LPL RESEARCH

MARKET INSIGHT QUARTERLY

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FOURTH QUARTER 2017 IN REVIEW

BETTER GROWTH, NEW TAX LAW DRIVE STRONG FINISH TO THE YEAR

- **Data point to a U.S. economy that has picked up some speed.** Real gross domestic product (GDP) growth increased at an annual rate of 3.2% in the third quarter, representing the second consecutive quarter over 3.0%, and exceeding the 2.2% average for the economic expansion. Measures of economic surprises relative to expectations rose to decade highs. As of year-end, Bloomberg economists' consensus forecast for fourth quarter GDP stood at 2.7%, while leading economic indicators pointed to continued solid growth as 2018 began, potentially supported by the new tax law.

  Consumer-oriented reports were mostly positive in the quarter, including the strongest increase in holiday retail sales since 2011. Although consumer spending in the third quarter only rose at a 2.2% annualized rate, measures of consumer confidence remain high and job growth has been steady; the hurricane-related dip in jobs created in September was followed by a strong rebound in October. Business investment picked up in the third quarter, increasing at a solid 10.8% annualized pace, while manufacturing surveys remained strong and near expansion highs. As 2017 ended, guidance from the Federal Reserve (Fed) was for three interest rate hikes in 2018 as labor markets continued to tighten incrementally amid signs of budding inflation pressures.

1 Q4 2017 AT A GLANCE

	Q4 2017	2017
GDP*	2.7%	2.3%
S&P 500 Index	6.6%	21.8%
Bloomberg Barclays Aggregate Bond Index	0.4%	3.5%
Bloomberg Commodity Index	4.7%	1.7%

Source: LPL Research, Bloomberg, FactSet 12/31/17

*Bloomberg consensus as of December 31, 2017.

Figures for S&P 500 Index, Bloomberg Barclays Aggregate Bond Index, and Bloomberg Commodity Index are total returns from 09/30/17 – 12/31/17 (Q4).

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 December 31, 2017, 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.

- **U.S. stocks returned 6.6% during the fourth quarter, which is the ninth straight quarterly gain and best since the fourth quarter of 2015.** Solid U.S. economic and earnings growth, improving overseas economies, and monetary policy support helped drive gains, while optimism that the new tax law would stimulate growth and corporate profits supported higher stock valuations. Growth beat value for the fourth straight quarter on strength in the technology and consumer discretionary sectors. Broadly, cyclical sectors outpaced defensives, as healthcare, real estate, telecommunications, and utilities lagged. Small caps trailed large caps in the quarter despite more potential benefit from lower corporate tax rates; large caps benefited from U.S. dollar weakness, improving overseas growth, and repatriation of overseas cash at low tax rates, which was part of the new tax law. Emerging markets (EM) outperformed U.S. and developed international equities in the quarter based on the MSCI benchmarks, benefiting from U.S. dollar weakness, improving economic growth overseas, and commodities gains. The S&P 500 Index returned 21.8% in 2017, while the MSCI EM Index topped major regions with a 37.8% return for the year.

- **Tax reform progress and ultimate passage during the quarter dominated headlines, sending expectations for future Fed rate hikes higher.** With longer-term Treasury yields more muted, the Treasury yield curve flattened again over the quarter, and made for a positive month for all major fixed income sectors.

  The Bloomberg Barclays Aggregate Bond Index returned 0.4%, outperforming Treasuries, which returned 0.1% (Bloomberg Barclays U.S. Treasury Index). Richening valuations helped investment-grade corporates outperform the broader market, returning 1.2% (Bloomberg Barclays U.S. Corporate Index) during the quarter. Economically sensitive, lower credit quality sectors continued higher, with high yield returning 0.5% (Bloomberg Barclays High Yield Index), bank loans returning 0.9% (S&P/LSTA US Leveraged Loan Index), and EM debt returning 0.5% (Bloomberg Barclays EM USD Aggregate Index).

  Municipal bonds were impacted by tax reform, as headlines about the potential for some areas of the market to lose tax benefits led to a late-year surge in issuance. The Bloomberg Barclays Municipal Bond Index posted a quarterly return of 0.8% as market participants chose to look past heightened December issuance, and instead focus on the possibility of reform leading to lower supply in the municipal market in the future.

- **The HFRX Systematic Diversified CTA Index led all quarterly alternative investment returns with a gain of 7.1%.** Long equity exposure continued to drive portfolio gains, as the upward trend in global markets persisted. The HFRX Market Neutral Index was the main laggard, as the category declined 1.0%. Many strategies within the category have a long bias to value stocks, while being short growth firms, an approach that was a broad headwind to overall returns this year.

- **Commodities rose 4.7% during the fourth quarter, bringing the 2017 gain to 1.7%.** Oil helped drive the quarterly gain, as WTI crude jumped 16% amid improving global demand,

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.

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

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.

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overseas supply disruptions, OPEC and Russia extending their production cut agreement, and increasing geopolitical risk in key oil-producing countries. Natural gas ended the quarter down nearly 12% despite a December cold wave throughout much of the middle and eastern parts of the United States. Strong global manufacturing activity drove double-digit gains in industrial metals, led by copper and nickel, while U.S. dollar weakness helped precious metals produce modest gains despite the market's apparent preference for riskier investments. Agriculture commodities fell, led down by grains, partly offset by strength in cotton, sugar, and livestock. ■

A LOOK FORWARD

The return of the business cycle, as discussed in our *Outlook 2018*, remains our major theme for the year. With the Fed pulling back on its monetary policy support, we believe that fiscal policy and earnings will emerge as key drivers. We also believe the combination of improved personal consumption and capital spending from the tax legislation could add anywhere from 0.25–0.50% to our original 2018 forecast of 2.5% in U.S. real GDP growth in 2018.

The reduction of the corporate tax rate combined with businesses' ability to fully expense their capital expenditures for the next five years are likely powerful tailwinds for profits. We look for business investment and further gains in corporate earnings per share (EPS) to power the economy and equity markets. Our recently raised 2018 operating earnings forecast for S&P 500 companies is $147.50. Assuming a trailing 12-month price-to-earnings ratio (PE) of 19–20, we believe the S&P 500 would be fairly valued in the range of 2,850–2,900 by year-end 2018.

Given our outlook for the economy, Fed policy, and the potential for fiscal stimulus, as well as our expectations for a gradual pickup in interest rates across the yield curve, we expect flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index in 2018. Moderate GDP growth and rising inflation may lead to gradually higher interest rates, limiting bond returns. We expect the 10-year Treasury yield to end 2018 in the 2.75–3.25% range. ■

Please see our *Outlook 2018: Return of the Business Cycle* publication for additional descriptions and disclosures.

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2 STRONG FOURTH QUARTER AND 2017 FOR TECHNOLOGY

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

Sector	Q4 2017	2017
Consumer Discretionary	9.9%	23.0%
Technology	9.0%	38.8%
Financials	8.6%	22.2%
Materials	6.9%	23.8%
S&P 500	6.6%	21.8%
Consumer Staples	6.5%	13.5%
Industrials	6.1%	21.0%
Energy	6.0%	-1.0%
Telecommunications	3.6%	-1.3%
Real Estate	3.0%	10.4%
Healthcare	1.5%	22.1%
Utilities	0.2%	12.1%

3 GROWTH AND EM TOPPED ASSET CLASS RANKINGS

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

Asset Class	Q4 2017	2017
U.S. Large Growth	7.9%	30.2%
Emerging Markets	7.5%	37.8%
U.S. Mid Growth	6.8%	25.3%
U.S. Mid Value	5.5%	13.3%
U.S. Large Value	5.3%	13.7%
U.S. Small Growth	4.6%	22.2%
Large Foreign	4.3%	25.6%
U.S. Small Value	2.1%	7.8%

4 CREDIT RISK GENERALLY REWARDED BOND INVESTORS IN 2017

Bond Market Performance, Ranked by Fourth Quarter Returns

Sector	Q4 2017	2017
Municipal High-Yield	1.8%	9.7%
Foreign Bonds (Unhedged)	1.6%	10.3%
TIPS	1.3%	3.0%
Investment-Grade Corporates	1.2%	6.4%
Foreign Bonds (Hedged)	1.1%	2.1%
Bank Loans	0.9%	3.3%
Preferred Securities	0.8%	12.0%
Municipal Bonds	0.8%	5.5%
Emerging Market Debt	0.5%	9.3%
High-Yield Bonds	0.5%	7.5%
Bloomberg Barclays U.S. Aggregate	0.4%	3.5%
Mortgage-Backed Securities	0.2%	2.5%
U.S. Treasuries	0.1%	2.3%

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 – Bloomberg Barclays U.S. Treasury Index; Mortgage-Backed Securities – Bloomberg Barclays U.S. MBS Index; Investment-Grade Corporate – Bloomberg Barclays U.S. Corporate Bond Index; Municipal – Bloomberg Barclays Municipal Bond Index; Municipal High-Yield – Bloomberg Barclays Municipal High Yield Index; TIPS – Bloomberg Barclays Treasury Inflation-Protected Securities Index; Bank Loans – Bloomberg Barclays U.S. High Yield Loan Index; High-Yield – Bloomberg 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 12/31/17

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.

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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.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

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.

Distressed Debt is an investment in companies in or near bankruptcy. The investment is often made to gain control of the company with the goal of either improving the operations of the company or disposing of assets. The risks associated with distressed investing arise from several factors including: limited diversification, the use of leverage, limited liquidity, and the possibility that investors may be required to accept cash or securities with a value less than their original investment and/or may be required to accept payment over an extended period of time.

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.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

Small cap is a term used to classify companies with a relatively small market capitalization. The definition of small cap can vary, but it is generally a company with a market capitalization of between $300 million and $2 billion. The prices of small cap stocks are generally more volatile than large cap stocks.

Index Definitions

The Bloomberg 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 Bloomberg 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 Bloomberg 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 Bloomberg 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 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 Citigroup Economic Surprise Index (CESI) measures the variation in the gap between the expectations and the real economic data.

The HFRX Equity Hedge Index, also known as long/short equity, combines core long holdings of equities with short sales of stock or stock index options. Equity hedge portfolios may be anywhere from net long to net short, depending on market conditions. Equity hedge managers generally increase net long exposure in bull markets and decrease net long exposure (or even are net short) in a bear market. Generally, the short exposure is intended to generate an ongoing positive return in addition to acting as a hedge against a general stock market decline. Stock index put options are also often used as a hedge against market risk. Profits are made when long positions appreciate and stocks sold short depreciate. Conversely, losses are incurred when long positions depreciate or the value of stocks sold short appreciates. Equity hedge managers' source of return is similar to that of traditional stock pickers on the upside, but they use short selling and hedging to attempt to outperform the market on the downside.

The HFRX Event Driven Index managers maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

The HFRX Macro: Systematic Diversified CTA Index strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ counter trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Systematic Diversified strategies typically would expect to have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

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 S&P/LSTA U.S. Leveraged Loan 100 index is a market value-weighted index designed to measure the performance of the U.S. leveraged loan market. The index consists of 100 loan facilities drawn from a larger benchmark - the S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan Index (LLI).

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