

O Consumer, Consumer! Where the Heck Art Thou,

Our apologies to The Bard, but economists are starting to wonder. For 40 years leading up to the Great Recession, U.S. consumer spending was the world's economic lynchpin. It still accounts for nearly 70% of our GDP and 15% of global output. But since the mid-2009 trough, it has grown at less than half the rate that prevailed over the prior 15 years. Last year's plunge in gas prices looked like it could add an annualized \$180 billion to households' discretionary income. Indications are that a lot of those savings are being banked or used to pay down debt. The savings rate has rebounded from its historic lows of a decade ago. Wage growth has been tepid until quite recently, and part-time employment remains high. Prolonged low interest rates have been a boon to those who were solvent enough to refinance. But the *Bank Credit Analyst* points out

that household debt at 1.1 times income is still pretty high, although down from its peak of 1.3 in 2007. Since the recession, income growth and wealth expansion have tended to favor upper-income households with a lower and slower propensity to spend those gains.

Periods of lukewarm U.S. consumption often prompt the question of when other regions might pick up the slack. But there's no clear heir to the consumption crown. Europe is looking a little better with large dollops of monetary stimulus and a broad benefit from lower oil prices. China has the numbers and rising prosperity but also big transition challenges. Big oil *exporting* nations aren't feeling very flush. And much of the rest of the developing world still looks for reacceleration in the U.S. and/or China.

In other words, it's back on *us*, a rather familiar story. ■

China's Great Wall, of Worry

A year ago we walked through the concerns surrounding the apparent slowdown in China's growth rate and its efforts to better balance its economy between investment and consumption. For the year ended June 4, 2015, the average China Region mutual fund gained 26.5% in U.S. dollar terms. On might wonder what all the worrying was about? Yet international investors have remained pretty skeptical even as the key index of shares available to domestic Chinese investors soared skyward in recent months. Starting in April, China eased restrictions on its citizens investing on the Hong Kong exchange, prompting a wave of mainland money into shares listed there. Still, equity valuations look modest compared to U.S. and other developed equity markets. China has been a growth juggernaut, but it's still a developing nation with lots of debt and economic imbalances. The government is fighting a growth slowdown by loosening liquidity and credit provisions. Domestically, real estate is in considerable oversupply. Globally, China's sustained, historic surge of production continues to weigh on a host of sectors.

Last year China exported more steel than the combined output of the U.S., India and South Korea, the world's third, fourth, and fifth biggest producers. In 2013 Chinese officials identified 19 areas of significant overproduction including cement, aluminum, copper, chemical fiber, and paper. Those disinflationary winds blow around the world, helping to spur counter

Consumer?

Taking Turns

It's no secret that U.S. stocks have been *the* major asset category to have and hold since the 2008 financial crisis. But there have been other periods when stocks of companies *outside* the U.S. took the honors. The accompanying table shows how the trophy has changed hands over the past 44 years. Of special note is the big edge in the 1980s for the broad mix of foreign stocks, followed by the super bull

| U.S. vs. Foreign Stocks * From | | To |
|--------------------------------|------------|----------------|
| Outperformer By** | | |
| 04/30/1971 | 03/30/1973 | MSCI EAFE 62% |
| 03/30/1973 | 10/31/1976 | S & P 500 31% |
| 10/31/1976 | 10/31/1980 | MSCI EAFE 90% |
| 10/31/1980 | 10/31/1982 | S & P 500 34% |
| 10/31/1982 | 02/28/1989 | MSCI EAFE 409% |
| 02/28/1989 | 08/31/2000 | S & P 500 491% |
| 08/31/2000 | 11/30/2007 | MSCI EAFE 61% |
| 11/30/2007 | 10/31/2014 | S & P 500 58% |
| 10/31/2014 | 06/04/2015 | MSCI EAFE 1% |

* U.S. Stocks: Standard & Poor's 500 Index
Foreign Stocks: MSCI Europe-Australia-Far East
** Difference in cumulative ending values

Source: Morgan Stanley, Bloomberg

measures by U.S., European, and Japanese central bankers intent on heading off a run for U.S. equities from 1989 through 2000. Based on all this his-

tory, it seems obvious that the *next* actual deflationary, big move will favor ...? ■ *continued on page 4* ►

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The Long Game: Are We Heading for a Lower Return World?

It's widely assumed that interest rates will soon rebound prompting a realignment of investment valuations and allocation strategies. rates stay quite low for another several years, reflecting a sustained excess of global savings and relatively tepid demand for credit?

returns for various asset classes over the past 30 to 40 years. If the whole structure of mainstream investment returns compresses, the challenge of income sustainability becomes even more acute. Likewise for corporate and public pension plans whose promises of future benefits and funding requirements have largely been predicated on similar historically based assumptions. Past periods of ultra-low real bond yields – the Great Depression, the World Wars, and the late 1970s – featured flight-to-safety investing with quality bonds heavily favored over stocks. Market price-to-earnings ratios (P/Es) fell below 10 in each of those periods, which were great times to build equity exposure if one had the nerve. Periods that began with P/Es as high as they are today typically have produced more lackluster multi-year returns. An optimist can hope that corporate earnings rise at a good clip and interest rates remain subdued.

A *realistic* optimist will hedge the potential for modest returns by boosting savings, controlling volatility through diversification, mixing bond maturities, taking advantage of tax-deferral, and strategizing to maximize Social Security benefits. All these can boost the likelihood of reaching long-term goals whatever the markets deliver. For those entering or nearing retirement, the strong recovery by equity markets since the financial

| Investment Performance Review | TOTAL RETURN * (dividends and capital gains reinvested) | | | |
|-----------------------------------|--|--------|-------|--------|
| | --- Annualized through June 5, 2015 --- | | | |
| Selected Mutual Fund Categories * | 1 yr. | 3 yr. | 5 yr. | 10 yr. |
| Large-Cap Stocks (Blend) | 8.2 % | 19.3 % | 15.5% | 7.4 % |
| Mid-cap Stocks (Blend) | 7.7 | 20.1 | 15.7 | 8.4 |
| Small-cap Stocks (Blend) † | 6.9 | 19.3 | 15.3 | 8.3 |
| Foreign Stocks (Large Blend) † | - 1.5 | 14.1 | 9.4 | 5.5 |
| Diversified Emerging Markets † | - 4.6 | 6.0 | 3.9 | 7.5 |
| Specialty Natural Resources | -16.9 | 3.3 | 4.3 | 5.3 |
| Specialty Real Estate | 5.3 | 11.3 | 14.2 | 6.9 |
| Moderate Allocation | 3.9 | 11.8 | 10.3 | 6.1 |
| Long-term Bond | 4.2 | 3.5 | 7.1 | 6.0 |
| World Bond † | - 4.5 | 1.0 | 3.1 | 3.8 |
| High-Yield Taxable Bond † | 0.3 | 7.3 | 8.0 | 6.7 |
| Long-term Municipal Bond | 3.3 | 3.1 | 4.6 | 4.0 |

* Source: Morningstar. **Past performance is NOT indicative of future results.**
 † Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

Then again, that's been a widely held assumption for several years now. Many investors would relish higher yields on CDs, money market funds, and investment grade bonds which traditionally set a base of real returns and forced riskier assets to offer a genuine prospect of even higher returns. That concept of a "risk premium" is a central tenet of capital asset pricing theories. But what if

Do other investment assets, especially stocks, continue the strong performance of the past six years, or does the whole hierarchy of returns compress downward?

Implications for retirement planning are not trivial. Many projections to determine sustainable withdrawals from a diversified allocation are built on historical

crisis has been a very welcome lifeboat. But there's still a long game to be played, and most studies of portfolio sustainability for a 30-year stretch show that performance during the first 10 years is a bigger factor than returns over the subsequent 20 years. That's a little food for thought before casting one's fate entirely to the market winds and assuming that those historical averages will prevail. ■

Income Now or Later? It Makes a Difference.

Speaking of playing the long game, Lord Abbett Management passes along this striking statistic. A \$10,000 investment in the Standard & Poor's 500 Index in 1976 would have produced \$4,452 in dividends in 2014. That assumes the investor had taken each year's dividends in cash along the way. By comparison, \$10,000 invested in the Barclays U.S. Aggregate Bond Index in 1976, with interest drawn each year, would have yielded just \$253 in 2014. At

the outset bonds looked like the better income play, producing \$745 of interest in 1976 versus the S&P 500's dividend output of just \$461. In fact, it was more than a decade before the yearly flow of dividends from the S&P pushed ahead of the interest income from the bonds of the Barclay's Agg.

These days, investors can look to much broader horizons than the S&P 500 for their equity dividend plays, but patience is paramount. And the next four decades are sure to be different from the past four in ways no one can really predict. It is a long game indeed. ■

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Having a Target Seems to Help

What if Congress passed a law to help investors, and it actually worked? About a decade ago these fund investors typically fall short of what they need. The performance of the funds they with *participant-directed* 401(k) hold. But the popularity of target retirement plans. A lot of those date funds is not a case of chasing participants weren't showing much hot market sectors or stocks. interest in self-directing their invest- Mutual fund researcher Mornments. At the same time, employ- ingstar studied investor experience ers and plan trustees didn't want the across the dozen fund companies liability of automatically steering that had target-date offerings for those accounts into anything but the the full decade ended December most conservative alternative, often 31, 2014. Morningstar found that,

a money market fund. on average, those investors experi Letting retirement savings idle ended somewhat *better* returns than away the decades at short-term in- the funds themselves. On an assetterest rates seemed a dubious strat- weighted basis, their average annuegy. Enter the Pension Protection alized return was pegged at 6.13% Act of 2006. One provision of that compared to 5.03% for the funds. huge legislation laid out guide- That advantage appeared *not* to be lines for something called a Quali- a fluke, as it appeared in eight of the fied Default Investment Alternative 12 fund companies studied.

(QDIA). Plans could automatically Retirement plan trustees and direct participant contributions into participants will want to understand investments meeting those guide- and monitor the target-date funds lines and be substantially insulated available to them, their ongoing exfrom liability. penses, and the manager's approach

Investment companies respond- to modifying allocations along that ed with a proliferation of target-date specified glide path to retirement. retirement

funds, the most familiar That said, the primary value may be type of QDIA. As these pages have the target-date concept's reinforcepreviously discussed, target-date ment of basic precepts of retirement funds are broadly diversified allo- investing such as: cations designed to gradually shift • Focusing on long-term objectives their holdings as the targeted date rather than short-term volatility and draws nearer. Such funds now hold performance;

more than \$755 billion in assets, up ten-fold in less than a decade. • Maintaining broad diversification Of course, popularity is not al- through multiple market cycles; ways predictive of great investment • Saving regularly and persistently. results, and investors are notoriously poor timers. Over the years a host So far, targets seem to help. ■

Higher Income Can Raise Your Medicare

Premiums, with a Time Lag

Most retirees know that rising income (\$170,000 if married filing jointly) raises the amount of one's Social Security benefits counted as taxable income, up to 85% of one's benefits. But at even higher incomes, Uncle Sam takes another bite from Social Security. Retirees with modified adjusted gross income (MAGI) over \$85,000

are subject to increased Medicare Part B premiums. Since those premiums are deducted from Social Security benefits, that's where the adjustment is felt. It's based on the most recently filed tax return, so a 2014 return showing excess MAGI will affect the taxpayer's Social Se-

Watch for Budget

Battles to Resume

Remember the great kerfuffle over the "fiscal cliff" a few years back? It's been pretty quiet on the federal budget front since then, partly due to generally favorable trends. From 2011 to 2014 federal red ink shrank from \$1.37 trillion to \$513 billion. That still may sound like a big gap, but it's just 3% of U.S. gross domestic product, near the average deficit of the past 45 years.

The pace of improvement is slowing. In the first seven months of fiscal 2015 the deficit was \$22 billion less than the year-earlier period.

Revenues were up 9%, but outlays rose 6.5%, wholly attributable to Social Security and Medicare which may be entering a multi-year surge.

Defense spending has been flat to down, but geopolitical challenges are adding pressures on that front. Interest on the federal debt also has been flat, but the debt outstanding now tops \$12 trillion. Interest expense could be a bigger factor if rates really do rise sustainably.

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High profile budget skirmishes are looming, as four major forcing events converge around September 30th. The debt ceiling will need to be raised this fall, and spending authority must be established for fiscal 2016 which starts October 1st. Also percolating are partisan differences over an array of tax extenders and a big highway funding bill. Hardly anybody is talking about this right now, but markets probably won't like it when budget brinkmanship is again hogging the headlines. Last time around it created a little *buying* opportunity. ■

curity benefits during 2016. MAGI includes Adjusted Gross Income *plus* any tax-exempt municipal bond interest. This is also the figure that determines how much of a retiree's Social Security benefits are taxable. So for many retirees, municipal bonds are *not* exactly tax-exempt. The sale of a home, business, or appreciated securities *continued on page 4* ►

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► *continued from page 1 /
China's Great Wall ...*

Newton taught us that for every action there's an equal and opposite reaction. In the marvelous maze of a global economy, the myriad reactions to any targeted action will hold many surprises. The International Monetary Fund recently estimated that China is now the world's largest economy. There may be some debate as to how that's measured, but not much doubt about the impact of its dynamic economic transition.

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► *continued from page 3 /
Income Boost ...*

Making Every Second Count

Every four years we get an extra day in February. Leap Day was introduced more than 2,000 years ago to have to adjust the Julian calendar, and it has long been a market worrywart. A few market worrywarts have been associated with quirky traditions such as women proposing to computerized trading men. The rest of the time they typically programs. But the masters of those calls display better judgment. algorithms should be able to devise a work-around so that the rest of us can just sit back and relish the extra match between our best clocks and time. After all, what is so rare as a the Earth's rotation. Notwithstanding - *second* in June? ■

also can easily result in smaller Social Security checks a couple years later.

Most retirees pay \$104.90 per month for Medicare Part B which covers doctor visits and outpatient services. For those whose MAGI exceeds the threshold noted above, there are five levels of premium *surcharge* ranging from \$42 to \$230.80 monthly. Medicare Part D drug plan premiums also are subject to these

incomebased surcharges ranging from an extra \$12.30 to \$70.80 per month. All of the above figures are per person, so the impact on a retired couple can really add up.

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One may qualify for a premium adjustment if the following year's income dropped due to a "life changing event" such as retirement, marriage, divorce, death of a spouse, or the disposition of an income producing property that was beyond the taxpayer's control. The voluntary sale of a property does *not* qualify.

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The income brackets that determine Medicare premium surcharges are not adjusted for inflation, so more retirees may find themselves getting clipped for higher premiums year by year. Social Security operates on a sliding scale in several ways. In other words, Uncle giveth, and Uncle taketh away. ■
