SUMMER 2012

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PLANNING WITH PURPOSE

Economic Update

Irrational exuberance vs. rational despair

By Brian T. Jones, CFP®

The first seven months of 2012 are in the history books and from a stock market perspective the numbers have been encouraging to say the least. Through the end of July the DJIA is +6.5% and the S&P 500 is +9.7%. While getting to this point has not been without its ups and downs, the market has done so in the face of severe economic and political headwinds.

The European situation continues to be a hot spot as a result of both political elections and forced fiscal austerity. The increasing reality is that Europe will not solve its problems any time soon nor will it be torn apart before year end. On top of this the continent seems headed for a recession, so this will only add to the gloom on the European front.

Here in the U.S., we continue to face our own economic and political realities. The economy is in year three of an economic expansion (since early 2009). History since WWII shows the typical expansion lasts on average five years. We also know that a frail domestic economy and a weak global economy only adds to the possibility of a future recession.

Earnings have been reasonably good, not great, but also not terrible. Consumers seem to have slowed their personal spending, and this will be an issue the remainder of the year because of the importance that consumer spending plays in GDP growth. Oil prices have climbed higher in recent weeks and the drought like conditions in America's farm belt will only shrink supplies in the face of rising global demand. Housing has begun to show signs of life in certain pockets across the country, but it is still too early to declare the housing crisis officially over. And the unemployment rate continues to be unacceptably high, especially if you count workers who have stopped looking for work. This is a national tragedy that will weigh on our economy for many years to come.

Last but not least, is the upcoming political elections and the looming fiscal cliff (see the article herein by Kim McLeland). Uncertainty breeds anxiety and volatility. We continue to remain cautious and guarded until the elections have past, and Congressional action has been taken on the sequestration targets and the fiscal cliff.

In conclusion, Europe continues to be a mess and the domestic elections and budget sequestration will cause anxiety for markets. We expect slow growth for the U.S. economy but no recession in the U.S., and continuing moderating growth in corporate earnings will cause the markets to (hopefully) squeak a little bit higher into the Fall, but not without some downside swings.

The "Fiscal Cliff" -- What is it?

By Kim A. McLeland, CFP®

"Fiscal cliff" has been in the headlines lately so we would like to take a few moments to explain what it means. It refers to the negative impact on our slowly recovering economy of three things. (1) The expiration of the tax reductions passed under the Bush administration and extended for two years under the Obama administration. These affect taxation on both income and estates and gifts. (2) The triggering of "sequestration" which will force a reduction in US Government expenditures due to an inability of the Congress and the administration to agree on specific cuts in programs and expenditures. This is a provision of the legislation authorizing an increase in the national debt ceiling in 2011. It forces a $600 billion cut in defense expenditures and a $600 billion cut in domestic programs, starting in 2013, IF lawmakers can't agree on comparable cuts by then. When passed, "sequestration" was considered to be a sure means of forcing the Congress to find and agree on expenditure cuts. (3) The introduction of new taxes that are part of the Patient Protection and Affordable Care Act passed by the Congress in 2010 and signed into law by President Obama.

The expiration of tax reductions

The tax reductions were passed early last decade when we were just emerging from a bad downturn in the economy contributed to by the technology (spending) "bubble" bursting and the terrorist attacks on the US in September 2001. I am sure everyone remembers the "bubble" – it came from all the additional spending that was necessary to make sure that our computers would still function after December 31, 1999. The tax reductions that were put in place included: lower tax rates on regular income, reduced capital gains taxes and reduced taxes on dividends received. In addition, there was an expansion of the 15% rate bracket for married taxpayers that made it double that of unmarried taxpayers. Estate taxes will also be raised as the increased exclusion amount of $5,120,000 (amount that can be left to someone other than a spouse and have no tax due) will fall to $1,000,000 and the starting rate of the estate tax will rise from 35% to 55%. This is not a complete list but it does include the items that may affect most people.

Sequestration

As noted above, no one ever expected sequestration to actually trigger. Everyone expected that the two parties would find ways to spread necessary spending reductions throughout the budget in a manner that would reflect greater thought and concern for what was being accomplished. Unfortunately, since 2010 the two parties have found little if anything that they could agree or compromise on.

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Kevin’s Corner: Morningstar

By Kevin Donovan, CFA

Last month, Parker Trasborg, CFP®, and I attended the Morningstar Investment Conference, a gathering of leaders in the investment industry that covered a wide range of topics from global economic issues and broad outlooks on the stock and bond markets to more focused discussions on retirement income, cash strategies and individual mutual funds.

The main feeling among attendees was one of relief. Despite the worrisome headlines we all read about the possibility of the European Union falling apart and the impact of a Chinese recession on the world economy, the people who are focused on these issues for their own firms have a more balanced outlook on the future. While none were giddy with optimism, most of them felt that the worst-case scenarios played out in the financial press were unlikely to happen.

The feeling among most experts at the conference was to expect more of the same in Europe. That is, the Euro Zone will neither collapse nor solve its problems in the foreseeable future, but it will act to avert any major crises when it has no other choice but to do so. This isn’t the boldest way to go about providing confidence but it seems to be the only short-term way to get so many different players to act to avert a crisis.

For the U.S. markets, the consensus was that this is a good time to be invested more in stocks than in bonds. This is obviously not what the average mutual fund investor believes as the overwhelming amount of investor money is being transferred by individuals from stock mutual funds into bond funds. U.S. equity mutual funds have seen outflows for 13 straight months. Individual investors have not been very good at timing their moves into and out of different asset classes in the past and the experts mostly agreed that it would be better for investors to do the opposite of what they have been doing and to put more money back into stock funds.

There are several reasons for this. On the bond side, interest rates are at historic lows. People are buying bond funds because they appear to be safer than stocks but with rates this low it is hard for bond fund returns to even beat the current mild inflation rate. The result is that investors are actually losing money, adjusted for inflation, by buying the safer, lower-yielding bond funds.

Additionally, no one knows when, but eventually interest rates will rise again. When that happens, current bonds that are paying lower interest rates will be worth much less and the value of the funds holding them will decline. This may not happen for a year or two, or more, but it will happen.

(Kevin's Corner article, continued from page 3)

On the equity side there are several positive indicators. Stock valuations are low compared with historical averages such as price-earnings ratios. As a result of the lower prices dividend yields are higher, in many cases dividend yields are higher than bond yields.

Also on the positive side, companies are in much better financial shape than they were in the recent past. The severe down market and loss of liquidity in 2008 scared companies into making sure their balance sheets were stronger so they would not be in the position of having to seek outside money when there is none available. Companies on average now have more cash on hand and lower debt levels making their dividends safer and ensuring a less treacherous ride through economic difficulties.

Investors have fled equity funds due to the risks involved and the volatility of the markets since 2008. This year stocks have continued to see large moves up and down within the same week which many find disconcerting. Despite these swings, stocks are having a very solid year so far, with the Standard & Poor's 500 stock index up over 10% through July 27th, compared with a 3.4% gain in the Barclays Aggregate Bond Index.

No one is advocating putting all of your money into equity funds. Depending upon where you are in the investing cycle, saving for retirement or enjoying your retirement, the best allocation remains to be invested in a diversified portfolio of both equity and fixed income. The point is to not be caught up in the emotion of the day-to-day movements of the stock market but to have a longer term view and sleep better at night.

(The "Fiscal Cliff" article, continued from page 2)

New taxes from the Patient Protection and Affordable Care Act

The law introduced a new 3.8% investment tax on investment income. This tax is imposed on the lesser of investment income or the amount by which total income exceeds $200,000 on a single return or $250,000 on a joint return. Investment income includes: interest, dividends, capital gains, annuities, royalties and passive activity income. It does not include: wages or self-employment income, IRA or retirement plan distributions, tax-free interest, Social Security or other retirement benefits.

It should be noted that this 3.8% tax will apply as well to the taxable portion of the gain on the sale of a principal residence. For most people, this will not apply because of the $250,000 per person exclusion – but if one has not owned and lived in the home the full 2 out of 5 years to qualify for the exclusion this will be another expense.

In addition there is a new 0.9% Medicare tax on wages and self-employment income over the threshold amounts.

Particularly notable in these new taxes is the fact that the "marriage penalty" has returned. The threshold for imposing the new taxes on a joint return is $250,000 rather than $400,000 which would be twice the single taxpayer amount.

While we would certainly not suggest that it is unnecessary to take steps to reduce the national debt that we have been accumulating – we do suggest that compromise between the parties should allow better solutions than those scheduled to be imposed on us.

Say What?

Here are some of our favorite quotes from various financial media publications from the last few months. As you read down through these, remember to take each with a grain of salt.

"What we're witnessing is the breakdown of the great American jobs machine. The official unemployment rate is 8.2%. But if you add to that the number of discouraged workers who have dropped out of the labor market since the recession began in early 2008 – approximating eight million – the rate would be an alarming 12%. Fifty percent of the jobs created since the recession hit have been part time, with no benefits and a wage that's inadequate to enter the middle class. If you add the number of part-time workers into the mix, the unemployment rate climbs to 14.9%. Fewer Americans are working today than in the year 2000, despite the fact that our population has since grown by 31 million and our labor force by 11.4 million".

- Mortimer Zuckerman, Chairman and Editor in Chief of U.S. News & World Report, Op Ed piece in The Wall Street Journal, Tuesday July 24, 2012

"When Paul Krugman dies, he'll be primarily remembered for three things: He won the 2008 Nobel Prize in economics; he has been one of the world's most-read and most influential political pundits; and he said with total seriousness that a way to fix America's economy would be for the government to spend a ton of money preparing for a nonexistent alien invasion because at least that would get people working".

– NY Post article by Kyle Smith May 27, 2012

"Greece conceded on Thursday it had slipped in "some respects" in implementing the cuts and reforms demanded by lenders in exchange for saving Athens from bankruptcy, and tried to persuade them to cut the country some slack".

– Reuters posting on July 5, 2012

"The Federal Open Market Committee, the Fed's policy making arm, has said since January that it expects to keep short-term interest rates near zero through at least late 2014. But comments and recently revised projections from Fed officials have some economists guessing the Fed might decide to stick with its easy-money policy into 2015. One clue is in the revised interest-rate projections Fed officials released last week. In June, six out of 19 officials indicated they thought the first interest rate hike should come in 2015, up from four at their April meeting".

– The Wall Street Journal, June 26, 2012

"U.S. politicians appear not to have heeded the lessons of past mistakes, or perhaps the lure of re-election is just too strong. After last year's deficit and debt ceiling debacle, the fact that we are even contemplating a repeat with the upcoming Fiscal Cliff – Fed Chairman Bernanke's term for the expiration of prior tax credits, new taxes and automatic, sequester-required spending cuts – is ludicrous. Immediately after the elections, changes likely will be made to avoid the worst case outcome of the very large hit to GDP growth these measures would deliver".

– BNY Mellon May/June Investment Update

CJM News

Dave Greene, Brian Jones, and Tim Jones will each be named as a "Top Financial Professional" in the September issue of Northern Virginia Magazine.

In June, Brian Jones attended the Pershing INSITE 2012 conference in Hollywood, FL. Brian spent time meeting with Pershing, BNY Mellon, and other investment professionals from around the world as well as attending numerous presentations on topics ranging from innovations in IT to economic policy roundtables.

Also in June, Parker Trasborg and Kevin Donovan both attended Morningstar's annual conference in Chicago, IL. Parker and Kevin spent time in numerous sessions covering a full range of investment topics from global economic concerns to insights on individual mutual funds.

Since 1978, CJM Wealth Advisers, Ltd. has been working with affluent individuals, families and business owners to address financial concerns no matter how acute or broad they may be. With a collective focus on helping our clients live the life they want, we understand that financial planning needs to be done with a purpose in mind. Otherwise, what is the use of planning at all? At CJM Wealth Advisers, Ltd., we believe in planning with purpose.

What is your purpose? Is it to…

…create a retirement income stream to last a lifetime?
…minimize investment risk and maximize return?
…prudently plan a legacy for your heirs?
…carefully position a business for a future sale?

We offer our clients real solutions by being objective and approachable while delivering excellent client service.

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