Investor Insights & Outlook

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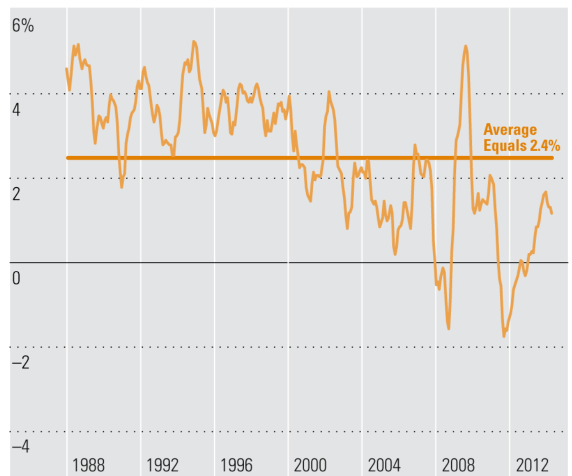
Inflation Rate and Typical Spread Suggest Higher Interest Rates Ahead

Given that the U.S. Federal Reserve is stepping back some of its maneuvers to keep interest rates low, interest rates are expected to increase to more normal levels. Normal means that interest rates are generally dictated by the rate of inflation plus a spread. In the case of the U.S. 10-year Treasury bond, the spread has averaged about 2.4%, though that level has been quite volatile. If one puts that 2.4% spread on top of the current inflation rate of 1.5% (as of Apr. 2014), one could expect an interest rate of 3.9% (compared with 1.8% at the end of 2012 and 2.9% at the end of 2013). Yet, it might take some time to get there. Higher rates are generally bad news for the economy as they tend to slow both housing and auto activity.

10-Year Treasury and CPI Inflation Spread



Source: St. Louis Federal Reserve, updated June 2, 2014. Last data point is for April 2014.

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Advisors Corner

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They provide the morning and afternoon market reports and financial commentary for AM 1360 KUIK. Articles and interviews are available at http://brcapitalinc.com.

A Simple Plan

Outlining an investment plan can be challenging: Today, individuals are responsible for building their own retirement accounts. This is a dramatic change from the past generation, who relied heavily on defined-benefit pension plans, which guaranteed income for life following retirement. Investors are faced with the challenge of making decisions on how much to save each month, how to allocate savings, and how to take disbursements in retirement. Fortunately, target-date funds offer a convenient solution to help simplify investing for the future.

Target-date funds, also known as lifecycle funds, have emerged as a popular investment option for individuals who may be unprepared or reluctant to make their own investing decisions. These funds provide a pre-built asset allocation strategy that automatically adjusts based on the participant's age.

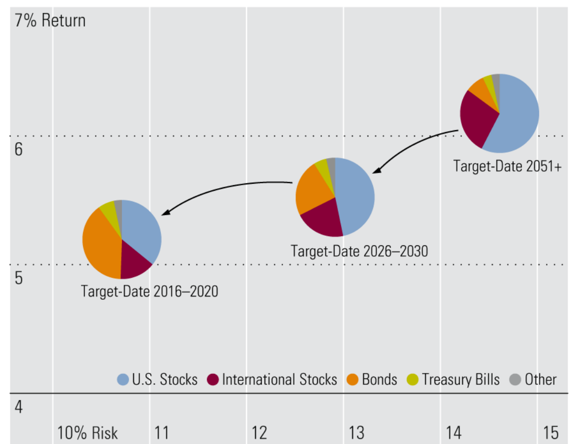
Target-date funds can make retirement planning easier: The image above illustrates three target-date fund categories with varying maturities. As time passes, each portfolio is adjusted to meet the needs and goals of investors. Target-date funds achieve this by continually adjusting the mix of stocks, bonds, cash, and other investments. These funds become more income oriented as they approach and pass a target date.

For example, an investor who plans to retire in 15 years might select a fund from the Target Date 2026–2030 category, which places a large amount of assets in domestic and international stocks. Similarly, an investor with a retirement horizon of three years may choose to invest in a fund from the Target Date 2016–2020 category, which offers a more conservative mix. Consult your financial advisor to learn about target-date funds that may be right for you based on your investment objectives and risk tolerance.

Diversification does not eliminate the risk of experiencing investment losses. 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 United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Target-Date Funds Alter Allocations Over Time January 2002–May 2014



Source: Target Date 2016–2020, Target Date 2026–2030, and Target Date 2051+ are target-date fund categories from Morningstar's open-end database.

Monthly Market Commentary

Economic data from the past month revealed some positive trends, with upbeat employment numbers for June being the biggest headline. In addition, weekly shopping center data from the ICSC have now broken out to new highs; auto sales exceeded all expectations in June despite some strong headwinds, and pending home sales made one of their biggest jumps in the history of the now 5-year-old recovery.

GDP: The last GDP revision was a huge bomb, now showing a massive and unexpected first-quarter decline of 2.9%, from a previously estimated rate of decline of just 1.0% and the original estimate of 0.1% growth. Two thirds of the revision was due to negative revision to the effects of the Affordable Care Act, and a third was due to an expected revision in net exports. Based on the nature and size of this revision, plus a poor consumption report for April and May, economic growth of 2% in 2014 is now starting to look aggressive even to the most optimistic. Because of the consumption data in April and May, it looks like the best-case scenario for the second quarter is now somewhere around 3% GDP growth.

Employment: The June employment report was strong as the economy added 288,000 total jobs compared with the 12-month average of 208,000. Professional and business services, which tend to be higher-paying jobs, were the strongest sector with a gain of 67,000 versus a 12-month average of 53,000. Despite all the positive news, the longer-term private payroll growth rate, using an average of three months of data compared year over year, ticked up to 2.1%, which is right in line with the slow and steady pace we have experienced over the past two years.

The unemployment rate decreased by 0.2%, to 6.1%. The labor force participation rate was unchanged at 62.8%, which is a positive because it means that the unemployment rate went down because of increased employment and not workers leaving the job force. Over the past year, the unemployment rate has dropped 1.4%.

Housing: Both new homes and existing homes moved nicely higher in May than in April and were considerably above expectations. This may be a sign that interest in housing in general is improving. With the labor market growth continuing, weather improving, mortgage rates down again, and home price growth slowing, the picture looks good over the next several months, and housing may be a bright spot in the second-quarter GDP report after negative results in the fourth quarter of 2013 and the first quarter of 2014.

Home price growth, however, continues to slow. Some of the more drastic slowing in growth rates has been on the West Coast where annually growth rates that may have soared as much as 30% at one point have now moderated to 20% or less, according to Case-Shiller. The rest of the nation in general has seen a slowing in price increases, but not nearly as dramatic. Remember, we are talking about slowing growth rates and not price declines. For the full year, Morningstar economists are expecting 5%–6% increases in home prices, a much more palatable level for homebuyers.

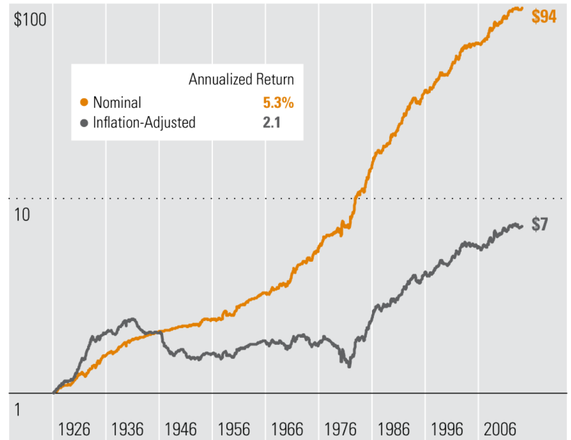
Consumption and Personal Income: The poor GDP report for the first quarter was followed by even more disappointing consumption data, which now showed consumption expenditures slumped 0.2% in April and 0.1% in May. (The May data had a lot of quirks including a large drop in food spending and a massive swing in utility bills.) However, the month-to-month data has proven to be exceptionally volatile, while year-over-year data averaged over three months has shown almost rulerlike growth at around 2.0%. The income report provided at least a small antidote to the GDP and consumption reports, notching its fourth consecutive month of growth. Income growth for May was 0.2% (or 2.4% annualized), which should have fueled more spending growth than it did.

Inflation, not Rising Rates, Biggest Bond Threat in the Long Term

Since the beginning of 2013 when rates started to rise, investors have been concerned about a potential decline in bond performance. In general, bonds tend to perform poorly in times of rising interest rates, but by worrying about rates investors may lose sight of an even bigger long-term threat: inflation.

Over the long term (since 1926) investors have lost 3.2% (the difference between 5.3% nominal and 2.1% inflation-adjusted) in return every year to inflation. Compounded over almost 89 years, the difference in ending wealth values is astounding: A $94 nominal value becomes only $7 when adjusted for inflation. Investors may be well advised not to neglect inflation risk while focusing on interest-rate risk.

Intermediate-Term Government Bonds
January 1926–March 2014



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

Data: Nominal performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, total return. Inflation-adjusted performance of intermediate-term government bonds—Ibbotson SBBI U.S. Intermediate-Term Government-Bond Index, inflation-adjusted return. Inflation—Consumer Price Index. The data assumes reinvestment of all income and does not account for taxes or transaction costs.

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