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MARKETWATCH

Deeply Rooted in the Community | Third Quarter 2016

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Current Outlook

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Though mid-Summer is already upon us, clarification on the 2016 outlook for the economy, interest rates, inflation and, as Larry Kudlow would remind us, "the mother's milk of the stock market"—corporate profits—has yet to occur. Central bankers around the world continue to foster extraordinarily accommodative monetary policies in an effort to revive growth even after seven years of trying. At long-last, our Federal Reserve Board Chairman acknowledged last month that perhaps the world economy is experiencing a "New Normal" of lower growth potential following the "Great Recession" of 2008-2009.

In the rest of the world, some previously unthinkable things are also happening, including the vote by Great Britain to leave the European Union trading block, negative interest rates forcing banks to pay people to borrow money, and slowing growth rates in emerging-market countries. As a result, we continue to forecast "lower for longer" interest rates, economic growth and inflation.

This "New Normal", which has been posited by many economists and market strategists since as early as 2009, demands a rethinking of portfolio construction and asset allocation. No longer should we expect the growth rates experienced in the post-World War II period, and concurrently we should not expect the same level of inflation, interest rates and portfolio earnings. One of the factors creating this "New Normal" is the slowdown in productivity growth that seems to be limiting growth in the U.S. standard of living. Productivity is measured as the increase in the per person output per hour worked. Some think this recent decline in productivity may reflect a large increase in the labor force since the "Great Recession" that was not offset by normal levels of economic growth. The unemployment rate appears at near-boom rate levels due to continued hiring, but because output has not kept up with employment growth, per person productivity has declined. Ultimately, this decline in productivity could result in either pressure on corporate profits or a slowdown in hiring.

Another factor that may be leading to slower potential growth are new regulations on the world's financial sectors. As a result of the "Great Recession" and laws passed in the wake of the financial crisis, financial institutions have had to change their business models to include increased numbers of nonproductive compliance staff. In a sense, the "New Normal" now includes many more regulations and the loss of productivity that these regulations entail.

In the near term we also expect the potentially chaotic U.S. Presidential election cycle to cause some real or perceived uncertainty in the financial markets. As we have said many times, we are watching the "long slog" to the 2016 Presidential vote, and "continue to expect divided government to be the norm for some years to come." Regardless of whose team ultimately occupies the White House, we see little of substance being agreed upon given the expected composition of the Congress, the Executive branch and the courts after the inauguration. As always, for long-term investors the main thing to watch is the direction and trend of the economy, interest rates and inflation. By those measures, we remain cautiously optimistic that investors will continue to achieve modest growth in their portfolios as the uncertainties of today become the realities of the rest of 2016 and all of 2017.

Prince's Estate: Purple Pain

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People around the world will be remembering Prince (Prince Rogers Nelson) as one of the most influential artists of our time, known for his flamboyant style, extravagant dress and incredible talent. His death, at age 57, was a surprise and a shock to everyone, especially to trust and estate attorneys around the country when they learned that Prince allegedly died without a will.

One of Prince's famous songs was titled, "Money Don't Matter Tonight," but for his heirs it is certainly going to matter tomorrow! His estate, estimated at $300 million, will now go through the Minnesota probate courts without the benefit of prior estate planning that could have named specific heirs, preserved his wealth, minimized or avoided taxes, and ensured that loved ones and charitable causes were provided for in the future.

Instead, his estate will be subject to a 40% federal estate tax plus a 16% Minnesota state tax, be subject to the Minnesota laws of intestacy, and face an onslaught of claims and lawsuits from those who believe they are entitled to a portion of the money as long-lost siblings, half siblings, and even those claiming to be wives or children. The costs of paying the taxes and defending the claims are estimated to be more than $140 million and will take years to settle.

Under Minnesota laws of intestate succession (dying without a will), because Prince died without a surviving spouse, surviving children, or surviving parents, his siblings will inherit everything. "Half" siblings inherit as if they were "whole" so that sharing one parent with the decedent entitles you to inherit the same as those who share both parents. A corporate trustee was appointed by the Minnesota Probate Court, and in the first three weeks following Prince's death, more than 700 people filed claims of being somehow related. Defending those claims on behalf of the estate means even more of the assets will be spent on lawyers, trustee fees, and genetic testing.

During his lifetime, Prince gave millions of dollars to charity, helped those in need, and was a devout Jehovah's Witness. Estate planning could have created a charitable remainder trust, whereby he could have named the beneficiaries he wanted to support with a lifetime income stream with the remainder going to charity. The bulk of his estate is comprised of intellectual property – the music rights to his songs. Had Prince transferred those rights into an irrevocable trust, a separate legal entity would own, control, and protect those music rights and pay dividends to named heirs. Those songs would be free from additional capital gains tax if they increased in value after his death.

The irony is, Prince could have accomplished these estate goals simply, economically and efficiently by seeking expert advice. Give yourself and your loved ones the peace of mind that comes from working with an estate planning professional. Prudent estate planning is designed to give your loved ones the benefit of your wealth in the most tax efficient and timely manner possible.

Portfolio Review & Strategy

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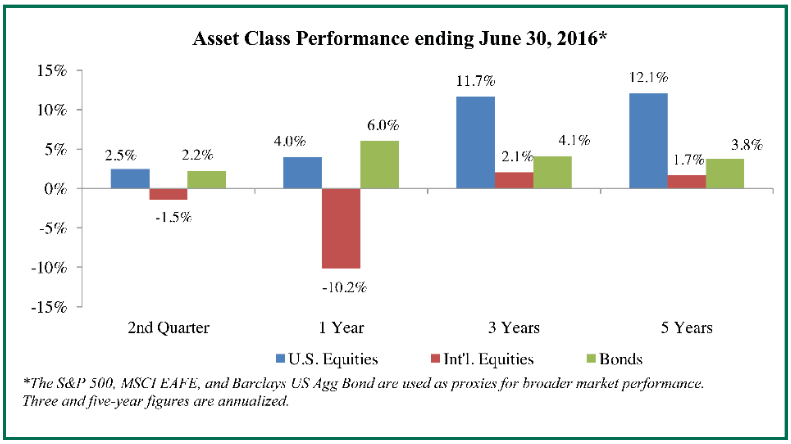
Prior to Britain's referendum on leaving the European Union (Brexit) on June 23, the most salient piece of economic data during the second quarter was the May jobs report. The weak report caused market participants to bid stocks modestly higher presumably on the idea that interest rates would remain unchanged. Following the surprising Brexit vote, much of the second quarter progress had been erased leaving U.S. markets essentially flat for the year. Equity markets invariably perform poorly in the short term following a surprise. The actual process of leaving the European Union may take as long as two years to work out and, in the meantime, may act as a drag on UK, European, and ultimately world economic growth. Client portfolios have been structured to reflect lower for longer world growth rates, inflation, and interest rates. We remain comfortable with our equity exposure and continue to invest, being careful but not fearful.



Similar to results experienced in 2014, companies paying substantial dividends were favored by market participants through the first half of the year. The renewed belief that global interest rates would remain lower for longer caused investors to again covet 3%-4% current dividend yields despite modest underlying revenue and earnings growth. Conversely, stock prices of many "growth" companies (those without dividends) have struggled lately despite improving long-term business trends and, in many cases, strong fundamental results. We see good value across our portfolio strategies, particularly for clients where our growth strategy is most appropriate.

As the market anticipated, on June 15th, the Federal Reserve Board voted to keep the Federal Funds Rate the same. The likelihood for a July increase now seems very low. Moreover, Fed participants collectively reduced their outlook for the likely Federal Funds Rate through 2018. This is consistent with our expectation that interest rates will remain lower for longer. For this reason, we continue to avoid most traditional fixed-income (bond) investments for our clients who need current income. We are happy to use bonds for clients who want volatility reduction, as long as our clients understand that adding bonds will likely limit their long-term total return potential. Instead, we continue to favor high-quality dividend stocks, preferred stock, real estate investment trusts (REITs), and master limited partnerships (MLPs) as a source of current income.

International investments continue to struggle and volatility increased dramatically following Brexit. At this point, our exposure to direct international investments is minimal. While there is undoubtedly good value among many overseas companies, our domestic strategies remain attractive from a valuation standpoint (particularly our growth strategy), and we are confident we can achieve our client's long-term goals by staying primarily with U.S. companies.

Living with Low Rates

TIMOTHY P. VICK
SENIOR PORTFOLIO MANAGER, THE NAPLES TRUST COMPANY

Two years ago, we stated that interest rates would stay low for an extended period, defying expectations that the world's "easy money" policies would soon lift economic growth and prompt credit costs to rise. Instead, borrowing rates have fallen worldwide. What are the implications? Low rates tend to cause short-term "gain" by re-inflating asset values, but when mismanaged, they cause long-term "pain." They are like a motor with a small gasoline leak. You can continue to run the motor as normal – until the moment the gas is gone. As such, we caution investors to remember the price paid for cheap money, and now make the case that rates need to rise.

Anyone whose balance sheet relies on "yield" and yield spreads has faced hardship watching interest rates and bond yields plummet. For example, amid the most-recent plunge in rates, lending margins for U.S. banks hit historical lows – 2.9% today vs. 4.9% in 1994 – which has been a boon for borrowers. Yet banks are not making enough profit on lending anymore to cover overhead, and thus need to resort to other means to stay profitable. We find this troublesome, since bank lending is a critical component to economic expansion. Low rates and new regulatory burdens have lessened banks' ability to inoculate the economy.

Another slow-brewing impact of low yields is that portfolio returns get squeezed. If interest rates indeed reflect the prevalent demand for money and the returns available on invested capital, then low rates are a "symptom" of sluggish economic growth and low investment returns. When a 10-year Treasury bond yields just 1.5% (what economists deem the "risk free rate"), it may be unrealistic to presume stock indexes can return more than 8% a year (five times the risk free rate).

This situation poses a special quandary for pension funds that manage $3.2 trillion for current and upcoming retirees. The average municipal pension in the U.S. assumes a long-term portfolio return of 7.68%, figures based on past returns when bonds provided 7% yearly total returns, and stocks 9%. Today, 7.68% is nearly impossible to meet given that bond yields have plummeted below 2%, and returns on "alternative" assets have dropped sharply. Pension managers are slowly reducing their rate of return assumptions, but such a move forces the municipality to increase yearly pension contributions and/or cut operating budgets to make up funding shortfalls. Likewise, large universities that heavily depend on endowments to plug budget gaps could feel a severe pinch should portfolio returns average just 3% or 4% for an extended period.

Insurance companies face similar dilemmas. Their ability to pay trillions in future claims, and pay out annuitants, relies on portfolios that deliver 4%-6% returns long term. But with roughly 80% of the life insurance industry's portfolios held in bonds and mortgages, and 60% of their reserves set aside to pay annuities (many which promise a minimum return), the prolonged slide in rates has punished margins. Returns on equity for the largest insurers have fallen 40%-50% since rates began dropping in 2007-2008.

In the past, interest rate cuts by central banks tended to encourage more capital spending, more lending, and more consumption. This post-recession cycle, however, is markedly different due to the already high debt levels that existed prior to the recession. With rates pushed artificially low for seven years, all market participants – investors, pensioners, savers, governments, and financial institutions – are being starved for yield and forced to take more risks. Only rising rates can relieve these pressures.

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