StoneRidge Wealth Management

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The Quarterly Profit

TARIFFS & DEFICITS

The markets have been exceptionally volatile since early March when Mr. Trump first threatened our trading partners with tariffs and trade wars. With my usual blanket disclaimer of "No political statements, please", let's try to make some sense of the frightfully complicated issues and why they create disruption in the U.S. and global markets.

We'll begin with the challenging (and too often misunderstood) concept of trade imbalance. It's easy to think of a trade deficit or imbalance between two nations as something inherently negative or unfair. The arguments that "Exporting is good and importing is bad" and "We buy too much from them, so they should buy more from us" may have a heartfelt appeal, but the fundamentals of global economics show that a trade imbalance is not necessarily unfair or harmful. Unfairness can and does exist of course, especially when trade agreements are outdated, have been violated, or were made for short term political gain or strategic military advantage. Trade imbalances will always exist, and whether they are negative or positive between trading partners may be irrelevant so long as a capital surplus is generated in the process. The initial imbalance is merely a component of the totality of all other trading and financial activities that result. The U.S. has shown 42 consecutive years of trade deficits since 1976, but it has also shown 42 consecutive years of capital surplus.

Several years ago, I wrote a column about manufacturing costs and trade imbalance using Mattel's Barbie Doll as an example. This may be simplistic, but I believe it illustrates the issues at hand. Manufacturing had been moved from the U.S. to China because our labor and factory overhead could not compete with China's $2.50 production cost. Mattel imported container loads of Barbies without shipping any raw materials or components to China for Barbie's assembly. Clearly, there was an imbalance of trade. While trade unions and manufacturing associations in the U.S. may have had good reason to cry "foul" for the shuttered factories and lost jobs, a significant capital surplus was created despite this trade deficit. Barbie's retail price was about $25.00 in the U.S. The real money was not made from the manufacturing but in the transportation, marketing, distribution, design, financing and accounting functions that resulted from bringing Barbie to market. From the initial manufacturing process in China to the final retail sales around the world, buyers, sellers, shareholders, financiers and consumers traded freely, creating a significant capital surplus, and balancing out the costs and values of all currencies, components, transactions and services. This is the essence of globalization and free trade. Whether the product is a Barbie Doll, a smart phone, or a metric ton of steel, manufacturing will always seek the source of lowest cost, and attempts to reverse this natural economic flow by imposing tariffs creates uncertainty in the global markets. (continue...)

Mr. Trump hopes that his threats of tariffs and trade wars will reduce our trade deficit with China, reinvigorate manufacturing in the U.S. and recapture the relative prosperity that we enjoyed from the end of WWII through 1975. This was the golden age when U.S manufacturing was dominant and trade surplus was the norm; our corporations and factories had very little competition from a world devastated by WWII. We assumed that our dramatic rate of economic growth, manufacturing capacity, wage increases, job security, benefits and social entitlements constituted the new norm that was our inherent right. The problem is that the world has fundamentally changed since then. As the global economies began to recover, it was clear by 1975 that our manufacturing dominance could not continue against the rising competition from Western Europe, Japan, and later China and South Korea. Tariffs and trade wars will never bring back the golden era because technology has virtually levelled the global playing field.

Here is where it really gets messy. Our nation's total trade deficit is not defined by the pluses and minuses of trading between bilateral partners (Barbie and China), but by the excess of our nation's total spending over our total income. The calculations are horrific and include the combined spending and savings of all entities including our government, corporations, individual households, and foreign investment in the U.S. This is the elephant in our living room. Our staggering trade deficits will increase more from our low savings rate vs high spending, (including the escalating cost of our social entitlements: Social Security, Medicare, Medicaid) than from our increased trade imbalances with our trading partners.

For years, China has been accused of stealing technology secrets and/or demanding technology in return for access to China's markets. Global markets would prefer that complaints of theft and unfairness be registered with the World Trade Organization rather than by the threats of tariffs and trade wars. The U.S. has been instrumental in developing the WTO forum, and even though the process can be slow, inefficient and riddled with political inequities, arbitration in this forum is far less disruptive to the global markets. With that being said, Mr. Trump's threats of tariffs and trade war might possibly be effective in wringing necessary trade concessions from China, as China's best interests are also served by maintaining as much economic stability as possible. Trading technology secrets for access to China's markets may appear to be more one sided that it really is, as by definition technology is constantly evolving and what is a secret today may be old technology tomorrow. Apple and other high-tech corporations have struggled with this trade-off for years, but their stockholders have rarely objected to the astonishing increase in share value.

The markets do not respond well to uncertainty, and the recent threats of tariffs and trade wars have created a level of short term disruption that has offset the positive forces of corporate earnings, economic expansion and low unemployment. Year to date, the Dow has swung from a 7.2 % high to a minus 5.2% low and was close to break-even on Friday May 11. Despite the volatility of these first four months and the most bizarre political news in recent memory, I believe that we should be fairly optimistic and look forward to a reasonable degree of positive trending for the remainder of the year. For the talking heads who call for a 10% market drop, we've already seen a 12% swing. Market performance always comes back to the economy, and most indicators point to continuing growth and expansion. Until these indicators change, let's carefully ride the momentum.

Van Mason, CFP®, CLU, MBA

Fixed Income Index Annuities

Read the fine print!

A client recently attended a seminar on Social Security Strategies. The information was interesting so he signed up for a consultation, only to be hit with a sales pitch for Fixed Income Index Annuities. Our client was irritated with the bait and switch technique but wanted to know what I thought about the underlying value of the product being sold. After all, guarantees of principal, market participation and interest rate all sounded very compelling, especially since there were no fees; he thought it was almost too good to be true. Sound familiar? Haven't we all encountered sales presentations that were almost too good to be true until we read the fine print? Let me emphasize that there is nothing inherently negative or unethical about these products, and I have access to some of the leading Index Annuities through the LPL Financial platform. While Index annuities might possibly offer some contribution to a wealth management strategy, my personal opinion is that their costs and constraints usually negate whatever fundamental value they might provide, especially when compared to an actively managed portfolio that seeks to optimize a balance of growth and income.

Fixed Index Annuities are probably the most complex and confusing of all annuity products. There are numerous variations of Fixed Index Annuities on the market, and each promotes its own unique features, benefits and guarantees. An analysis of all products is outside the scope of this column, but the following example includes actual offerings from specific annuities and should raise some questions as to whether or not these products should occupy a position in a retirement portfolio.

We'll use the example of $100,000. The client is justifiably concerned about market volatility, and the salesman assures the client that his investment in this fixed income index annuity will be guaranteed against market loss. There will be a guaranteed interest rate, the investment may experience growth in positive markets, and there will be no fees. Let's start with the guarantee of principal. The client assumes that his $100,000 is fully protected, and that the insurance company guarantees this amount. However, a careful reading of the fine print states that the guaranteed value is 87.5% of the invested dollars, or in this case $87,500. If the investor surrenders his contract before the ten years have passed, there will be significant penalties. If the investor holds the annuity for ten years, he is guaranteed to receive a minimum of $100,000. However, if he should die in the early years after the contract is issued, the death benefit may only be $87,500.

And the guaranteed interest rate? Many of the annuities offer from 1% to 3% in the first year, but then only guarantee .5% (one half of one percent) in the following years. The interest rates are applied to the guaranteed value, ($87,500) so that in ten years the original investment of $100,000 is guaranteed to be repaid. My primary objection to the interest rate guarantees is that they contribute almost nothing to the investor's cash flow needs, and positive cash flow is probably the most critical aspect of retirement planning.

But what about the growth in positive markets? Most Index Annuities guarantee a degree of participation in market growth but place a cap on the percentage of growth allowed, often at 6%. In one piece of sales literature, the Index Annuity company showed a return of about 5% in 2013, when the Dow was up approximately 28%. (continued...)

Fixed Income Index Annuities (continued)

In relatively low growth markets, the annuity may show only minimal participation. The fine print in some contracts says that the $100,000 will not actually be invested in the market at all, but in a "synthetic basket" of investments instead. The insurance company places the $100,000 in its own general fund, where it is invested in various categories of bonds, treasuries, and other relatively low risk investments, with 100% of these investment gains going to the company. Then, the insurance company purchases a complex array of stock options (puts and calls) that bet on gains and losses of the various market indices (S&P 500, Dow, NASDAQ, etc.) that comprise the investor's synthetic basket. (Remember, the actual dollars are held in the general fund) The investor's share of these gains is then declared by the insurance company using various time frames, such as "point to point" or "contract anniversary date". While a strict legal interpretation of these participation formulas allows the insurance companies to advertise that there are no fees, a careful reading of the fine print is necessary to understand that the investor incurs significant costs in the lost opportunities and in the margins shared with the insurance company.

Ten years is very, very long time to commit to an investment with limited benefits and significant penalties for early withdrawal. Portfolio loss is a serious concern of course, but lost opportunity is another. While we must always be mindful of market volatility, we must not allow ourselves to be sucked into sales promotions that play upon our fears. In the 77 years since the Great Depression, there has never been a consecutive ten-year period where the markets have not shown positive returns. And, the markets have usually begun to recover within a year of the most serious losses. As frightening as the 2008 crash was, the plunge that began in September, 2008 had already begun to reverse itself by early March, 2009. Rather than committing to a Fixed Income Index Annuity with such limited benefits, an alternative strategy to consider may be to hold about a year's income requirements in cash and bond funds. In the event of a serious market drop, this "cookie jar" would supplement the income needs and allow the investment portfolio to take advantage of the significant recovery that has historically followed a serious market loss. If you have been presented with a Fixed Income Index Annuity, please call us and schedule an appointment. We'll discuss the positive features and benefits, then carefully review the fine print. No fees? Perhaps. But what about the costs?

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Fixed annuities are long-term investment vehicles designed for retirement purposes. Gains from tax-deferred investments are taxable as ordinary income upon withdrawal. Guarantees are based on the claims paying ability of the issuing company. Withdrawals made prior to age 59 ½ are subject to a 10% IRS penalty tax and surrender charges may apply.

StoneRidge Wealth Management
Rock Solid Retirement & Estate Planning

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