalancing may involve tax consequences.

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.

Absolute Return funds have the goal of providing a positive return in all market conditions and tend to have low volatility and provide bond-like returns. They also tend to have a very low correlation to bonds and low correlation to stocks. Because of their goal of low to moderate volatility, these securities are more suited for accounts with more moderate risk/return goals.

A Market Neutral strategy seeks to profit from both increasing and decreasing prices in a single or numerous markets. Market neutral strategies are often attained by taking matching long and short positions in different stocks to increase the return from making good stock selections and decreasing the return from broad market movements. Market neutral strategies may also use other tools such as merger arbitrage, shorting sectors, and so on.

Long/Short funds focus on managers who go long and hedge against the market through options or shorting equity securities with the goal of outperforming the market while limiting volatility. These funds tend to have a higher correlation to equities than other alternative strategies and, therefore, are most appropriate for more aggressive portfolios.

Unconstrained Eclectic funds have a flexible investment style that does not limit the fund to a single asset class or security type. However, the fund is primarily a long-only equities manager. Managers in this category invest opportunistically, capitalizing on market inefficiencies.

Managed Futures funds use systematic quantitative programs to find and invest in positive and negative trends in the futures markets for financials and commodities. Historically, the benefit of managed futures have been solid long-term returns with very low correlation to equities and fixed income securities.

Global Macro funds use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical managed futures fund. Historically, the benefit of global macro has been solid long-term returns with very low correlation to equities and fixed income securities.

## Common Alternative Strategies

- Managed Futures strategies take long and short positions in futures contracts, government securities, and options on futures contracts. Managed futures tend to use technical analysis in most of their management practices.
- Global Macro strategies profit from global mispricing and trends across various markets. In a volatile environment, these strategies may find more mispricing and, therefore, more possible investment opportunities.
- Long/Short strategies hold stocks long and short other stocks to hedge the underlying long position. Unlike traditional long strategies, the ability to short stocks allows these portfolios to seek possible opportunities during weak markets.
- Absolute Return strategies strive to generate a positive return in any market at any time. The investment's return is not evaluated relative to a specific index or the market's performance.
- Market Neutral strategies seek to create portfolios not correlated to overall market movements and are insulated from systemic market risk.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

# The Redefining of American Foreign Policy



With President Obama's Democratic Party having lost its significant majorities in Congress, domestic policy in 2011 will likely be characterized by greater gridlock, resulting in increased exertions by the White House in its primary area of influence: foreign policy.

For nearly a decade, the United States has engaged in simultaneous wars in Iraq and Afghanistan, efforts that have consumed a tremendous amount in terms of resources and focus. Many nations have been able to capitalize on America's preoccupation to assert themselves in their own "backyards." Two noteworthy examples to consider:

- First, Moscow invaded Georgia in the summer of 2008 with total impunity, at a time when the United States simply did not have the forces with which to deter or counter Russian aggression on behalf of its ally.
- Second, in May 2010, following an investigation, the United States labeled North Korea's deliberate sinking of a South Korean warship two months earlier an act of aggression. However, top U.S. officials did not call the attack an act of war or state-sponsored terrorism and American forces were not put on a higher level of alert. As with the invasion of Georgia, this lack of action by the United States was largely anticipated in the region.

However, as U.S. combat troops fully depart from Iraq and the proportional response to the threat in Afghanistan is reassessed, the United States will likely regain military bandwidth and its ability to address conflicts across the globe. This is a potential geopolitical "game changer" that allows the White House to regain the military presence it needs to deal directly with various regional challenges, while more effectively using the policy to balance any potential military threat.

## Foreign Policy Market Impact in 2011

- **Increased volatility in global markets.** Renewed U.S. military-political strength will conflict with nations reluctant to give up their newfound regional authority or influence. As a result, the markets will likely begin to increasingly react to the potential for geopolitical conflict, even as the probability of such conflict diminishes.

- **A tactical investing approach becomes more important than ever.** In this geopolitical “new normal,” an overall tactical approach to investing will become more prudent than ever. Among the evaluation of many factors impacting the investment environment, institutional and individual investors will move to protect themselves from threats and profit from potential opportunities created by the shifting geopolitical landscape.
- **Greater regional selectivity with global investments.** In recent years, the mantra has been that investors should aggressively chase returns from non-U.S. capital markets. As part of this increased emphasis on a more tactical investing approach in 2011, investors with global exposure could begin taking a more actively selective approach to the regions of the world in which the prospects of international tension remain high (such as Northeast Asia) versus those where the potential for conflict involving the United States is fairly low (such as South America).
- **Rising opportunities for profit and loss with oil-industry investments.** Oil prices are often driven by geopolitical events. Oil currently appears to be trading roughly in line with the historical relationship between demand and price. However, the historical range was briefly broken when prices escalated in early August 2010, around the perceived risk of military action with Iran over Tehran’s escalating nuclear program. All signs point to the strong possibility of more geopolitical risk-driven volatility in the price of oil in 2011.

It is noteworthy that this past September, U.S. Secretary of State Hillary Clinton proposed in a speech to the Council on Foreign Relations that this is a “new American moment” to “lay the foundations for lasting American leadership for decades to come.” Does 2011 mark the beginning of a next phase of American power projection, in which the nation is no longer tied down in a military-political sense? Only time will tell, but investors would be wise to begin preparing for a new era of geopolitical risk.

The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings.

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#### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Stock investing may involve risk including loss of principal.

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

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 Group of Twenty (G-20) Finance Ministers and Central Bank Governors is the premier forum for our international economic development that promotes open and constructive discussion between industrial and emerging market countries on key issues related to global economic stability. By contributing to the strengthening of the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions, the G-20 helps to support growth and development across the globe.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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

Mortgage-Backed Securities are subject to credit risk, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

The fast price swings in commodities and currencies will result in significant volatility in an investor’s holdings.

Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index, while providing a real rate of return guaranteed by the U.S. Government.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection or the exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials Sector: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery; provide commercial services and supplies, including printing, employment, environmental and office services; or provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

Dow Jones Industrial Average is the most widely used indicator of the overall condition of the stock market, a price-weighted average of 30 actively traded blue chip stocks, primarily industrials. The 30 stocks are chosen by the editors of *The Wall Street Journal*. The Dow is computed using a price-weighted indexing system, rather than the more common market cap-weighted indexing system.

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.

The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of May 27, 2010 the MSCI World Index consisted of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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.

This Barclays Aggregate 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.

LPL Financial Research Current Conditions Index Components:

Initial Claims Filed for Unemployment Benefits – Measures the number of people filing for unemployment benefits. A rise in the number of new claims acts as a negative on the CCI.

Fed Spread – A measure of future monetary policy, the futures market gives us the difference between the current federal funds rate and the expected federal funds rate six months from now. Typically, a rise in rate hike expectations weighs on the markets since higher rates increase the cost of bank borrowing and has tended to slow the growth in the economy and profits. A rise in the Fed Spread acts as a negative for the CCI.

Baa Spreads – The yield on corporate bonds above the rate on comparable maturity Treasury debt is a market-based estimate of the amount of fear in the bond market. Baa-rated bonds are the lowest quality bonds still considered investment grade, rather than high-yield. Therefore, they best reflect the stresses across the quality spectrum. A rise in Baa spreads acts as a negative for the CCI.

Retail Sales – The International Council of Shopping Centers tabulates data on major retailer's sales compared to the same week a year earlier. This measures the current pace of consumer spending. Consumer spending makes up two-thirds of GDP. Rising retail sales acts as a positive for the CCI.

Shipping Traffic – A measure of trade, the Association of American Railroads tracks the number of carloads of cargo that moves by rail in the U.S. each week. A growing economy moves more cargo. A rise in railroad traffic acts as a positive for the CCI.

Business Lending – A good gauge of business' willingness to borrow to fund growth, the Federal Reserve tabulates demand for commercial and industrial loans at U.S. commercial banks. More borrowing reflects increasing optimism by business leaders in the strength of demand. A rise in loan growth acts as a positive for the CCI.

VIX – The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market. A rise in the VIX acts as a negative on the CCI.

Money Market Asset Growth – A measure of the willingness to take risk by investors, the year-over-year change in money market fund assets tracked by Investment Company Institute shows the change in total assets in cash equivalent money market funds. A rise in money market asset growth acts as a negative for the CCI.

Commodity Prices – While retail sales captures end user demand for goods, commodity prices reflect the demand for the earliest stages of production of goods. Commodity prices can offer an indication of the pace of economic activity. The CRB Commodity Index includes copper, cotton, etc. A rise in commodity prices acts as a positive on the CCI.

Mortgage Applications – The weekly index measuring mortgage applications provides an indication of housing demand. With much of the credit crisis tied to housing, keeping tabs on real-time buying activity can offer insight on how the crisis is evolving. A rise in the index of mortgage applications acts as a positive on the CCI.

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