

LPL RESEARCH PRESENTS
MIDYEAR

outlook

2022

NAVIGATING TURBULENCE



 LPL Financial

Navigating Turbulence



Markets rarely give us clear skies, and there are always threats to watch for on the horizon, but the right preparation, context, and support can help us navigate anything that may lie ahead. So far, this year hasn't seen a full-blown crisis like 2008–2009 or 2020, but the ride has been very bumpy. We may not be flying into a storm, but there's been plenty of turbulence the first part of 2022. How businesses, households, and central banks steer through the rough air will set the tone for markets over the second half of 2022.

The sources of turbulence are clear. A global economy that was already vulnerable to inflation from supply chain disruptions, tight labor markets, excess stimulus, and loose monetary policy came under more pressure when Russian aggression in Ukraine added sharply rising commodity prices and Europe on the brink of recession to the mix. The effects have included renewed pressure on interest rates, which hurt bond investors and contributed to tightening financial conditions, and a much more aggressive stance by the Federal Reserve (Fed) and other global central banks. Add in the typical market challenges of a midterm election year and the third year of a bull market, and it's not surprising it's been a bumpy ride.

Understandably, rising prices, slowing economic growth, and a challenging first half for both stocks and bonds have many investors on edge, and fatigue from more than two years of COVID-19 measures doesn't make it any easier. But markets are always forward looking, so it's important to remain focused on what lies ahead. There will most certainly be challenges, but there are also some tailwinds from a strong job market, still resilient businesses, and the likelihood that inflation will soon start to slow. Markets historically can even get a little lift from lower uncertainty around elections as midterms approach.

Turbulence cannot be avoided, but it also need not deter us from making progress toward our financial goals. LPL Research's *Midyear Outlook 2022: Navigating Turbulence* is designed to help you assess conditions over the second half of the year, alert you to the challenges that may still lie ahead, and help you find the smoothest path for making continued progress toward your destination. When times are turbulent, the surest path toward progress remains sound financial advice from dedicated professionals who have logged many hours in similar conditions. Please reach out to your trusted financial advisor with any questions.

 **Economy**

negative print in first quarter gross domestic product (GDP), we think the economy has sufficient momentum to offset the inflationary pressures. Our base case forecast includes an inflation rate that moderates as supply bottlenecks improve and we potentially get some closure to the Russian war with Ukraine. Our most likely scenario is the economy avoids an official recession, as growth is expected to notch just above 2% in 2022 with another downshift to under 2% in 2023. These are annual figures so intra-year economic activity could be quite volatile as the Fed becomes more aggressive in the tightening cycle.

 **Inflation**

Inflation will most likely be significantly above the Fed's long-run target of 2%. Inflation rates will likely cool throughout this year, but the cool down period will be long and slow. Some inflation pressures should subside as China adjusts its COVID-19 policy and supply chains improve. A slowing housing market could also eventually ease inflationary pressures later this year and into 2023.

 **Stocks**

which inflation falls. Volatility may persist, but an improved macroeconomic environment may set the stage for higher valuations, further earnings growth, and solid gains for stocks over the rest of the year. The challenge comes from predicting how fast inflation will come down. Our year-end fair value target for the S&P 500 is 4,300–4,400, based on a price-to-earnings ratio of 18–19 and our 2023 S&P 500 earnings per share forecast of \$235.

 **Bonds**

values is 100% certain all the time. Like all markets, fixed income investing involves risks and, at times, negative returns. However, despite the historically poor start to the year, the value proposition for core bonds has actually improved recently. With the big jump in yields that has already taken place this year, we believe core bonds look as good as they have in quite some time. As rate hikes work their way through the economy and slower growth starts to get priced in, we could see the 10-year Treasury yield end the year between 2.75–3.25%.

We believe the domestic economy will continue to grow this year, albeit slower than we expected six months ago. Other than the anomaly of a

 **Policy**

One of the things we knew coming into this year was that 2022 will be a midterm year—and those have historically not been kind

to stocks. In fact, since 1950, midterm years have seen the largest peak-to-trough pullback of the four years of the presidential cycle, with the S&P 500 Index down 17.1% on average during the year. The good news is, one year off those lows, stocks have been up more than 32% on average. And the S&P 500 has been higher a year after every midterm election since 1950—18 out of 18 years—with an average gain one year later a very solid 14.5%. It looks like a divided government is in the cards, which markets have historically liked.

 **Alternatives**

Losses across both stock and bond markets in 2022 have left many searching for

ways to further diversify exposures. While alternatives cover a wide range of approaches, several have helped fill that gap, and may continue to do so over the rest of the year. We continue to believe our preferred alternatives implementations—event-driven strategies, market neutral strategies, and relatively conservative low volatility strategies—have the ability to act as a source of ballast during such periods of high volatility.

 **Currencies**

As we enter the second half of 2022, the factors that led to a sharp and nearly uninterrupted

ascent for the U.S. dollar such as a hawkish Fed and demand for safe havens may begin to reverse. In the intermediate term, easing inflation from unsnarling of supply chains post-COVID, aided by China's reopening, could help push the dollar lower.

 **Commodities**

Commodities have garnered support from both demand and supply, and

we believe upward pressure on prices will likely persist for at least the next several months. Demand has gotten a lift as the global economy emerged from the pandemic. Sanctions on Russian energy exports have kept oil and gas prices elevated. Ukraine is an important global supplier of agricultural commodities such as corn and wheat, putting upward pressure on food prices. From an investment perspective, we would favor energy.

Midyear downshift for macroeconomic environment

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Economic growth will likely downshift in the latter half of 2022, reflecting a slowdown in real spending as a consequence of elevated, persistent inflationary pressures. Recession risks are increasing but our base case is no recession this year as consumers, particularly the upper-income ones, can sustain spending patterns from income growth, excess savings, and revolving consumer credit.

U.S. ECONOMY SLOWING, NOT SHRINKING

We believe the domestic economy will continue to grow this year. Other than the anomaly of a negative first quarter GDP print, we think the economy has sufficient momentum to offset the inflationary pressures. Our base case forecast includes an inflation rate that moderates as supply bottlenecks improve and we potentially get some

closure to the Russian war with Ukraine. Our most likely scenario: the economy avoids a recession as forecasted growth surpasses 2% in 2022 with another downshift to under 2% in 2023 [Fig.1].

Looking back, the U.S. economy took off in 2021, surging 5.7% after contracting by the most since the Great Depression at 3.4% the previous year. Last year, consumer spending was extremely robust, particularly on consumer goods as consumers flush with stimulus checks were still less inclined to spend on services. Goods spending contributed roughly 2.7 percentage points to the headline growth rate, the highest since 1955. While we do not think consumer spending will continue at this clip in 2022, the consumer will likely weather the headwinds of high prices and geopolitical uncertainty and support the overall economy throughout 2022, offsetting the expected decline in residential investment.

Forecast shows downshift, but likely not a recession

GDP Growth (Y/Y%)	2022	2023
United States	1.9 – 2.5%	1.3 – 1.9%
Eurozone	2.1 – 2.7%	1.5 – 2.1%
Advanced Economies	2.2 – 2.8%	1.9 – 2.5%
Emerging Markets	3.1 – 3.7%	3.6 – 4.2%
Global	2.5 – 3.1%	2.8 – 3.4%

Inflation (Y/Y%)	2022	2023
United States	6.6 – 7.2%	3.5 – 4.1%
Eurozone	6.7 – 7.3%	3.6 – 4.2%
Advanced Economies	6.5 – 7.1%	3.8 – 4.4%
Emerging Markets	6.8 – 7.4%	4.2 – 4.8%
Global	6.5 – 7.1%	3.9 – 4.5%

Source: LPL Research 6/30/22

FLIP THE SCRIPT

As it turns out, monetary policy might not necessarily be the main factor underneath growth or recession prospects. The consumer is the key variable. U.S. consumers, particularly the upper-income ones, might be the primary factor for the base case estimate that the U.S. gets a “softish”

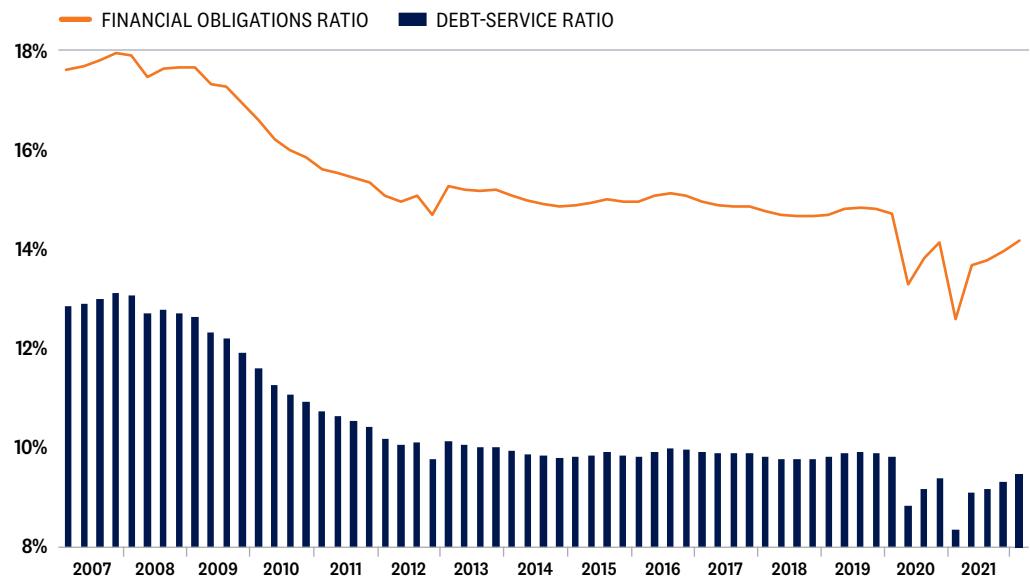
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Consumers deleveraged since the financial crisis

landing. Instead of only focusing on the probability that the Fed makes a policy mistake, watch consumer behavior—especially during these times of higher food and energy prices—as consumer spending makes up roughly 70% of the economy.

Overall, consumer spending will likely slow during the latter half of this year as inflation pressures weigh on consumers and wage growth likely lags inflation. These factors in tandem will erode consumers' real purchasing power. However, recent spending activity shows a fairly stable consumer. Real consumer spending rose 0.7% in April, the fourth consecutive monthly increase in real spending, before pulling back slightly in May. The job market is tight, supporting consumer spending from gains in personal income, but the real cushion for consumers comes from roughly \$3 trillion in excess savings accumulated during the pandemic.

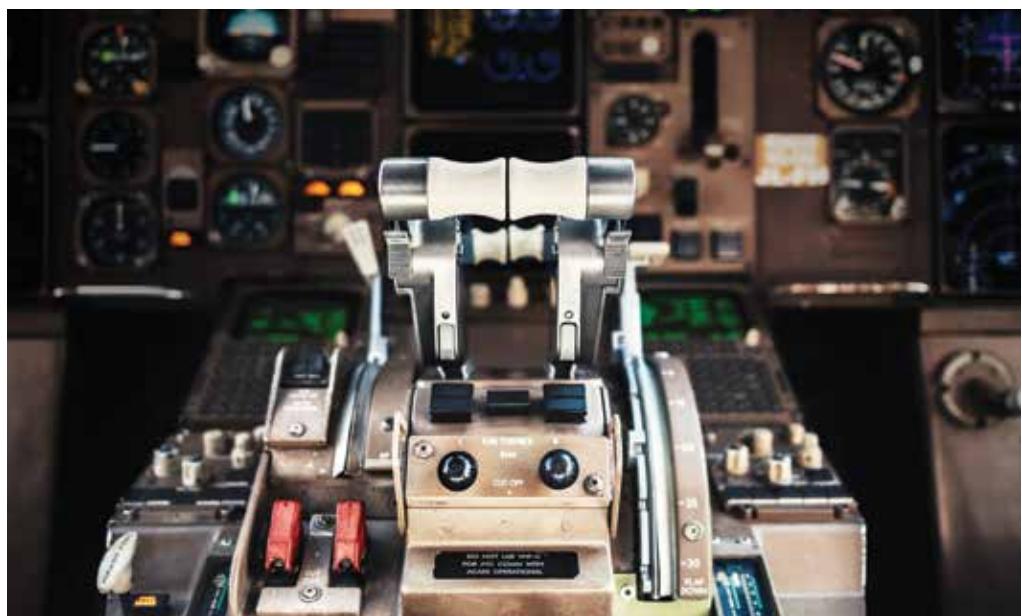
To further pad personal spending, consumers will likely tap into consumer credit. We expect revolving credit demand to increase in the latter half of this year without

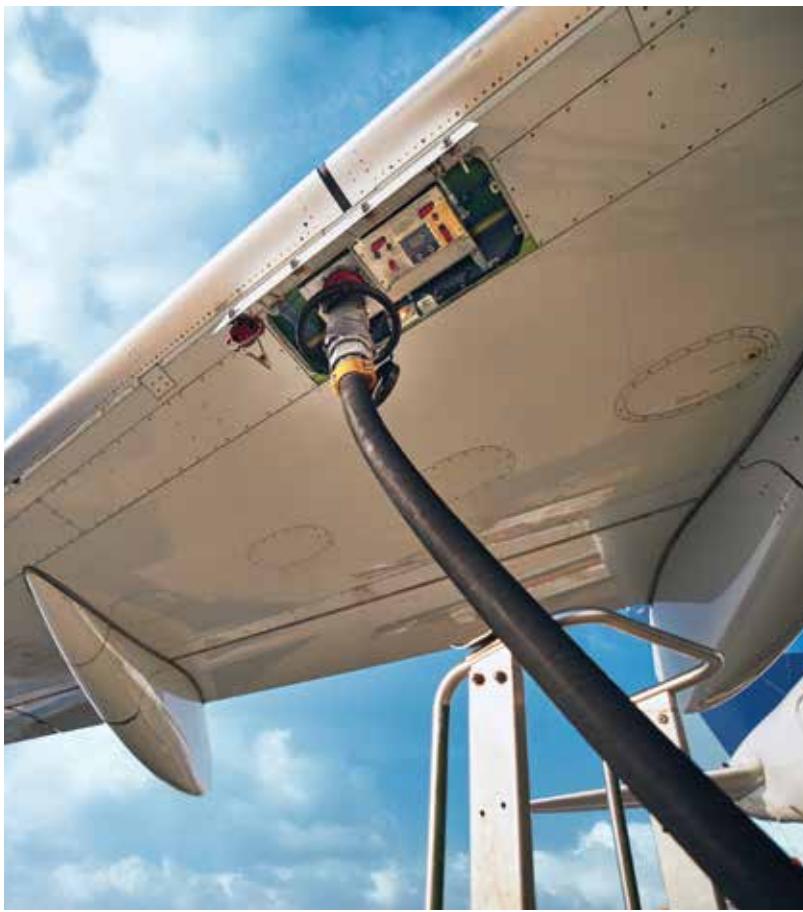


Source: LPL Research, Federal Reserve Board 6/30/22

reaching unstable levels since consumers hold much less debt now relative to previous cycles. After the Great Financial Crisis, consumers started aggressively deleveraging. Overall debt payments as a percent of disposable income declined and remained steady until the emergence of COVID-19 [Fig.2]. Government pandemic assistance programs, including stimulus and

Economic growth will likely downshift in the latter half of 2022, as a consequence of inflationary pressure.





If supply bottlenecks improve and inventories are restocked, the economy could see growth in the latter half of this year.

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Business backlog decline as China reopens

forbearance periods, added volatility to consumers' financial obligations. But if consumers are able to keep relatively low debt levels, we think the consumer can successfully navigate a period of rising borrowing costs without squelching spending.

INVENTORY REBUILDING COULD FUEL GROWTH

If supply bottlenecks improve, we expect to see firms restocking inventories, supporting underlying economic growth. Recent reports from the Institute of Supply Management show that order backlogs are declining for both the manufacturing and services sectors [Fig.3]. As firms have improved access to required inputs and as the transportation sector recalibrates

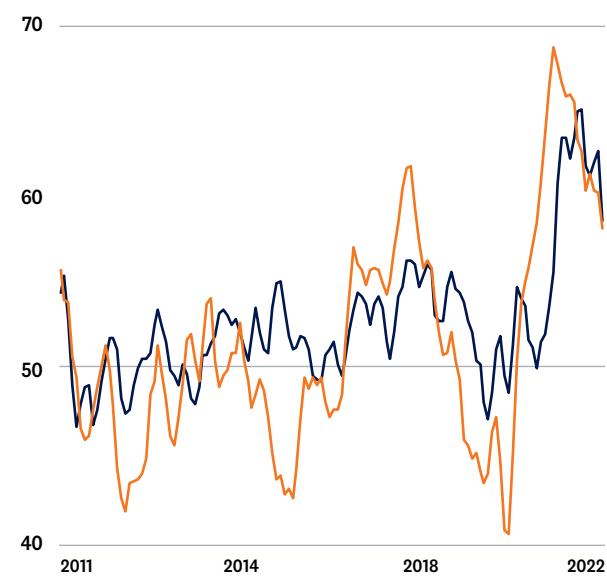
to the current environment, the economy could likely see growth in the latter half of this year and avert a recession.

INFLATION IS STILL THE WILD CARD

Inflation rates will likely cool throughout this year, but the cool-down period will be long and slow and inflation will still very likely be above the Fed's long run target of 2%. Improvements in supply chains have started to impact consumer prices [Fig.4]. Technically, consumer price changes lagged by four months are 72% correlated with the New York Fed's Global Supply Chain Pressure Gauge. Given the improvement in supply chains, inflation pressures should subside.

ORDERS BACKLOG (3-MONTH MOVING AVERAGE)

ISM SERVICES ISM MANUFACTURING



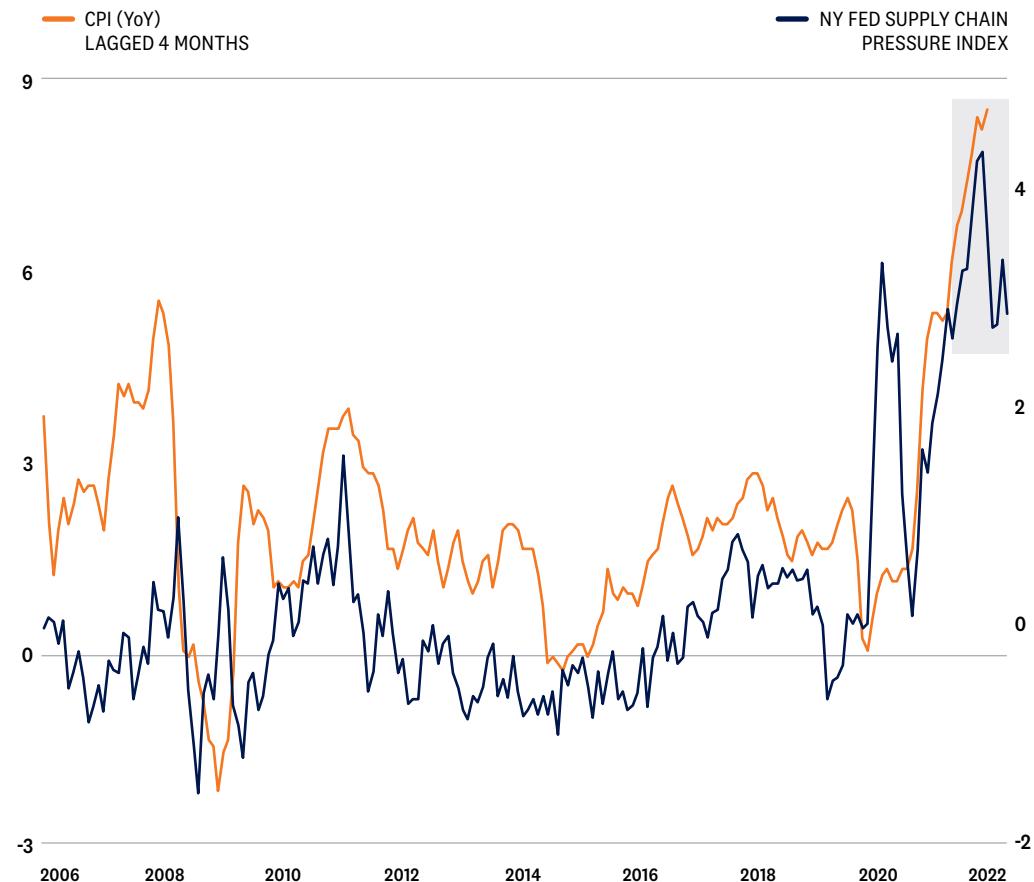
Source: LPL Research, Institute for Supply Management 06/02/22

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Consumer prices should ease as supply chains improve

POTENTIAL DRAG ON GROWTH

A slowdown in residential investment will likely have a meaningful impact on growth this year. The slowdown could come from both the demand and supply sides as interest rates increase. The average rate on a 30-year fixed rate mortgage has risen over 2 percentage points since the beginning of the year and has created a damper on housing activity. Secondary effects from rising mortgage rates will likely slow consumer spending. At the beginning of this year, the principal and interest payment on a \$300,000 loan at 3.27% was \$1,309. At the end of May, the monthly payment rose by \$366. As housing becomes a larger percentage of an individual's budget, we will likely see a decrease in discretionary spending.



Source: LPL Research, New York Federal Reserve, Bureau of Labor Statistics 06/02/22

When we look at changes in borrowing costs we often focus on homebuyers, but higher borrowing costs also affect builders. High capital and labor costs are a current challenge for all builders, and high interest rates particularly impact developers who rely on the debt market for construction. Tighter financial conditions could eventually slow new home construction, putting a damper on home supply and residential investment. Inventories of new and existing homes are already low, and if builders slow the rate of construction, home prices will not likely decline as much as they did in 2006–2011 since current supply is low.

RISKS TO THE OUTLOOK

A still unknown variable to our forecasts is the Fed's shrinkage of its

balance sheet, known as quantitative tightening (QT). The Fed will only allow its nearly \$9 trillion balance sheet to shrink incrementally over time while also paying attention to the impact QT is having on the markets. The Fed has stated that QT could "replace" several rate hikes as a way to tighten financial conditions and help curb inflation, but the bigger risk is the Fed aggressively tightening and intentionally engineering a recession to slow down pricing pressures. Remember, it took two recessions in the early 1980s to put an end to inflation back then. The other risk could come from weakening consumer spending. As consumers become more concerned about future economic conditions, they may become less inclined to spend on consumer goods or services.

Equities face heavy cloud cover

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Stocks will face a number of headwinds in the second half of the year, but the amount of turbulence will likely depend on the pace at which inflation falls. It's tough to see the bull case through the cloud cover right now, and volatility may persist, but an improved macroeconomic environment may set the stage for higher valuations, further earnings growth, and solid gains for stocks over the rest of the year.

SEVERAL FACTORS CAUSING TURBULENCE

Stocks faced many challenges in the first half of the year. At the top of the

list were rampant fears of recession as the Fed began to pull back monetary policy support and pushed interest rates higher to combat high inflation. The Fed's track record of fighting inflation without causing a recession is not reassuring. More often than not, its rate hiking campaigns have preceded (or caused) recessions—though typically at interest rates above current levels. Nonetheless, high inflation has been a common ingredient in recessions since WWII—see the 1970s, early 1980s, early 1990s, and even 2008. Add to that, an unexpected war in Eastern Europe and lingering—though diminishing—effects

of COVID-19 on global supply chains, and the skies are far from clear.

EASING INFLATION PRESSURE IS KEY

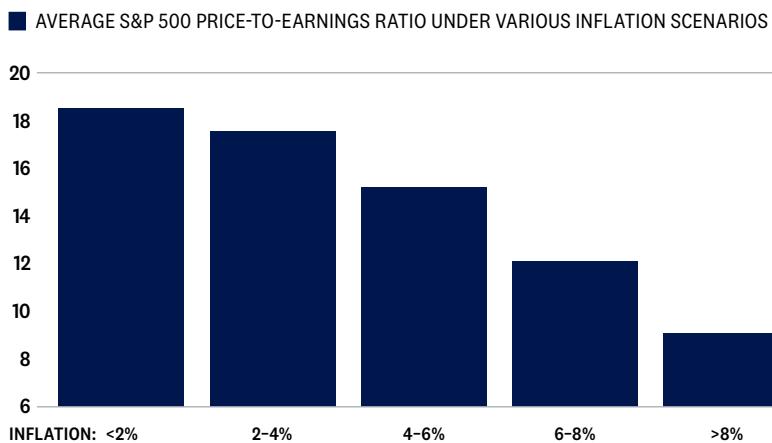
The amount of time it takes for stocks to return to prior highs will be largely determined by the path of inflation. LPL Research expects perhaps 1.5 percentage points to come off of core consumer prices by year-end—the latest reading for the Fed's preferred inflation measure, the Core Personal Consumption Expenditures (PCE) Index excluding food and energy for April, was 4.9%. Lower inflation tends to bring higher valuations [Fig.5]. The market clearly does not expect 8% inflation to persist based on current stock valuations, but whether inflation eventually settles at 2%, 3%, or 4% will go a long way toward determining how much higher stock valuations can go from current levels.

EARNINGS TRAJECTORY LEVELING OFF

First quarter earnings season wasn't exactly pretty, but given the difficult environment, a roughly 10% increase in S&P 500 earnings per share (EPS) and nearly 14% increase in revenue, both solidly above expectations, were excellent results. Companies were generally able to pass through price increases to limit pressure on profit margins amid higher materials and transportation costs, labor shortages

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Lower inflation typically means higher valuations

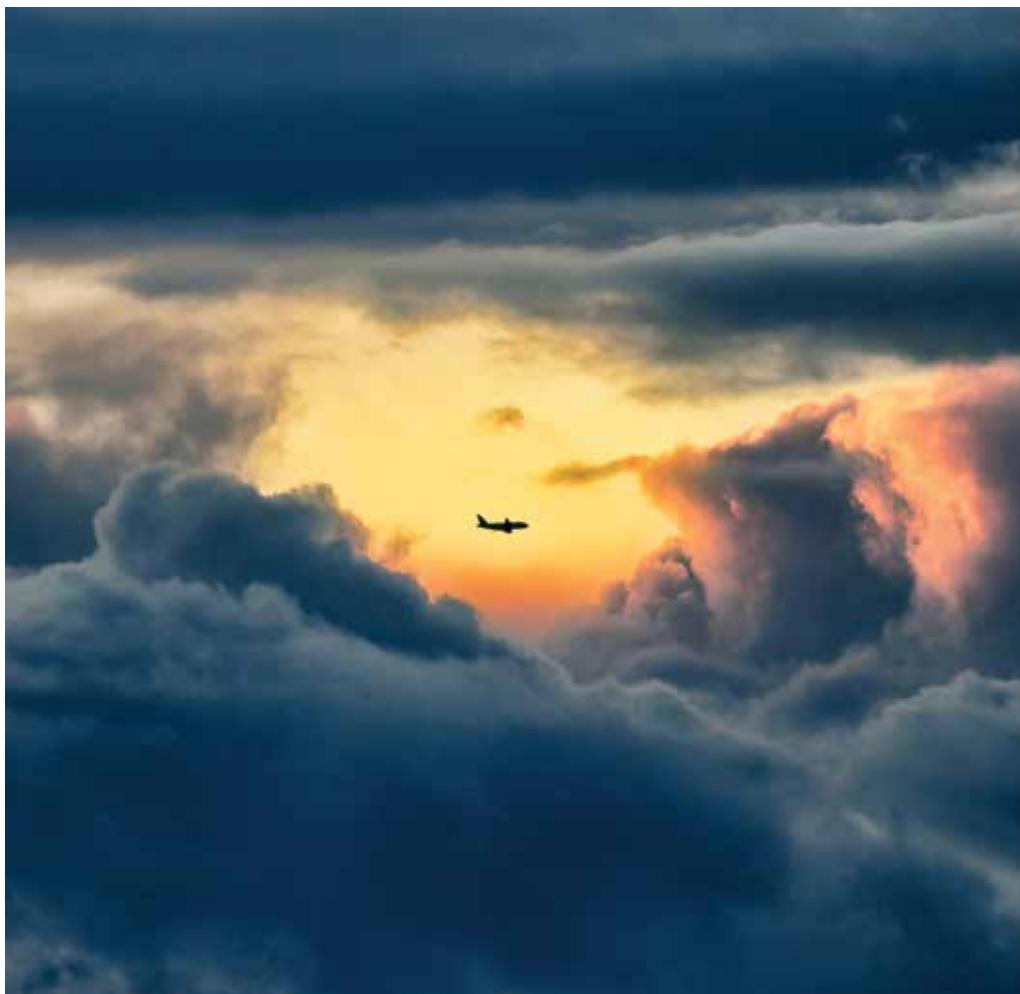


Source: LPL Research, Bloomberg 6/30/22 (Data 1962 - 2022)
Inflation represented by the annual change in the Consumer Price Index. Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Volatility and inflation may cloud the outlook for equities, but higher valuations and earnings growth could lead to stock gains over the rest of the year.

and rising wages, and various supply chain disruptions.

Solid first quarter results set corporate America up to potentially grow S&P 500 EPS by 8% in 2022 to \$225 per share. That forecast is still about \$5 below the consensus estimate and potentially conservative [Fig.6]. Our forecast for 2023 is \$235, a mid-single-digit increase over our 2022 forecast and more than \$16 below the consensus estimate of over \$251 per share. We expect mid- to high-single-digit earnings growth this year and next to help support a stock market turnaround in the months ahead.

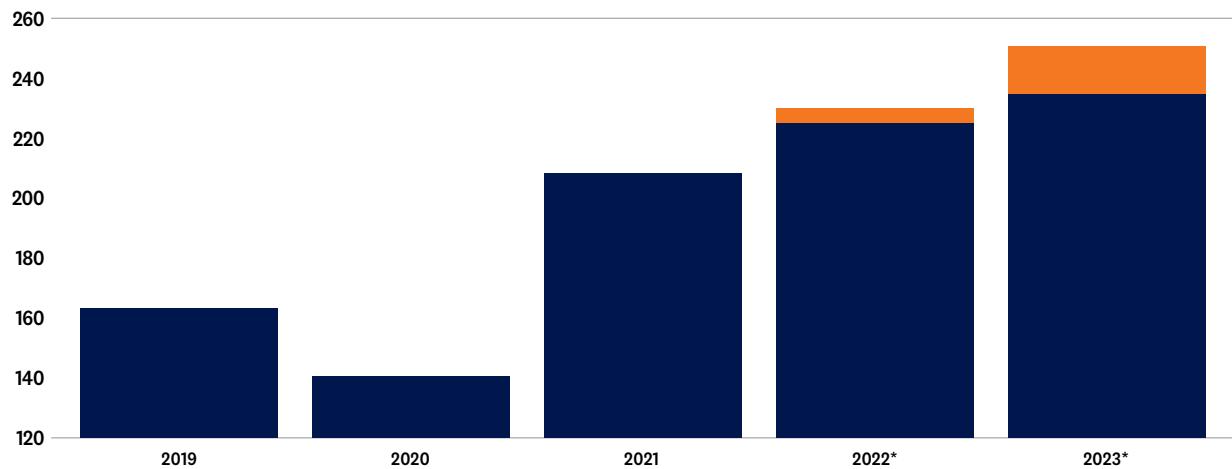


LPL Research earnings estimates appear conservative

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■ LPL RESEARCH VS. CONSENSUS S&P 500 EARNINGS PER SHARE (LPL VS. CONSENSUS)
■ LPL RESEARCH S&P 500 EARNINGS PER SHARE (ACTUALS / FORECAST)

*FORECAST



Source: LPL Research, FactSet 6/27/22

Indexes are unmanaged and cannot be invested in directly. Estimates may not develop as predicted.



Stock valuations may get a lift if economic growth picks up in the second half as inflation falls. But profit margins may be a drag as cost pressures remain intense.

LIFT FROM VALUATIONS, DRAG FROM MARGINS

As of June 27, the S&P 500 Index was trading at a price-to-earnings ratio (P/E) of about 15 times consensus 2023 S&P 500 EPS, slightly below the long-term average. If U.S. economic growth picks up in the second half as inflation falls, calming recession fears and supporting earnings growth, we would expect valuations to get a nice lift by year-end.

But will profit margins be a drag? Current margins may support above average valuations, but cost pressures remain intense as inflation has been stubbornly slow to come down. Labor markets are still tight. Commodity prices are still high, especially oil. Supply chains are improving but remain a challenge, keeping prices for certain inputs elevated. Revenue growth is expected to slow with the economy, leaving less cushion for companies to hit their margin targets. These potential headwinds to profitability may make it difficult for corporate America to maintain its current high-single-digit

2022 & 2023 U.S. market forecasts

S&P 500 Fair Value at Year-End	4,300 – 4,400
2022 S&P 500 Earnings per Share	\$225
2023 S&P 500 Earnings per Share	\$235

Source: LPL Research 6/30/22
Indexes are unmanaged and cannot be invested in directly. Forecasts may not develop as predicted.

Equity asset allocation recommendations



Market cap

LPL Research favors a benchmark-level exposure to small, mid and large cap stocks for the second half of 2022 (compared with the LPL Diversified benchmark). Although large cap stocks may be better positioned for a late-cycle economy, small and mid cap stocks enjoy attractive valuations and may benefit from greater exposure to a potential second half rebound in the U.S. economy.



Style

Growth-style stocks were trounced by their value counterparts in the first half of 2022. As the second half gets underway, with inflation still very high, leaning toward the inflation beneficiaries on the value side such as energy may still be prudent. Once inflation starts to come down and economic growth and interest rates potentially stabilize, growth performance may begin to turn around.



Sector

LPL Research recommends a modest tilt toward defensive sectors and away from cyclicals as the second half begins with uncertainty still elevated. Our favored defensive sectors include healthcare and real estate, while the near-term outlook for the energy sector remains positive on both a fundamental and technical basis. The aforementioned conditions for a style shift toward growth (falling inflation, stabilizing economic growth, and interest rates) may also drive a turnaround in the leading growth sector, i.e., technology, so that is one to watch for the second half of the year.



Region

The U.S. economy appears better positioned than Europe to withstand higher energy costs, particularly Germany which is very reliant on Russian energy, supporting LPL Research's preference for U.S. equities over their developed international counterparts. Headwinds for U.S. stocks include the large weighting in the technology sector and strong U.S. dollar. Our outlook for emerging market (EM) equities is neutral, as geopolitical risk offsets the reopening of China's economy and attractive valuations. The U.S. dollar is a wildcard but a potential reversal lower after such strong first half gains could be supportive.

earnings growth pace, but our base case calls for steady earnings gains through 2023.

LIMITED VISIBILITY

With so much uncertainty, this is a difficult stock market to forecast. The range of potential outcomes is wider than most years. The challenge comes from predicting how fast inflation will come down, which will determine how much profit margins narrow, how fast earnings can grow, and where interest rates eventually land.

The opportunity for a strong second half is not hard to see. Earnings growth and higher valuations can be a powerful combination. Our base case expectation calls for a P/E of 18-19 and \$235 in S&P 500 EPS in 2023, resulting in a year end S&P 500 fair value target range of 4,300 to 4,400 [Fig.7]. That's an attractive destination from the market's current location, though the flight path may not be a straight line. The wide range reflects the high degree of uncertainty and the possibility stocks get re-routed.

Clearer skies for core bonds



The value proposition for core bonds (as defined by the bonds within the Bloomberg Aggregate Bond index) is that they tend to provide liquidity, diversification, and positive total returns to portfolios. Unfortunately, none of those values is 100% certain all the time. Like all markets, fixed income investing involves risks and, at times,

negative returns. However, despite the historically poor start to the year, the value proposition for core bonds has actually improved recently. Investing is a forward-looking exercise and with the back-up in yields that has already taken place this year, we believe now could be as good as it's been in quite some time for core bonds.

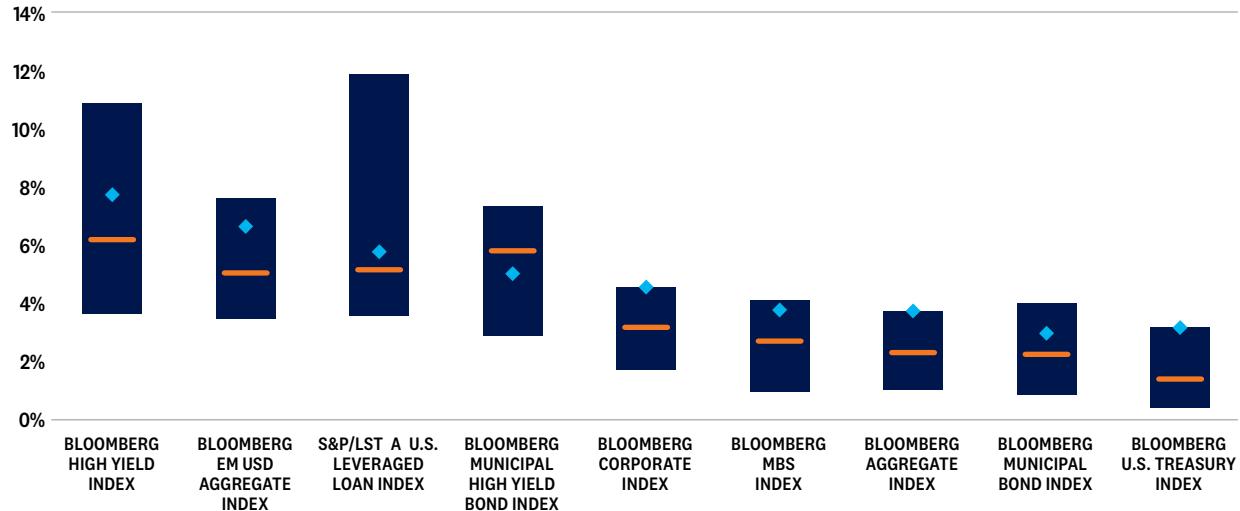
RAPIDLY ASCENDING RATES

Importantly, yields have moved higher because of the changing expectations of higher short-term interest rates and not an increase in credit risk. Coming into 2022, markets were only expecting one or two short-term interest rate hikes by Fed this year, with most of the hikes

Yields across fixed income sectors are above longer-term averages

YIELD-TO-WORST (YTW) ACROSS FIXED INCOME SECTORS (%) SINCE 2010

■ RANGE OF YIELDS — MEDIAN YIELDS ◆ CURRENT YIELDS



Source: LPL Research,
Bloomberg 6/10/22

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. Yield to worst is the minimum yield that can be received on a bond, assuming the issuer doesn't default on any of its payments.

Despite the poor start to the year, the value proposition for core bonds has improved recently and clearer skies may be ahead.

expected to come in 2023. However, markets have aggressively re-priced the number of potential Fed rate hikes and now expect as many as 13 by year-end. As such, the yield on the 10-year Treasury security has more than doubled this year after increasing around 100 basis points (1.00%) off its lows in 2020. The 250 basis points (2.5%) move higher that has already taken place this cycle is the biggest move higher in yields since 1994, when rates moved higher by 280 basis points—and that was at the end of the rate hiking cycle. So, with so many rate hikes priced in at this point, we think the worst could be behind us.

So have rates peaked? Historically, rates have tended to move a lot before the first rate hike (like they've done this year) but they still move marginally higher throughout the rate hiking process. Typically rates don't actually make a top until inflation peaks and the Fed stops raising rates, two things that clearly haven't happened yet, as this cycle has only just started really. That doesn't mean we will see significantly higher yields—we don't think we will—but we could see 3.50–3.75% on the 10-year



this year, which would likely be the top in yields for this cycle, in our view. As rate hikes work their way through the economy and slower growth starts to get priced in, we expect to see the 10-year Treasury yield end the year between 2.75–3.25%.

NO MORE TINA?

TINA, or “there is no alternative” has been a big reason diversified asset allocation portfolios have been overly geared toward equities over the past few years. The relative attractiveness of equities over fixed income was undeniable when interest rates were hovering around all-time lows. Now that interest rates have moved higher recently, though, the relative attractiveness between stocks and bonds is much more balanced.

But for investors unwilling or uninterested in taking on additional equity risks, there are a number of fixed income markets with yields

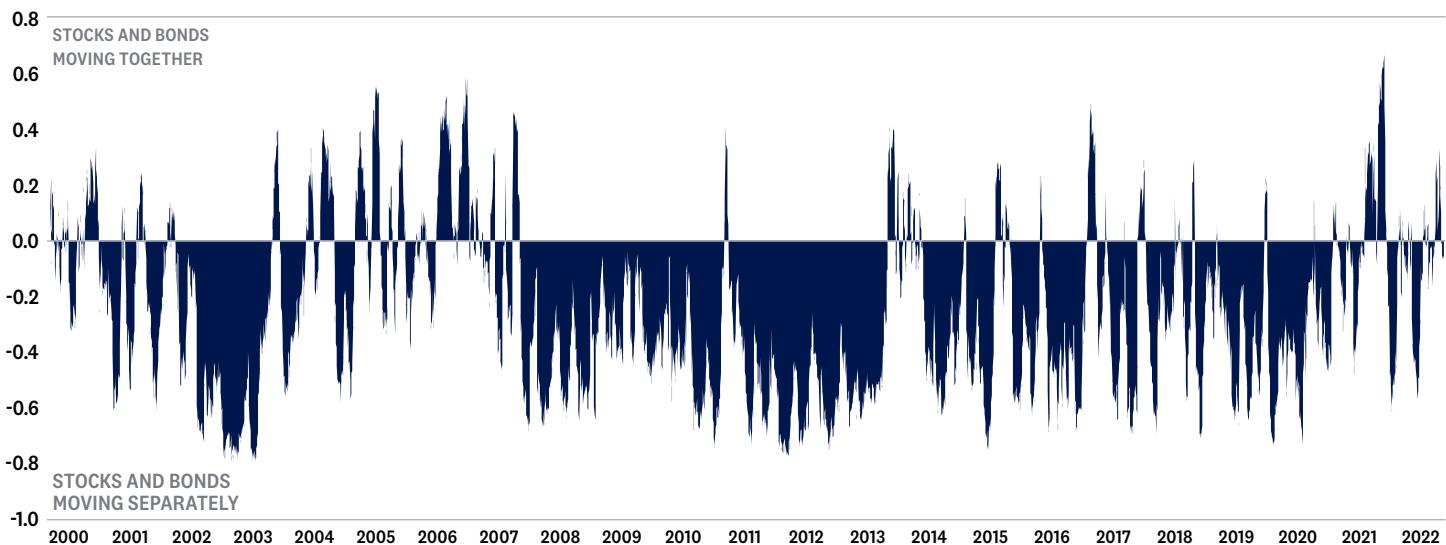
trading above long-term averages. The yield on most fixed income asset classes is hovering around the highest levels we've seen in a decade [Fig.8]. And for the Bloomberg Aggregate index, yields are the highest they've been since 2010. Since starting yield levels are the best predictor of future returns, following the big move higher in yields this year, future returns look more attractive than they have in years. With interest rates so low over the past few years, the back-up in yields could be an attractive opportunity for income-oriented investors. And while we can't guarantee that interest rates won't go higher, at current yields, the risk/reward for owning fixed income has improved dramatically, in our opinion.

We still think maintaining a slight underweight to the most interest-rate sensitive assets is appropriate, although we are more likely to increase

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Are bonds starting to act like equity diversifiers again?

30-DAY ROLLING CORRELATION OF THE BLOOMBERG AGGREGATE INDEX TO THE S&P 500 INDEX



Source: LPL Research, Bloomberg 5/31/22

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

exposure to longer-maturity/duration bonds as the year unfolds given our view on rates. Additionally, we think mortgage-backed securities and high-quality short-to-intermediate corporates are attractive areas within the taxable fixed income market. Next, we think the high-quality national municipal market is as attractive—from both a fundamental and valuation perspective—as it's been in quite some time. Finally, for income-oriented investors, high-yield corporate bonds may be an attractive option. However, we still expect above-average levels of volatility as the Fed removes monetary accommodation.

DIVERSIFICATION BENEFITS OF BONDS MAY BE IMPROVING

Since 2000, the correlation between stocks and bonds has generally been negative—that is as equity prices were falling, bond prices were rising—although there has been considerable variation with that relationship [Fig. 9]. And at times, the relationship between stocks and bonds has, in fact, been positive. As a result, the historical correlation between stocks and bonds is actually close to zero—meaning it's generally noisy. In other words, it isn't that uncommon to see equity and bond prices moving lower (or higher) at the same time, i.e., correlations well above zero.

That said, now that interest rates have soared off the all-time lows set back in August 2020, there is more of a cushion to act like a diversifier during equity market drawdowns. The back-up in yields this year has certainly been painful, but the ability for fixed income to act as an equity buffer has increased, in our view. As bond and equity markets both move past the aggressive repricing of Fed rate hikes that have caused both markets to sell off this year and grapple with a potential slowdown in economic growth, we believe bonds are likely to provide that safety net for portfolios again as we move through the year.

Midterms' arrival affects policy outlook



Midterm elections are often a balancing act for voters, historically tilting heavily against the sitting president's party. Since 1900, the president's party has lost House seats in midterms 87% of the time, averaging 30 seats lost (remember, all House seats are up for re-election in midterms). In the Senate, where only about one-third of seats are up for grabs, the president's party has lost seats 67% of the time with an average loss of three seats. More recently, losses have been more extreme, with President Obama losing 63 seats and President Trump losing 41. The only president to add seats in recent

times is George W. Bush, riding a wave of support after 9/11, when the Republicans added 8 seats.

Democrats would have a difficult path to hold their current slim majorities in the House and Senate if they were only facing historical trends. Add in President Biden's low approval rating, which correlates with midterm performance, and weak consumer confidence due to high inflation, and the odds heavily favor Republicans taking the House. Republicans seem to be moderate favorites in the Senate. The make-up of seats up for re-election favors Democrats, with 21 Republicans up

for re-election in November compared with 14 Democrats. But genuine toss-up seats are more evenly matched and Republicans only need to flip one seat to become the majority party.

HISTORICAL IMPACT OF MIDTERMS ON MARKETS

One of the things we knew coming into this year was that 2022 will be a midterm year—and those have historically not been kind to stocks. In fact, since 1950, midterm years have seen the largest peak-to-trough pullback of the four years of the presidential cycle, with the S&P 500 Index down 17.1% on average during the year (the max drawdown this year for the S&P 500 has been 23.5%, as of June 27). The good news is, one year off those lows, stocks have been up more than 32% on average.

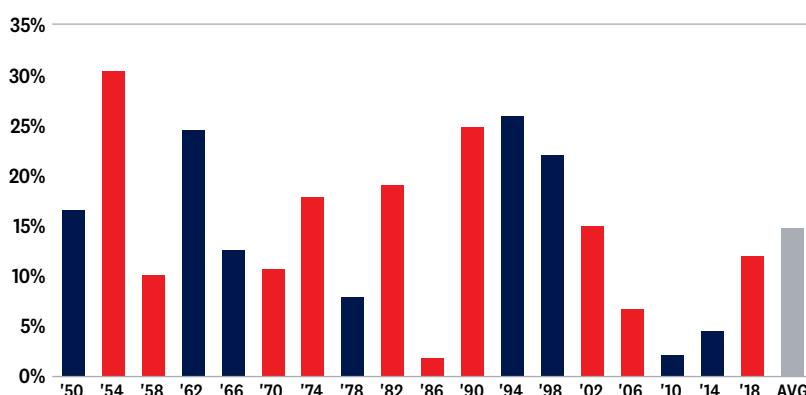
Also consider the first half of the year is historically one of the weakest parts of the entire four-year presidential cycle, matching up quite well with what we saw in 2022. But by the time the election rolls around in November, many of the policy worries are lifted, as the uncertainty of the election is over. Voters might not like the results, but stocks can adapt and move forward once the election uncertainty is gone.

And move forward they have. The year after midterm elections has historically been quite strong for stocks. Incredibly, the S&P 500 has been higher a year after every midterm election since 1950. That is 18 out of 18 years, with the average gain a year later a very solid 14.5% [Fig.10].

Stocks have gained a year after midterms every time

S&P 500 INDEX RETURNS 1 YEAR AFTER MIDTERM ELECTIONS (1950–CURRENT)

■ DEMOCRATIC PRESIDENT ■ REPUBLICAN PRESIDENT



Source: LPL Research, FactSet 6/30/22. All indexes are unmanaged and cannot be invested into directly. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90. Past performance is no guarantee of future results.



Breaking it down by presidential party doesn't show much difference, up 14.8% under a Republican and 14.5% under a Democrat.

LESS UNCERTAINTY, DIVIDED GOVERNMENT OFTEN PREFERRED

Markets hate uncertainty and we know that midterm elections can bring with them a good deal of uncertainty. What

could it mean if history repeats and the Republicans take over both the House and Senate this coming November? Well, one of the best scenarios under a Democratic President is Republican control of Congress, with the S&P 500 up an average of 16.3% during those years—hard for investors to ignore. What if the Democrats hold onto the Senate, but lose the House (the second most likely scenario)?

While markets don't like the uncertainty brought on by midterm elections, they have historically responded well to a divided government, which seems likely after the 2022 midterms.

That combination has also been quite strong for stocks historically, with the S&P 500 gaining 13.6% on average during those years [Fig.11].

Either way, it looks like divided government is in the cards, which markets have historically liked. That may be because neither party is able to give in to its worst excesses, because the parties are forced to find common ground, or possibly because little gets done and sometimes the government that governs best is the one that governs least.

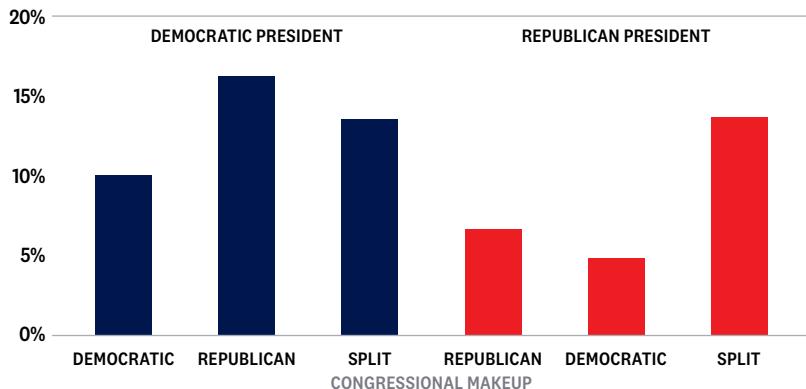
Strong prospects for divided government in 2023 are fueling Democrats' last-ditch effort to get a "skinny" reconciliation bill through Congress before midterms, though we are skeptical. Tax increases on the ultra-wealthy, alternative energy tax credits, and drug price reform are policies to watch that could potentially be market moving if Senators Joe Manchin and Kyrsten Sinema can be brought on board.

WHAT MIDTERMS COULD MEAN FOR 2024

Finally, in a very early note on the 2024 presidential election, midterm weakness has not been predictive of the next presidential election. Presidents Reagan, Clinton, and Obama all lost more than 20 seats in their midterms and won reelection. But approval ratings have mattered, and with President Biden's approval rating at about the same level as President Trump's at the same point in his term, winning a second term looks like a daunting task from the current perspective, although November 2024 is still far away.

Stock performance based on congressional makeup

AVERAGE S&P 500 INDEX ANNUAL RETURN (1950–2021)



Source: LPL Research, Bloomberg 06/30/2022

Data are from 1950–2021. All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

WHAT TO WATCH

Alternatives, commodities, and currencies

ALTERNATIVE STRATEGIES SHOW DIVERSIFICATION POTENTIAL

As we look back on the first half of 2022, the market environment has provided a compelling reminder of the potential benefits of including alternative investment strategies within portfolios. While investors have often been rewarded for focusing exclusively on traditional stocks and bonds over the past decade, significant losses across both markets in 2022 left many searching for ways to further diversify exposures. While alternatives cover a wide range of approaches, several have helped fill that gap, and may continue to do so over the rest of the year.

As discussed in LPL Research's *Outlook 2022: Passing the Baton*, we continue to believe our preferred alternatives implementations—event-driven strategies, market neutral strategies, and relatively conservative low volatility approaches—have the ability to act as a source of ballast during such periods of high volatility, especially when both stocks and bonds struggle at the same time. While we look for alternatives to act as a source of diversification from traditional risks, we're also stressing diversification within alternative allocations. While all the previously mentioned strategies may mitigate traditional sources of portfolio risk, selectively adding these alternative strategies as bond diversifiers in particular may be appropriate to hedge against potential further bouts of bond volatility. We

continue to emphasize these lower volatility alternative strategies that can play this role as we look ahead to the second half of 2022.

SHOULD COMMODITY INVESTORS PREPARE FOR LANDING?

Commodities enjoyed a strong first half, though recent weakness endangers some uptrends. The Bloomberg Commodity Index has gained more than 23% so far in 2022, far outpacing losses for the major stock and bond market indexes. Energy was the headliner, not surprisingly, with oil and natural gas up 55% and 80%. A strong U.S. dollar, normally a headwind for commodity prices, didn't seem to slow commodities' ascent at all.

Commodities have garnered support from both the demand and supply sides. Demand has gotten a lift as the global economy emerged from the worst of the pandemic. Sanctions on Russian energy exports have kept oil and gas prices elevated, particularly the ban on imports of seaborne Russian oil into the European Union, accounting for roughly two-thirds of Russia's crude deliveries to the region. Ukraine is an important global supplier of agricultural commodities such as corn and wheat, putting upward pressure on food prices, while some key metals also come from the region.

Upward pressure on commodity prices will likely persist for at least the next several months, bolstered by China's reopening, the U.S. summer driving season, tight inventories,

and disciplined capital investment by domestic oil and gas producers. A potential cease-fire in Ukraine is a wildcard, but sanctions on Russian oil aren't going away anytime soon and energy and other commodities were in uptrends before Russia's invasion.

From an investment perspective, we would favor energy, followed by precious metals then industrial metals. The highest profile industrial metal, copper, has not participated in the commodities rally, while other parts of the industrial metals complex appear to have topped. We would expect gold, which has been range-bound for nearly two years now and tends to do better when the dollar is weak, to be hurt by rising interest rates.

GREENBACK HAS TAKEN OFF IN 2022

As we enter the second half of 2022, the factors that led to a sharp and nearly uninterrupted ascent for the U.S. dollar may begin to reverse. A hawkish Federal Reserve is intent on reining in inflationary pressures by softening the economic backdrop. Perhaps the most important underlying dynamic for the U.S. dollar against foreign currencies is the interest rate differential. As such, a Bank of Japan insistent on keeping the yen near multi-decade lows and a European Central Bank that will lag the Fed in its interest rate cycle may keep upward pressure on the greenback in the short term.

In the intermediate term, easing inflation from unsnarling of supply chains post-COVID, aided by China's reopening, could help push the dollar lower. Meanwhile, less demand for so-called "safe havens" in the event of a possible cease-fire in Ukraine, though difficult to predict, could also push the dollar lower. Finally, the massive trade and budget deficits should be dollar negative over time.



The right support is key to a safe landing

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As we try to orient ourselves to what may lie ahead in 2022, it can be hard to get our bearings, especially when we feel buffeted about by forces that are either unique or that we haven't experienced in some time. We are still dealing with COVID-19-related economic disruptions. Inflation is at its highest level in decades, central banks are trying to figure out how to unwind more than a decade of extraordinary monetary support to fight inflation, and Europe's two largest countries are at war.

All of these forces are having a real impact on businesses, consumers, and financial markets. As we look at our potential landing point for 2022, the environment remains challenging and the growth outlook

has unquestionably weakened. But there are also positives. Households, on average, still have deep reserves, and the job market remains strong. Businesses are feeling margin pressure but are also adapting to the shifting environment with help from strong balance sheets. Stock and bond valuations have become much more reasonable, and even, in places, historically low. Potentially helping things along, some historical patterns relating to midterm years, the election, and seasonality may even offer support toward the end of the year.

Business cycles are normal. There will be another recession one day, and some of the forces that will contribute to it over time are likely

already in play. The turbulence we're feeling is real, but we believe there are ways to more effectively navigate it. LPL Research's *Midyear Outlook 2022: Navigating Turbulence* is our guide to what we're experiencing now, what may be ahead, and the potential investing opportunities and risks we may encounter along the way.

Ultimately, we believe the best path forward to navigating any environment, whether skies are clear or stormy, is having a thoughtful plan and the right support that can help get you safely to your destination, whatever bumps there may be along the way. Please reach out to your trusted financial advisor with questions about how to stay on course toward reaching your financial goals.

STAAC

Our investment committee is your investment committee

The Strategic and Tactical Asset Allocation Committee (STAAC) is the investment committee broadly charged with overseeing the investment decisions for LPL's discretionary asset allocation platform. The 10-member committee is comprised of the senior members within LPL's Research department and is responsible for the firm's stock and bond views that ultimately form the firm's asset allocation decisions.

STAAC determines the firm's investment outlook and asset allocation that helps define LPL Research's investment models and overall strategic and tactical investment guidance. That guidance is delivered via recommended allocation weightings and a suite of strategy reports, articles, chart analysis, videos, and podcasts.

The committee is chaired by the director of research and includes investment specialists from multiple investment disciplines and areas of focus. The STAAC meets weekly to foster the close monitoring of all global economic and capital market conditions, and to ensure the latest information is being digested and incorporated into our investment thought.



Marc Zabicki, CFA
Senior Vice President,
Director of Research



**Lawrence Gillum,
CFA, CAIA**
Assistant Vice President,
Fixed Income Strategist



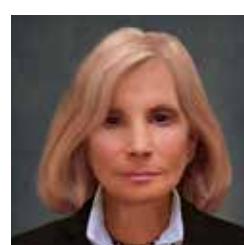
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Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the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

Event driven strategies, such as merger arbitrage, consist of buying shares of the target company in a proposed merger and fully or partially hedging the exposure to the acquirer by shorting the stock of the acquiring company or other means. This strategy involves significant risk as events may not occur as planned and disruptions to a planned merger may result in significant loss to a hedged position.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All index data from FactSet.

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

GENERAL RISK DISCLOSURES

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. Investing in foreign and emerging markets debt or 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.

GENERAL 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.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The Standard & Poor's 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 Bloomberg U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

EQUITY RISK

Investing in stock includes numerous specific risks including the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market. Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. The prices of small and mid-cap stocks are generally more volatile than large cap stocks.

EQUITY DEFINITIONS

Cyclical stocks typically relate to equity securities of companies whose price is affected by ups and downs in the overall economy and that sell discretionary items that consumers may buy more of during an economic expansion but cut back on during a recession. Counter-cyclical stocks tend to move in the opposite direction from the overall economy and with consumer staples which people continue to demand even during a downturn.

Growth stocks are shares in a company that is anticipated to grow at a rate significantly above the average for the market due to capital appreciation. A value stock is anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

Value stocks are anticipated to grow above the average for the market due to trading at a lower price relative to its fundamentals, such as dividends, earnings, or sales.

Large cap stocks are issued by corporations with a market capitalization of \$10 billion or more, and small cap stocks are issued by corporations with a market capitalization between \$250 million and \$2 billion.

FIXED INCOME RISKS

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield. Government bonds and Treasury bills are guaranteed by the US 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. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

FIXED INCOME DEFINITIONS

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates to the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Base-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

The Barclays Aggregate U.S. Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

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Not Bank/Credit Union Deposits or Obligations | May Lose Value**

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