Pettinga Insights and Outlook

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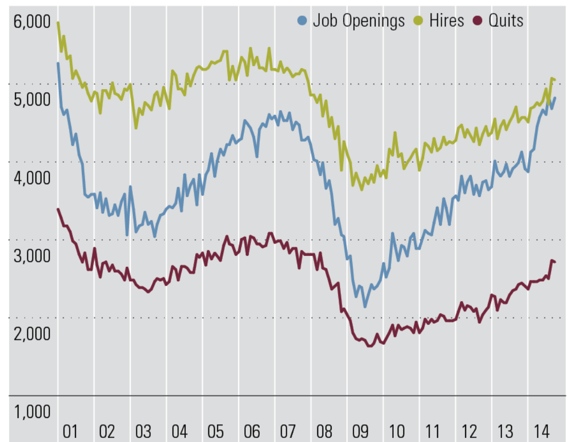
# One of Yellen's Favorite Metrics 'Jolts' Ahead

The formerly unimportant job openings report has taken on a new significance since U.S. Federal Reserve Board Chair Janet Yellen has included this metric in a list of labor market reports that she is watching closely. And this relatively new report is now sending a message that we really haven't seen before. Job growth isn't much better than it has been in the past three or four years, while the number of openings per person employed is now at its best level since 2001 and way above year-ago levels.

The chart below illustrates how the growth in job openings is outpacing the growth in hires. This means that there are increasingly less workers matched with the jobs that are being posted, and it may soon force employers to increase wages in order to fulfill those unmatched job openings.

Job Openings, Quits, and Hires, Seasonally Adjusted, Thousands of Workers




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: Bureau of Labor Statistics. Data through November 2014.

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# Monthly Market Commentary

As we said good-bye to 2014, falling gas prices have encouraged many to hope that the economy might finally jump to 3% GDP growth or even more. Besides oil prices, the positives include an improving wage and employment outlook and a slightly better government spending situation. On top of that, inflation is likely to remain in check. However, slowing international markets, a still-slow housing market, a less robust gain in auto sales, and rising interest rates may all weigh on economic activity in 2015.

Consumption and Income: Not only did November consumption data look great, but also some previous months of data were revised upward. Consumption growth, even on an averaged basis, was all the way up to 2.7% for the three months ended in November. This compares with consumption growth of around 2% for most of this recovery. However, on the flip side, the savings rate has fallen sharply over the past several months. It probably has room to fall a little more, but after that, spending gains will have to come from employment growth and wage gains. That may make consumption gains a little harder in early 2015, even if wages and employment continue to improve.

Housing: November's existing-home sales report was very worrisome, dropping from 5.25 million units to 4.93 million units, its lowest result since May. In fact, existing-home sales, which are seasonally adjusted, had been above 5 million units for five months in a row, so the November number was quite a setback. Stable mortgage rates, improving economic conditions, and better labor markets, along with the pending home sales data, suggest that existing-home sales data should not have shown such a dramatic drop. However, there is no reason to panic just yet. The annual, averaged data show very, very slow but steady improvement both in pending-home sales and existing-home sales. The gap between the growth rate in pending and existing-home sales suggests that existing-home sales should pick up, at least a little.

One unfortunate consequence of the soft existing-home sales data is that it will hit economic activity and the GDP calculation. Without a massive rebound in existing homes in December, it would appear that poor existing-home sales (and at lower prices to boot) will subtract at least 0.2% from the GDP calculation after providing a modest addition in the third quarter.

Inflation: The Consumer Price Index fell a sharper-than-expected 0.3% (3.6% annualized) in November, largely but not entirely because of falling gasoline prices. The year-over-year inflation rate is still over 1% but should continue to trend down to under 1% even if energy prices fall no further. Even the moving average year-over-year growth rate is down to 1.5%. A word of caution, however: The positive effects and the sustainability of such lower prices remain an open question.

Year-End Insights: Overall GDP growth is likely to remain in the 2.0%–2.5% range in 2015, as it has for the past three years. Though some year-end data, especially from the United States, looks stronger going into 2015, a weak world economy is likely to act as a brake on overall U.S. results. Fed tightening, combined with low inflation expectations and normal spreads over inflation, suggest a higher interest rate of around 3.5% for the 10-year Treasury bond.

The consumer represents about 70% of the U.S. GDP. While everyone is concerned about oil prices and the Fed, consumer and demographic trends are probably more important in the long run. Morningstar economists estimate that the hourly wage rate is likely to go up, but the demographics of an aging population will limit employment growth, keeping consumption below its long-term trend of 3.6% but above the 1.9% rate of the past 10 years. Furthermore, long-term demographics are going to be more important than temporarily low oil prices. Cheap oil prices come and go quickly; demographic realities, not so much.

# Could Rising Interest Rates Hurt Your 529? (Part 1)

Bond investors have been worried about a rise in interest rates for years now, pretty much ever since the Fed lowered rates in response to the 2008–09 financial crisis. Any rise in rates hurts the value of existing bonds (on the contrary, a drop in rates helps it), and rates have been hovering near historic lows for quite a while.

For families saving for college, bonds have long been seen as a safe-haven investment—a place to park cash reserved for a specific purpose within a specific time frame and a pretty good bet to increase in value faster than cash while avoiding the volatility of stocks. But what happens when bonds themselves become riskier than they've been in the past? It's a question that many college savers, especially those who will need the money in just a few short years, are asking.

529 Plans and Duration

The majority of the $200 billion invested in 529 college-savings plans is held in so-called age-based portfolios—all-in-one investments made up of stocks, bonds, and other securities allocated based on the age of the beneficiary and, in some cases, the risk tolerance of the account holder. Typically these age-based portfolios are heavily weighted toward stocks when the beneficiary is very young, and they gradually shift assets into bonds and cash as the beneficiary gets closer to college age.

With traditional bond funds, the most commonly used method of gauging interest-rate sensitivity is a statistic called average effective duration. The higher the duration, the more sensitive the fund is to interest-rate movements. It works like this: For each percentage point that rates increase, the fund may be expected to lose in value a percentage equal to its duration in years, minus the fund's yield. For example, if rates increase 1 point, a fund with a duration of 4.5 years and a yield of 2% could be expected to lose 2.5% of its value.

Finding the Numbers for a Specific 529 Plan

Although this rule of thumb may be a convenient way of assessing the interest-rate sensitivity of a single bond fund, most 529 accounts hold multiple stock and bond funds, making it difficult to arrive at a single duration measure for the entire portfolio.

Even though your 529 plan may not provide information on the duration of your portfolio, you might be able to track it down yourself by taking a closer look at the bond funds in the plan.

Unless you have all of your 529 assets in a single bond fund, you might have to do some calculations to figure out how to weight the various duration measures. For example, if your 529 portfolio is made up of 60% equities and 40% bonds, but the bond portion is half intermediate-term bonds with a duration of 5 years and half short-term bonds with a duration of 1 year, then the bond portion of your portfolio has an average duration of 3 years.

On average, an age-based portfolio for a 15-year-old beneficiary holds about 55% of assets in bonds, according to Morningstar data, and by the time most beneficiaries are ready to enroll in college at age 18, that weighting reaches 60%. At the same time, the average allocation to cash increases even more, from about 15% at age 15 to about 30% at age 18.

Options for 529 Plan Holders

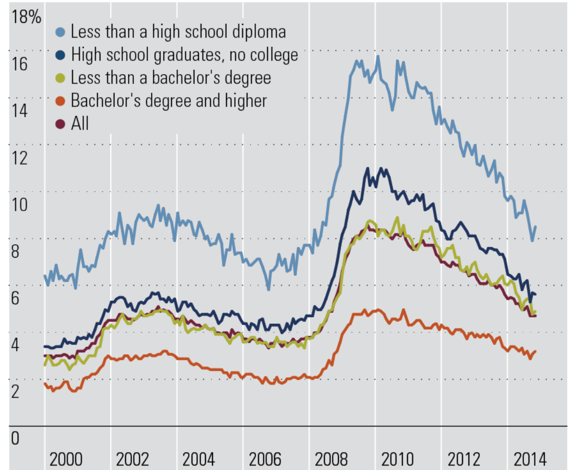
Once you have some idea of how vulnerable your 529 assets are to a rise in rates, you then can decide what, if anything, to do next. If stocks dominate your account, leaving just a small allocation to bonds, you may have little to worry about in terms of interest-rate risk. But if bonds make up the bulk of your account and you find the average duration of the portfolio makes you nervous in case rates do rise sharply, you may be contemplating some major changes.

# Unemployment by Education Level

There is a clear connection between educational attainment and unemployment rate. As expected, the people with the highest rate of unemployment are the people without even a high school degree. The unemployment rate for this group is almost triple that of college graduates. In general, the more education you have, the better off you are.

The percentage of the population that has a college degree has been relatively stable in the 30% range. And there is a large part of the population that could probably use yet more college education. Putting these two together, the conclusion is evident: It pays to go to college, and it would also be good if the percentage of the population who are college graduates could increase.

Unemployment Rate, 25 Years and Older




Source: Bureau of Labor Statistics, Morningstar calculations.
Data as of November 2014.



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