STRATEGIC Wealth Advisors

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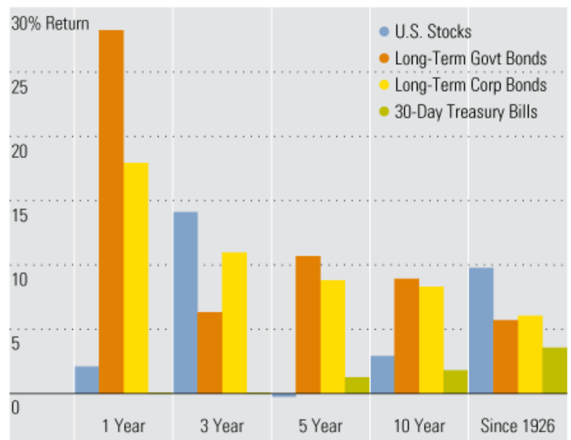
Recent Bond Performance Explained

For investors, it comes as a surprise that bonds have recently outperformed stocks. Investors often assume that stocks offer higher returns compared with bonds. Recent market conditions, however, have proved otherwise. The image shows that while stocks have outperformed other asset classes from a return perspective since 1926, they have struggled over the last 10 years. Don't be surprised at the higher bond returns in the past 1-, 5-, and 10-years. Besides the dot-com bubble and subprime mortgage crisis in the past decade, several unique events in 2011, such as the Arab Spring, U.S. credit downgrade and the sovereign debt crisis, led to a flight to safety into government bonds. Under these circumstances, investors are advised to stick with their long-term investing strategy and be aware that asset class characteristics may deviate in the short term based on current market conditions.

Unusual Stock and Bond Behavior 1926–2011



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. U.S. stocks are represented by the Standard and Poor's 90 index from 1926 through February 1957 and the S&P 500 index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general, long-term government bonds by the 20-year U.S. government bond, long-term corporate bonds by the Ibbotson® Long-Term Corporate Bond Index, and 30-day Treasury bills by the 30-day U.S. Treasury bill. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes. With corporate bonds an investor is a creditor of the corporation and the bond is subject to default risk. Corporate bonds are not guaranteed. Returns are compound annual returns.

What's Happening at SWA

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As we draw closer to the end of the year, it is a good time to review and update beneficiary designations and legal documents. Have you experienced any life event this year such as a marriage, birth, death, divorce, move, mortgage refinance, or even have a minor who reached adult age? If so, you may want to review the titles and beneficiary designations for various assets including homes, cars, investment accounts, trusts, business and investment partnerships and life insurance and annuity contracts. When not properly updated, assets can fall into the wrong hands, become encumbered during legal proceedings or probate or be mismanaged or consumed by a beneficiary not ready for such responsibilities. Please call us if you have experienced a life event and/or would like to review your situation in more detail.

Monthly Market Commentary

Markets in October and early November were mostly distracted from the positive economic news in the U.S. by poor earnings reports, election jitters, and Hurricane Sandy. The earnings reports have not been pretty, with negative news from slowing emerging markets, a weak Europe (and, to a lesser degree, China), and large currency swings. Although the U.S. won't remain immune to the rest of the world forever, and our fiscal situation remains in disarray, there still are a few factors that will help the domestic economy. These include Boeing's ongoing ramp-up, a nicely improved and stable auto industry, increased oil production, a relatively stabilized banking industry, and a lumbering housing industry that has finally begun to recover.

GDP: Third-quarter real GDP grew by 2%, ahead of the second quarter's 1.3% rate. Much of this improvement was due to a very strong consumer, an improved housing market, and strong government spending. Consumption, which represents about 70% of GDP, is always the most important factor, because if consumers continue to spend, businesses will have to invest in plant and equipment, inventory, and most importantly, employees.

Employment: In October, 171,000 jobs were added, sharply exceeding expectations. While this was great news, Morningstar economists believe that at the current pace of job growth, an additional 23 months is still required to recover pre-recession jobs. Employment recovery across sectors has not been consistent. The overall service sector is nearly back to pre-recession levels, while good-producing sectors (mining, manufacturing, and construction) have only recovered 15% of the jobs lost. Furthermore, massive efficiency gains in manufacturing have moved industrial production levels to near pre-recession levels, even as manufacturing has regained a measly 25% or less of the jobs lost. The unemployment rate inched upward to 7.9%.

Housing: Despite the arrival of fall, which typically brings a drop in real estate activities, home prices, new home sales, and pending home sales all showed improvement. On a year-over-year basis, the August Federal Housing Finance Agency (FHFA) Home Price Index was up 4.6%, with all nine regions in the U.S. showing positive growth. While almost always moving in the same direction, pending sales (contract executed but not closed) have exceeded closed sales by a large margin for many months, as below-market appraisals and mortgage denials caused many contracts to not close. Recently, the gap between growth in pending and closing sales has narrowed to about 2% from as much as 6%, which Morningstar economists believe points toward an improving housing market.

Manufacturing: October's manufacturing data showed gains in new orders and an increase in employment, which suggested that the manufacturing sector in the U.S. may have bottomed and is now recovering. Auto sales in October were better than a year ago, but slumped from 14.9 million units in September to 14.2 million units in October. Hurricane Sandy was most likely the cause of this shortfall, as a large portion of auto sales occur on the last few days of the month, and the area hit by the storm accounted for 20%-25% of all auto sales. Outside of the U.S., China showed meaningful improvement between September and October as the Chinese construction market continued to show signs of bottoming. Europe's manufacturing, on the other hand, continued to contract and is currently at its lowest level in 40 months.

Election results: With President Barack Obama narrowly beating out Republican challenger Mitt Romney to win a second term in office, all attention has now turned to global woes and the looming fiscal cliff. If nothing is resolved by the end of 2012, massive spending cuts and across-the-board tax increases may occur. Markets reacted negatively on Wednesday November 7th, falling by as much as 2.73%, with energy and banking sectors among the hardest hit.

The Fiscal Cliff

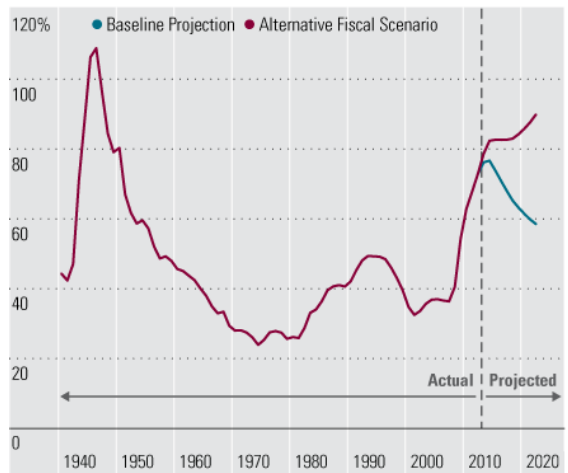
The term "fiscal cliff" has dominated headlines but besides adding another phrase to your political vocabulary, what does it really mean to you? The "fiscal cliff" is the U.S. fiscal situation that could dramatically change the economic landscape in this country, defined by a bundle of momentous tax hikes and spending cuts that are due to take effect at the end of 2012 and early 2013. The intended goal of these tax hikes and spending cuts is to reduce the national deficit. A reduction of national deficit appears to be a good thing on the surface but such dramatic belt-tightening so quick has raised concerns about the possibility of growth deceleration and a potential recession. Before digging deeper, it is important to distinguish between baseline and alternative fiscal scenarios. Under the baseline scenario, existing policies would expire, allowing for the implementation of tax hikes and spending cuts whereas the alternative scenario calls for an extension of existing tax provisions.

According to the Congressional Budget Office (CBO), the 2012 federal debt held by the public will reach 73% of GDP; the highest level since 1950. Under the current baseline scenario*, the federal budget deficit will shrink to an estimated $641 billion in 2013 from $1.1 trillion in 2012. Given the current fragile economic conditions, the CBO anticipates that the U.S. economy may fall into a recession if GDP declines and unemployment increases. To be precise, the CBO expects the 2013 (year-over year) fourth quarter real GDP to decline by 0.5% and the unemployment rate to rise to about 9% in the second half of 2013. Under the alternative scenario*, the 2013 federal budget deficit could total $1 trillion, with the 2013 (year-over-year) fourth quarter real GDP growing by 1.7% and unemployment staying in 8% range.

If Congress fails to extend tax breaks, here is what we can expect. The Bush tax cuts will expire and income taxes, estate taxes, capital gains taxes, and tax rates on dividend income will increase. The Social Security tax cut will expire, raising the rate from 4.2% to 6.2%. The alternative minimum tax (AMT) will affect significantly more Americans. High-income earners will be taxed as part of the Affordable Care Act (Obamacare). Spending cuts legislated by the Budget Control Act of 2011 will affect the national defense budget and other programs across the board. The emergency unemployment compensation will expire at the end of the year. The Medicare payment rate at which Medicare pays physicians will decrease by about 27%.

While inaction by Congress may have dire consequences, Morningstar economists expect Congress will take action after the 2012 election season to keep tax rates from rising too drastically and delay the spending cuts. Until then, revisit your retirement portfolio to ensure it is well positioned to weather a fiscal cliff worst-case scenario.

Federal Debt (as % of GDP) Held by the Public

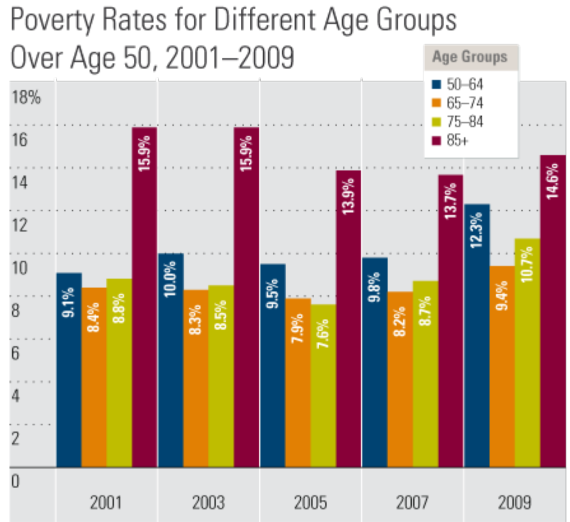


*The baseline project assumes that current laws remain in place and are set to expire as planned. The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (started at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.

Poverty Trends in Retirement

Retirement for most Americans nowadays is a far cry from the legendary "golden years." Relying on Social Security alone will simply not cut it anymore, and even people who have worked and saved diligently all their lives are worried their nest egg may not be enough. The worst-faring population group, however, may be retirees who live below the poverty line.

A recent study from the EBRI* examined poverty trends among Americans aged 50 or older from 2001 to 2009. Poverty rates are highest for those aged 85 and above, since by that time most personal savings tend to deplete. Another factor that may be at work behind these numbers is the increasing level of medical expenditures as we age. Those in poverty are almost 45–55 percent more likely to suffer from various health conditions as compared with those who are not classified as poor.



*Report cited: "Time Trends in Poverty for Older Americans Between 2001–2009," Employee Benefit Research Institute Notes, Vol. 33, No. 4, April 2012.

This study uses the poverty threshold levels from the U.S. Census Bureau to determine poverty status. The Census Bureau uses a set of money income thresholds that vary by family size and composition to determine who is in poverty. If a family's total income is less than the family's threshold, then that family and every individual in it is considered in poverty.

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