Investor Insights & Outlook

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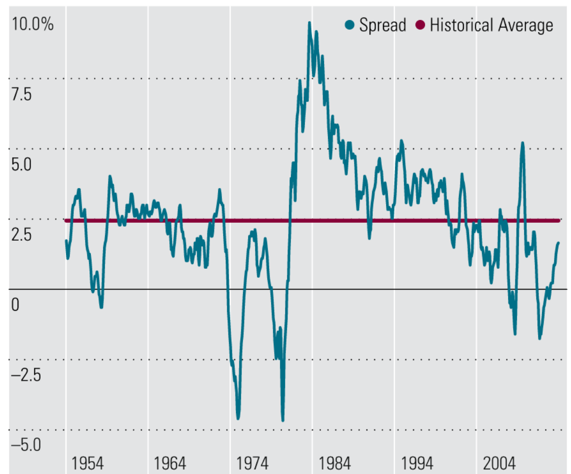
Fed Policy, Inflation, and Interest-Rate Risk

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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Advisors Corner

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Five Estate-Planning Tasks That You Shouldn't Put Off

Keeping tabs on the estate-planning rules during the past few years has been a little like watching Olympic-level table tennis: The action moves quickly, and it's difficult to keep up. However, no matter how laws and rules change, there are a few basic tasks that are actually pretty evergreen and that everyone should execute. Five such estate-planning to-dos are outlined below.

1) Update Beneficiary Designations. Even people who have never set foot in an attorney's office may have laid the groundwork for an estate plan if they filled out beneficiary designation forms for their financial accounts. Those designations, in fact, trump other estate-planning documents when it comes to distributing assets, so it's worthwhile to periodically review them to make sure they're up-to-date with your current situation—if you've gotten married or divorced, for example. (How would your spouse feel if you inadvertently left your 401(k) account to your brother?) People who have drafted estate-planning documents such as wills should ask their attorneys to help them review beneficiary designations to ensure that they sync up with other estate-planning documents.

2) Designate Legal Guardians. Parents of young children should designate legal guardians who will look after their children if the parents should die or otherwise be unable to care for their minor children. It is important to focus the discussion on actual child-rearing abilities and willingness to do the job. What is not helpful is to get hung up on hurting anyone's feelings or bypassing friends or family members who might expect to be guardians but aren't the best choice. Most importantly, a guardian should be willing and able (emotionally and financially) to take care of your children if the need arises, so an essential step is to discuss the responsibilities with the potential guardian beforehand.

3) Create a Living Will and Last Will and Testament. A living will tells your health-care providers and your loved ones how you would like to be cared for if you should become terminally ill and unable to express your wishes yourself. It is called a "medical directive" in some states. This document details your views toward life-support equipment. Not to be confused with a living will, a last will and testament details how you'd like your assets and possessions distributed after your death.

4) Draft Powers of Attorney. A basic estate plan should also address what would happen to your affairs if you are still living but incapacitated. A power of attorney is a document that specifies who will handle your affairs if you are unable to do so. You'll need to draft two separate documents: one that names your power of attorney for health-care decisions and another for financial matters (often called a durable power of attorney). The person you entrust with your power of attorney for health care will, ideally, live in close geographic proximity to you. The person you name on your durable power of attorney form should be detail-oriented and comfortable with financial matters.

5) Name an Executor. Your executor will gather all of your assets after you're gone and make sure they are distributed in accordance with your will. Ideally, your executor will be someone who's comfortable with numbers and good with details, and will also be able to find the time to work on your estate. It's common to name family members as executors, but in more complicated situations it might be preferable to use a professional, such as a bank trust officer, to serve as your executor. It's a good idea to tell your executor that you've named him or her, and also provide details on how to obtain access to important documents, such as your will and a master directory detailing all of your accounts.

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.

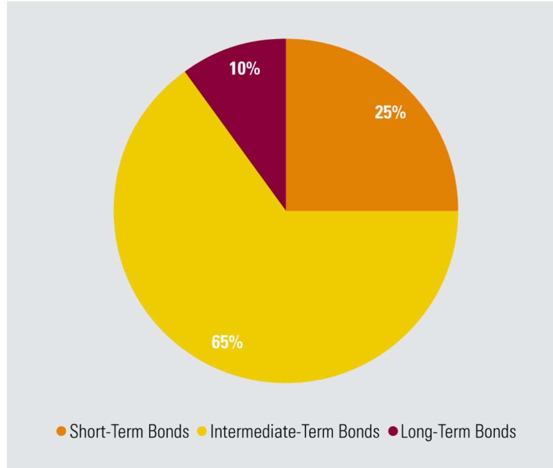
Overall, the economic data remained weak, as it has for the past three months. It is now clear that the problems probably stretch beyond the weather. Morningstar economists' analysis suggests that the economy will bounce back this spring, but without any fireworks to the upside. GDP growth forecasts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

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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