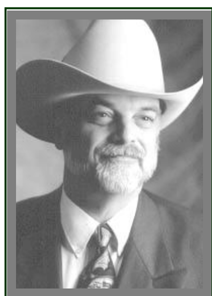

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TPWC Market & Economic Update

By Jeff McClure

February 10, 2012

Administrative Items

The always efficient and dedicated TPWC staff has asked me to provide you with a few items of information they believe may be helpful… So here they are:

ROTH and traditional IRA contributions for 2011 have a deadline deposit date of April 17 this year. *Please* do not wait until the last minute to contribute, as your contribution has to be at the custodian by the deadline, not just handed to us.

The modified adjusted gross income ("MAGI") limit reported on your tax return if you want to make a contribution to a full tax-deductible IRA *and* you have an employer retirement plan for persons married, filing jointly, is $90,000. The deductible amount phases out between that number and $110,000.

For single filers, the deductible IRA MAGI limit is $56,000 to $66,000.

The MAGI limit for ROTH IRA contributions is $169,000 phasing out to $179,000 for joint filers. For singles the limit is $107,000 to $122,000.

The contribution limits for both the ROTH and the traditional IRA are $5,000 for those under age 50 and $6,000 for those older. The contribution cannot be more than the taxable earned income you received in the tax year.

Pershing has received an extension to report on IRS form 1099 until February 15, so do not be alarmed if you have not received your 1099 already.

Fund Changes

I just finished many hours of work researching mutual funds. While I typically look at the funds at least once per quarter, I try to dig extra deep in January. As a result, you may see, or have already seen some changes in your investment line up. Among other changes, we are going to be able to use "institutional" class shares in several funds where we previously were restricted to classes that are more expensive. Pershing has recently negotiated the lower expense ratios and we are planning to take advantage of the cost reduction wherever possible. There is normally no taxable event and usually no transaction fee when we change share class to the lower-cost institutional shares.

In other cases, you may see a move from a one fund to another where we have concluded that the new fund is simply likely to do better over the long term than the old one. In some cases we will be moving into what we believe are better funds that were previously closed to new investors but have recently reopened. In other cases, there have been management changes at the old fund and we have seen the performance become less than exceptional.

WRL

For those with Western Reserve variable products, the funds available there continue to be less diverse and some are closing to any new investment. That effectively means that for accounts where automatic rebalancing was occurring, you

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may receive a letter advising you that it has been “turned off” if you have a fund or funds that are no longer accepting money. We are continuing to monitor this, but if you do receive a notice from WRL, please let us know, as they do not provide copies to us.

The Markets

The S&P 500 Stock Index (“S&P 500”) hit a low for this cycle back on March 9, 2009 as it closed at 676. As I write this, today the S&P 500 stands at about 1,340. That is not quite a doubling of value, but is close enough that I think it is safe to simply state that the value of the stock market has doubled, or increased by about 100% over the past three years. Meanwhile, according to Morningstar, the average intermediate term bond portfolio has gained about 32% over the same period.

As the chart below shows, the S&P 500 has had some bumps along the way. In2010 and again in 2011, it dropped around 20% but then went on to recover. Those short term declines, normally generated by some element of *fear* are widely known as "corrections." That is *normal* market behavior when it rises this fast. It is important to recognize that the faster the market appreciates, the greater the fear that will normally accompany that rise. As Jake often quotes from Sir John Templeton, "A bull market climbs a wall of worry." It is when there is no fear and people say, "This could go on forever." that we need to be cautious.

The two market corrections are marked in red. The key is not the relatively short-lived downturns, but the average annual return across this chart of about 20% per year. Under other circumstances I might be concerned about growth as rapid as what we have seen, but critically, the underlying earnings of the S&P 500 companies have not only kept up with the market, but have actually moved ahead. In other words, in real terms the stock market is at least as cheap as it was in 2009 despite the near doubling in value.

Asset Allocation

Of course, your portfolio is not the same as the S&P 500 stock index. Generally, our allocations right now include Mid-Cap Value domestic stock funds, Real Estate stock funds, Diversified Emerging Market funds, and GNMA or general Bond funds as well as some cash positions in regular brokerage accounts. Here are the returns for those asset classes. The 3-year number is the average annual rate of return. The asset classes used here are from Morningstar Categories or funds.

Asset Class	3 Months	1 Year	3 Years
Mid-Cap Value	8.19%	0.36%	21.45%
Real Estate Stock	9.85%	12.16%	31.16%
Diversified Em Mkts	4.51%	-7.33%	24.19%
GNMA Bonds	1.30%	8.97%	6.81%
Intermediate-Term Bond	1.60%	7.56%	9.77%
S&P 500 (for reference)	6.57%	1.97%	17.75%

The reason for including this table here is to demonstrate the need for diversification into different asset classes over time. For example, over longer periods the Diversified Emerging Markets asset class has produced the highest return. Even in this relatively short-term sampling, it has well outperformed the S&P 500, but over the last year has done very poorly. The reality of this picture is that either by reallocating more money to that asset class by rebalancing or by simply staying put in an asset class that has recently underperformed its historic norms, an investor has a much higher potential return than in the recently better performing classes.

As an example of why we use asset allocation, if an investor had an allocation of 33% Mid-Cap Value, 7% Real Estate Stock, 24% Diversified Emerging Markets, 33% Intermediate Term Bond, and 3% in cash, over the last three years that allocation results in an average annual return of about 20% per year. For one year, the return was 1.71%, and for the last three months it was about 5%. Those results compare very favorably with the S&P 500 but the portfolio was only 64% invested in stocks. As a result, the ride was smoother with the downturns taking a far smaller bite out of the portfolio than they did out of the S&P 500 Index.

Another aspect of the numbers listed above is the fact that Real Estate Stock funds did better than any other asset class. That was certainly counter-intuitive. Three years ago, the consensus was that real estate as an investment was a horrible idea. Looking back from today, we can see that having a bit of that “horrible” asset was an excellent move.

The future is always uncertain so the best we can do is noting that over the long-term asset classes have had some consistent behaviors. Of all the methods to predict where one should have money invested, to date, asset class history is the one that has worked the best. If I had made the asset allocation choices three years ago based on my “gut-reaction” I can assure you I would not have chosen this particular allocation. The discipline of following the science of Portfolio Theory, once again seems to be working.

The Economy

GDP and Employment

The Commerce Department reported the U.S. Gross Domestic Product (“GDP”) to have risen to an annualized rate of 2.8% in the fourth quarter of 2011. In January, the official unemployment rate dropped to 8.3%. The official number of new jobs expanded by 243,000 in January as well. Quite significantly, in the Household Survey the Labor Department reported an estimated 491,000-job growth.

The difference is not insignificant, and is consistent with the reduction in unemployment. The official number, known as the “Establishment Survey” asks state employment agencies and major corporations how many jobs they saw created. The Household survey involves calling residences and asking questions about how many people have jobs of those in the household who want to work. Historically, when the economy starts to seriously grow, self-employment and hiring by small start-up companies leads the way. Those new jobs do not show up in the Establishment Survey. Over time, those jobs show up in the data, but it takes a while.

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Another good indicator is present in the revisions. The Labor Department revised the job number up about 211,000 for the last two months of 2011. Upward revisions tend to mean that smaller businesses are hiring more people. Generally, there visions to the employment numbers go in the direction employment is likely to go in the future; upward revisions indicate future job growth while downward revisions indicate future job shrinkage.

Manufacturing numbers are up, as are the number of hours worked. The entire employment picture is very consistent with a steady growth in productive employment. There are negatives though. The two areas where the most jobs are being lost is in finance and government. At all levels, governments are reducing employment. Given the mandated federal government funding cuts scheduled to hit at the beginning of next year we could see the overall employment picture slip into reverse. That will not necessarily be a bad thing, but it will increase spending for unemployment and sound ominous when it happens.

Meanwhile the private sector is adding jobs. In that area, the business and the jobs are growing in consumer durable goods and other necessities. People are replacing their larger appliances and their worn out cars. What they are not yet doing is buying a lot of clothes and non-necessities.

Debt

From the numbers I see, it appears that the reason the consumers are not driving this recovery is quite simple. They are still paying down outstanding debt, and many are trying to sell a house somewhere. In order to find work, more than a few people had to relocate. The house where they lived before is in many cases empty and for sale. That is both a potential time-bomb and a sign of responsibility. At some point those absentee home owners may just give up and stop pouring money down that particular black hole. If they do, a new but manageable financial crisis will be upon us. As the economy recovers, at some point in the next few years, it may be possible to sell those houses. However, I suspect that the price they may bring may be still below the mortgage owed in many cases.

In some ways, this situation is like the European debt crisis. The lenders, assisted by the government, can agree to take a partial loss on the debt, or they can get little or nothing from their loan. Since there is much discussion on this subject right now. An announcement came out this morning that the state attorneys general and the major banks reached a $26 billion settlement that may assist at least some of those homeowners to reduce their mortgages. We will have to see the details before determining whether or not this is likely to help. One of the problems with forgiven debt, like those mortgages, is that it creates "phantom income" for tax purposes. If a bank knocks $100,000 off of a mortgage, it may be that the out-of-work homeowner will owe income taxes on that $100,000. Far from being a solution, that might make a bad problem far worse.

The government debt is still growing. In mid-December, the Republican controlled House of Representative passed an “Omnibus Spending Bill” that was quickly approved by the Senate and signed by the President. Federal spending was thereby set for 2012 at a bit over $3.2 trillion. The House Ways and Means Committee estimated that total federal revenues would be about $2.5 trillion. Given that the federal government is already running over budget for this year, we are likely to see a trillion dollar or so deficit. That is the bad news. The good news is that a one trillion dollar deficit is a lot less than the ones we had the past two years!

The better news is that beginning next year, the “sequestration” law that Congress passed last summer goes into effect. The spending cuts required by that law are “draconian” and include a very substantial reduction in defense funding. That is about the time that the economy should be kicking into a serious, sustained growth mode. The combination of the two, unless of course Congress or some outside event derails them, will very likely set us on the course to federal fiscal responsibility. The Congressional Budget Office (“CBO”) also estimates that, if no exceptions are passed by Congress, tax revenues will rise quickly, not only because of a reversion to the “pre-Bush” tax levels, but because an improving economy will push many people into higher tax brackets. Very critically, the CBO also noted that the Alternative Minimum Tax, unless it is repealed, will start producing a great deal of revenue and be critical in paying down our federal debt.

I actually do not think anyone seriously considered that law when it was crafted to be likely to take effect, but today it looks more and more like there will be no compromise. We will get our budget cut, but we probably will not like it.

There is an area we are watching that is worth being concerned about. The ten-year Treasury note continues to trade at an annual interest rate of around 2%. Effectively, regular Treasury securities out to about ten years are trading at a real yield to maturity that is below zero. Insurance companies, banks, and individual investors have poured quite literally trillions of dollars into those debt instruments. At some point as our economy gets into a more rapid expansion, the broad interest rate environment will rise. When that happens, the market value of those Treasury bills, notes, and bonds will fall accordingly. That could easily result in a new set of problems. Again, the Federal Reserve and a lot of people are aware and concerned about this. The most critical effect may be on insurance companies. Many of the major life

insurance/annuity companies appear to still be on shaky ground. Following the crisis in 2009 they stocked up on Treasury securities as they traded in their mortgage bonds to the Federal Reserve. That was a life saver then but may have some potential for difficulty going forward.

You may remember that back in the early 1990s, banks and savings and loan institutions that were in the worst shape offered unreasonably high rates on their CDs in order to get more money to stay afloat a little longer. Today, insurance companies are offering high commissions and interest rate guarantees that do not appear to be possible to sustain. It could be they have some magical set of securities to back those rate guarantees, but it appears more likely to me that they are scrambling to get investors' money transferred to their books to stave off possible default. Financial companies tend to do that in hope that things will get better if they can just hang on a little longer. Only time will tell. Remember that any interest rate offered that is higher than an FDIC insured bank CD or a U.S. Government backed debt instrument carries a distinct risk. The higher the rate supposedly "guaranteed" the higher the risk of default. **Any organization issuing a rate *guarantee* of 4% or higher in this environment is at a heightened risk of failure**.

One of the difficulties with non-variable products issued by insurance companies is that the underlying portfolio backing the interest rate and principal guarantees is not available for public review. Recently MF Global declared bankruptcy only about a week after being audited by at least one ratings agency. The Congressional testimony in the hearings related to that collapse and the disappearance of about $1.2 billion of supposedly secure customer money revealed that MF Global did a masterful job of hiding their "off balance sheet" risks in Greek and other distressed Eurozone bonds. Insurance company internal portfolios are commonly far less open to scrutiny than was MF Global's portfolio. One of the reasons MF Global got so big so fast was that it was offering higher than standard market interest rates. That is a story that has been repeated as long as there have been markets.

Taxes

This Congress and to a lesser degree, the last one, seemed to be enamored with passing bills that they were confident would not actually go into effect. As one of the last acts of the last Congress, it passed a bill extending the “Bush tax cuts” until the end of 2012, but which raised taxes dramatically on January 1, 2013. Unless this Congress can agree on a compromise, in my opinion a rather unlikely event, next January the tax code will substantially revert to what we had in 2000.

That means taxes will go up, and do so significantly in 2013. When we add the tax increase to the mandated “sequestering” in last year’s budget bill, it means we will be getting out of debt. The difficulty is that we all may suffer some withdrawal pains. Then, in 2014 the Medicare portion of the payroll tax applies to “investment income” for those making over $250,000 per year. The net result is that we need to be aware that taxes are going to be higher in the future. That, in turn, means that we will need in some cases to adjust your portfolio expected rate of return to accommodate the reality of that situation.

As the Congressional Budget Office ("CBO") noted in its 2012 budget analysis, a key element in whether we move toward a long-term reduction in federal debt as a percentage of GDP or tip over into a rapidly increasing debt load is the Alternative Minimum Tax ("AMT"). For many years, Congress has deferred the imposition of that tax, even though it passed at the urging of Ronald Reagan in the 1980s! It is extremely unpopular among wealthy Congressional donors in both parties, but Congress has not repealed it because it is critical to keep it on the books else the CBO will announce that the federal debt will spiral out of control. In short, according to the CBO, the Congress will either allow a big tax on higher income Americans (which is already on the books) to take effect or face a near certain Greek-like debt crisis in the future. Between the AMT, the extension of the Medicare tax to investment income over $250,000, and the increase in regular tax rates, the "millionaire tax" is a moot point. Higher income recipients *will* pay a much higher portion of their income to the IRS (unless of course Congress passes a tax cut aimed solely at upper income filers).

Note that the CBO has also assumed that the “draconian” spending cuts passed into law last summer that were to take effect unless the “super committee” came up with an acceptable solution in 2011 *will* go into effect. The result of what appears to be a series of laws passed that were proclaimed publically to be very unlikely to actually take effect is that we actually do have a route out of the debt trap. The question is whether Congress and the President will blink. If they hold to this course, we will suffer some collective pain, but be headed in the right direction. If they relent we can look forward to a much bigger problem in a few years.

We will be watching this carefully, but in the meantime, it is probably a good idea for you to consider that taxes on investment income this year will almost certainly be less expensive than income deferred until next year. The really good news about higher taxes and reduced government spending, as painful as that will be in the short term, is that it will put us on the path to a better economic situation several years from now.

Europe

The European debt crisis sometimes seems like a never-ending story. Greece teeters in and out of a total collapse, but at least in my opinion, it is mainly for dramatic effect. The Greeks have managed to get their creditors to agree to about a 70% reduction in Greek government debt. Admittedly, the Greeks will have to cut their collective life style for a bit, but I would be quite surprised if they did not cheat on the rules as soon as everyone looks the other way. In reality, it is very questionable that the Greeks can even pay back the 30% of the debt remaining. The key is to make it all appear to be "voluntary" to not trigger the credit default swaps held by banks all over Europe. The Portuguese have already used the Greek crisis to their advantage by getting their creditors to agree to a debt reduction before their situation becomes another Greek crisis.

Following a last minute resolution of the Greek debt crisis, watch for the other countries with overwhelming debt to follow suit. One thing that appears clear to me is that each of the involved nations has already anticipated the moves. Each nation is maneuvering to get the maximum advantage either in debt reduction or in legally mandated control over the rest of the Euro-zone. There is still not any resolution as to where all the money will come from to reduce the debt load of the Eurozone countries that are in trouble. The final solution is still an unknown, but at least they are talking about it very seriously.

The risk factor is parallel to the one generated by our Congress. By continuing to hold out the threat of default until the last possible minute in order to terrorize those in power, a slight miscalculation could push things over the edge. I frankly do not like this kind of brinkmanship, but I do believe that the participating parties are not likely to intentionally "blow-up" the situation. I also see evidence that the banks and the Federal Reserve here in the United States have made contingency plans for the collapse of the Euro. The British have also reportedly drawn up plans for that event. It may yet happen.

It is critical to understand that any crisis we see coming for months or years is very unlikely to do much damage. Lehman Brothers' collapse was unexpected, and the world economic and financial systems were unprepared. In this case many and possibly most players think that a collapse of the Euro system is quite possible. As a result the fire-walls are in place and the fire extinguishers have been passed out. Meanwhile, the rest of the world looks to the dollar and the American system as the most secure in the world. Never lose sight of the fact that as dysfunctional as we may seem to us, we are far, far ahead of and better than anywhere else!

The Future

I continue to believe that the rolling crisis scenarios will fizzle out in 2012 and we will begin to see a perceivable return to a more normal economy. In 2013, I expect to see the economy and the equity markets move very positively. Whomever we elect President will get the credit for a delightful growth surge in the market and the economy. I believe that by the time this decade ends we will see a significant reduction in the portion of our GDP represented by government debt, a stock market far higher than any of us can imagine today, and an economy in great shape and moving forward.

Meanwhile, all the evidence in the short term points to a steady improvement with little or no inflation. Many things could go wrong, but so many people are aware and worried about them that the corrective plans are already on the books. That means that even if something happens, it will not be devastating. The bottom line is that I believe we will look back in a few years and wonder why we were so worried.

As always, your comments, questions, and suggestions are welcome.

Sincerely yours,

Jeff McClure