LPL RESEARCH

MARKET INSIGHT QUARTERLY

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THIRD QUARTER 2016 IN REVIEW

STOCKS RIDE STRONG JULY TO SOLID Q3 RETURN

- **U.S. economy accelerated in Q3, but growth remains restrained.** Based on data received through early October 2016, third quarter 2016 real gross domestic product (GDP) growth is tracking to 2–3%, following 1.4% growth in the second quarter of 2016 and 0.8% growth in the first quarter. Uncertainty around the United Kingdom's (U.K.) impending exit from the European Union (EU), tepid international growth, and an unusual U.S. election cycle may all be contributing to a more cautious attitude among consumers and businesses. Manufacturing has been stabilizing but continues to experience only a slow recovery from the impact of falling oil prices and a strengthening dollar. Even at a 2–3% pace, GDP growth may be enough for the Federal Reserve (Fed) to hike rates in late 2016 or early 2017, supported by a labor market that has created, on average, over 225,000 jobs per month over the last three months of data, and rising inflation.
- **Stocks rose in Q3 on the strength of July.** The S&P 500 Index posted a 3.9% total return during the third quarter, following up a solid July with flat returns in August and September. Central bank support was the dominant theme, helping buoy investor sentiment as Fed rate hike expectations were pushed out to December 2016 amid continued slow economic growth, while market participants generally expected further actions from overseas central

1 Q3 2016 AT A GLANCE

	Q3 2016
GDP*	2.9%
S&P 500 Index	3.9%
Barclay's Aggregate Bond Index	0.5%
Bloomberg Commodity Index	-3.9%

Source: LPL Research, Bloomberg, FactSet 09/30/16

*Bloomberg consensus as of September 30, 2016.

Figures for S&P 500, Barclays Aggregate Bond Index, and Bloomberg Commodity Index are total returns from 6/30/16–9/30/16 (Q3).

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment.

Please note: All return figures are as of September 30, 2016, unless otherwise stated.

Past performance is not indicative of future results.

The economic forecasts set forth in the presentation may not develop as predicted.

Stock investing entails risk including loss of principal.

banks. Markets largely shrugged off political uncertainty in the U.K. post-Brexit vote and in the U.S. ahead of the November presidential election. Market leadership shifted from defensive dividend-paying sectors to cyclicals, as technology and financials topped the quarter's sector rankings; while consumer staples, telecom, and utilities suffered losses.

- **Economically sensitive sectors continue to rally as yields rise**. Treasury yields, which started the quarter at depressed levels due to the surprise Brexit vote, rose steadily over the quarter to end higher across the yield curve. Despite the Fed opting not to hike interest rates in September, global central bank action during the quarter was hawkish on balance, helping to drive global yields higher. The Barclays Aggregate Bond Index returned 0.5%, with corporate bonds returning 1.2%. Economically sensitive, lower-credit quality sectors continued to rally, with high-yield returning 5.6% (Barclays U.S. Corporate High Yield Index), emerging markets debt returning 3.7% (JP Morgan Emerging Markets Bond Index), and bank loans returning 3.3% (Barclays U.S. High Yield Loan Index). A meaningful pickup in inflation expectations was a tailwind for TIPS, which returned 1.0% (U.S. Treasury Inflation Protected Notes Index) during the quarter.
- **Distressed debt leads in the third quarter.** The 5.8% return from the HFRX Distressed Debt Index led third quarter alternative investment category gains, as a higher trading range for oil prices supported performance within the energy and basic materials sectors. While long/short equity strategies (HFRX Equity Hedge +3.4%) marginally underperformed the 3.9% S&P 500 gain on an absolute basis, from a risk-adjusted view performance was very strong. The index maintained a beta profile of roughly a third of that of the broader market, indicating managers were able to add alpha from both their long and short positioning. As measured by the 0.8% decline in the HFRX Systematic Diversified Index, performance from managed futures strategies was lackluster, as the increase in U.S. Treasury rates weighed on portfolios.
- **Oil prices vacillate but end the third quarter lower.** In a quarter with extreme energy price volatility, WTI crude oil prices ended down 1.5%. U.S. crude oil production fell during the quarter, but ended off the lows. News of a potential OPEC production cut late in the quarter buoyed prices. The Bloomberg Commodity Index returned -4.8% in the quarter with agricultural commodities leading to the downside. The trade-weighted U.S. Dollar Index was down marginally, returning -0.2%. ■

A LOOK FORWARD

We expect stocks to produce mid-single-digit returns in 2016, as laid out in our *Midyear Outlook 2016* publication,* based on an expected second half 2016 rebound in earnings, a modest pickup in global growth, stable oil prices, and a largely range-bound U.S. dollar. Although fourth quarters of election years have historically been favorable for stocks, we continue to expect volatility to increase amid global political uncertainty and an aging business cycle. We expect modest positive bond market performance (based on the Barclays Aggregate Bond Index) in 2016 as the Fed is expected to hike interest rates just once this year—likely in December—and low yields overseas continue to put downward pressure on domestic yields.

*As noted in our *Midyear Outlook 2016* publication, we believe the conditions are in place for a solid earnings rebound during the second half of 2016, due to the easing drags from the U.S. dollar and oil, coupled with minimal wage pressures. A slight increase in price-to-earnings ratios (PE) above 16.6 is possible as market participants gain greater clarity on the U.S. election and the U.K.'s relationship with Europe, and begin to price in earnings growth in 2017. Following several quarters of earnings declines, a turnaround in growth should support our forecast for mid-single-digit gains for stocks in 2016.

Bonds are subject to market and interest rate risk if sold prior to maturity.

Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

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.

Alternative strategies may not be suitable for all investors. The management of alternative investments may accelerate the velocity of potential losses.

2 MARKET LEADERSHIP SHIFTED TOWARD CYCLICALS IN Q3

S&P 500 Sector Performance, Ranked by Third Quarter Returns

Sector	Q3 2016
Technology	12.9%
Financials	4.6%
Industrials	4.1%
S&P 500	3.9%
Materials	3.7%
Consumer Discretionary	2.9%
Energy	2.3%
Healthcare	0.9%
Consumer Staples	-2.6%
Telecom	-5.6%
Utilities	-5.9%

3 EMERGING MARKETS AMONG TOP EQUITY ASSET CLASSES IN Q3

Domestic & International Asset Class Performance, Ranked by Third Quarter Returns

Asset Class	Q3 2016
U.S. Small Growth	9.2%
Emerging Markets	9.2%
U.S. Small Value	8.9%
Large Foreign	6.5%
U.S. Mid Growth	4.6%
U.S. Large Growth	4.6%
U.S. Mid Value	4.4%
U.S. Large Value	3.5%

4 RALLY IN ECONOMICALLY SENSITIVE FIXED INCOME SECTORS CONTINUED IN Q3

Bond Market Performance, Ranked by Third Quarter Returns

Sector	Q3 2016
High-Yield Bonds	5.6%
Emerging Markets Debt	3.7%
Bank Loans	3.3%
Municipal High-Yield	1.3%
Investment-Grade Corporates	1.2%
TIPS	1.0%
Preferred Securities	0.7%
Mortgage-Backed Securities	0.6%
Foreign Bonds (Hedged)	0.6%
Barclays U.S. Aggregate	0.5%
Foreign Bonds (Unhedged)	0.1%
U.S. Treasuries	-0.3%
Municipal Bonds	-0.3%

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Bond Market Asset Class Indexes: Foreign Bonds (hedged) – Citigroup Non-U.S. World Government Bond Index Hedged for Currency; Preferred Securities – Merrill Lynch Preferred Stock Hybrid Securities Index; Treasury – Barclays U.S. Treasury Index; Mortgage-Backed Securities – Barclays U.S. MBS Index; Investment-Grade Corporate – Barclays U.S. Corporate Bond Index; Municipal – Barclays Municipal Bond Index; Municipal High-Yield – Barclays Municipal High Yield Index; TIPS – Barclays Treasury Inflation-Protected Securities Index; Bank Loans – Barclays U.S. High Yield Loan Index; High-Yield – Barclays U.S. Corporate High Yield Index; Emerging Market Debt – JP Morgan Emerging Markets Global Index; Foreign Bonds (unhedged) – Citigroup Non-U.S. World Government Bond Index (unhedged)

Sources: LPL Research, FactSet 09/30/16

All indexes are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

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

The sectors are represented by the 10 S&P 500 Global Industry Classification Standard (GICS) indexes.

Asset classes based on Russell 1000, Russell 3000 Growth and Value Indexes, Russell 2000, Russell Midcap Index, MSCI EAFE, MSCI Emerging Markets Index.

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.

General Stock & Debt Equity Risks

Stock investing may involve risk including loss of principal.

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.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio. Diversification does not ensure against market risk.

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

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

Long/short equity funds are subject to normal alternative investment risks, including potentially higher fees; while there is additional management risk, as the manager is attempting to accurately anticipate the likely movement of both their long and short holdings. There is also the risk of "beta-mismatch," in which long positions could lose more than short positions during falling markets.

Definitions

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Hawk/Dove. The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

Index Definitions

The Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, noninvestment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging markets debt.

The Barclays U.S. High Yield Loan Index tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the U.S. High-Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflation-protected securities issued by the U.S. Treasury.

The BofA Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research.

The Bloomberg Commodity Index is calculated on an excess return basis and composed of futures contracts on 22 physical commodities. It reflects the return of underlying commodity futures price movements.

The HFRX Distressed Restructuring Index strategies employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

The HFRX Equity Market Neutral Index strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both factor-based and statistical arbitrage/trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical arbitrage/trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies that may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely, or accurately discounted into current security prices. Equity market neutral strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 92% of the U.S. market.

The Russell Midcap Index offers investors access to the mid cap segment of the U.S. equity universe. The Russell Midcap Index is constructed to provide a comprehensive and unbiased barometer for the mid cap segment and is completely reconstituted annually to ensure that larger stocks do not distort the performance and characteristics of the true mid cap opportunity set. The Russell Midcap Index includes the smallest 800 securities in the Russell 1000.

The Russell 2000 Index measures the performance of the small cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index.

The Russell 3000 Growth Index measures the performance of the broad growth segment of the U.S. equity universe. It includes those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 3000 Value Index measures the performance of the broad value segment of U.S. equity value universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

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.

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 Barclays U.S. Municipal Index covers the USD-denominated, long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The Barclays Municipal High Yield Bond Index is comprised of bonds with maturities greater than one-year, having a par value of at least $3 million issued as part of a transaction size greater than $20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies.

The Citigroup Non-U.S. World Government Bond Hedged Index measures the performance of fixed-rate, local currency, investment grade sovereign bonds. This index is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. It provides a broad benchmark for the global sovereign fixed income market, excluding the U.S., with currencies hedged against the U.S. dollar.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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