YOUR FINANCIAL FUTURE

Your Guide to Life Planning

September 2017

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In This Issue

HIGHLIGHTS

- The Fed is expected to offer details about when it will begin reducing its balance sheet this week.
- We expect the short-term market impact to be minimal, but that could change as the reduction accelerates in coming years.
- Other global central banks are still providing liquidity to markets, helping ease the impact of monetary policy normalization.

BALANCE SHEET BALLYHOO

The Federal Reserve (Fed) is widely expected to announce more details about the timing of its balance sheet reduction during the Federal Reserve Open Market Committee (FOMC) meeting this week, and markets are buzzing with anticipation. The Fed has purchased more than $4.2 trillion of bonds since 2008 through multiple quantitative easing (QE) programs in order to decrease supply in the market and push interest rates lower to catalyze borrowing and economic growth. With the economy expanding consistently, albeit modestly, and the Fed having achieved one of its two mandates (reaching full employment), the Fed believes that balance sheet reduction is an appropriate step toward monetary policy normalization. But is this cause for an uproar? Based on the expected gradual pace, we don't think so.

A MOVE THAT'S BEEN THREE YEARS IN THE MAKING

Even though the latest QE program in the U.S. ended nearly three years ago (October 2014), these holdings, known as the Fed's balance sheet, have remained stable [Figure 1]. The Fed has rolled the proceeds from maturing bonds into new purchases, keeping the size of the Fed's balance sheet relatively constant over the past few years, and also likely keeping rates slightly lower than they otherwise would be. With QE long over, curiosity as to when the Fed will actually start to reduce the balance sheet has been building in the markets.

1 STILL NO REDUCTION IN FED BALANCE SHEET, THREE YEARS AFTER THE END OF QE

Asset Type	Securities Held ($Millions) as of 09/14/17	1 Year or Less	1–5 Years	5–10 Years	Over 10 Years
Treasuries	$2,465,469	$361,937	$1,144,904	$325,435	$633,193
Mortgage-Backed Securities	$1,782,346	$1	$93	$17,608	$1,764,644
Total	$4,247,815	$361,938	$1,144,997	$343,043	$2,397,837

Source: LPL Research, Bloomberg 09/14/17

The Fed will likely announce this week that it will slowly begin to reduce the amount that it reinvests each month. The immediate impact of normalization is likely to be limited given that it will start with allowing just $10 billion of maturing bonds to roll off the $4.5 trillion balance sheet each month ($6 billion of Treasuries and $4 billion of mortgage-backed securities [MBS]). However, these amounts will increase over time until the total roll-off reaches $50 billion per month as detailed in the Fed's Addendum to the Policy Normalization Principles and Plans.

WHAT DOES THIS MEAN?

The implementation of this policy is not expected to cause commotion, as markets are forward looking and widely anticipated this policy shift for much of 2017. However, over the course of a few years the impact could become larger, with $1.2 trillion in Treasuries maturing within one to five years. On the MBS front, the effect would take a little longer to feel. The majority of the $1.7 trillion in MBS on the Fed's balance sheet will mature in more than 10 years, though the potential for mortgage borrowers to pay down their loans early (refinancing, home sales, or even just additional payments) means that the impact could end up being felt sooner.

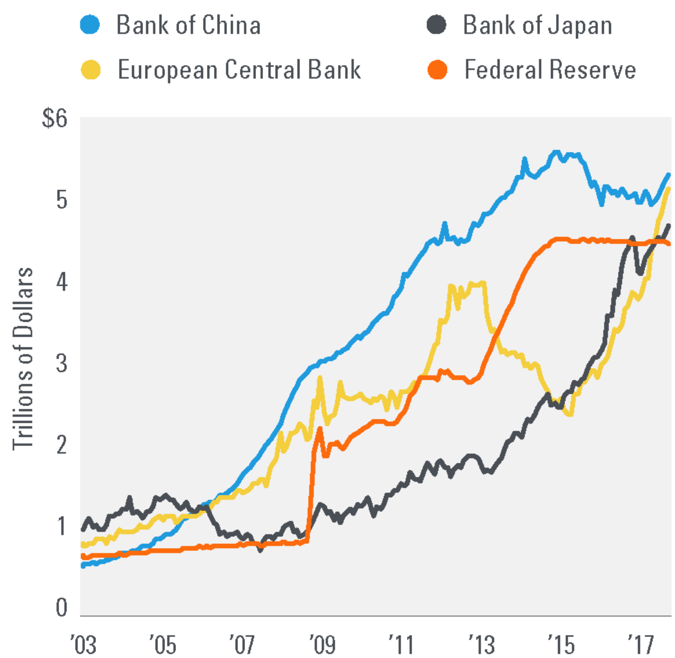
It is important to note that the balance sheet will not be reduced to zero. The Fed has indicated that the process will be very gradual and the balance sheet will remain above $3 trillion until late 2019. Market consensus indicates that the long-term balance sheet may fall near $2.5 trillion, still far above the pre-financial crisis balance sheet, which was less than $1 trillion.

LIQUIDITY LINGERS

Along with pushing interest rates lower to stimulate borrowing and economic growth, QE also injected liquidity into the financial system. Many market participants fear that balance sheet reduction will lead to a decrease in liquidity, which could strain financial markets, especially if meaningful headwinds appear for equities. It is important to remember, however, that the Fed is just one of many central banks in a global financial system in which capital can move quite quickly from one country or region to another.

There are now three other central banks in the world with balance sheets larger than the Fed's **[Figure 2]**. Scale is important, but directionality is as well. Although the Fed may be reducing its balance sheet, these three central banks are increasing the size of their balance sheets, limiting the impact of normalization on global liquidity.

2 GLOBAL CENTRAL BANKS PROVIDE LIQUIDITY EVEN WITH FED NORMALIZING



Source: LPL Research, Bloomberg, Moody's, Federal Reserve 09/18/17

WHAT COULD CHANGE THE FED'S COURSE?

Under the Trump administration, the makeup of the Fed may change, and so may its policies. President Trump is not expected to tap Fed Chair Janet Yellen for reappointment (though he could do so in order to quell financial market uncertainty), and Vice Chair Stanley Fischer resigned from his post early, effective October 13. Trump's influence goes beyond the chair and vice chair nominations, however, as four of the seven Fed board seats are currently vacant. This means that Trump will appoint a higher percentage of the Fed's board of governors than any president since Woodrow Wilson, who selected the original board of governors. This could result in a shift in Fed policy, or a continuation of Yellen-era policy, but only time will tell. A more hawkish Fed could implement a more aggressive balance sheet normalization process, which could alter the market's reaction to the current gradual approach employed by the Fed under Yellen. A more dovish Fed could potentially do the opposite.

The Fed's balance sheet normalization plan for the coming years implicitly operates under the assumption that the economy and markets will behave normally and a recession will not occur. Should the economy fall into a recession, the balance sheet reduction would likely be slowed down, curbed all together, or even reversed, with the Fed buying assets once again in QE fashion to stimulate an economic recovery.

CONCLUSION

This week, the Fed is expected to announce more concrete timing for the reduction of its balance sheet. Although the undertaking is massive and unprecedented, we believe that the impact will not be severe in the short term, as this move has been well telegraphed by the Fed to forward-looking market participants. As the roll-off accelerates over the coming years, we could see more dramatic effects, such as higher long-term interest rates, assuming the Fed retains policy continuity and the economy avoids a recession that could most certainly knock the Fed off its stated course.

IMPORTANT DISCLOSURES

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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.

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.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

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Tracking #1-645847 (Exp. 09/18)

Weekly Market Commentary | Week of September 18, 2017

HIGHLIGHTS

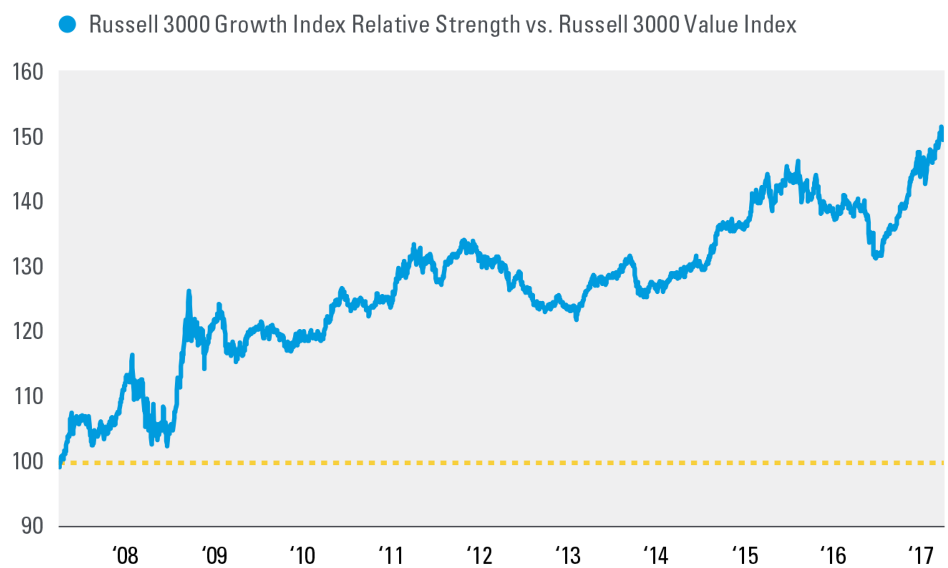
- Growth stock valuations appear rich; its run may be poised to pause or reverse.
- Economic growth is improving, which tends to favor value.
- Technical analysis suggests that the growth rally may be overextended.

UPDATE ON GROWTH AND VALUE STOCKS

Growth has been on a roll. Based on the Russell 3000 style indexes, growth's 18% year-to-date gain is 14% ahead of value's 4% advance. Looking further back, this growth outperformance is nothing new. Over the past 10 years, including the entire financial crisis period of 2008 and 2009, growth has outpaced value by about 50% [Figure 1], representing the longest period of growth outperformance since style indexes began to gain a following about 40 years ago. Using Fama-French* data back to the 1930s, before the Russell indexes were created, this is the longest bull market ever for growth stocks.

Due to this observation setting off contrarian alarm bells in our heads, this week we discuss the potential for a value rebound.

1 GROWTH HAS BEEN ON A HISTORIC RUN



Source: LPL Research, FactSet 09/15/17

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

MACRO INFLUENCES

A historically favorable condition for the value style to potentially thrive is an acceleration in economic growth. Although today's economic growth is still subpar, it has picked up a bit from 2% gross domestic product (GDP) growth to around 2.5%. GDP grew 3% annualized in the second quarter but a slowdown to 2-2.5% is likely in the third, excluding the temporary effects of Hurricanes Harvey and Irma. Additionally, we have seen a pickup in earnings growth, which also tends to correlate with better value performance. The S&P 500 Index has produced two consecutive quarters of double-digit year-over-year earnings gains. Yet, the value style continued to lag.

So has this relationship been broken? We don't think so, for a couple key reasons:

- **Low interest rates and inflation.** Interest rates have remained low, and inflation contained, which has prevented the value-oriented reflation trade that would normally lift the financials and natural resources stocks on the value side (which occurred after President Trump was elected) from working. So part of value's struggles is skepticism toward the Trump administration's policy agenda.
- **Mixed market confidence.** We think market participants are skeptical about whether this latest GDP pickup can be sustained. After a lackluster recovery over the past eight years, the skepticism is understandable. Bond traders

pricing in only two small 0.25% rate hikes through 2018 clearly shows little confidence in the economy's strength.

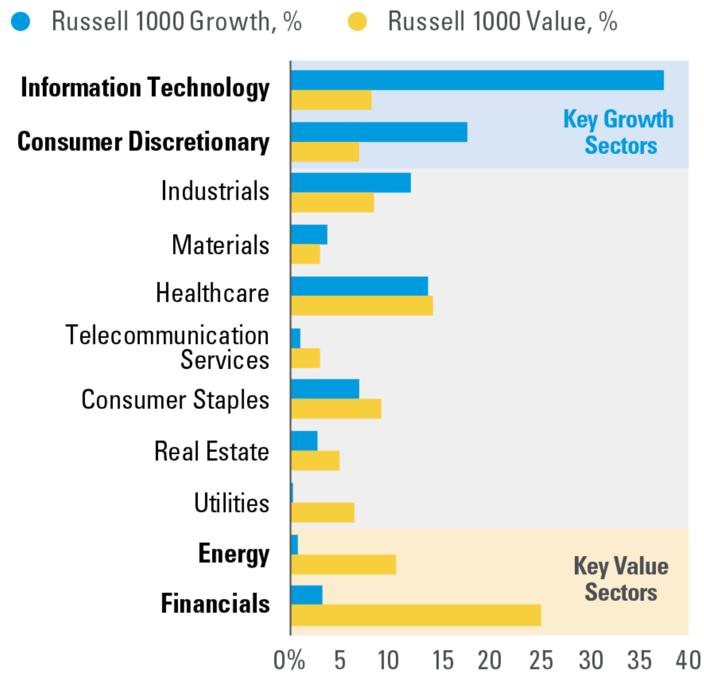
In a slow economic growth environment, faster earnings growth is scarce, so the growth style that almost always produces faster earnings growth tends to trade at a premium. Value stocks tend to require an economic tailwind to outperform, but the market right now doesn't think they will get it. We expect that to gradually change over time--and tax reform may help next year--providing a reason to watch out for a value rebound.

Keep in mind, accelerating economic and profit growth does not always lead to value outperformance, as was the case in the late 1990s when growth stocks significantly outperformed on technology's strength.

SECTOR CONSIDERATIONS

In the late 1990s, we certainly saw how important sector performance can be in the growth-value decision. Performance of the biggest value sector, financials, relative to the biggest growth sector, technology [Figure 2], is a key determinant of style performance. Technology's significant outperformance over financials year to date (27% versus 7%) is the biggest reason for growth's strong performance in 2017.

2 TECHNOLOGY AND FINANCIALS ARE KEY TO THE GROWTH-VALUE EQUATION



Source: LPL Research, FactSet 09/15/17

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Looking forward, we like both the technology and financials sectors. But after such a strong year for technology, the sector may be due for a pause. That could give value an opportunity to close the gap on growth if financials start to work. The flattening yield curve and still low interest rates have held financials back, but the potential for a more conducive rate environment and the ongoing deregulation efforts present an opportunity.

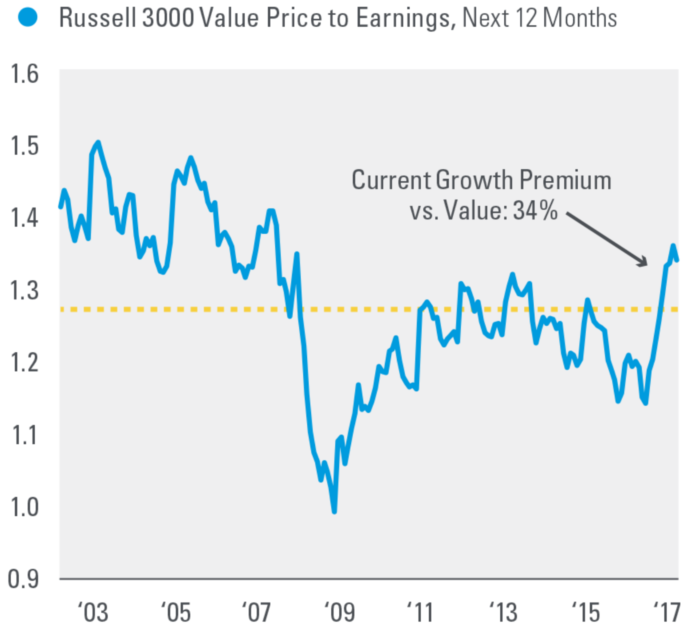
Losses in energy--down 10% year to date--are another reason value has lagged so much this year. After financials, energy is the biggest value sector. Oil prices are up and energy producer earnings are rising, which may help the sector reverse its fortunes. An energy rebound would also likely correspond to further underperformance from consumer discretionary (a growth sector), as those sectors generally tend not to outperform at the same time, though weakness in utilities (a value sector) could offset some of the impact should interest rates rise.

What this means from a sector perspective is that we see an opportunity for better value performance should it get some help from the macroeconomic environment.

GROWTH NO LONGER A BETTER VALUE

When we discussed growth and value earlier this year, value appeared to be a bit expensive relative to growth. However, after such strong relative performance this year, we would say growth is now on the expensive side. Growth almost always trades at a higher valuation than value, but the current premium, at 34% on a forward price-to-earnings (PE) ratio basis [Figure 3] based on the Russell 1000 style indexes, appears rich. That premium is the highest in a decade and is above the 15-year average of 27% (we look at shorter periods to avoid the distortion from the dotcom bubble in the late 1990s). Although valuations are not good timing tools, in the context of current fundamental drivers, they may present a headwind for growth performance in the months ahead.

3 GROWTH NOW ON THE EXPENSIVE SIDE FOLLOWING STRONG 2017 PERFORMANCE



Source: LPL Research, FactSet 09/15/17

Data: 09/30/02–09/14/17

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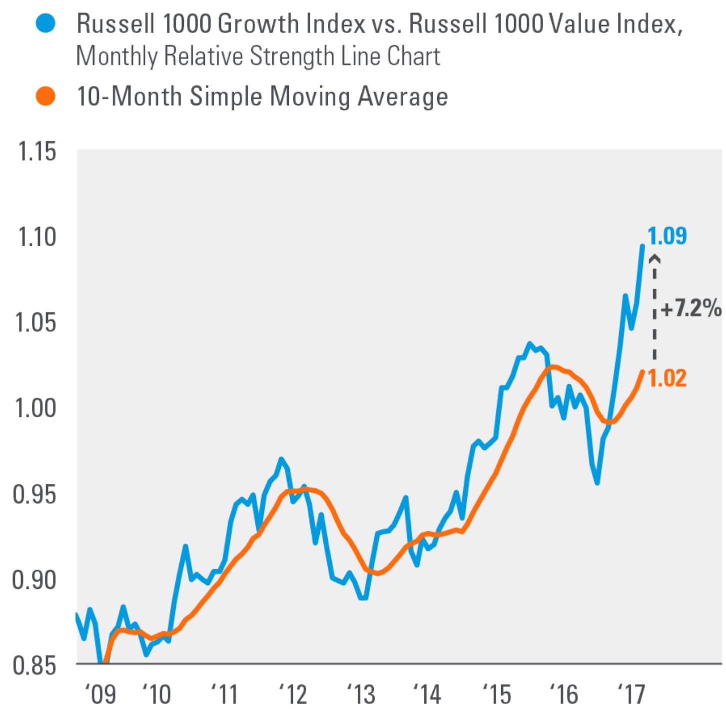
Forward Price-to-Earnings is a measure of the price-to-earnings ratio (PE) using forecasted earnings for the PE calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated P/E

TECHNICAL PICTURE

Taking technical analysis into account, the strength of recent growth outperformance suggests that there may be an opportunity for value to play some catch-up. The relative strength of growth versus value using monthly returns stood 7% above its 10-month moving average as of August 31, 2017 [Figure 4]. Historical analysis suggests that this may be stretched too far, potentially setting up an opportunity on the value side over the next several months.

4 **GROWTH RELATIVE STRENGTH MAY BE OVEREXTENDED FROM A TECHNICAL PERSPECTIVE**



Source: LPL Research, Bloomberg 09/15/17

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CONCLUSION

Growth has been faring well over the last 10 years but value may be poised to make a comeback in the months ahead. Economic growth is improving, which tends to favor value. Growth stock valuations appear rich, and technical analysis suggests that the growth rally may be overextended. So for those still overweight growth, even though growth is currently enjoying strong momentum, we suggest being on the lookout for opportunities to play a value rebound.

**The French-Fama value factor sorts all U.S. incorporated NYSE, AMEX, and NASDAQ listed stocks in the comprehensive Center for Research in Security Prices (CRSP) database, divides them into two groups by size, and sorts each size grouping by book value to price. Book value is an accounting estimate of the amount that would be left to shareholders if all assets were liquidated and all debts repaid. Stocks with a high book value to price are considered cheaply valued and are often referred to as value stocks; those with low book value to price are considered expensively valued and are often referred to as growth stock. The performance of the value factor is the difference between the average return of the 30% highest book to value stocks and the 30% lowest book to value stocks. The return of the growth factor is simply the inverse of the value factor. The overall performance of value versus growth over time can be represented by turning the return to the factor into an index. For more information and updated historical data see http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, or for a complete description of the methodology, see Eugene F. Fama and Kenneth R. French, "Common Risk Factors in the Return on Stocks and Bonds," Journal of Financial Economics 33 (1993) 3-56.*

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to *greater volatility than investing more broadly across many sectors and companies.*

Technical Analysis is a methodology for evaluating securities based on statistics generated by market activity, such as past prices, volume and momentum, and is not intended to be used as the sole mechanism for trading decisions. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns and trends. Technical analysis carries inherent risk, chief amongst which is that past performance is not indicative of future results. Technical Analysis should be used in conjunction with Fundamental Analysis within the decision-making process and shall include but not be limited to the following considerations: investment thesis, suitability, expected time horizon, and operational factors, such as trading costs.

All investing involves risk including loss of principal.

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 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 Russell 3000 Value Index measures the performance of the broad value segment of U.S. equity value universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 3000 Growth Index measures the performance of the broad growth segment of the U.S. equity universe. It includes those Russell 3000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 3000 Value Index measures the performance of the broad value segment of U.S. equity value universe. It includes those Russell 3000 companies with lower price-to-book ratios and lower forecasted growth values.

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Tracking #1-645332 (Exp. 09/18)

IRAs account for nearly half of all assets in private sector retirement plans, far exceeding monies held in either defined benefit or defined contribution plans.

IRAs: Who's Contributing Today?

When traditional IRAs were introduced more than four decades ago, the federal government sought to give individuals without access to an employer-sponsored retirement plan a way to save for retirement in a tax-advantaged manner. Fast-forward to today, and IRAs account for nearly half of all assets in private sector retirement plans, far exceeding monies held in defined benefit and defined contribution plans.[1]

Retirement Assets by Plan Type -- Q3 2016

Defined Benefit Plans	Defined Contribution Plans	IRAs
$3.3 trillion	$5.7 trillion	$7.8 trillion

Sources: The Center for Retirement Research at Boston College and the U.S. Board of Governors of the Federal Reserve Systems, *Flow of Funds Accounts* (2016).

Yet even though more than one-third of American households -- some 43 million -- now own IRAs, just 14% of all U.S. households contributed to an IRA in 2015. Instead, the vast majority of assets held in IRAs come by way of rollovers from employer-sponsored retirement plans.

Who's Using IRAs?

With rollover assets dominating the IRA landscape, the real question becomes: Who is contributing to an IRA today? To help answer this question we turn to recent research published by The Center for Retirement Research at Boston College (CRR). The CRR compiled key demographic and financial data about IRA owners who contribute to their accounts versus those who do not.

Among other discoveries, the report revealed that IRA contributors are more likely to be white, college educated, married individuals in two-earner households. IRA contributors are also more likely to contribute to a 401(k) account (in addition to an IRA) and have higher household earnings that non-contributors.

Characteristics of IRA Owners by Contribution Status, 2011
(Ages 25-70)

Characteristic	Not Contributing	Contributing
Demographic		
White	68%	86%
College or more	33%	61%
Average age	45	47
Marital status		
Single	30%	26%
Married, one earner	39%	35%
Married, two earners	31%	39%
Employment and financial		
Currently participates in a 401(k)	30%	53%
Average household earnings	$70,197	$110,523
Self-employed	9%	14%

Sources: The Center for Retirement Research at Boston College. Authors' calculations from U.S. Census Bureau *Survey* *of Income and Program Participation*, 2008 panel.

Find Your Match

The researchers further broke down the data, creating three prominent subgroups within the IRA contributing population.

1. Dual-income super savers -- Married couples in two-income households that frequently also contribute to an employer-sponsored retirement plan. This group is motivated to save beyond their 401(k)s and is attracted by the tax benefits of IRAs.
2. Frugal breadwinners -- Either single individuals or one-earner married couples in the middle-income range that also tend to participate in an employer's retirement plan. This group could be described as thrifty and knowledgeable about the income requirements of retirement.
3. Successful entrepreneurs -- Higher-income, self-employed individuals who are not currently contributing to a 401(k). This group uses IRAs as an alternative vehicle to an employer plan to save for retirement.

Keep in mind that with just 14% of American households contributing to IRAs, these groups represent a very small minority of the population. As for IRAs, they continue to serve primarily as repositories for assets accumulated in employer-based plans -- not as the tax-advantaged retirement savings vehicles intended for those individuals without access to a workplace plan.

[1]*The Center for Retirement Research at Boston College, "Who Contributes to Individual Retirement Accounts?" April 2017, Number 17-8.*

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