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Highlights

The Road to Recovery is behind us now and the market's next phase marks a new part of the journey: the Transition to Sustainable Growth.

In the next stage of the journey from recession to recovery to growth, the market enters a period where the catalyst for growth will shift from stimulus-led to business- and consumer-led expansion.

- **Transition Stage 1:** Committing to the Recovery (stage we have just entered)
- **Transition Stage 2:** Preparing for Life Without Help
- **Transition Stage 3:** The Market On Its Own Two Feet

In this edition of the White Paper, we will explore how the economy and market will move to sustainable growth—weaning off the assistance of accommodative monetary policies and stimulus-inspired growth.

The Transition to Sustainable Growth

The Phase After the Road to Recovery

In late 2008, when the recession was at its peak, LPL Financial Research rolled out the Road to Recovery, our roadmap of how we thought the market and economy would find its bottom and begin to recover. That journey unfolded almost exactly as we outlined from 2008 through the beginning of 2010. However, the economy does not stay in a recovery phase forever. Eventually, a recovering economy and revived market needs to evolve to one that shifts—from healing to growing, recovery to prosperity, and survivability to sustainability. In a sense, the economy has already shifted from recession to recovery; now it gives way to the next series of mile markers, which will guide it from recovery to growth. The Road to Recovery is behind us now and the market's next phase marks a new part of the journey: the Transition to Sustainable Growth.

Transitioning to sustainable growth is an important phase following a recession where consumers and businesses begin to heal from a severe economic contraction and switch slowly from a strategy of conservative protectionism to one of fueling future growth. As optimistic sounding as it is to hear about "growth" in this phase, we must not forget that it is the word "sustainable" that makes this phase of the market's journey daunting. This is because in order for the economy and market to truly have sustainable growth, they must be weaned from the assistance of accommodative monetary policies and stimulus-inspired growth in favor of a market capable of creating and maintaining expansion without help. In a bumper-sticker, the economy needs to transition from supported growth to sustainable growth.

This is certainly not an easy transition to make. With interest rates at all-time low levels, how will the market grow when rates return to normal levels? With the unemployment rate around 10% and unemployment benefits extended to record durations by governments, when will the market support significant hiring and overcome the exit of government issued "paychecks"? How will the market do when Washington shifts from accommodative stimulative policies to ones that potentially offer headwinds for the economy through tighter reforms, increased taxes, and a bulging deficit? The economy and the market have enjoyed being "propped up" by accommodative government policies, but as the burden shifts towards consumers and businesses to be the catalysts for growth, both opportunities and challenges are presented.

Where We Have Been: The Road to Recovery

The Road to Recovery, which was rolled out in late 2008, was the journey the market followed to find its bottom, establish equilibrium between buyers and sellers, emerge from recession to recovery, and shift from a contracting to a rebounding economy. The Road to Recovery had 3 stages.

- **Recovery Stage 1:** Bull Market for Volatility (Timeframe: Entire recession through early first quarter 2009)
- **Recovery Stage 2:** Risk is Opportunity (Timeframe: Early first quarter 2009 through early third quarter 2009)
- **Recovery Stage 3:** Cyclical Growth Returns (Timeframe: Early third quarter 2009 through first quarter 2010)

Trends give way to transitions. In a market undergoing multiple transitions, volatility and a shifting landscape become the norm.

Benefitting from the easy monetary policies of central banks and government stimulus, companies have been allowed to weather the recession by maintaining a protective, reduced spending paradigm. However, the baton is being handed over from governments to businesses and the catalyst for continued growth now lies with companies, which must shift from protecting profits through cost reductions to investing for future growth through expansion, hiring, exploration, and new initiatives. This transition from assistance to independence is not an easy one, especially following such a severe recession. However, it is required and will be the challenge faced during the next stage of the market's journey as it undertakes the Transition to Sustainable Growth.

The Next Step: The Transition to Sustainable Growth

In the next stage of the journey from recession to recovery to growth, the market enters a period where the catalyst for growth will shift from stimulus-led to business- and consumer-led expansion. The three stages of the Transition to Sustainable Growth are below.

- **Transition Stage 1:** Committing to the Recovery (stage we have just entered)
  The market is unsure if this recovery is really sustainable. As this idea becomes accepted as reality, consumers and businesses become committed to the recovery and begin to spend to fuel future growth.
- **Transition Stage 2:** Preparing for Life Without Help
  With consumers and businesses having committed to growth, the central banks of major countries start to hint at undertaking and even begin the tightening cycle. Markets and the economy must come to grips with the notion of growth without being propped up by stimulus and accommodative policies.
- **Transition Stage 3:** The Market On Its Own Two Feet
  With the tightening cycle across the globe in full force, growth shifts entirely onto the backs of consumers and businesses.

Investing During Transitions

Before diving into more details on the three stages of the Transition to Sustainable Growth, let's focus on some key "rules" for investing during periods like this. During the Road to Recovery, the market was largely on an upward-trending trajectory as the improving economy and price recoveries from deeply oversold levels produced an environment for a predominantly "one-way", strong returning market. But in this current phase, trends give way to transitions. In a market undergoing multiple transitions, volatility and a shifting landscape become the norm. As a result, different techniques are required to thrive in periods where the only trend is one of shifting directions.

There are nine rules for navigating a market in transition.

- **Be Flexible:** With a market in flux, portfolios will need to be nimble to take advantage of opportunities. Therefore, tactical, not buy-and-hold, or strategic portfolio strategies, will be key in 2010.

During transition periods, portfolios should have an eye towards risk management, be more concentrated to fewer high conviction investment ideas, employ trading ranges (buy at the low end and sell at the high end), and stay nimble by committing to a more tactical approach to investing.

"When you are expected to exceed expectations, expect the unexpected" — Oleg Vishnepolsky

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative strategies may accelerate the velocity of potential losses.

- **Take Bigger Bets in a Fewer Number of High Conviction Ideas:** In a trendless market, there are fewer great ideas which will mean investors will have to concentrate on a smaller number of high conviction bets.
- **Establish Trading Ranges:** A shifting market will experience multiple pullbacks, but be largely range bound. Therefore, the most successful strategy is to buy the dips and trim the rips—meaning a more active re-balancing strategy is a way to success.
- **Benefit from Increased Volatility:** When volatility spikes, so may opportunity.
- **Don't Give it Away in Fixed Income:** Don't forget about the fixed income side of portfolios as the potential for rising rates could make risk-controlling bonds actually risky.
- **Don't Forget the Simple Rules:** Don't fight the Fed. Listen to the market. Beware when the crowd gets too optimistic or pessimistic.
- **Use Alternative Strategies, Not Just Bonds, to Help Manage Risk:** Once central banks begin to raise rates and bonds do not provide risk control anymore, investors should consider alternative strategies to help cushion the downside.
- **Invest in What You Know:** 2010 is not the year to be a hero or to guess—have a plan and follow it.
- **Manage Expectations:** After last year, expectations are sky high. As the market transitions to fueling sustainable growth, market returns will likely be volatile and modest. Remember the famous quote by Oleg Vishnepolsky: "when you are expected to exceed expectations, expect the unexpected".

In addition, unlike the recovery phase of the market which dominated most of 2009, the transition phase will be marked with "uneven" data and market reaction—it can view both good and bad news as bad. As a result, a market in transition typically prefers "goldilocks" results, not too bad, not too good. News that is too good may result in a quicker exit of government aid, but news that is too bad is a sign that the recovery may be stalling or reversing. In the end, volatility will be on the rise and will make portfolio management techniques perhaps just as important as investment selection. During transition periods, portfolios should have an eye towards risk management, be more concentrated to fewer high conviction investment ideas, employ trading ranges (buy at the low end and sell at the high end), and stay nimble by committing to a more tactical approach to investing.

Transition Stage 1: Committing to the Recovery

For nearly a year, companies have enjoyed an economic recovery that has been largely fueled by accommodative government and expansive monetary policies. However, in Transition Stage 1, these tailwinds begin to fade. The economic backdrop will continue to improve as housing will find its bottom, employment will shift towards an environment of making jobs, and companies will begin to see both top- and bottom-line growth. During this

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

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

REGIONS AND COUNTRIES WHERE THE CENTRAL BANKS ARE:

Tightening	Hinting to Tighten	Not Tightening
China	United States	Europe (via ECB)
Australia	Brazil	United Kingdom
Israel	Canada	Japan
Norway	New Zealand	Switzerland
Vietnam	South Korea	
	India	
	Turkey	

Source: LPL Financial, Bloomberg

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

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

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

High Yield/Junk Bonds are not investment-grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Cap-Ex Tends to Decline During Recessions as Companies Reduce Spending to Protect Profits

Source: Census Bureau/Haver Analytics 01/12/10

time, businesses will be required to take the helm as the growth leaders by recognizing the recovery and making the transition from a defensive to opportunistic stance.

That said, the global economy will still be reliant on accommodative government policy during this Transition Stage 1. As a result, the vast majority of countries, including the United States and the European Union, will remain in an accommodative stance in order to give businesses the tailwinds they need to make the transition from protection to growth. There will be, however, some strongly growing countries and regions, such as China, Australia, and Emerging Markets, that will be begin to withdraw stimulus and start the tightening cycle. This begins the shift from an expansionary to tightening policy cycle for global central banks.

During this stage, companies have to commit to the recovery by loosening their grips on corporate expense controls and begin investing for the future. Not every company will be willing to accept the reality of the recovery and commit to the transition from protecting profits through expense management to protecting market share through funding growth initiatives. This shift from protecting profits to propelling growth is the reason that this phase of the cycle is considered a transition. Like most phases of change, businesses will make this transition at different times and at different magnitudes. As a result, volatility will increase.

From a selection perspective, investment opportunities in this phase will be in those areas of the market that most benefit from a shift to increased capital spending, the re-stocking of inventories and the refocus on research, development, and exploration. In addition, those companies most flexible to shift from defense to offense in the pursuit of growth will be the market-share gainers. In Transition Stage 1, LPL Financial Research likes investments in the Technology, Industrial, and Materials sectors and the Biotechnology industry, as these are the biggest beneficiaries of business capital investment and increases in depressed capital expenditures (cap-ex). The Energy sector may be another likely winner, with the Exploration and Production (E&P) industry having the best opportunities for growth. Emerging markets and commodity asset classes are other potential winners in Transition Stage 1, as the demand for goods due to increased business spending will trigger higher raw material prices and benefit the cheaper production and higher export markets of emerging countries. The growth style should also be a relative winner.

Transition Stage 2: Preparing for Life Without Help

In the second stage, global central banks, having successfully transitioned "expansion responsibility" to businesses to fuel the continued resurgence in global growth, begin to move in unison to withdraw stimulus and transition to more normal lending and credit levels. What is interesting is that in Transition Stage 1, it is businesses that make the transition: from self protection to investing for the future. In Transition Stage 2, it is global central banks' turn to transition from an easing to tightening monetary stance.

The signal that Transition Stage 2 has begun is when the largest central banks of countries and regions hardest hit by the recession, namely the

Transition Stage 2 is one where volatility may be at its highest. The reason is that businesses, which have begun to invest for the future, finally get the dose of reality that the tailwinds of accommodative policies are now shifting to headwinds.

Federal Reserve Bank (Fed) in the United States or the European Central Bank (ECB) in Europe, begin their shift from easing to tightening monetary policies by withdrawing stimulus, raising interest rates, or removing reserves from the financial system. The reason is that global central banks will not begin to withdraw their accommodative policies unless sustainable growth is well underway.

Transition Stage 2 is one where volatility may be at its highest. The reason is that businesses, which have begun to invest for the future, finally get the dose of reality that the tailwinds of accommodative policies are now shifting to headwinds. It is like being a rock climber. When tied to a safety line, climbing is much easier (and safer) than when climbing without one. In Transition Stage 2, the market, having been cut from its easy monetary policy "safety line", will be responsible for manufacturing its own growth and, worse yet, having to compensate for the increasing headwinds due to withdrawing central banks.

Many of the same investments and portfolio management techniques used in Transition Stage 1 are also appropriate in Transition Stage 2, including the Growth style, Emerging Market Equity and Debt, Commodity asset classes, High-Yield Bonds, and Cyclical sectors; as the economic expansion continues in earnest. In addition, Bank Loans will become a solid opportunity, as the adjustable rate feature of the investment will benefit from the rising rate environment. To help with increased volatility, alternative strategies, including Global Macro and investment vehicles exposed to Long/Short and Covered Call strategies, may be a potential source of diversification and risk reduction.

Transition Stage 3: The Market On Its Own Two Feet

By the time that Transition Stage 3 unfolds, global central banks will be in a virtual chorus of tightening monetary policy. While in Transition Stage 2 markets should have gotten accustomed to this new global policy environment and had the surprise factor removed, it will nonetheless be met with very little excitement. Like the way a screw pierces wood easily at the start, but becomes harder to turn the further it goes in, the same effect will be felt by the markets. As one global central bank after another transitions from easy to tightening monetary policy, the markets benefitting from tailwinds will slowly be impacted by stiff headwinds and their reaction is likely to be negative.

This does not mean that there will not be investment opportunities in Transition Stage 3. In fact, with volatility opportunity may come, especially when the market gets a sense of the pace and the degree of the tightening, which will answer the market's final unknown. In each of the two preceding stages, the market had questions it asked that were eventually answered. In Transition Stage 1, the market worried ***if*** growth would ever be sustainable without global central bank intervention. In Transition Stage 2, the concern surrounded ***when*** tightening would unfold to slow down the sustainable growth. In Transition Stage 3, the final market unknown is ***how much*** and ***how fast*** the tightening cycle will be. Once this final market worry is clarified, market concern could give way to renewed return opportunities.

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The investment opportunities in Transition Stage 3 have more defensive characteristics, especially during the "unknown" period listed above. These would include a shift from more cyclical sectors to more defensive sectors like Consumer Staples and more conservative Technology names, as well as the Large Cap asset classes. While defense is certainly the name of the game, be careful about the traditional use of bonds as the sole method to help mitigate risk. Remember that rates will be moving higher as global central banks raise interest rates in their tightening cycle, which is a negative for bonds. It is especially hindering for the lower yielding, traditionally more conservative bond sectors such as Treasuries and Mortgage-Backed Securities, as the lower yields cannot make up for the impact of rising rates. Another approach will be to use High-Yield Bonds (the higher income can overcome the rise in rates), Bank Loans (benefit from higher rates), and Alternative Strategies.

SUMMARY OF THREE PHASES OF THE TRANSITION TO SUSTAINABLE GROWTH

	Transition Stage 1	Transition Stage 2	Transition Stage 3
Who is transitioning?	Businesses: From protecting profits to investing for the future	Central Banks: From accommodative to restrictive monetary policies	The Market: From an environment of central bank tailwinds to central bank headwinds
Market Bias	Volatile, upward moving	Volatile, range bound	Volatile, downward moving
The Sign When it Begins	We are here now	When either the ECB or Fed shifts to tightening	When most major central banks are in tightening mode
Opportunities?	▪ Investments at the lower end of trading ranges, especially: Cyclical investments and Commodity asset classes ▪ Emerging Market Equity & Debt ▪ High-Yield Bonds	▪ High-Yield Bonds ▪ Bank Loans ▪ Alternative Strategies ▪ Growth Equities	▪ High-Yield Bonds ▪ Bank Loans ▪ Alternative Strategies
Risks	Market at the top of the trading range	Conservative fixed income	Conservative fixed income
Rules to Remember	Stay nimble, don't fight the Fed; Establish trading ranges	Benefit from increased volatility. Use Alternative Strategies to manage risk.	Manage expectations. Don't give it away in fixed income.

Conclusion

While the transition will not be easy, it will be rewarding, as the market can begin to count more on capitalism as opposed to Capital Hill and profits instead of policies.

During the Transition to Sustainable Growth, businesses take the baton from central banks as the market's growth catalyst. This transition from assisted growth to independent, sustainable growth will result in the market getting weaned from the reliance on governments and central banks. While the transition will not be easy, it will be rewarding, as the market can begin to count more on capitalism as opposed to Capital Hill and profits instead of policies. Change is not easy for anyone and the market is no exception. During periods of transition, the market is often fickle around good and bad news, as well as usually exhibiting extreme levels of volatility. However, with volatility and change comes opportunity. After all, the transition of businesses from relying on accommodative central bank policies to becoming independent catalysts for sustainable growth is certainly a great platform for long-term success for corporate America and investors alike.

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.

Stock investing involves risk including loss of principal.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing the entire amount paid for the option.

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

Investing in alternative investment may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. There is no assurance that the investment objective will be attained.