Investor Insights & Outlook

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Economic Indicators in an Election Year

The 2012 presidential election is in full swing and, as we draw closer to the November 6, 2012 election date, many Americans are wondering which presidential candidate will be better for the economy. The U.S. economy has always been a focal point of elections, and although no crystal ball exists to determine election results (or stock performance, for that matter), economic indicators may show how an incumbent has performed. A strong or improving economy may add more credibility to the incumbent's leadership abilities, which may increase his odds of winning another term in office.

Since President Barack Obama took office in January 2009 in the midst of a recession, through his time in office till now, economic results have been mixed. The unemployment rate has fluctuated, but is now lower from the high of 10% back in October 2009. The S&P 500 has recovered nicely and GDP growth has also improved and held steady over the last 11 quarters.

However, home prices have continued to fall and gas prices to rise. A home is one of the biggest purchases for a family, with most of their wealth tied to their home. Falling home prices negatively impact the net worth of American households and may affect their propensity to spend. Higher gas prices mean people have to spend more money on gas, leaving less money for other discretionary purchases. Finally, interest rates remain at all-time lows as the Federal Reserve attempts to spur economic growth. This makes it difficult for investors to earn any return from saving accounts and other low-yielding investments, offering little reward to risk-averse investors or retirees.

Regardless of the election outcome, the President will probably continue to make economic recovery one of his priorities and, in light of this assumption, investors should expect the low-interest rate environment to continue.

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Advisor Corner

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Garner Financial Management utilizes global non-proprietary resources in order to design investment portfolios to meet all of your financial needs. We provide a customized and straightforward approach to financial growth, protection and management. Our fee-only structure is specifically designed to avoid conflicts of interest. As an independent advisor we utilize no proprietary investment products, and are free to select from all available investments. This investment process allows us to identify the most appropriate investment strategy and to focus on helping you attain your long-term financial goals.

The fiduciary role we assume in every client relationship is paramount. We understand the duty that we serve and hold ourselves to the highest personal and professional standards. It is our mission to grow and protect your wealth through integrity, passion and knowledge.

Does QE3 Matter to You or the Economy?

On September 13, Federal Reserve Chairman Ben Bernanke announced that the Fed would undertake a new program to stimulate the U.S. economy--and the move was immediately dubbed "QE3" by pundits and columnists. But what, exactly, is it, and how is QE3 likely to affect you and the rest of us?

"QE," as you probably know, stands for "quantitative easing," a term which refers to a surprisingly simple tool that any government's central bank can use to put new money into its economy. In most cases, the central bank buys government bonds and puts them on its balance sheet. A more complicated example is the Federal Reserve Board's response to the 2008 global economic meltdown, which is now called QE1. Before Congress had finished squabbling over the political ramifications of putting out the fire, the Fed purchased $600 billion of toxic mortgage-backed securities (pools of home loans) whose values had gone into free-fall on the balance sheets of large lending institutions. When that didn't completely stabilize the banking system, the Fed subsequently bought roughly $500 billion more bank debt off of troubled banks' balance sheets and became an active purchaser of short -term Treasury obligations.

This accomplished three things at once. First, it took a lot of toxic securities off the books of large banks and prevented them from collapsing--averting what most economists at the time thought would be a prelude to disaster. Also, when the Fed became an aggressive new bidder in the Treasury auctions, it created more demand for short-term Treasuries, lowering the interest rate that the government had to pay on its burgeoning debt while the government decided how else to shock the economy back to health.

Finally, the transactions amounted to printing money, since the Fed could simply buy the securities based on the full faith and credit of the U.S. government. In all, $2 trillion of new money entered the U.S. economy, and the hope was that this would result in more lending, more buying and a quick exit to the recession.

QE2 started in November of 2010, when the Fed purchased another $600 billion of Treasury securities. Once again, new money entered the economy and the U.S. government's borrowing costs were driven down to near zero levels. Perhaps more importantly, this initiative also caused the value of the dollar to drop, making U.S. exports cheaper, stimulating export activity and counteracting efforts by Japan and other countries to artificially make their own exports more attractive on the global market.

Later, starting in late 2011 and continuing through the end of this year, the Fed extended QE2 with something that has been described as "Operation Twist," which was basically an effort to reduce longer-term interest rates. Under Operation Twist, the Fed has been selling $700 billion worth of its short-term Treasuries and is using that money to bid on longer-term government bonds.

So what, exactly, is QE3, and why is everybody so excited about it? In its third round of stimulus, the Fed has pledged to buy $40 billion worth of mortgage-backed securities a month--or, to put it another way, to inject $40 billion a month into the pool of money that banks can lend to homeowners, so they can either buy new homes or refinance the homes they already own.

If QE3 works as expected, the additional money will drive down mortgage rates, which would make homes more affordable. That should attract new buyers of homes and stimulate the moribund construction industry. Greater demand for newly-constructed homes could move the job market needle by creating work for all the professions that rely on home construction and housing. At the same time, QE3 will put a little extra money in the pockets of people who refinance their current mortgages at lower rates. If they spend some of that money, then that, too, will help spur additional economic activity.

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QE3 Continued..

How is it working so far? Interestingly, mortgage rates have hardly budged since the first QE3 money began filtering into the marketplace. Economists believe that 30-year fixed-rate mortgages will eventually come down from 3.55% to somewhere around 3.25%, and 15-year fixed-rate mortgages could drop from 2.85% to 2.75%. But that hasn't happened yet, in part because banks haven't relaxed their tight lending standards, in part because many banks currently have so many refinancing applications on their desks that they can't process any more.

As a result, the pernicious initial effect has been to give cheaper money to banks without lowering mortgage rates. Instead of lending more money at lower rates, banks are simply taking a larger spread on the loans they do make. That's why you sometimes hear that QE3 has been a government welfare program to large, solvent lending institutions.

The biggest impact, so far, has been on stock prices. As the Fed buys mortgage pools, QE3 is driving down the returns that investors can get on Ginnie Mae and Fannie Mae mortgage-backed bonds. These had been among the most attractive fixed-income vehicles in a marketplace starved for yield, delivering higher-than-historical average spreads over Treasuries of comparable maturity. As those investments deliver lower yields, stocks, especially those of dividend-paying companies, become relatively more attractive.

The last and perhaps most effective stimulative effect is psychological. Unlike the QEs of the past, the Fed has put no time or dollar limits on QE3. The formal announcement of the program promised that it would continue until the Fed has decided that there is "substantial improvement" in economic growth and the unemployment rate. These are not exactly precise terms, and of course commentators have been trying to parse out exactly what "substantial improvement" means. In real terms, however, it appears that the Fed has lost patience with corporations hoarding cash rather than investing in their own (and the economy's) growth, and banks that have been sitting on all the cheap QE money that is available to borrow and re-lend at a profit to homeowners and corporate borrowers. If these companies stay on the sidelines and refuse to participate in the economic growth that the Fed is determined to engineer, then they'll be left behind and forced to answer to their shareholders.

How much growth are we talking about? In the report that accompanied the announcement, nine out of the twelve Fed districts reported modest or moderate economic growth. Before QE3, the Fed's projections for GDP growth in 2012 was somewhere in the 1.7-2% range, which is clearly below long-term averages. The Fed had projected 2.5-3% GDP growth for 2013 and 3.0-3.8% for 2014--again without taking QE3 into account.

If the housing market and construction industry can be lifted off the ground, one would have to assume that those numbers will go up. Estimates vary, but the U.S. economy needs to reach 3% annual GDP growth before hiring levels absorb new job market applicants and start to reabsorb the people who lost their jobs in the downturn. The Fed seems to have decided that reviving the construction industry is the most focused possible way to bring about the growth that economists would expect America to achieve by 2014 without the benefit of a stimulus.

One more thing: how much does QE3 add to the national debt? Zero. For the money it created, the Fed owns interest-bearing mortgage-backed securities and pools of mortgage debt, which can be sold at any time, and it earns a return on the money it magically created in the meantime.

The Tax Man Cometh … Or Does He?

You've probably heard a lot about how the election will affect both the economy and your wallet. What you're probably asking is, "What does this mean for the dividend portion of my portfolio?" To take a step back, the appeal of dividends is not now, and has never been, purely a function of tax policy. Dividends work because they deliver what capital gains can't: consistent cash returns that are always and only positive. Cash flow that you can use to meet your personal investment objectives even if stock prices are down. And, compared with bonds, dividend-paying stocks offer a measure of protection from inflation and a good shot at lasting capital appreciation. This is not to say that taxes are irrelevant, but most of what you're hearing needs to be taken with a grain of salt.

Since 2003, dividends (as well as long-term capital gains) have been taxed at a maximum federal rate of 15%. If the President and Congress do nothing, then the top tax rate on long-term capital gains will revert to 19.8% on New Year's Day 2013, but the top tax rate for dividends will skyrocket to 39.6%. (And this doesn't include the additional 3.8% Medicare tax on investment income for high earners next year) But before you dump all your dividend-paying stocks in fear of a tax hike, consider the following:

1. Will dividend taxes actually go up? That outcome can't be ruled out, but it's worth remembering that in 2003, 2008, and again in 2010, a span encompassing three different congresses and two presidents of differing political affiliations, the current taxation of dividends has been affirmed. A comprehensive tax reform package might involve a more modest tax increase on upper-bracket earners, but neither Republicans nor Democrats actually want the country to roll off the "fiscal cliff".

2. Let's assume the worst: that the pre-2003 tax rules snap back into effect. What's changed? That depends on you. Most investors aren't in the top tax bracket so their tax rates might rise from 15% to 25% or 28%, but the implication that everyone's dividends will be taxed at 39.6%, is simply not true.

3. Two key groups of high-yielding equities, master limited partnerships (MLPs) and real estate investment trusts (REITs), were never eligible for the 15% federal tax rate in the first place, so the treatment of these income streams isn't at risk.

4. Many investors hold the bulk of their stocks (and receive the bulk of their dividends) in tax-deferred accounts like IRAs, Roth accounts and 401(k) plans. What's the impact of a dividend tax hike here? The answer is nothing as the investor only pays tax when money is withdrawn from the account.

5. Even if taxes on dividends go up, what's the alternative? Except for municipal bonds, the interest paid on fixed-income securities is already taxed as ordinary income. Bolting for the bond market would only reduce your tax bill because you would earn much smaller returns!

Past performance is no guarantee of future results. Returns and principal invested in stocks or REITs are not guaranteed. Dividends are not guaranteed. A REIT must distribute at least 90% of its taxable income to shareholders annually. REITs involve special risks such as management quality, corporate structure, the ability to increase revenues from rents, and the balance of the supply of new buildings with demand for space. Investments in securities of MLPs involve risks that differ from an investment in common stock, including limited control, cash flow and dilution risks. Funds in a traditional IRA grow tax -deferred and are taxed at ordinary income tax rates when withdrawn. Contributions to a Roth IRA are not tax-deductible, but funds grow tax-free, and can be withdrawn tax free if assets are held for five years. A 10% federal tax penalty may apply for withdrawals prior to age 59 1/2. Authored by Josh Peters, CFA; Chief Equity-Income Strategist; Editor, Morningstar DividendInvestor.

Politics and Investment Performance

With President Obama's first term in office coming to a close, here's the result of an investigation into the relationship between the composition of the legislative and executive branches of the U.S. government and market performance. The "unified" situation refers to years when the Senate, the House of Representatives, and the White House were all controlled by the same party. The "partially divided" situation represents years when the House and Senate were controlled by the same party, but the White House was held by a different party. The "completely divided" situation uses data from years in which the two houses of Congress were divided. Both the S&P 500 and the diversified portfolio (60% stock/40% bond) averaged the highest returns during unified years, lower returns during partially divided years, and the lowest under completely divided years.

Average Annual Returns 1926–2011

	S&P 500	Diversified portfolio	Number of years
"Unified" years	14.8%	9.9%	45
"Partially divided" years	11.1%	9.5%	30
"Completely divided" years	1.1%	7.4%	11

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. Diversification does not eliminate the risk of experiencing investment losses. Government bonds are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. The time period examined is 1926–2011, and the returns are average annual returns.

Stocks—represented by the Standard & Poor's 90 index from 1926 through February 1957 and the S&P 500® index thereafter, which is an unmanaged group of securities and considered to be representative of the U.S. stock market in general. Bonds—20-year U.S. government bond.

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