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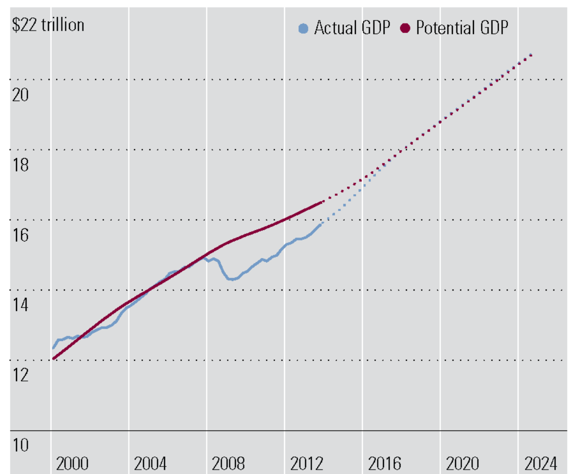
Output Potential Gap Suggests Limited Inflation Risk

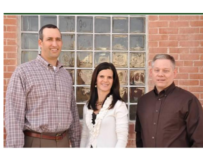
Outside of food and drugs, the prospect of high inflation remains dim. The output gap, which compares current and forecasted Gross Domestic Product levels to the estimated potential of the economy, remains at one of its widest levels in history. Every major, sustained bout of inflation in the Post-War era has occurred when the economy has been running above its theoretical capacity. The Congressional Budget Office, the keeper of this key metric, believes that the economy will not operate up to its full capacity until 2017, as shown in the chart. CBO considers unemployment, demographics, capital investment, and productivity, making it a much more comprehensive measure than simpler capacity utilization metrics. Besides the output gap, Morningstar economists believe that monetary and fiscal policy, as well as commodity prices, could also influence inflation levels going forward.

Potential Versus Actual GDP



This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results. Source: Congressional Budget Office.

What's Happening at SWA



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It's time for an employee benefits review. Those still working may want to evaluate their choices for health, dental, disability, long-term care and life insurance coverages. If accounts such as a Flexible Spending Account, Health Savings Account or Dependent Care Reimbursement Account exist, do you have a plan to contribute to or utilize these accounts before the end of the year? Are you on track to maximize contributions to your retirement savings plan for 2014? If you are 50 or older, have you made Catch-Up contributions? Are you taking advantage of an existing Employee Stock Purchase Plan? For the highly compensated, is there a Deferred Compensation plan available to you? Other benefit plans such as employee stock options, restricted stock, and performance bonuses can be an important part of your long-term financial security. Start your review by obtaining a copy of your summary of benefits. Feel free to contact SWA and we will gladly assist you.

Monthly Market Commentary

The U.S. market returned 8.3% so far this year (as of the end of the third quarter). The U.S economy appears to be holding its own despite setbacks in the rest of the world.

Employment: Private sector employment growth has been stuck in an exceptionally narrow range of 2.0%–2.2% year-over-year growth since 2011. As suggested by a falling unemployment rate (5.9%), recovery-low initial unemployment claims, and wage growth in select categories, Morningstar economists believe the economy may face spot labor shortages in 2015. That could mean that pay rates in some industries will need to go up. That could also pressure corporate earnings in the year ahead, along with rising interest rates and an increase in the trade-weighted dollar that has now appreciated by close to 12%. 2015 could be the first year when it might be better to be an employee than an employer.

Consumption and Income: For most of 2014, income growth has been excellent while consumption growth has been volatile and much slower. Between December and August real wages are up 3.1%, real disposable income is up 2.8%, and consumption a meager 1.4%. The premise and reason for optimism, at this point, is that incomes don't grow faster than consumption for long in the United States. As inflation backs down again and the job market continues to improve, consumers are likely to increase spending in the back part of 2014, which in turn should help push overall third-quarter GDP growth.

Trade: The trade deficit shrank from $40.3 billion in July to $40.1 billion in August. The inflation-adjusted deficits for July and August are running considerably lower than the slightly inflated numbers of the second quarter. Net trade took 0.4% off of GDP growth in the second quarter and is likely to add 0.2% in the third quarter, providing potential for a meaningful swing. Unfortunately, trade may hurt the U.S. economy in the fourth quarter because of a stronger dollar.

Quarter-End Insights: 2014 was to have benefited from a huge swing in the government category as well as a continued big rebound in housing and a strengthening world economy. That didn't happen. Housing slowed because of affordability and credit tightness. Government did get a little better, but not nearly as much as hoped, as last year's budget agreement weighed on spending. In fact, as fiscal 2014 draws to a close, federal government spending looks to be lucky to grow at 1%, before adjusting for inflation.

Furthermore, world growth has been a big disappointment. After just one year of mediocre growth, Europe didn't show any growth at all in the second quarter. China, too, has been a disappointment, with both exports and real estate turning in poor results. China's currency has been weaker, also, which has helped exports to the U.S. and hurt imports. The bright side to this surprising world weakness has been more liberal central banks, falling inflation rates, and lower interest rates.

Lately, there was some fear that in the long term, U.S. GDP growth could slip well under 2%. That is as overblown as the expected return to 3%-plus growth was just a few short years ago. First and foremost, residential spending has yet to return to its normal level (5% of GDP), despite population growth and five years of economic recovery. Exports to the rest of the world will also help keep the U.S. growth story afloat. Airliners are likely to be in strong demand throughout the world over the next 10 years. With long production and design cycles, competition for the U.S. airliners will prove minimal. Growing agricultural demand and growing oil-related exports should also keep the U.S. ahead of the developed world growth rates. Demographics, however, including lower population growth rates and an unfavorable shift to older, lower-spending consumers, may keep a lid on long-term economic growth.

How to Widow-Proof (or Widower-Proof) Your Portfolio

Plenty of people who pass away or become debilitated leave their spouses with overly complicated financial plans, too little information, and no clear instructions about where to turn for help. Below are some of the key ways to make sure that doesn't happen to your family.

1) Start the Conversation. Even if your spouse is happily hands-off, it's important that he or she is looped in on the basics of your financial plan, including how much you have, your chief financial assets, and what type of withdrawal rate your portfolio can safely support. Alternatively, or in addition to having a money conversation with your spouse, share at least the basic information about your finances with your most financially literate (and trustworthy) child.

2) Simplify. Assuming a financial plan includes a well-thought-out asset allocation and reasonable intra-asset-class diversification, less may be more in terms of the number of individual holdings. That's particularly true if you're concerned about your spouse's ability to manage the portfolio on his or her own.Of course, multiple accounts with multiple providers may be inevitable in some households, but collapsing your overall number of accounts (and the holdings within them) could be a good starting point on the road to portfolio simplification.

3) Shape Up (and Share) Your Record-Keeping System. Organizing files in broad, easy-to-understand categories (for example "Investments," "Insurance," and so on) is a good starting point, with subfiles for each account. Another good idea is to create a master directory, which can be either electronic or paper. It should contain financial assets such as bank, fund, and brokerage accounts; company-retirement plan and pension fund details; real estate holdings, and business interests. Alongside or beneath each account name, include account numbers, URLs, passwords, key contacts, and phone numbers. Include similar details for debts you owe and insurance policies. Having such a document can be a good way to provide your spouse with a 3,000-foot view of your household's finances; just be sure to tell him/her where to find this document and keep it password-protected or under lock and key.

4) Provide Guidance on Where to Go for Cash. Many surviving spouses may not have adequate cash reserves to fund their near-term living expenses. Stashing too much of your portfolio in cash may carry a steep opportunity cost right now, but every retiree household should aim to keep at least two years' worth of living expenses in true cash. It's also important to provide your spouse with guidance on which assets are most liquid and appropriate to tap in a pinch and which are less so.

5) Put It on Autopilot. Putting as much of your investment plan on autopilot as possible can allow your portfolio to run itself for a time if need be. A key benefit is that you'll be less tempted to override your carefully laid investment plan at an inopportune time, but another is ease of use. Investigate what options your investment provider has for automating your investment program. Switching on features such as automatic required minimum distributions is a good example of this idea.

6) Help Identify a Suitable Advisor. Many individuals with spouses who are disengaged financially take comfort in knowing that their spouse will be able to turn to an advisor after they're gone. If you think your spouse will eventually need to turn to an advisor, it doesn't hurt to begin the search for a qualified advisor while you're still around to help with the screening.

This is for informational purposes only and should not be construed as legal, tax, or financial planning advice. Please consult a legal, tax, and/or financial professional for advice specific to your individual circumstances. Asset allocation and diversification are methods used to help manage risk. They do not ensure a profit or protect against a loss.

Get a Tax-Smart Plan for In-Retirement Withdrawals

The following sequence may make sense for retirees to preserve the tax-saving benefits of tax-sheltered investments for as long as possible.

1) For retirees over age 70 1/2, the first stop for withdrawals are those accounts that carry required minimum distributions, or RMDs, such as Traditional IRAs and company retirement plans such as 401(k)s (to avoid paying penalties).

2) For retirees who are not required to take RMDs or have taken their RMDs and still need cash, turning to taxable assets may be an option. A good start may be selling assets with the highest cost basis first and then moving on to those assets where cost basis is lower (and the tax hit higher). Relative to tax-deferred or tax-free assets, these assets have the highest costs associated with them. However, taxable assets could also be valuable to tap in later retirement years because retirees will pay taxes on withdrawals at their capital gains rate, which is generally lower than the ordinary income tax rate.

3) Finally, after taking RMDs or tapping taxable assets, retirees still in need of cash may want to further tap company retirement-plan accounts and IRAs (Roth IRA assets last.)

401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Direct contributions to a Roth IRA are not tax-deductible but may be withdrawn free of tax at any time. Earnings may be withdrawn tax and penalty free after a 5 year holding period if the age of 59 1/2 (or other qualifying condition) is met. Otherwise, a 10% federal tax penalty may apply. Please consult with a financial or tax professional for advice specific to your situation.

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