LPL RESEARCH

PRIVATE CLIENT THOUGHT LEADERSHIP

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DISRUPTIVE INSIGHTS

LPL Financial

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INVESTING IN AN UNCERTAIN WORLD

Our analysis of 2016 “surprises” discusses lower-probability, but high-impact events that may unfold over the course of 2016. While no one can predict the future, the surest way to build a surprise-resistant investment plan is to take the time to consider all potential outcomes. Thinking through all possibilities, even those that may not be the most probable, can help investors understand how different scenarios may play out, and allow them to see the warning signs that may indicate a shift is ahead. With this in mind, we explore potential surprises that could impact markets in 2016 [Figure 1].

1 Potential Surprises & Market Impacts in 2016

Scenario	Sectors That May Benefit	Sectors That May Be Harmed
Sharply Higher Interest Rates	Financials (if the increase is not driven by inflation)	High-Quality Bonds, Consumer Discretionary, Utilities
Inflation Accelerates	TIPS, Real Estate	High-Quality Bonds, Financials
Price of Oil Rebounds	Energy, Materials	Consumer Discretionary
Emerging Markets Make a Comeback	Emerging Market Equities, Commodities, Energy	High-Quality Bonds
Economic Expansion Is Younger Than It Looks	Financials, Consumer Discretionary, Industrials	Utilities, Telecom
Severe Weather Disrupts the Economy	Utilities, Energy	Consumer Discretionary, Financials (property insurers)
Tax Holiday Gets the Green Light	Technology, Industrials	High-Quality Bonds (assuming growth and rates increase), Emerging Market Equities
Political Changes	Energy, Financials, Telecom	Healthcare, Consumer Discretionary

Source: LPL Research 11/23/15

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

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SHARPLY HIGHER INTEREST RATES

SECTORS THAT MAY BENEFIT

- Financials (if the increase is not driven by inflation)

SECTORS THAT MAY BE HARMED

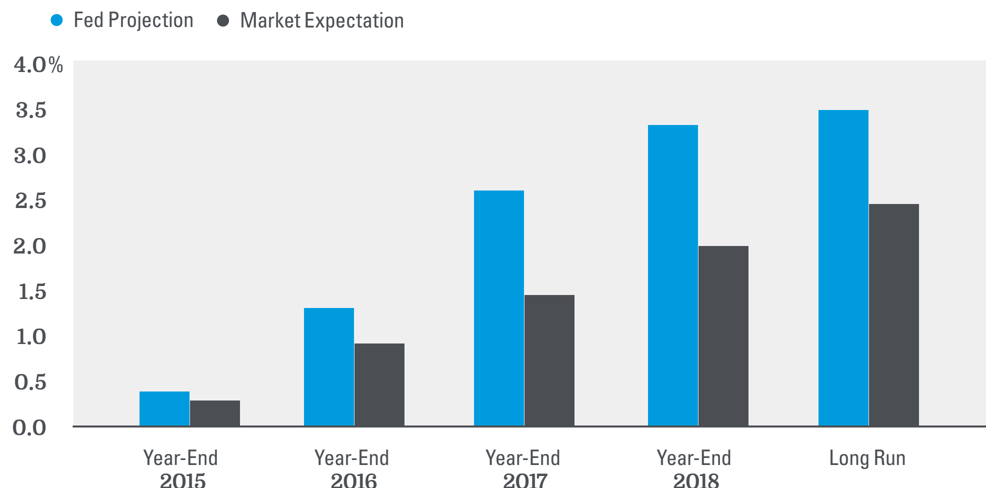
- High-Quality Bonds
- Consumer Discretionary
- Utilities

The long anticipated sustained rise in interest rates has failed to materialize over the past several years. Is 2016 the year? Market-based estimates of future interest rates are low, but a pickup in inflation, better economic data, or both could easily lift those expectations and bond yields along with them.

The benign inflation environment and expectations of limited rate hikes has led to low yields and high valuations, which, in turn, have led to low future yields on bonds. Based on market futures, the 10-year Treasury yield will finish 2018 at 2.9%, implying a very gradual increase in rates.

The Federal Reserve (Fed), for its part, also currently estimates a slow trajectory of rate hikes, though the market expects rates to rise even more slowly [Figure 2]. The Fed's long-run (five years out) expectation of the fed funds rate averages 3.5%, while interest rate futures reflect a fed funds target rate below 3% 10 years in the future. The market essentially doesn't believe the Fed's forecast, meaning that one side will ultimately be wrong. If the market view converges toward that of the Fed, rates could be pressured higher.

2 The Market Expects the Fed Funds Rate to Increase More Slowly Than the Fed Projects



Source: LPL Research, Federal Reserve, Bloomberg 11/23/15

Long run is defined as five years.

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INFLATION ACCELERATES MORE THAN EXPECTED

SECTORS THAT MAY BENEFIT

- TIPS
- Real Estate

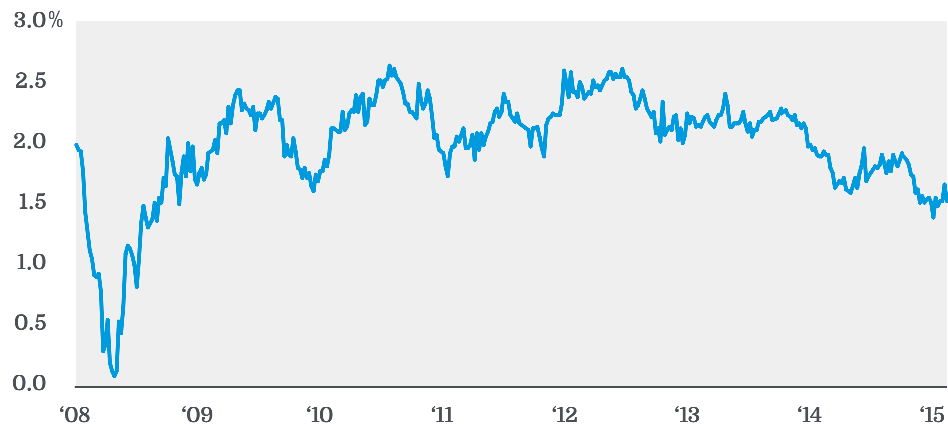
SECTORS THAT MAY BE HARMED

- High-Quality Bonds
- Financials

Growth in the current expansion has been slower than previous cycles, which has helped to keep actual inflation and inflation expectations low for the past several years [Figure 3]. Market-based measures of inflation expectations, such as Treasury Inflation-Protected Securities (TIPS) prices, are not suggesting an inflationary environment in the forseeable future. Is it possible for inflation to pick up in these conditions, and if so, what would be the likely drivers?

One potential driver would be stable or increasing oil prices. The commonly referenced Consumer Price Index (CPI) is influenced by energy, especially oil prices. The more than 50% drop in oil since mid-2014 caused headline inflation numbers to decelerate sharply. The latest CPI reading, for October 2015, was 0.2% annualized, but was 1.9% with energy and food removed. As we enter the one-year anniversary of the steepest portion of the oil decline, which began in October 2014, the year-over-year comparisons will become easier. For example, assuming services (which makes up approximately 68% of CPI) maintain a year-over-year growth rate of 2.3%, even if oil prices (a part of the smaller goods basket, which makes up 32% of CPI) were to remain flat, inflation would increase to approximately 1.6% by December 2016. If, however, the price of oil surprised to the upside and gained 50%, headline inflation would be pushed to 3.2%, well above the Fed's targeted range of 2%.

3 Inflation Expectations Remain Low

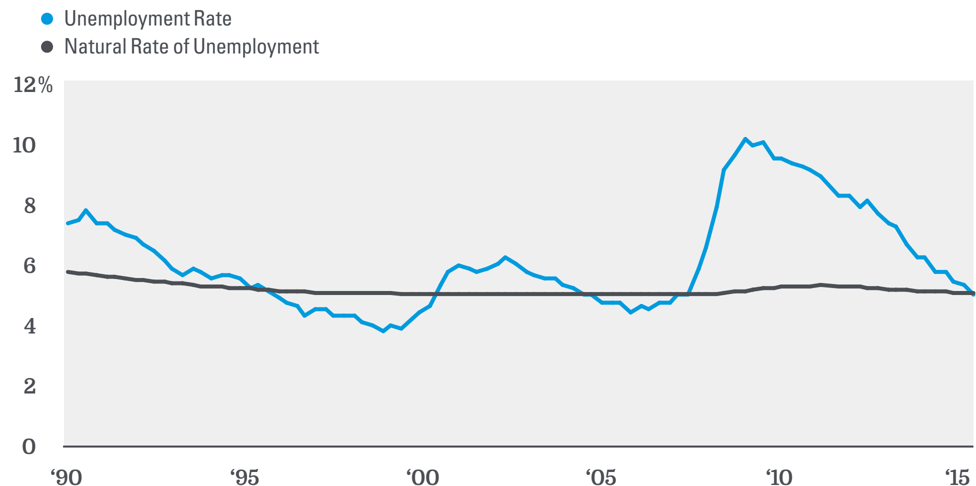


Source: LPL Research, FactSet 11/23/15

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 (CPI), while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of is that the CPI might not accurately match the general inflation rate; so the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Inflation could also increase through wage growth. Wage growth has historically been a driver of inflation, and the unemployment rate tends to be a driver of wage growth. The current unemployment rate is already near what economists believe is the natural rate (the rate of unemployment where cyclical unemployment is near its low) [Figure 4], and a continued decline would make it more likely that wages will increase over time, potentially putting upward pressure on inflation.

4 Unemployment Has Been Falling Steadily, and Is Now Near the Natural Rate of Unemployment



Source: LPL Research, Haver, Bureau of Labor Statistics, Congressional Budget Office 11/23/15

PRICE OF OIL REBOUNDS

Oil prices started falling in mid-2014, as the shale boom in the U.S. and steady supply from OPEC (Organization of Petroleum Exporting Countries) resulted in a worldwide supply glut. Demand has increased over time, but not fast enough to overtake the rate of supply growth, though the U.S. Energy Information Administration (EIA) estimates that the gap between the two will shrink in 2016 [Figure 5]. Given that the market remains oversupplied, what would need to happen for oil to see a comeback in 2016?

OPEC has historically been able to influence oil prices by increasing or decreasing production, but the additional supply created by the U.S. shale boom distorted this process. To avoid ceding market share to U.S. shale producers, OPEC has so far refused to reduce production, which is the biggest factor behind the drop

SECTORS THAT MAY BENEFIT

- Energy
- Materials

SECTORS THAT MAY BE HARMED

- Consumer Discretionary

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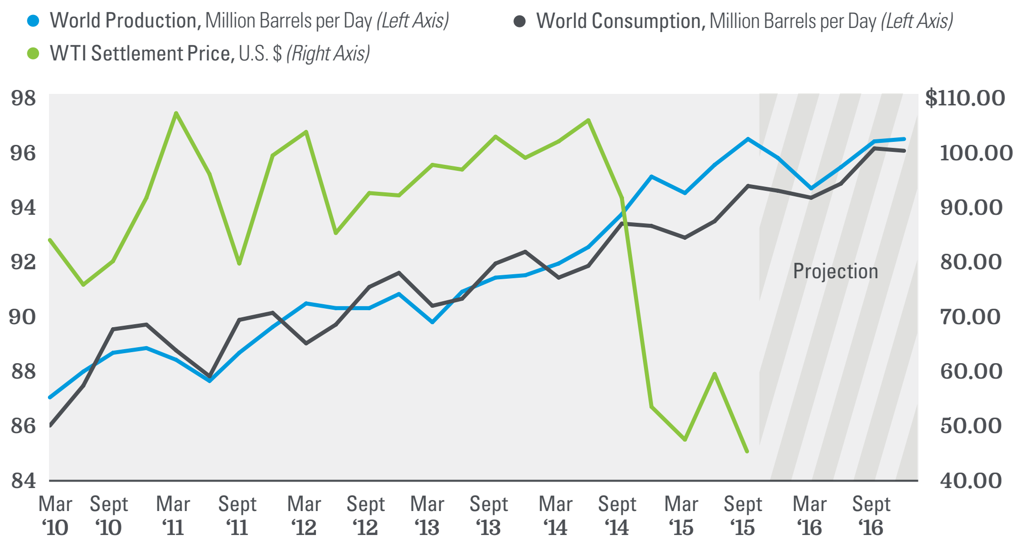
in price. However, this is a gamble against time on OPEC's part. Many member countries, including OPEC's biggest producer, Saudi Arabia, use oil revenue to fund government budgets. A prolonged glut could have a much bigger impact on these countries than a few producer bankruptcies would have on the U.S. Although it is possible that declines in U.S. production could fuel price gains, a cut in production from OPEC would have the best chance of driving prices higher.

An increase in world economic growth could also be a driver that pushes prices higher in 2016. Over the past 30 years, oil consumption has, on average, grown by 1.7% per year (or approximately 462 million barrels per year), while world gross domestic product (GDP) growth has averaged 2.9% per year over the same period (in U.S. dollars, based on World Bank and EIA data). Though demand has been increasing overall, the impact of the slowdown in emerging and developed foreign markets has acted as a drag on demand over the past few years, with an average consumption growth rate of just 1% between 2011 and 2013, before demand increased in 2014 due to lower prices. An uptick in growth expectations for the Eurozone or China could cause markets to believe that demand will overtake supply sooner than the EIA currently estimates, causing prices to increase at a faster rate.

5 Oil Prices Started Falling in Mid-2014 as Production Exceeded Consumption



Source: LPL Research, U.S. Energy Information Administration (EIA), FactSet 11/23/15

Geopolitical risk is another common driver of oil prices, though it has been less important recently given the amount of supply coming from North America. The recent terrorist attacks in France and the consequent increased military activity in the Middle East would likely have had an impact on oil prices but for the additional supply from the U.S. However, there is a limit to the extent U.S. supply can buffer the markets, and conflict in the Middle East could likely increase energy prices significantly.

EMERGING MARKETS MAKE A COMEBACK

Pessimism over the pace of emerging market growth may reverse as global growth improves. If U.S. growth continues to improve, the European Central Bank (ECB) conducts further stimulus, and China and Japan follow suit, the stage may be set for an emerging market rebound.

The ECB's move to initiate quantitative easing (QE) earlier this year has already started to have an effect on key indicators of growth such as bank lending. However, inflation remains below ECB targets and recent comments suggest that more QE may be on the way. Japan expanded its QE in recent years but has again slipped into a recession, and more stimulus may be on the table there as well. Improvements in these developed countries, and continued growth in the U.S., may increase the demand for imports from China and other developing nations.

The Chinese government is easing monetary and fiscal policy as well as undertaking regulatory reforms in an attempt to boost economic growth. Having cut rates five times already, among other measures, China has not been shy in using targeted stimulus to support its economy. We expect this to continue and for growth to stabilize; however, we do not expect China to return to the double-digit rates of several years ago.

Emerging market valuations are attractive relative to U.S. and developed foreign stock markets, with the forward price-to-earnings ratio (PE) for the MSCI EM Index sitting at 11.3 as of November 23, 2015 (which is in-line with its average month-end PE of 11.03 since the beginning of 2000) versus a forward PE of 16.5 for the S&P 500 and 15.1 for the MSCI EAFE Index. Attractive valuations, coupled with the potential for a return to stronger global growth in 2016, may mean emerging market equities have room to improve over the next year.

SECTORS THAT MAY BENEFIT

- Emerging Market Equities
- Commodities
- Energy

SECTORS THAT MAY BE HARMED

- High-Quality Bonds

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ECONOMIC EXPANSION IS YOUNGER THAN IT LOOKS

At 6.5 years old, the current expansion is already the fourth longest of the post-World War II era, but the economy is only 9.4% larger than its prior peak, putting it ahead of only the two shortest post-WWII expansions. We are still seeing typical early cycle behavior in some areas of the economy, with inflation and interest rates remaining low, and business lending and wages yet to show the kind of growth typical of later cycle behavior. Figure 6 shows the percent increase over the previous cycle high for three indicators during the current expansion, compared with the average increase at the end of the last three economic expansions. While confidence has picked up in some areas, we are also seeing little of the borrowing or spending activity typical of late cycle behavior.

Later cycle behavior is most evident in corporate America, where strong profit margins have started to come under modest pressure and earnings growth has slowed. The manufacturing sector, in particular, has struggled, but services sector growth, which is a much larger part of the economy, remains steady. Even though corporate earnings have slowed, earnings numbers are still exhibiting growth more typical of the middle of the cycle after removing the impact of energy and the U.S. dollar. These factors are indicative of the middle of the economic expansion; but the fact that many important indicators are still exhibiting early cycle behavior suggests that a recession may be a few years off, rather than just around the corner.

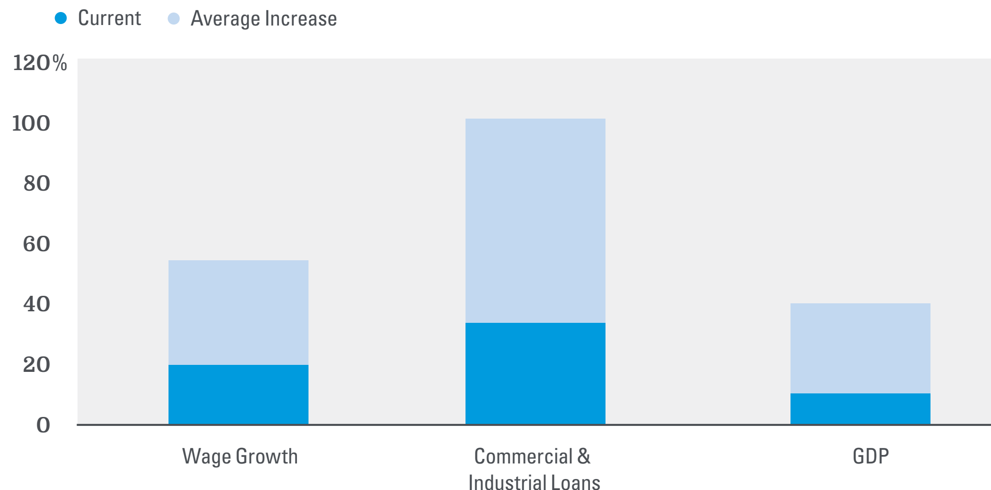
SECTORS THAT MAY BENEFIT

- Financials
- Consumer Discretionary
- Industrials

SECTORS THAT MAY BE HARMED

- Utilities
- Telecom

6 Though We Are in the Second Half of the Economic Cycle, Many Indicators Exhibit Early Cycle Behavior



Source: LPL Research, Federal Reserve 11/25/15

Average increase is measured against the previous cycle high at the end of the previous three expansions

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

SEVERE WEATHER DISRUPTS THE ECONOMY

SECTORS THAT MAY BENEFIT

- Utilities
- Energy

SECTORS THAT MAY BE HARMED

- Consumer Discretionary
- Financials (property insurers)

Weather events are inherently unpredictable; however, early forecasts show that 2016 may see an unusually powerful El Niño pattern, an impactful weather event caused by a shift in ocean temperatures. As a result, the southern and northeastern U.S. are expected to be wetter than normal. This could lead to economic disruptions and may include colder than expected temperatures in the South that could affect agricultural yields. Past El Niños have also resulted in a hurricane season that is stronger in the Pacific and weaker in the Atlantic. This season has already seen 21 category 4 and 5 storms in the North Pacific (beating 1997's record of 17), and October saw Hurricane Patricia, which was the most powerful tropical cyclone ever measured in the Western Hemisphere. While storm damage hasn't been heavy so far, the potential for a larger number of hurricanes means a greater chance that one may hit a heavily populated area.

This year's El Niño may also bring some benefits, especially rain for California, which has been dealing with a historic drought. However, other parts of the world, such as Indonesia, may see dryer conditions. El Niño–related droughts have caused crop failures in South Asia in the past, which have led to local spikes in food prices.

Though economic damage from El Niño is a risk, economic disruptions caused by weather are generally transitory. The first quarter of both 2014 and 2015 saw weather-related weak economic growth as colder than normal winter weather adversely impacted the economy, but both years also saw a bounce back in the second quarter once weather conditions improved.

TAX HOLIDAY GETS THE GREEN LIGHT

SECTORS THAT MAY BENEFIT

- Technology
- Industrials (companies in both sectors hold a lot of offshore cash)

SECTORS THAT MAY BE HARMED

- High-Quality Bonds (assuming growth and interest rates increased)
- Emerging Market Equities

Because 2016 is an election year, we will likely continue to hear about tax reform. One idea that has received attention from several presidential candidates is a tax holiday for repatriating offshore cash.

Currently, U.S. law doesn't tax foreign profits until the cash is brought home, and U.S. corporations held almost $2.1 trillion in cash offshore at the end of 2014. If all of this money were brought back to the U.S., it would create a tax bill of more than $730 billion at the standard 35% corporate tax rate.

In 2004, the U.S. government allowed a tax repartition holiday where the tax on offshore funds was dropped to 5.25%. The intent of this holiday was to

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stimulate the U.S. economy by giving companies an opportunity to bring large amounts of cash back from overseas, which could then be invested in the U.S. and help create jobs. The actual outcome of the last holiday is debatable, with some of the larger companies actually shedding jobs over the next several years. However, the economy was also heading toward the worst recession since the Great Depression, so the layoffs might have been worse if there had not been a tax holiday.

A tax repatriation holiday may face some pushback from Congress no matter who ends up in the White House, and may end up causing companies to expect these holidays going forward, creating a moral hazard. However, given the current focus on government debt levels (especially heading into an election year) and the continued call for more job creation, the potential benefits of a tax holiday may prove too tempting for the government to pass up.

POLITICAL CHANGES

Although the presidential race generates the most headlines, a more important area to watch in the 2016 election may be Congress. Republicans currently hold a majority of seats in both the House of Representatives and the Senate, but their respective leads are not big enough to overcome a presidential veto. If Republicans, who are defending more Senate seats than Democrats in 2016, are able to pull off an upset and increase their seat count, they may end up driving the legislative agenda for the next few years. The highest number of seats Republicans could have in the Senate would likely be in the 60 range, short of the 67 needed for overturning a veto, but enough to stop a filibuster. This would be significant and potentially help Republicans get legislation pushed through, especially if a Republican wins the presidency.

Political uncertainty could undermine fiscal efforts to support the Eurozone. In Portugal, left-wing parties made gains in recent elections and raised the odds, even if still low, of reversing previously enacted reforms and austerity measures. Catalonia's bid for independence may also distract Spain from maintaining reforms, and concerns about terrorism may shift budget priorities as well. Together, these political forces may weaken the resolve to improve the financial strength of the Eurozone as a whole and could create periods of market volatility. ■

SECTORS THAT MAY BENEFIT

- Energy
- Financials
- Telecom (which have historically performed better under Republican leadership)

SECTORS THAT MAY BE HARMED

- Healthcare
- Consumer Discretionary (which have historically performed better under Democrat leadership)

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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 indexes are unmanaged and cannot be invested into directly.

Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

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

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

DEFINITIONS

Quantitative easing (QE) 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.

OPEC is an organization consisting of the world's major oil-exporting nations. The Organization of Petroleum Exporting Countries (OPEC) was founded in 1960 to coordinate the petroleum policies of its members, and to provide member states with technical and economic aid. OPEC is a cartel that aims to manage the supply of oil in an effort to set the price of oil on the world market, in order to avoid fluctuations that might affect the economies of both producing and purchasing countries.

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.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indexes that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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