

Compass Points

Bringing you our latest tactical investing ideas



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Taking Precautions

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Overview

This bi-weekly update provides an in-depth look at the latest tactical investment thoughts from LPL Financial Research as presented in the Portfolio Compass. This publication is designed to cover a broad investment landscape and present ideas to assist when considering portfolio strategy and to customize investment solutions.

	Fundamentals	Technicals	Valuation	View			Bias
				Negative	Neutral	Positive	
U.S. Stocks				●			
Cash					●		←
REITs	●	●	●		●	○	
Materials	●	●	●			●	←
Financials	●	●	●	●	○		
Utilities	●	●	●	●			→

● Negative ● Neutral ● Positive

As of 06/08/11

Please refer to the Portfolio Compass publication for complete details.

Compass Changes

- Removing our positive bias to our negative/neutral view on U.S. stocks
- Adding a negative bias to our neutral view on cash
- Downgrading Real Estate Investment Trusts (REITs) from positive/neutral to neutral
- Downgrading the Financial sector to negative/neutral from neutral
- Adding a negative bias to our positive view on the Materials sector
- Adding a positive bias to our negative view on the Utilities sector

Investment Takeaways

- The recent employment report and Institute of Supply Management (ISM) manufacturing survey index confirmed that an economic soft spot has arrived. We believe the ongoing slowdown represents a deceleration and not a return to recession.
- Nonetheless, as a precaution we removed the positive bias to our negative/neutral view on U.S. stocks. Our negative bias on cash is a



reflection of our desire to use market weakness in the coming months as an opportunity to add to our favorite investment ideas.

- We downgraded REITs following solid year-to-date performance and our belief that the sector may be more sensitive to an economic slowdown. Similarly, we downgrade the Financial sector due to its greater sensitivity to the economy and an increase in regulatory risk.
- High-quality bond prices may remain firm over the near term as investors debate the length and severity of the economic soft spot. Still, we believe that further gains are limited and over the remainder of the year more economically sensitive sectors, such as high-yield bonds, may offer more reward among fixed income sectors.

Economy

- Economic data continued to deteriorate in early June with an economic soft spot confirmed by top-tier data. Both the monthly jobs report and ISM survey disappointed and showed a notable deceleration. Disruptions from the aftermath of the earthquake in Japan have proven greater than anticipated. Coupled with severe weather in the central and southern United States, these extraordinary factors have added to the mid-cycle economic slowdown. We continue to believe recent softness reflects a deceleration and not a return to recession. Digging under the layers of the jobs report shows that aggregate hours worked increased in May, a positive note, suggesting that core output remains intact and the deceleration in hiring may be temporary. Still, the economic soft spot may persist through the summer months and early fall warranting a more cautious approach.

Equity and Commodities Asset Classes

- We removed our positive bias on U.S. stocks as risks for stocks have increased over the near-term. Stocks may remain volatile while investors debate the duration and severity of the economic soft spot and we believe patience is warranted until further clarity on the economy arrives. In addition, second quarter earnings season will get underway in mid-July and, in coming weeks, companies may provide negative pre-announcements and downward earnings guidance as a result of the economic slowdown and corresponding Japan earthquake and weather-related impacts. Furthermore, in coming days, China will begin to release another round of economic data and should reports come in stronger than forecast, China may respond by hiking interest rates. An interest rate increase may pressure stocks lower as investor fears over the global economic expansion increase.
- We placed a negative bias on our neutral/positive view on cash as we intend to redeploy our cash overweight once the soft spot passes. Ultimately, we believe the economic expansion remains intact and the economic soft spot temporary. We believe a greater-than-normal cash position will enable investors to help take advantage of investment opportunities as they arise.



- We downgraded REITs to neutral from positive/neutral. REITs have enjoyed good performance year-to-date but valuations have become expensive relative to underlying fundamentals. We believe the sector may be overdue for a pullback. Although we believe the housing market is bottoming, REITs and a still-fragile housing market will be sensitive to an economic slowdown even if temporary.

Equity Sectors

- We downgraded the Financial sector to negative/neutral from neutral as the sector, like REITs, is overly sensitive to changes in the pace of economic growth and a slowdown presents additional risks relative to other stock sectors. In addition, regulatory risks recently increased with regulators suggesting even more risk controls that may adversely impact profitability. Finally, technical indicators have deteriorated suggesting that downside price momentum may continue.
- A change in technical indicators motivated our placement of a positive bias on Utilities and of a negative bias on our positive view of the Materials sector. Technical analysis is one component of our three-pronged technical, fundamental, and valuation approach to analyzing investments. The improvement in technical indicators of the Utility sector is a reflection of investors seeking more defensive sectors and the decline in interest rates over the past few weeks. This may prove transitory like the slowdown, however. We continue to find fundamentals and valuations attractive on the Materials sector but the recent deterioration in technical indicators may be an early warning sign from the market. We continue to monitor the sector closely in case fundamentals change also in response to the economy's change in speed.

Fixed Income

- Safe-haven flows pushed high-quality bonds higher for an eighth straight week and the 10-year Treasury yield is challenging the psychologically important 3% level. We believe the low level of interest rates may persist until economic data improves. This process may take several weeks as investors will likely want to see improvement among several reports not just one. Nonetheless, we believe that additional high-quality bond gains are limited as valuations are approaching their most expensive levels since late August 2010 when double-dip recession fears were widespread. We believe another leg weaker in the economic data is warranted to push valuations above the peak witnessed late last summer. We believe that economically sensitive bond sectors, such as high-yield bonds, still possess the most attractive return prospects when viewed over the balance of the year.

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.

Past performance is no guarantee of future results.

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, are subject to availability, and change in price.

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.

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

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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

High Yield bond portfolios concentrate on lower-quality bonds, which are riskier than those of higher-quality companies. These portfolios generally offer higher yields than other types of portfolios, but they are also more vulnerable to economic and credit risk. These portfolios primarily invest in U.S. high-income debt securities where at least 65% or more of bond assets are not rated or are rated by a major agency such as Standard & Poor's or Moody's at the level of BB (considered speculative for taxable bonds) and below.

A commodity is a basic good used in commerce that is interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services. The quality of a given commodity may differ slightly, but it is essentially uniform across producers.

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.

Utilities Sector: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Real estate portfolios invest primarily in real-estate investment trusts (REITs) of various types. REITs are companies that develop and manage real-estate properties. There are several different types of REITs, including apartment, factory-outlet, health-care, hotel, industrial, mortgage, office, and shopping center REITs. Some portfolios in this category also invest in real-estate operating companies.

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.

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