LPL Financial

4707 Executive Drive
San Diego, CA 92121-3091

75 State Street, 24th Floor
Boston, MA 02109-1827

January 20, 2016

Dear Valued Investor:

The market has certainly given us plenty to talk about over the years, and I've had the opportunity to write several of these market notes. The majority of these letters have been written during times of market stress. One was written in January 2013, when the market was concerned about the impending fiscal cliff, and then another later in the year, as the market had its "taper tantrum" over uncertainty regarding the Federal Reserve's (Fed) actions. In 2014, we discussed the harsh winter's impact on the economy, and the market sell-off due to the outbreak of Ebola and rise of the Islamic State militants. And last year, second-half fears triggered by the decline in oil prices, weakness in manufacturing, and a slowdown in China prompted multiple notes.

Although each of these letters focused on a unique topic and addressed varying market challenges, they all had one common denominator: fear. They all triggered a strong emotional reaction. Emotion is the most powerful fuel in humans. It drives us to love, to mourn, to cheer our favorite team, and to scream during horror films. Emotion is what makes life more than just a day-to-day routine; it makes it an adventure — full of rewards and sometimes disappointments. And while fear is not something we typically embrace, it is a necessary emotion. It helps us stay alert and seek security — whether that means locking our doors at night or increasing a life insurance policy after starting a family. However, in investing, emotion is often counterproductive to what it takes to be successful.

In an average lifetime, say about 80 years, we will experience roughly 9,000 down market days. We will experience about 13 recessions, approximately 20 bear markets, and too many pullbacks and corrections to even count. That is a lot of market declines. And every one of them will be marked with fear, worry, and the instinctive urge to seek safety. But history has shown that investing with fear as the catalyst is not a successful strategy. After all, very few of those 9,000 down market days in our life are actually a "Lehman Brothers" moment. Furthermore, fear causes us to sell at or near market bottoms and, more often than not, miss opportunities rather than add value with downside protection.

We are currently going through one of these periods of fear. This is best evidenced by examining investor surveys, such as the American Association of Individual Investors (AAII), which this week reported that bulls came in at only 18%, the lowest reading in nearly 11 years. Think about that last statement. The percentage of bullish/optimistic investors is at the lowest level in over a decade. That means that there are fewer bullish investors right now than at any time during the Great Recession. Meanwhile, the percentage of bears spiked up to 45%, the highest level in nearly three years. This degree of pessimism and the increased level of market volatility suggest to us that most of the potential stock market decline may be behind us.

Lately, China and oil are the most often cited catalysts for the fear. The oil market remains oversupplied, and we would not expect a major rally in oil until supply comes off the market. However, we do not think that low oil prices, in and of themselves, will cause a recession in the U.S. or lead to systemic contagion, such as what occurred during the financial crisis. Looking to China, the world's second-largest economy is rebalancing to be more consumption based and less reliant on construction and infrastructure. This transition has been painful. However, China also has vast resources to ease this transition. Should China acknowledge its shortcomings and take concrete steps to fix its economy, this should boost, not further hinder, the global economy.

The challenges and consequences of declining oil prices and a slowing China are not new. Rather, the market has violently shifted from broadly accepting these risks to a virtual abhorrence of them. This is a common market paradigm, where market negatives can be accepted, even embraced, for long periods of time before suddenly becoming major concerns, sparking a sell-off. In a sense, a lack of confidence is driving a full repricing of risk, and that is being reflected in lower values for stocks. Although this is a scary experience, these are the periods where short-term panic can potentially lead patient investors to long-term profit.

With U.S. stocks firmly in correction camp and many segments already in a bear market (Japan, Europe, small cap stocks, etc.), we believe that selling pressure on stocks is moving to extreme levels. At these extremes, the market tends to ignore all positive news and focus (and reprice) purely based on the worst case scenario. However, we do not forecast that a worst case scenario is currently the highest probability event. In fact, we see the likelihood of a recession in the U.S. at roughly 20%, higher than a few months ago but still relatively remote. Supporting our view is the fact that corporate America, outside of the challenged energy sector, remains in very good shape and, we believe, is in a good position to grow profits in 2016—despite the drags from the energy sector, a strong U.S. dollar, and slower growth in China.

While we do not know for certain what lies ahead for this market, we believe the best course of action is to face it with a steadfast commitment to your investment plan; and instead of reacting to the urges of fear, maintain a patient, long-term orientation to the future.

As always, if you have any questions, I encourage you to contact your financial advisor.

Sincerely,

Burt White
Chief Investment Officer
Managing Director, LPL Research

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual security. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Economic forecasts set forth may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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

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

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



RES 5352 0116
Tracking #1-459467 (Exp. 01/17)