Pettinga Insights and Outlook

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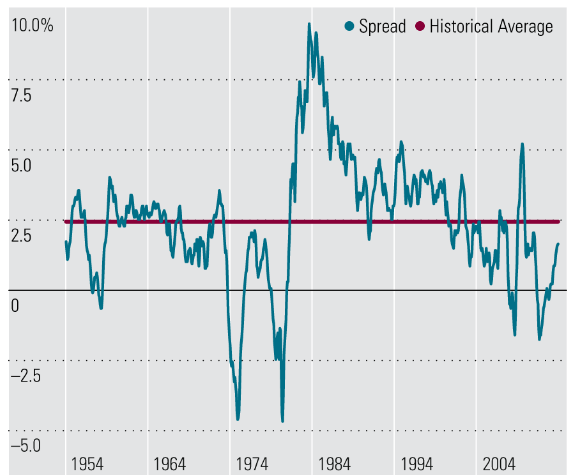
Fed Policy, Inflation, and Interest-Rate Risk

With interest rates still relatively low, the question today is by how much they are likely to rise. Historically, the 10-year Treasury bond has yielded, on average, about 2.5% over the inflation rate. With inflation at 1.5%, the 10-year Treasury bond typically would yield about 4.0%. In an attempt to support economic and job growth, the Federal Reserve has been purchasing long-term Treasury and mortgage-backed bonds to artificially keep interest rates low. As long as the Fed kept this asset purchase program up, 10-year Treasury yields remained relatively low. However, the Fed has begun tapering, and interest rates are likely to rise significantly in the near future. Both investors and advisors should be aware of the implications of rising interest rates.

Spread of 10-Year Treasury Over Inflation



Treasury bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

Source: 10-year Treasury yield data from the Federal Reserve. Inflation is represented by the Consumer Price Index, three-month rolling average, and data from the Federal Reserve. The time period displayed in the chart is January 1954 to December 2013.

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Monthly Market Commentary

The jobs report for February and initial unemployment claims were much better than expected, as weather effects began to diminish. That very same jobs report also dashed all hope that just maybe the U.S. Federal Reserve would temporarily halt its tapering program. The 10-year U.S. Treasury bond yield jumped to 2.79% on March 7, with some bond funds beginning to show losses.

Auto sales remained soft, but didn't collapse. Personal income and consumption both looked better than expected, but that was largely because of estimated effects of the Affordable Care Act and massive spending increases on utility bills. Excluding these special factors, consumption would have been down and income gains more muted.

Employment: The employment report for February came in better than expected, with the economy adding 175,000 jobs, up from 86,000 in December and 129,000 in January. This was above expectations of 140,000, but still below the 189,000 average of the prior 12 months. The year-over-year trends showed that weather appeared to have a minimal impact, with only a modest decline in the year-over-year total employment growth rate. Nonfarm payrolls are growing about 1.7% year over year, modestly trailing the 1.9% GDP growth rate reported for 2013. That almost always happens because of productivity growth. Government job losses held back the statistics as the private sector, approximately 84% of all jobs, grew a more robust 2.0%. The very encouraging news is that, at current trend rates, the U.S. economy is just about to recover all the jobs lost during the most recent recession.

GDP: The fourth-quarter 2013 GDP growth rate was downgraded to 2.4% from the previous reading of 3.2%. The news could have been worse, but business spending turned out to be better than expected, offsetting some of the downward revisions in consumer spending. The markets took the news in stride, as the drop was widely anticipated. It also potentially meant that interest rates could stay at low levels for a little longer.

Trade: The trade number for January wasn't terribly exciting, with the deficit basically flat from the previous month at $39 billion and following January trade deficits of $51 billion and $42 billion in 2012 and 2013, respectively. Taking a longer view, the year-over-year averaged data for both import and export showed some signs of softening despite all the excitement about an improving world economy. Both import and export growth rates slowed to their lowest levels since September. Trading partners counting on great sales to the United States might be disappointed, as trade is definitely not as robust as it was in the fall. The Ukrainian situation and continued slow growth in China won't help.

Consumer Spending: Month-to-month growth in consumer incomes and consumption came in stronger than expected because of the Affordable Care Act. Income grew by an acceptable 0.3% (0.2% after inflation) and consumption by an impressive 0.4% (0.3% after inflation). Spending on gas and electricity went up a stunning 11%, even after adjusting for inflation.

Housing: New home sales showed a surprising jump and pending home sales of existing homes finally started showing signs of stabilization. Home price growth also continued to cool, but not enough to create a lot of worries. In fact, low prices might be better for the economy and stimulate more demand. Recent data suggests that home prices are likely to grow at a more sustainable 5% rate in 2014 versus rates of between 8% and 13% in 2013, depending on the index used.

Overall, the economic data remained weak, as it has for the past three months. It is now clear that the problems probably stretch beyond the weather. Morningstar economists' analysis suggests that the economy will bounce back this spring, but without any fireworks to the upside. GDP growth forecasts for 2014 range between 2.0% and 2.5%, not much different from 2013.

Tips for Preparing Your Taxes

It's that time of year again. While many people cannot say they enjoy preparing their income-tax returns, you'll like it even less if you make mistakes and pay more tax, penalties, and interest than you need to. Here are some things to watch out for as you prepare this year's return or ready your tax documents for your accountant.

Qualified Dividends versus Nonqualified Dividends: Nothing can be more frustrating than receiving a corrected 1099 from your brokerage company. The 1099 is used to report various types of income other than wages, salaries, and tips. If you receive one after you had already filed your taxes, you might have to amend your return.

The problem is that mutual fund companies are required to submit tax information by the end of January, and in some cases they might not have the correct breakdown of qualified and nonqualified dividends by then. Because the tax treatment of qualified dividends might result in you paying less income tax, a revised 1099 might be to your advantage (although in many cases, only by a small amount). So it might pay to wait a bit before filing your tax return if you expect to receive a 1099.

Capital Gains and Losses: When you sell an investment for less than you paid for it, you realize a capital loss. The bright side is that capital losses can help you save on taxes. You can use capital losses to offset capital gains in your portfolio. You'll need to know if your gains and losses are short term or long term. If you held an investment a year or less, it will be a short-term gain or loss. If you held an investment longer than a year, it will be a long-term gain or loss.

In 2014, short-term capital gains are taxed at ordinary income-tax rates from 10% to 39.6%. Long-term capital gains, meanwhile, are taxed at lower, preferential tax rates from 0% to 20%.

Municipal Bond Income: If you own municipal bonds, interest income you receive is exempt from federal income tax. That income may or may not be exempt from state income tax. If the bonds are issued in your state of residence, you usually won't have to pay state and local taxes on the interest. You can find out for sure by contacting your state or the brokerage company at which you hold your securities.

Does that mean all money you receive from municipal bonds isn't subject to taxes? Not necessarily. If you own a municipal-bond fund that paid out capital gains, that money is taxable on your federal and most state returns. In addition, if you own municipals that are classified as "private-activity" bonds, you may be subject to the Alternative Minimum Tax. You may want to consult an accountant about this type of bond. To see if you have both interest income as well as capital gains distributions, check the 1099 forms you received.

Exclude Interest from U.S. Government Securities: Don't forget to exclude the interest from government securities on your state income tax return. You can exclude all income from "direct" government securities (for example, Treasuries). Some states also allow you to exclude income from "indirect" securities (for example, agency bonds like GNMA and FNMA securities). To know for sure, contact your state or the brokerage firm at which you hold your bonds.

Some mutual fund companies can be very good about sending information on the percentage of your funds that are invested in government securities. But there have also been situations where the fund company will only provide this information if you ask.

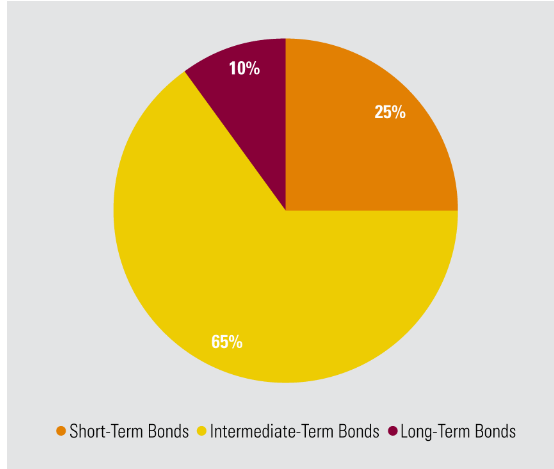
If you didn't obtain this type of breakdown when you received your 1099 statements, visit your fund company's website to find the information, or call the fund's customer-service line.

Investors Have Most of Their Money in Intermediate Bonds

The Fed has been slowing down its quantitative easing program, which would normally cause interest rates to rise. Long-term bonds tend to be more sensitive to changes in interest rates than intermediate- and short-term bonds. This is because investors want to be compensated for the higher risk and uncertainty that come with longer-term investments. Also, when interest rates start climbing, bonds already on the market have to compete with newer bonds that pay higher coupon rates.

As illustrated by the image, investors are aware of all this. As of December 2013, most of the assets allocated to fixed income were placed in intermediate-term bonds. This appears to indicate that most investors are risk-averse and avoid placing too large a share of their assets in long-term (more volatile) bonds.

Fixed-Income Allocations as of December 2013



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. 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. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. Corporate bonds are not guaranteed.

Data: The chart is constructed based on total net asset data from funds in Morningstar's database. The analysis includes U.S. open-end mutual funds and exchange-traded funds but excludes money market funds and funds of funds. Data as of December 2013.

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