Investor Insights & Outlook

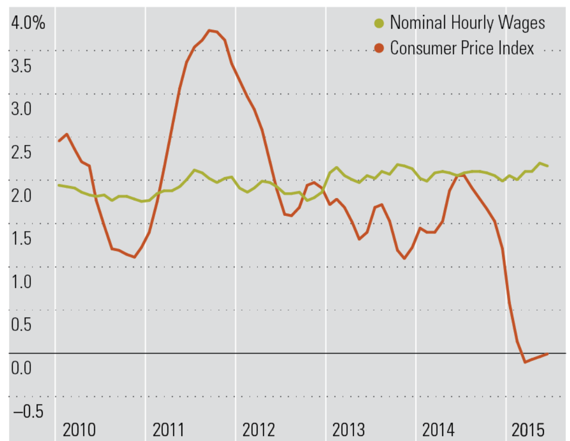
August 2015 | Vol. No. 3 | Investment Updates

Inflation and Hourly Wage Growth

Wage growth is an important leading metric of consumer behavior, as higher wages increase disposable income, which in turn drives more spending. The chart depicts nominal hourly wage growth and the inflation rate (represented by the consumer price index) since 2010. Both metrics are on a year-over-year basis, and averaged for 3 months in order to smooth out the monthly seasonality.

What really stands out is that nominal hourly wages have been growing at a steady 2% rate for many years now, and they have recently accelerated just slightly to about 2.2%. What contributed to a huge increase in the real wage growth (not shown on the chart), however, was the collapse of the inflation rate that began in the second half of 2014, driven by lower oil and gasoline prices.

Inflation and Hourly Wage Growth, Y/Y, 3-Month Average



Source: Bureau of Labor Statistics, Morningstar.

The Latest From Schroeder, Braxton & Vogt

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Richard Schroeder recently decided to distill 33 years of experience in writing about, and planning for, retirement. He has published an ebook on Amazon.com that should help anyone plan for retirement, whether they are 30 or 65 years old.

"The Quick and Painless Guide to Retirement Planning" takes readers through some simple exercises and calculations to help them determine what's coming to them in retirement, how much they to spend when they get there, and how to save and invest to make retirement a financial success.

The book is a valuable prelude to doing a complete retirement plan with a financial advisor. It will also help anyone who wants to figure out how much to save for retirement and how to invest those savings.

His book is the first in a planned series of ebooks on financial planning and investment topics. It is available on Amazon at http://amzn.com/B0115MCIO2, or by searching for "Quick and Painless" on the Amazon home page.

Monthly Market Commentary

The biggest debate in the past few weeks was, what mattered more, the Chinese stock market decline or Greece's potential exit from the eurozone? With a Chinese economy at $10.7 trillion and Greece at $0.2 trillion, it doesn't seem like much of a fight. However, Greece does have some potential for wrecking the E.U. system, which is a very large, $13.4 trillion economy. Morningstar economists believe that Greece itself and the solutions to its problems are not likely to have a major impact on the world economy. China's situation, however, remains much more worrisome.

Employment: The job openings report continued to show growth in May, setting yet another record for job openings at 5.36 million, up over 16% from a year ago and 0.5% (6% annualized) from April. Although records go back only as far as 2000, this is the highest reading in the entire data set.

Most economists have viewed this as a highly positive and leading indicator of future employment data. Morningstar economists, however, have pointed to the job openings data in several reports as an indicator that labor markets are tightening. Indeed, the indicator did a great job of forecasting the surge in hiring in late 2014 that almost no other data series did. Right now, the indicator seems to be saying that job growth may be plateauing as year-over-year averaged growth in openings is showing early signs of peaking. Year-over-year growth is still elevated at 19%, but that is down from a high of 24% several months ago.

Housing: Unfortunately, housing doesn't seem to be as strong as previously hoped. Demand seems somewhat better, but on the supply side, housing starts still look pretty anemic and inventories of existing homes still aren't really moving up, which is keeping continued pressure on prices.

Trade: The trade balance was the single largest factor in the U.S. economy's weak first-quarter performance. Trade took almost 2 full percentage points off of the GDP calculation. Without the negative trade performance, the economy would have grown 1.7% instead of shrinking 0.2%. The trade deficit, which had swung as high as $50 billion in March, moved to $40.7 billion in April and stabilized in May at $41.9 billion.

International: The International Monetary Fund revised its entire world growth outlook last week. These revisions were lower than the prior forecast, produced in January, which, in turn, was also lower than the forecast produced in October 2014. That October forecast predicted world growth of 3.8%, which was reduced to 3.5% in January and now to 3.3% in the July update. That is lower than the 3.4% actual world growth rate for 2014. And much like the United States, it's stuck in a rut that it can't dig itself out of, with world growth equaling 3.4% for each year of 2012 through 2014. (U.S growth has been between 2.1% and 2.4% since 2011).

Demographics: Demographics will also hold back the overall growth rates for some time to come. Low population growth (0.7% now, instead of 1.8% in the 1960s) is likely to keep the economy from growing any faster than Morningstar's 2.0%–2.5% forecast, versus the average GDP growth rate over the last 50 years of around 3.1%. In addition, it isn't helping that the fastest-growing age group in the U.S. economy is the miserly 65 and over crowd, while the absolute number of free-spending, high-income 50 year olds will be in a pattern of decline over the next five to 10 years.

Quarter-End Insights: Despite a disappointing first quarter, Morningstar economists expect higher growth rates in the second half of the year. Inflation is likely to run considerably higher in 2015 than either 2013 or 2014. Core inflation (excluding food and energy) will likely be around 1.7% for 2015, very similar to the last two years, but the ups and downs of energy prices will cause headline inflation to accelerate in 2015, especially if energy prices don't fall soon.

Four Retirement-Portfolio Withdrawal Mistakes to Avoid

Some errors in retirement-portfolio planning fall into the category of minor infractions rather than major missteps. Did you downplay foreign stocks versus standard asset-allocation advice? It's probably not going to have a big impact on whether your money lasts throughout your retirement years.

But withdrawal rate errors can have more serious repercussions for retirement-portfolios. If you take too much out of your portfolio at the outset of retirement, and that coincides with a difficult market environment --you can deal your portfolio a blow from which it may never recover. Other retirees may take far less than they actually could, all in the name of safety. The risk is that they didn't fully enjoy enough of their money during their lifetimes.

Mistake 1: Not Adjusting With Your Portfolio's Value and Market Conditions. Even though the popular "4% rule" assumes a static annual-dollar-withdrawal amount, adjusted for inflation, retirees would be better off staying flexible with their withdrawals.

What to Do Instead: The simplest way to tether your withdrawal rate to your portfolio's performance is to withdraw a fixed percentage, versus a fixed dollar amount adjusted for inflation, year in and year out. That's intuitively appealing, but this approach may lead to more radical swings in spending than is desirable for many retirees. It's possible to find a more comfortable middle ground by using a fixed percentage rate as a baseline but bounding those withdrawals with a "ceiling" and "floor."

Mistake 2: Not Adjusting With Your Time Horizon. Taking a fixed amount from a portfolio also neglects the fact that, as you age, you can safely take more from your portfolio than you could when you were younger. The original "4%" research assumed a 30-year time horizon, but retirees with shorter time horizons (life expectancies) of 10 to 15 years can reasonably take higher amounts.

What to Do Instead: To help factor in the role of life expectancy retirees can use the IRS' tables for required minimum distributions as a starting point to inform their withdrawal rates. That said, those distribution rates may be too high for people who believe their life expectancy will be longer than average.

Mistake 3: Not Adjusting Based on Your Portfolio Mix. Many retirees take withdrawal-rate guidance, such as the 4% guideline, and run with it, without stopping to assess whether their situations fit with the profile underpinning that guidance. The 4% guideline assumed a retiree had a balanced stock/bond portfolio. But retirees with more-conservative portfolios should use a more-conservative (lower) figure, whereas those with more-aggressive asset allocations might reasonably take a higher amount.

What to Do Instead: Be sure to customize your withdrawal rate based on your own factors, including your portfolio mix.

Mistake 4: Not Factoring In the Role of Taxes. The money you've saved in tax-deferred retirement-savings vehicles might look comfortingly plump. However, it's important to factor in taxes when determining your take-home withdrawals from those accounts. A 4% withdrawal from an $800,000 portfolio is $32,000, but that amount shrivels to just $24,000, assuming a 25% tax hit.

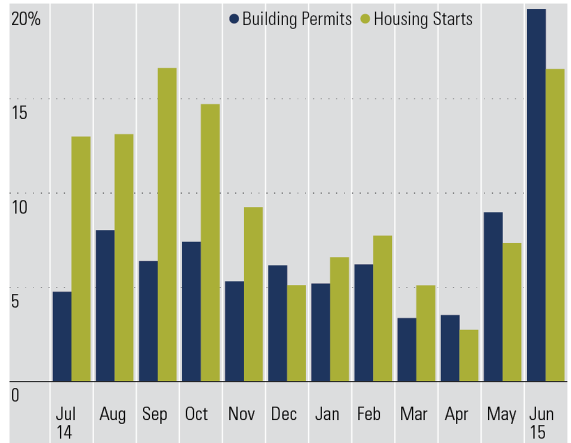
What to Do Instead: It pays to be conservative in your planning assumptions. To be safe it's valuable to assume a higher tax rate than you might actually end up paying.

This article contributed by Christine Benz, Director of Personal Finance with Morningstar.

Housing Construction in Good Shape

The chart depicts the state of the housing construction industry, suggesting that there is still plenty of room to grow in this slow, but steady recovery we've seen so far. The latest starts and permits data from the Census Bureau, however, shows a slightly exaggerated picture, as it is the multi-family category that's been making overall housing construction look better than it is in reality. Both starts and permits picked up in June, as multi-family activity rose sharply amid expiring construction tax incentives for developers in the New York City area. As a result, the housing construction revival is probably not as strong as the numbers seem to currently suggest. Nonetheless, improvements for single-family construction still look healthy, and continue to trend up closer to the 10% rate year over year.

Building Permits Versus Housing Starts
Year-Over-Year Growth, 3-Month Average



Source: Census Bureau, Morningstar.

This article contains certain forward-looking statements which involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially from any future results expressed or implied by those projected statements. Past performance does not guarantee future results.

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