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Pence Perspectives February 2016

BOTTOM LINE UP FRONT

We don't see a recession in the US in 2016. Our economy is well-positioned for another year of modest growth, thanks to rising employment and income as well as consumers' strong balance sheets. Europe and Japan will grow too but more slowly, relying on extraordinary monetary interventions to stimulate growth. Among emerging markets, China is decelerating, and Brazil and Russia are in recession.

The ends of the Federal Reserve's quantitative easing ("QE") and zero-interest-rate policy may be causing a temporary disconnect between the US economy's direction and the path of financial markets. Volatility has become more frequent and of larger amplitude. We expect the ride for investors will be bumpier this year compared to the calmer conditions engineered by the Fed over the last several years.

THE WAY WE SEE IT

Continuing US Growth; Recession Unlikely

As in our last newsletter, we believe the US economy will continue to expand in 2016 at a rate near last year's 2.4% in spite of conditions elsewhere. Continuing strength in the labor market, with record jobs and higher wages, will lead to increases in consumption and housing. These sectors represent 70% of US gross domestic product ("GDP"). We expect that lower oil prices, now in effect for nearly a full year, will also support these sectors. Consumer balance sheets are healthy as debt levels have declined. And, after last year's bipartisan deal on the federal budget, government expenditures no longer drag on GDP. In our opinion, these positive factors make recession unlikely.

That said, growth is constrained by opposing headwinds. On the domestic front, the dollar's appreciation has hurt US exports of manufactured goods, contributing to a contraction in the sector over the last several months. Credit conditions have also tightened, not just from the Fed's termination of QE in 2014 and the quarter-point hike in the target Federal funds rate in December, but also in banks' loan underwriting. The declines in the prices of oil and natural gas threaten the viability of over-leveraged producers and other energy players and may inflict significant losses on their banks and other lenders. Also worth mentioning is the potential for the US election cycle to surprise. Outside the US, we live in a multi-speed world where business cycles and fiscal and monetary interventions vary across countries. Concerns over China's slowing growth and possible credit crisis, the stress on emerging economies caused by the dollar's appreciation, and continuing conflicts in the Middle East and elsewhere will be constant contributors to market uncertainty. Separately or in combination, these headwinds may ultimately weigh on the trajectory of the US real economy.

While the Fed has moved to the sidelines, it continues to emphasize that its future actions will remain dependent on economic data. In its wide-ranging interventions in response to the Great Recession, it accomplished its primary objectives: avoiding a collapse of financial markets, ending the decline and supporting recovery. Unemployment now stands at 4.9%, the lowest rate since the Great Recession began. No longer the heavy lifter, the Fed will act as the economy's hyper-attentive spotter: we believe it will closely monitor the US economy's progress and, if necessary, intervene to prevent a downturn.

So Why are Stocks Lower? And Volatility Higher?

Despite the US economy's obvious momentum, stocks here and around the world have headed steadily and steeply lower since the start of the year. Yes, the headwinds weighing against the US economy have increased the last couple months, but the situation also reminds us of a quip by Paul Samuelson back in 1966: "The stock market has predicted nine of the past five recessions."

We don't believe the declines in stocks and other risk-oriented assets signal impending recession. Instead, they reflect, in our opinion, the transition from the extraordinarily accommodative monetary policies and the do-what-it-takes commitment of the world's central banks, in particular, the Fed, to counter the Great Recession to the data-dependent

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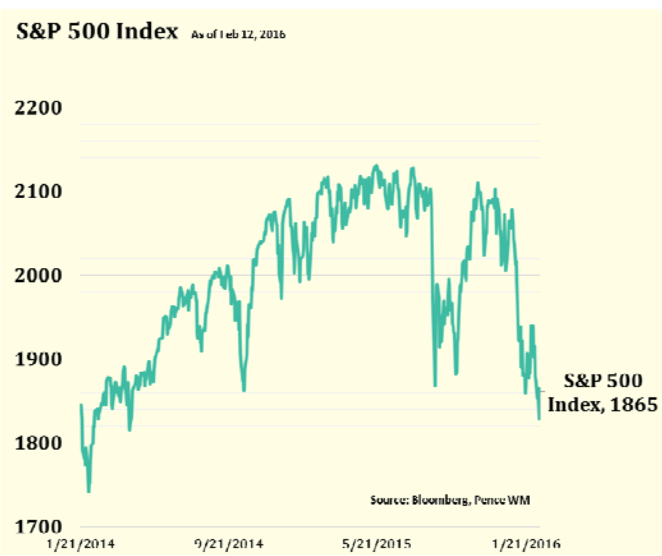
and less-certain environment for intervention today. With the Fed's foot on the monetary accelerator, markets were prepared to overlook downside risks. Now that its foot is removed, markets are taking fuller account – maybe more than they should – of the uncertainties of the current global environment. While markets remain susceptible to frequent and widened swings as opinions and perceptions of the global economy evolve, we believe the repricing of risk assets is a healthy realignment between the real economy and financial markets and an important consolidation of the post-Great Recession gains for each.

Investing in the Current Environment

First, we acknowledge the potential for declining or volatile financial markets to affect the real economy, a negative feedback loop proven by the Great Recession. We are monitoring conditions in financial markets and relevant economic data to identify adverse developments and adapt our investment actions.

Second, we continue, as we have over the last year, to emphasize US companies. Their profits should grow in the mid-single digits. Heightened uncertainty and volatility likely will, we believe, cause a compression in valuations, at least temporarily. Taking higher profits and lower price-to-earnings ratios together, we expect another flat year for the S&P 500 (though a high-single-digit climb from today's writing). Dividends could be a large component of total return this year, so we expect to focus on dividend payers.

Third, sector and stock selection will be critical to both capital preservation and portfolio returns this year, a so-called "stock-picker's market". We believe that prospects for growth in both revenue and earnings are attractive in the consumer-discretionary, technology, healthcare and telecommunications sectors.



Finally, we will be tactical in our approach, adjusting positions when the market or an individual stock rises or falls, to help protect capital and increase returns. The accompanying chart depicts the S&P 500's level since January 2014. The market's path highlights the recent trading range between 1800 and 2100 or so with periods of sharp volatility, both up and down. This year's drop is the fourth time in fourteen months the market has dipped to nearly 1800. In previous cases, the S&P 500 has recovered quickly. Bouts of volatility can be infuriating and sometimes worrisome, but, other than during the recovery from the Great Recession when the Fed consciously repressed them, they're typical and not cause for extreme action or alarm. As the market or a stock nears the top of its trading range or becomes overbought, we may reduce our exposure and raise cash. When the market or a stock moves toward the trading range's bottom or is oversold, we may consider the opportunity a bargain and choose to increase our position.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

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For our clients with Strategic Asset Management (SAM) accounts where we manage with full discretion, depending on your individual situation and account, we expect to hold slightly higher cash positions as opposed to bonds, as they may become more volatile. We will deploy excess cash positions opportunistically as we evaluate both volatility and value. In short, we will remain tactical in a market we expect to be volatile.

For our clients who hold brokerage accounts, if you are interested in a similar fee-based strategy, please contact your advisor.

If you are not yet a client and are interested in learning more about our services, please contact Susan Herman, our receptionist, at 949.660.8777, extension 100, or susan.a.herman@lpl.com to schedule an appointment.

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