LPL Financial

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Dear Valued Investor:

Autumn is a time of tradition and ritual: post-season baseball, a new school year, apple picking. For those of us in financial services, there is no change in seasons, but fall is another time to check in on the U.S. economy, the Federal Reserve (Fed), and the financial markets as investors return from summer breaks.

The many indicators we follow suggest the U.S. economy continues to improve at a moderate pace and that the economy remains firmly in the middle stage of the business cycle. Our forecast for U.S. gross domestic product growth over the remainder of 2014 remains at 3%, consistent with growth rates during the middle of the previous business cycles. Some bright spots for the economy continue to shine despite the onset of grayer weather in many parts of the country:

- The job market continues to gradually improve. Initial jobless claims as a percentage of the labor force have never been lower and the economy created an average of 216,000 jobs per month over the past seven months.
- The latest round of U.S. manufacturing data suggests businesses are increasing their level of capital spending, a sign of confidence that corporate profits may continue to grow at a steady pace in the quarters ahead.
- Household net worth is on the rise and is currently about $13 trillion above its prerecession peak, providing solid support for consumer spending in the coming quarters.

But is the economy doing well enough that we should worry about the Fed hiking interest rates? We don't think so. The Fed meeting in mid-September 2014 gently reminded markets that higher short-term rates are on the way, which could put some upward pressure on borrowing rates for consumers and businesses, but the Fed was also clear that it is unlikely to raise rates soon. If the economy continues to grow at the 4% pace it did during the second quarter of 2014 (unlikely, in our view) and reaches its full potential sooner, then the Fed will likely move up its timetable for rate hikes. We expect the Fed to begin hiking rates in about a year's time, assuming the economy tracks near our forecast.

Fed rate hikes have created short-term jitters in the stock market, but historically have not caused stocks to deviate from their longer-term upward trajectory. In fact, stock market returns between the start of Fed rate hikes and the peak in the stock market have been very attractive. And let's remember why the Fed hikes rates—it's because the economy is performing well and the Fed believes that normalizing policy is the best path to sustainable long-term growth. The market's tendency to do well during the fourth quarter (especially during midterm election years) and continued growth of corporate profits are other causes for optimism.

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The upcoming Fed rate hikes are reason to take a cautious approach toward the bond market, where a lack of broad-based opportunity in bonds persists. Low yields are unattractive, and we do not expect price gains over the balance of 2014.

As you enjoy your autumn traditions, we will continue to watch the U.S. economy, the Fed, and the financial markets. We maintain our positive stock market view, and the bond market is unlikely to do much more than provide a buffer against stock market declines, especially if interest rates rise as we expect. Still, we believe a diversified portfolio makes sense to mitigate unforeseen risks.

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

Sincerely,

John Canally, CFA
SVP, Chief Economic Strategist