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Client Newsletter

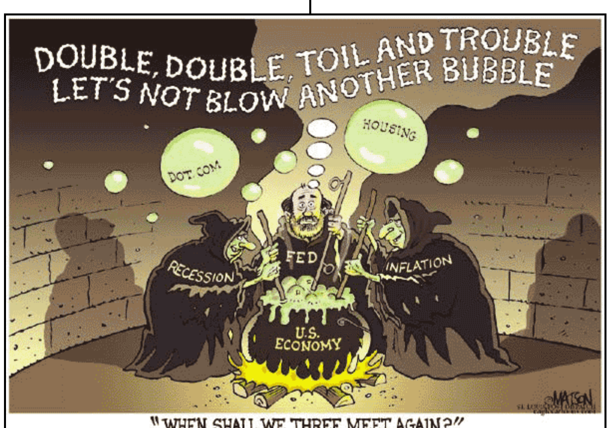
Past market performance is not indicative of future results

Bonds: The Long and Short of It

Article Courtesy of S&P Capital IQ Financial Communications

Pity today's fixed-income investor. In the current ultra-low interest rate environment, finding a bond with a yield that outpaces inflation -- let alone one that generates enough income to live off of -- is not an easy task. One must either fish in the murky waters of "junk" -- those issues considered non-investment-grade that are rated BBB or lower -- or lock in long maturities.

At least that's what traditional wisdom says. But the latter option -- going longer -- is becoming increasingly risky. As rates plumb ever-greater depths, interest rate risk -- the risk that rates will rise and bond prices will fall -- goes up. With rates on many recent corporate issues under 3% (and U.S. Treasury yields well below that), there is little place for rates to go but up. Given Federal Reserve policy statements and the tepid pace of current economic growth, a rate increase is unlikely to happen in the immediate future. However, most analysts agree that it is just a matter of time before rates do start to rise. The only question is when.



There's also the matter of spread. The spread between yields on short- and long-term issues has narrowed over the past year and a half. For instance, the spread between one-year and 30-year U.S. Treasuries decreased from 4.32% in January of 2011 to 2.40% in July of 2012. Likewise, the spread between 1-year and 30-year interest rate swaps versus LIBOR shrunk from 3.85% to 1.93% over the same period. These compressed spreads leave little incentive for investors to go with longer maturities.[1] And then there's inflation to consider. Rates on many issues are not even high enough to outpace inflation. In fact, many recent issues have negative "real" yields -- those that have been adjusted for inflation. Consider that the inflation rate (as measured by the Consumer Price Index, or CPI, over the past year) is currently hovering at 1.7%, well above rates offered on U.S. Treasuries with maturities of up to 10 years. Also consider that the current rate of inflation is low by historical standards; the CPI averaged 3.0% for the 30 years ended December 31, 2011, and has been as high as 6.1%.[2]

So what is our beleaguered fixed-income investor to do? He could take his chances with low-rated issues, many of which do offer tempting yields. But these carry greater risk -- some significantly greater -- which is what most fixed-income investors look to avoid.

Alternatively, he could just stay short, which is exactly what many of today's bond investors are doing. This means living with very low yields, but it does limit exposure to rising rates and leaves opportunity to buy into longer maturities when rates do eventually rise.

Of course neither of these options is likely to please our fixed-income investor, who might best be advised to contact his financial advisor and see if there are other options available for his particular situation.

1Source: The Federal Reserve. The Treasury spread is the spread between 30-year and 1-year Treasuries. The swap spread is the spread between 30-year swaps and 1-year swaps versus LIBOR, as reported to the Federal Reserve by the International Swaps and Derivatives Association.

2Source: Bureau of Labor Statistics.

Education Planning: Is The End Near for Coverdell Accounts?

Fewer people are now using Coverdell Education Savings Accounts, which are scheduled to come off the books in 2013. As a result, now may be the time to take advantage of their tax benefits.

Article Courtesy of S&P Capital IQ Financial Communication

The Coverdell Education Savings Account is unique in that it provides tax breaks to families setting aside money that can be used to pay for a private education from kindergarten through high school, as well as for college expenses. However, with the Coverdell's popularity fading in recent years, and the law enabling its tax breaks set to expire at the end of 2012, questions loom about the future of the accounts.

Coverdells are qualified investment accounts that allow nondeductible contributions of up to $2,000 annually per beneficiary. Earnings in the account are not taxed, and as long as withdrawals are used for qualified education expenses, they are tax free as well. Assets in a Coverdell must be used before the beneficiary's 30th birthday. The designated beneficiary of a Coverdell account is free to take withdrawals at any time, but any amount in excess of his or her qualified education expenses will be taxable as income. A 10% additional federal tax may also apply.

Coverdells also have a special feature unavailable with 529 college saving plans: In addition to college, qualified withdrawals may be used to pay for elementary and/or secondary school expenses. In addition, unlike 529 plans, Coverdells impose income eligibility limits on contributors. Single filers with modified adjusted gross incomes of more than $110,000 and joint filers with incomes of more than $220,000 cannot contribute.

According to a report in *The New York Times*, the number of tax returns mentioning contributions to a Coverdell fell from 985,000 in 2005 to 644,000 in 2009. The IRS does not track the exact number of taxpayers who use the accounts for a K-12 education.

The deadline to contribute to a Coverdell is generally April 15, the same deadline that applies to IRAs. Before making a decision about a Coverdell, evaluate the investment options, fees, and services offered by competing financial institutions that provide the accounts. Also, bear in mind that current rules governing the Coverdell Education Savings Account will expire at the end of 2012 unless Congress acts to renew them.

Climbing the Wall of Worry

Dear Clients,

It seems like every quarter we find ourselves saying the same thing: what a difference a quarter makes! In the first two months of 2012, the U.S. stock market was recording excitingly positive returns. The U.S. economy seemed to be back on track and there was talk that the Eurocrisis was finally behind us. Even the pullback in March left the markets in positive territory. Then came a difficult second quarter where the indices fell across the board, nearly wiping out the first quarter gains. Now, in the last three months, while many investors were still anxious about Europe, deficits, paralysis in Washington and unemployment, the markets have delivered an unexpected gift. A steady, gradual rise in stock prices that seemed, week by week, contrary to the mood expressed in the financial press.

Here at the end of the third quarter, entering the home stretch for the year, the returns on many of the broad stock indices are, surprisingly, well into double-digit territory.

Overall, the Wilshire 5000--the broadest measure of U.S. stocks--was up 6.15% for the third quarter, and is returning a robust 15.85% so far this year. The widely-quoted S&P 500 index of large company stocks gained 5.76% in the same time period, and is up 14.56% so far this year. The Wilshire U.S. Mid-Cap index rose 5.59% in the three months ending September 30, up 11.86% for the year. Small company stocks *have posted returns nearly identical to the large multinationals. The Wilshire U.S. Small-Cap gained 5.16% in the third quarter, up 15.19% in the first nine months of 2012.*

The next time you read gloomy headlines about the economy, remember that every single industry sector in the S&P 500 is posting gains so far this year, led by telecommunication stocks (up 21.04%), information technology (up 20.64%), consumer discretionary goods manufacturers (up 19.99%), and financial stocks (19.88% gains so far this year).

Global stocks have not been as robust as American shares, but they, too, are in positive territory. The broad-based EAFE index of developed economies rose 6.14% for the third quarter, and is now in firmly positive territory, with a gain of 6.95% so far this year. For the first time this year, European stocks are showing gains for their investors, in dollar terms, up 8.13% for the recent quarter, now up 8.00% for the year.

The EAFE Emerging Markets index of lesser-developed economies rose 6.97% in the third quarter, and is now up 9.41% for the year.

Commodities have also moved into positive territory, with the S&P GSCI index rising 11.54% for the quarter, now up 3.47% this year. Energy and petroleum prices are up very modestly (0.55% and 0.93% on the year respectively); the biggest mover is agriculture (up 18.44% so far this year), with grain prices rising 31.05% due to the Midwestern drought.

On the bond side, those of us who could not imagine how U.S. Treasuries could possibly offer lower yields are watching it happen. The 12-month T-Bonds are now yielding just 0.15%, as investors seem to be happy to essentially lend the government money with a promise that they will get it back again 12 months later. Locking up your money for three years gets you 0.31% a year. Ten-year issues yield 1.63%, and 30-year Treasuries bring a 2.82% annual coupon yield. Muni bonds are also down from where they were last quarter, with aggregate yields of 0.203% (1-year), 0.286% (2-year), 0.624% (5-year) and 1.742% (10-year). The aggregate of all AAA corporate bonds is yielding 0.76% for bonds with a five-year maturity. (Bond yields were obtained from sources disclosed below. Quoted yields will fluctuate.)

Some economists think that the stock rally was a gift from the central banks. For months, it was rumored that the U.S. Federal Reserve Board would engineer another stimulus package, which had already been dubbed "QE3"--and indeed Fed Chairman Ben Bernanke announced that the Fed would inject $40 billion a month into the market for securitized home mortgages, adding to the money supply, possibly driving down mortgage rates and (again possibly) stimulating the housing and homebuilding sectors of the economy into hiring again.

Meanwhile, the European Central Bank has finally announced that it would do what economists were calling for three years ago: purchase Eurozone government bonds to reduce the borrowing costs of countries that are restructuring their finances--notably Spain and Italy. After two press conferences on different sides of the Atlantic, some of our worst-case economic scenarios (a 2008-like collapse of the Eurozone banking system; a U.S. recession) seem to have become less likely to occur.

The U.S. economy is certainly not in danger of breaking any speed records as it continues to climb out of the Great Recession. In the last week of September, the government announced that from April through June, GDP grew just 1.3%. Economists remain wary of the "fiscal cliff"--the simultaneous expiration of lower tax rates and automatic federal budget cuts—that will take place, absent Congressional intervention, at the stroke of midnight, December 31. Add in the discouraging 8.1% unemployment rate, and there is plenty of reason not to be bullish on stocks for the last three months of the year.

But of course the preceding information was also true before stocks went up the past three months. Optimists can point to 96,000 new jobs added in August, and the fact that long-term, the unemployment rate has been trending downward from around 10% at this time three years ago. A Bloomberg News survey recently forecast that the U.S. economy will grow 2.1% over the next three months, and the forecasts from the Federal Reserve Board anticipate 2.5% to 3% GDP growth in 2013. At the upper end of that estimate, we are talking about a return to economic normalcy, and a chance to chip away at the jobless rate.

Is there an explanation for this three-month bull market during what can only be described as trying economic times? People who have long experience with the investment markets are fond of saying that rallies "climb a wall of worry;" that is, the markets go up most steadily when it requires courage to buy into them. These past three months seem to be one of the best examples of this adage that you are likely to see. Today, it requires a certain degree of courage to believe in the long-term future of the economy and the long-term return on investments, and yet the market rise is evidence that many investors are finding that courage amid the discouraging headlines.

Who's right? Who knows? All we know for sure is that the global economy is in a slow-growth recovery, with little indication that growth will accelerate dramatically or that the U.S. will slide back into recession. Buying stocks today is a bet that the hard work of millions of people still employed will produce positive results over the long term, which will ultimately reward the owners who hold their shares. For as long as the markets have existed, staying invested has been a good long-term strategy--and in the face of so much short-term uncertainty, this is about all we have to go on.

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- Important Reminders:

1.) If you have not already forwarded your 2011 tax returns please mail them into the office, fax or email them to info@demmingfinancial.com.

2.) Roth Conversions for this year need to be decided by December 1st, 2012.

3.) Fourth quarter is a good time to make sure your Roth Contributions for 2012 are completed.

4.) Year-end tax planning should be accomplished in the next two months. If you have any questions or concerns please contact us.

All of us at Demming Financial Services Corp.
hope that you enjoy the upcoming Holiday season.

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ADDRESS CORRECTION REQUESTED