INVESTMENT OUTLOOK

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- Large cap stocks push higher.
- Bull market aging but still intact.
- U.S. growth picking up as much of world slows.
- More deleveraging in store for major economies outside U.S.

Third Quarter 2014 Review & Outlook

by Whitney Brown

Also in This Issue

In the third quarter major market averages managed to squeeze out nominal gains as leadership narrowed to the largest stocks in just a few sectors. Large cap indexes like the S&P 500 and the NASDAQ Composite tacked on 1 or 2 percent, but small caps represented by the Russell 2000 and foreign stocks fell sharply. The drop off in smaller company stocks while the biggest stocks lead the market higher is typical of an aging bull market.

The current uptrend has been in place for several years, and its longevity has many market watchers concerned. But, bull markets are not defined simply by duration. They end when imbalances in the system reach unsustainable extremes such as the “dot com” bubble in 2000 or the housing/credit bust in 2008. Such imbalances and extremes simply do not exist now. The U.S. economy is experiencing a lengthy and moderate recovery from the 2008 financial crisis with a steadily improving labor market and inflation running below the Fed’s target. Corporate profit margins are solid and banks are better capitalized than they have been in decades. Some areas of the market are fully valued, but others have room to run.

While the U.S. may not be of great concern for the markets now, much of the rest of the world is. Growth in Europe has ground to a halt. Japan has undertaken ambitious monetary and fiscal measures to revitalize its economy that have proven counterproductive to growth in the short run. (Please see the article on page 4 for more on Japan.) China is undershooting its modest growth targets so far this year. Beyond those major economic blocs many countries are not doing as well as they were a year ago. Yet, on a country by country basis, the large majority of economies around the globe remain in expansion mode.

Investors should want to know why the U.S. is gathering steam just as much of the global economy is slowing and if that divergence can be sustained. Much of the answer lies in how countries have dealt with the aftermath of the financial crisis. The root cause of the crisis was a credit bubble. The system was overleveraged with low quality debt. When the bubble burst, the U.S. was the first to deal with the leverage in the system and did so aggressively. Mortgages were foreclosed, debts written off, banks bailed out and forced to raise capital. Deleveraging in the U.S. has largely been accomplished. In contrast, Europe has been very slow to address the same issues, just as Japan was 20 years ago. China, which kept the global economy going at the onset of the crisis, is just now beginning to acknowledge and address similar issues.

The gloomy view would see the rest of the world dragging the U.S. down. The brighter, and more probable, scenario is that Europe and China will eventually do what must be done, even if it is a more painstaking process for political and cultural reasons. In the meantime, the U.S. market should continue to lead. Corporations have stayed lean since the recession, margins are very good, and the consumer is making a comeback. Companies have had half a decade to learn how to grow earnings in a slow growth economy. Even if better value can be found in markets abroad, investors will pay for growth in U.S. stocks.

Market Measures	3rd Qtr.	YTD
S & P 500 (price)	0.6%	6.7%
Dow Jones Industrial Average	1.3%	2.8%
NASDAQ Composite	1.9%	7.6%
Russell 2000	-7.7%	-5.3%
MSCI EAFE	-6.4%	-3.6%
Barclays Capital Inter Gov’t/Credit Bond Index	0.0%	2.2%
	9/30/14	9/30/13
10-Year Treasury Bond Yield	2.50%	2.62%
Three-month Treasury Bill Yield	0.03%	0.02%

Tax Inversion Aversion by Jim Hall

Although the term "tax inversion," has been around since at least the mid-'90s, it recently seems to have become a very popular buzzword in newspaper headlines and evening news summaries. The term is used to describe the process where a U.S.-headquartered company acquires a company headquartered in a foreign country and chooses to relocate its U.S. headquarters to that foreign country. The primary benefit is to enjoy a lower tax rate charged by the foreign country when compared to the rate charged in the United States. Unfortunately, this practice has been occurring steadily over the past decade as roughly 50 U.S. companies have participated in tax inversions. In fact, the S&P 500 Index used to feature only U.S.-headquartered companies; now 21 of the 500 are domiciled in other countries.

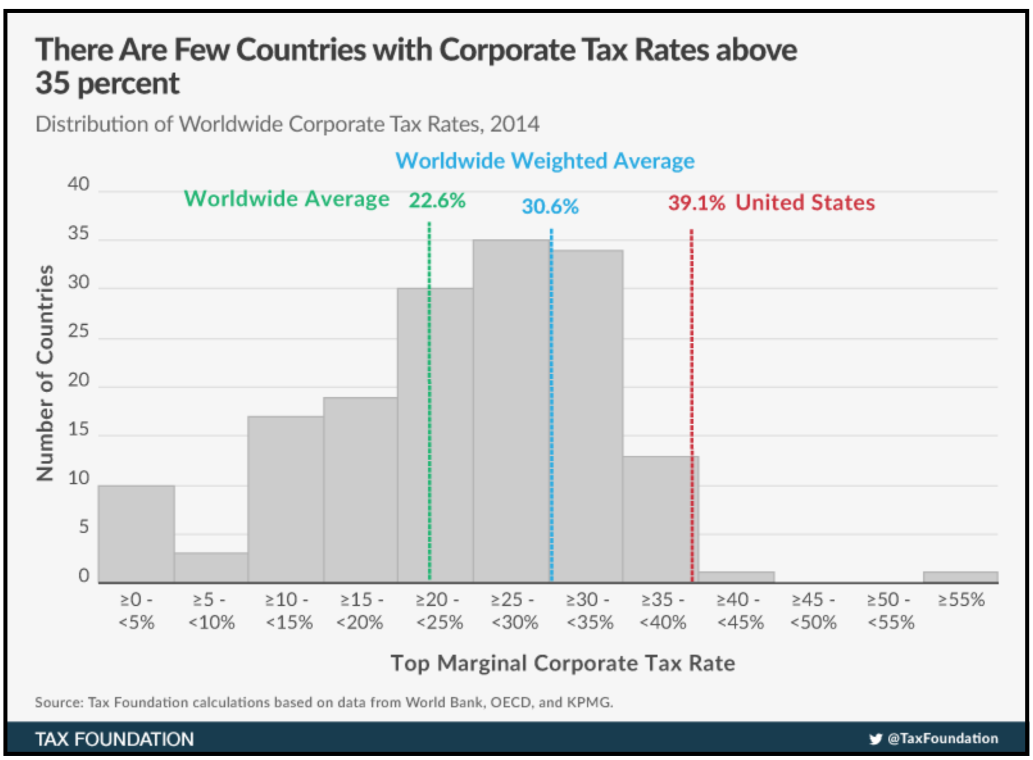
The root cause of the attractiveness of an inversion is our high top corporate tax rate when compared with other countries. In 2014, global corporate top rates are averaging 22.6% while the top U.S. corporate tax rate is 39.1% when combining our Federal and State levies. In fact, the "Tax Foundation," a non-partisan, non-profit tax policy research organization founded in 1937, recently polled 163 countries and found only the United Arab Emirates (55%) and Chad (40%) impose higher rates than we do.

To exacerbate the problem, we are one of only six countries to tax not only the profits earned in the U.S., but also those earned in other countries; these companies are already paying tax on the earnings in the countries where their earnings are generated. Many of our companies have gotten around this "double-tax" by choosing to leave any funds earned outside the U.S. in those other countries. A recent Washington Times article estimated $1.53 trillion is being "protected" in this manner.

Our politicians have tried to remedy the problem by appealing to a sense of patriotism to keep our companies here. Recently our Treasury Department instituted some new rules in an attempt to make inversions more expensive and less appealing. Our government officials obviously realize there is a problem but are missing one key factor. Corporations are owned by stockholders and they have a duty to generate profits to distribute to those stockholders.

Whether we like it or not, we are in a true global economy. A few clicks on a keyboard or a few numbers dialed on a phone will allow you to quickly and easily purchase items from anywhere they are made. Recently, Ireland has been airing commercials on the financial networks touting their strong "corporation-friendly" environment, their ample supply of skilled workers, and their low corporate tax rate. If our tax rates are higher, the goods manufactured here are likely to be more expensive than goods manufactured in other countries.

If our companies leave the U.S. for countries where they can be more profitable, future expansion and growth will not be in our country but will be in other countries. Future jobs will not be here but will be in those other countries. Instead of trying to use shame and penalties as methods of keeping our companies here, we should seek to avert further inversions by lowering our corporate tax rates and aligning the goals of our corporations with the needs of our country.



A Broader View of the Retirement Investment Portfolio Mix by Stebbins Hubard

An old adage, to determine a retirement investment portfolio asset allocation, was to subtract the retiree’s age from 100 in order to determine a percentage in stocks and invest the rest in bonds. Therefore, at age 75, a retiree would allocate 25% to stocks with 75% in bonds. Now with increasing life expectancies, in conjunction with inflation, it is imperative that our retirement savings last longer and grow to maintain purchasing power. That necessitates a higher allocation in stocks. Some retirement planners have suggested subtracting the age from 110, arriving at an allocation of 35% stocks and 65% bonds, for the same 75 year-old retiree.

A recent paper put out by Morningstar Investment Management says, "Financial assets, such as stocks and bonds, are only one component of an investor's total economic worth. Other assets, such as real estate equity, pensions and social security, often represent a significant portion of an investor's total wealth, (for many people, these assets represent half or more of their total wealth), but are not frequently considered when building portfolios, despite the fact that they share common risks with financial assets." Incorporating these assets into a financial plan can result in "huge adjustments in portfolio design, indicating the average investor should consider increasing the proportion of equities in his or her investment portfolio by 20 percentage points or more.”

Social Security and pension benefits with their regular payments providing a steady bond-like return, have more in common with bonds than with stocks. And though home equity pays no current income, home prices historically have appreciated by an average of 2% to 4% a year (despite the real estate bubble), providing a relatively steady, zero coupon bond-like return. As a result investors should include most of the value of these assets in the bond allocation of their portfolios. If that makes their overall wealth too heavily concentrated in bonds, they should adjust by selling some fixed income securities and buying more stocks.

The chart below illustrates a couple, both 75, with a current retirement investment portfolio of $2 million invested 35% in stock and 65% in fixed income (bonds). Their combined social security equals $57,600 annually ($4800 per month). Incorporating their social security into a revised portfolio necessitates calculating a present value. The multiplier taking into account mortality estimates and discounting future benefits into today's dollars is approximately 13.5, arriving at a present value of $777,600. Thus, it would cost $777,600 to purchase a joint-and-survivor annuity paying $57,600 per year. We then add $777,600 plus $600,000 (the couple’s equity in their home) to come up with an expanded retirement investment portfolio of $3,377,600. Under the revised portfolio, the illustration below shows, in order to get back to a 35/65 mix, the couple should raise their equity holdings from $700,000 to $1,182,160 and reduce their bond holdings from $1,300,000 to $817,840.

Sample Retirement Investment Portfolio

	Current Portfolio		*Expanded Portfolio*		*Revised Portfolio*	
	$	%	$	%	$	%
Stocks	$700,000	35%	$700,000	20.7%	$1,182,160	35.0%
Fixed Income	$1,300,000	65%	$1,300,000	38.5%	$817,840	24.2%
Social Security			$777,600 *	23.0%	$777,600	23.0%
Home Equity			$600,000	17.8%	$600,000	17.8%
TOTAL	$2,000,000	100%	$3,377,600	100%	$3,377,600	100.0%

* *estimated present value of social security payments*

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Rising Sun in Japan? by Watt Dixon

Japan, once one of the world's economic superpowers, has been experiencing several decades of very tough economic times. Most economists measure Japan's malaise in the realm of public finance. Japan has the worst public balance sheet in the world. The total public debt of Japan equals more than 200% of GDP. From 50% in 1980, the country's total public debt as a percentage of GDP has quadrupled and will reach 227% by the end of next year. By comparison the U.S. public debt is now at 100% of GDP. Germany is at 80% of GDP.

The Prime Minister of Japan, Shinzo Abe, has instituted an economic revival plan that, so far, has seen subpar results. Last year, Abe launched a program known as "Three Arrows" to stimulate growth. The program is comprised of fiscal stimulus, quantitative easing and structural reform. The first two components have seen little success, but the third component of structural reform may actually work if the government can avoid the traditional pitfall of Japanese politics, namely scandal.

In April the consumption tax in Japan was raised from 5% to 8%. The move was supposed to improve Japan's finances, but instead, decreased consumer spending. The government also misjudged the effects of the Bank of Japan's huge asset purchases (quantitative easing, or QE). It is buying $65 billion of Japanese government bonds a month, and now owns a fifth of the government's outstanding debt. A weaker yen, one of the consequences of QE, has failed to produce the boom in exports that the government assumed would help offset the harm done by the consumption-tax hike.

Also, many of the big Japanese firms have moved production overseas. In a few years, a majority of Japanese car makers will be making more vehicles elsewhere in Asia than in Japan. The waning appeal of electronic gadgets from the likes of Sony, Panasonic, and Sharp has also weighed on exports. Many firms have used the extra revenue from the weak yen to pad profit margins instead of lowering their prices abroad to boost their market share.

Despite record profits, Japanese businesses are not paying higher wages. After adjusting for inflation, base salaries are actually falling by around 3% per year. No surprise that consumer spending has slumped. Structural reform, the "third arrow" in the plan, has not really been fully implemented, yet. Overhauling social spending and making the labor market more flexible would help spur firms to invest at home and lift wages.

Japan's population began falling in 2004 and is now aging faster than any other on the planet. It is estimated that the population of Japan will have fallen from 127 million to 87 million by 2060. This disturbing trend, coupled with tough economic times, could spell real trouble for Japan for many years to come. It is still too early to tell if Abe's "three arrows" reform policy will mark the beginning of better times for Japan, but thus far we have seen little indication that things are looking brighter for Japan's economy.