Pettinga Insights and Outlook

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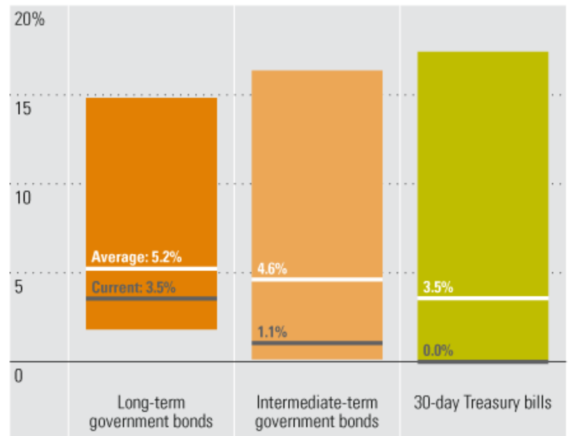
History of Interest Rates

It is commonly known that interest rates have been at historically low levels for a few years now. But how low are they? The image illustrates the characteristics of interest rates of various maturities. On average, long-term government bonds delivered the highest yield of 5.2%, while intermediate-term government bonds and 30-day Treasury bills provided an average yield of 4.6% and 3.5%, respectively. Current interest rates are positioned relatively close to the all-time lows, especially on the lower end of the maturity curve.

A rising interest rate environment seems to be the generally accepted forecast for the future. While rates can't drop much lower from their current level, the timing and magnitude of the rise still remains highly uncertain.

History of Interest Rates
January 1926–November 2013



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Indexes are unmanaged and not available for direct investment. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. U.S. government bonds may be exempt from state taxes and income is taxed as ordinary income in the year received. With government bonds, the investor is a creditor of the government. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest-rate changes.

Data: The long-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Long-Term Government-Bond Yield Index. The intermediate-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Intermediate-Term Government-Bond Yield Index. The 30-day Treasury bill yield series uses annualized monthly Ibbotson SBBI U.S. 30-Day Treasury Bill Total Return Index.

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Monthly Market Commentary

Recent economic data has not been uplifting, with poor auto sales, a subpar retail holiday season, and a weak employment report. Even home-price growth has been showing signs of slowing down. Only the trade report data was unequivocally good, though perhaps a little too good to be sustained. The Federal Reserve's Open Market minutes expressed a lot of concern about the bond-buying program, raising the question whether we might end up stuck with a modestly weaker economy and a less generous Fed all at the same time—not a good prospect.

Employment: Year-over-year employment data paints a picture of continued slow employment and economic growth. On average, growth has been consistent, with 183,000 jobs added per month in 2012 and a very similar 182,000 jobs per month in 2013. Morningstar economists forecast growth of about 190,000 monthly jobs in 2014. Total employment growth (government and private) is just 1.6% versus 2.1% for the private sector by itself. That makes sense given that the government is still shedding jobs and that the government (at all levels) still accounts for about 16% of all jobs. That being said, the employment report was riddled with many big swings and inconsistencies. The data is likely to be revised upward, or perhaps bigger gains are in store for the months ahead.

Retail sales: Preliminary data suggests a weak holiday season and poor consumer spending patterns. Poor weather conditions, a shortened holiday season, and a reduced food stamps program all put a damper on results at brick-and-mortar stores, although Internet retailers probably did significantly better, despite some last-minute delivery snags.

Auto sales: The auto data was particularly troubling, with sales managing to hit only 15.4 million units in December, a sharp decrease from November's recovery high of 16.3 million units. Averaging the two monthly figures is probably a better representation of reality, as Black Friday sales, bad weather, and a compressed holiday sales period hurt December sales.

Housing: Pending CoreLogic data suggests that home prices were down about 0.1% in December, and the year-over-year growth rate slipped to 11.5%. Hardly a disaster, but the data suggests an early-2014 end to the double-digit increases in home prices. Given slipping affordability and higher mortgage rates, this may not be an entirely bad thing, but those expecting a continued boom might be disappointed.

Pending home sales had a huge runup in the middle of the year, as buyers raced frantically to beat higher mortgage rates and temporarily distorted the market. The raw index moved from 95 in January 2012 all the way up to 111 in June 2013. The index then declined for five-straight months, bottoming at 101.5 in October. The November data showed a statistically insignificant increase to 101.7 (at least it didn't fall again). Unfortunately, the three-month-averaged year-over-year data is still in decline, and a snowy December won't help the last month of the year.

Overall, recent data suggests a stronger economy, but not a sharply stronger one. Autos, housing, and inventories are likely to contribute less to GDP growth in 2014 than in 2013. Still, Morningstar economists estimate that inflation-adjusted GDP growth at the high end of the 2.0%–2.5% range is entirely possible, and the likelihood of a big slump seems remote.

Looking forward, the data might suggest a temporary weakening in the spring (higher heating costs, new home-lending limits, difficult comparisons, and other issues related to cold weather). Reduced unemployment benefit periods and food stamp reductions in place since November (unless reversed by Congress) are likely to keep a lid on things, too. But as the wintry weather lifts, the economy could see a decent bounce, unlike the past two years when warm weather helped sales in the winter months, but normal spring rebounds were muted.

529 Plans: State Benefits

Among the most attractive benefits of a 529 college-savings plan are the tax breaks savers receive while building a nest egg to pay for a child's education expenses. 529 plan participants can avoid paying federal taxes on their 529 savings' gains, but many states offer local benefits on the initial 529 contributions, as well.

Morningstar recently tallied the states' benefits to determine which states offered the most generous local tax breaks. By quantifying these benefits, college savers are better able to determine whether their home state's 529 plan is a good choice. Generous tax benefits and fee waivers may offset other shortcomings in a plan, like higher expense ratios or mediocre investments options. Likewise, if a state's tax benefits are little to none, college savers have little reason to stay with their state's plan and may instead seek a better one elsewhere.

Morningstar found a wide range of benefits. Eight states (California, Delaware, Hawaii, Kentucky, Massachusetts, Minnesota, New Hampshire, and New Jersey) tax their residents' income and offer no state tax benefits. Residents in these states often invest elsewhere and are actively targeted by other states' 529 plans. On the flip side are states that offer portable tax benefits. Residents of states such as Maine, Kansas, Missouri, Pennsylvania, and Arizona receive benefits on their contributions to any 529 plan, not just the ones offered by their home state. For most 529 savers, however, their state's tax benefits are not portable, so if they choose another state's plan, they give up the local tax breaks.

Topping Morningstar's list of the states with the most generous 529 benefits is Indiana. While most states with tax benefits allow their residents to subtract their 529 contributions from their taxable income, residents of Indiana get something far better: a tax credit. This credit of 20% of the first $5,000 of 529 contributions allows them to subtract $1,000 from their annual state tax bill. When you also include two $20 account-fee waivers, Indiana residents can save $1,040 on $5,000 in annual 529 contributions by staying in-state. (Vermont and Utah also offer tax credits on 529 savings, but they're not as generous as Indiana's.)

Maine is another state with solid benefits, but much of them expire after the child's first birthday. Maine residents get a $500 grant from their state if they open a 529 account before their child's first birthday. From there, however, the Maine benefits are less generous. Residents may deduct from their taxable income just $250 per child in annual 529 contributions.

Beyond Indiana and Maine, six states offer benefits in the $400 to $500 range, and more than a half dozen are $300 to $400. The states with greater benefits, like Iowa and Oregon, often also have higher tax rates.

A handful of states offer smaller benefits. Some states, including Arizona, hold benefits in check by limiting the amount of 529 contributions that qualify for deductions. These smaller benefits, when expressed as a percentage of the overall 529 investment, can add up, but 529 savers may choose to give up smaller benefits in favor of a better plan elsewhere.

529 plans are tax-deferred college savings vehicles. Any unqualified distribution of earnings will be subject to ordinary income tax and subject to a 10% federal penalty tax. Tax law is ever-changing and can be quite complex. It is highly recommended that you consult with a financial or tax professional with any tax-related questions or concerns. An investor should consider the investment objectives, risks, and charges and expenses associated with municipal fund securities before investing. More information about municipal fund securities is available in the issuer's official statement, and the official statement should be read carefully before investing.

Year-End Portfolio Review: Rebalancing

Finding the right frequency for rebalancing is a personal decision that rests on a number of factors. Here's an overview of what to bear in mind.

Tax Status of Investments: Rebalancing involves peeling back on winners, which in turn could result in taxable capital gains if the sales occur within taxable accounts. Investors whose assets are mostly in taxable accounts may want to err on the side of less-frequent rebalancing. On the flip side, the tax costs of rebalancing aren't a concern for investors who hold assets mostly in tax-sheltered accounts.

Other Costs of Trading: Commissions, for example. Investors who use a commission-based broker or buy or sell by themselves on a commission-based platform may consider rebalancing less frequently. Those who do not use a broker can view transaction costs as less of an impediment to rebalancing.

Time Commitment: A more frequent monitoring and rebalancing approach requires a greater amount of time than a laissez-faire tack. For example, retirees who have the time to commit to more frequent oversight (and won't incur tax and transaction costs to rebalance) can take a more hands-on approach. For busy investors, it’s fine to check up annually.

Time Horizon/Risk Tolerance: The key benefit of rebalancing is in the realm of risk management, not potential return enhancement. By extension, investors with shorter time horizons and more limited risk tolerance may want to tightly police their asset allocations versus their targets. Longer-term investors, meanwhile, can employ a more hands-off approach.

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