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The Financial Solutions Advisor

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Economic & Market Perspectives

Rising Bond Yields: A Concern?
The yield on the benchmark 10-year Treasury had been trading at around the 2.0% level for a period of several months before moving sharply higher. The yield rose to above 2.35% by the end of the week (bond prices move inversely to yields). The sell-off in bonds has caused some to wonder whether we are at the forefront of a bond bear market. Additionally, it raises questions about what these yield movements mean for the stock market.

First, we would not be surprised to see additional upward moves in yields, at least in the short term. Economic news has been relatively good over the past few months and as long as that trend continues, yields should retain an upward bias. This is not to say, however, that a bond bear market is upon us.

Typically, bond bear markets happen during periods of interest rate policy tightening. While the Federal Reserve has indicated that economic trends have been improving, there is almost no evidence to suggest that the United States is entering into an inflationary environment, and the central bank has maintained its forward guidance that short term interest rates are set to remain low for some time.

Additionally, we do not believe that higher bond yields by themselves will act as an impediment to the stock market. While it is true that any sharp and sudden moves in yields have the potential to unnerve investors, such effects are likely to be temporary. Over the longer term, we do not believe that modestly higher yields should be a source of concern for stocks, especially since we believe that the rise in yields is coming as a result of improved economic conditions.

Economic Trends Remain Market Friendly
So what are some of the improved economic conditions that have been pushing yields higher? There have been improvements in the labor market, and while jobs growth is certainly among the most important economic indicators, there are other factors that have been showing signs of improvement as well.

Debt deleveraging remains a source of concern, but we have been seeing progress on that front. Individuals have been paying down their debt over the past few years and household debt levels have been falling noticeably. Similarly, the housing market has long been a significant source of weakness, but that sector of the economy does appear to be in the midst of a long-term bottoming process and may be entering into some sort of recovery.

An additional issue on the minds of many investors is the US fiscal situation. The end of this year marks several important deadlines, including the scheduled expiration of the Bush-era tax cuts and temporary incentive measures as well as the beginning of scheduled spending cuts. Forecasting exactly what will happen on the fiscal front is complicated due to this November's elections, but our guess is that there is probably a 50% chance that some sort of tax compromise is enacted either later this year or early next year. The likelihood of a bipartisan compromise on entitlement reform would be less likely.

Looking Past Downside Market Risks
There are a number of angles that could be taken if one wanted to emphasize potential downside market risks. In addition to concerns over rising yields, we could point to economic and debt problems in Europe, concerns over growth in China, relatively modest levels of global economic growth, weakening trends in corporate profits and escalating geopolitical tension in the Middle East.

2012 Returns

S&P 500	*12.66%*
NASDAQ	*19.11%*
Russell Small Cap	*12.44%*
Russell Mid Cap	*12.94%*
MSCI EAFE	*10.86%*
MSCI World	*10.94%*
Barclay US Agg	*0.32%*
Barclay Muni.	*1.96%*

While all of these concerns are real, we would argue that the current strong run for equities has mostly been a result of macro risks receding. We argued at the beginning of the year that as long as fundamentals were at least decent, that should be good enough for risk assets. We never believed that solid market performance would require a significant turnaround in global economic growth conditions and a continued environment of modestly positive fundamentals should remain a market-friendly one.

In our view, stocks still remain attractively valued and the market is still discounting a more negative environment than what we expect. Corporations remain flush with cash and are poised to engage in a number of shareholder-friendly activities. A large number of people are still underweight stocks and we have yet to see significant moves into equity mutual funds. As such, we believe we have not yet seen the end of the market's upward moves, but would not be surprised if there was some sort of short-term pullback due to the market's year-to-date, substantial upward move.

Source: BlackRock

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Keeping Market Volatility in Perspective

When markets are volatile, sticking to a long-term investing strategy can be a challenge. Though past performance is no guarantee of future results, it might help you keep the ups and downs in perspective to see how recent market action compares to previous market cycles.

Bears versus bulls

Corrections of 10% or more and bear markets of at least 20% are a regular occurrence. Since 1929, there have been 18 previous 20%-plus bear markets (not including 2011 market action). Losses on the S&P 500 in those markets ranged from almost 21% in 1948-49 to 83% during 1930-1932; the average loss for all 18 bears was 37%.*

However, since 1929, the average bull market has tended to last almost twice as long as the average bear, and has produced average gains of about 79%.* Individual bull market gains have ranged from 21.4% at the end of 2001 to the nearly 302% increase registered during the 1990s.* The worst annual loss--47%--occurred in 1931, but the all-time best annual return--a capital appreciation gain of just under 47%--happened just two years later in 1933.**

Points of reference

Last year's volatility rattled even seasoned investors. For example, during a single week in August, 2 of the Dow's 11 best days in history alternated with 2 of its 11 worst daily point losses ever.***

While by no means normal, the highs and lows are hardly unprecedented. Even though the 634-point drop on August 8 felt historic, it didn't begin to match the real record-holders. The single biggest daily decline occurred in September 2008, when the Dow fell 778 points. The biggest percentage drop was October 1987's "Black Monday," when the Dow fell almost 23%; that makes the Dow's 5.5% loss on August 8, 2011, seem relatively tame by comparison. And August 8 was followed by the Dow's 10th best day ever, with a gain of 430 points. While that upward movement may seem exceptional, the Dow's best day ever came during the dark days of October 2008, when a 936-point move up on October 13 represented a gain of more than 11% in a single day.***

Stocks versus bonds

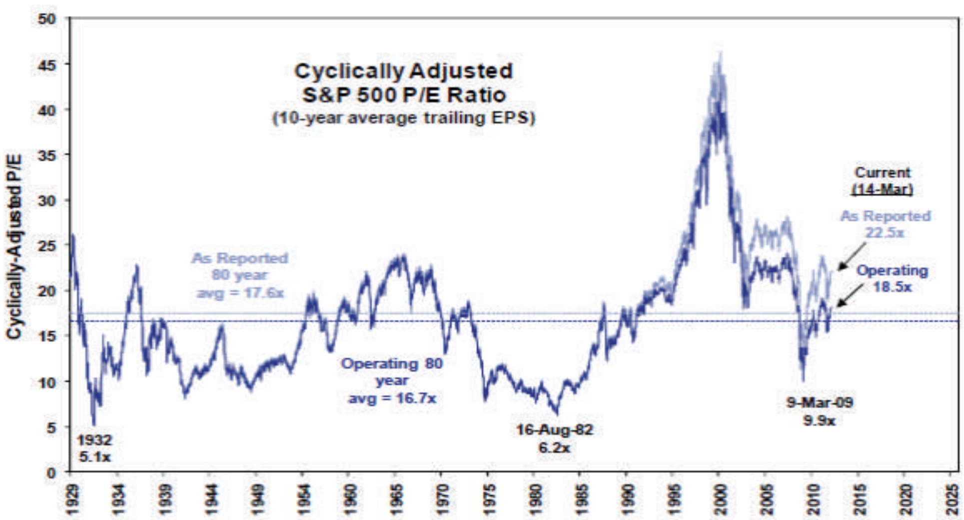
The last decade has been a challenging one for stocks. Between 2001 and 2010, the S&P 500 had an average annual total return of just 1.4%, while the equivalent figure for Treasury bonds was 6.6%.**** For much of that time, interest rates were falling, helping bonds to outperform stocks. However, interest rates are now at record lows, and rising rates could change the relative performance of stocks and bonds.

While there may be ongoing volatility in the markets that needs to be monitored, it's important to keep things in perspective. Your ability to meet your goals could be affected if you change your overall long-term game plan with every new headline.

Sources:

** Bull and bear market time frames, gains/losses: all calculations based on data from the Stock Trader's Almanac 2011 for the Standard & Poor's 500.*
*** 1931 and 1933 annual stock returns: based on Ibbotson SBBI data for capital appreciation of S&P 500.*
**** Based on data from the Stock Trader's Almanac 2011.*
***** 10-year rolling stock returns: based on Ibbotson SBBI data for annual total returns between 2001 and 2010 of S&P 500 and an index of U.S. Treasury bonds with an approximate 20-year maturity.*

S&P 500 Index: Cyclically Adjusted P/E



S&P 500 cyclically-adjusted P/E in-line with long-term levels (as of March 14, 2012)

Sources: Factset, Compustat, Haver Analytics, and Goldman Sachs Global ECS Research

Keeping Track of Expiring and New Tax Provisions

A number of significant federal income tax provisions expired at the end of 2011, a fact that might be easily overlooked with so much attention being focused on the "Bush tax cuts" that are still in effect, but scheduled to expire at the end of 2012. And new Medicare-related taxes, effective in 2013, have received surprisingly little coverage. Of course, new legislation could always extend some or all of these provisions, but here's a quick summary of how things stand.

Already expired

- *Alternative minimum tax (AMT):* A series of temporary legislative "patches" over the last several years has prevented a dramatic increase in the number of individuals subject to the AMT--essentially a parallel federal income tax system with its own rates and rules. The last such patch expired at the end of 2011. Unless new legislation is passed, your odds of being caught in the AMT net greatly increase in 2012, because AMT exemption amounts will be significantly lower, and you won't be able to offset the AMT with most nonrefundable personal tax credits.

- *Qualified charitable distributions:* This popular provision allowing individuals age 70½ or older to make qualified charitable distributions of up to $100,000 from an IRA directly to a qualified charity expired at the end of 2011. These charitable distributions were excluded from income and counted toward satisfying any required minimum distributions that you would have had to take from your IRA for the year.

- *State and local sales tax:* If you itemize your deductions, 2011 was the last tax year for which you could elect to deduct state and local general sales tax in lieu of state and local income tax.

- *Education deductions:* The above-the-line deduction (maximum $4,000 deduction) for qualified higher education expenses and the above-the-line deduction for up to $250 of out-of-pocket classroom expenses paid by education professionals both expired at the end of 2011.

Expiring at the end of 2012

- *Federal income tax rates:* After December 31, 2012, we're scheduled to go from six federal tax brackets (10%, 15%, 25%, 28%, 33%, and 35%) to five (15%, 28%, 31%, 36%, and 39.6%).

- *Long-term capital gains rate:* Currently, long-term capital gain is generally taxed at a maximum rate of 15%. And, if you're in the 10% or 15% marginal income tax bracket, a special 0% rate generally applies. Starting in 2013, however, the maximum rate on long-term capital gains will generally increase to 20%, with a 10% rate applying to those in the lowest (15%) tax bracket (though slightly lower rates might apply to qualifying property held for five or more years). And while the current lower long-term capital gain rates now apply to qualifying dividends, starting in 2013, dividends will be taxed at ordinary income tax rates.

- *2% payroll tax reduction:* The recently extended 2% reduction in the Social Security portion of the Federal Insurance Contributions Act (FICA) payroll tax expires at the end of 2012.

- *Itemized deductions and personal exemptions:* Beginning in 2013, itemized deductions and personal and dependency exemptions will once again be phased out for individuals with high adjusted gross incomes (AGIs).

- *Tax credits and deductions:* The earned income tax credit, the child tax credit, and the American Opportunity (Hope) tax credit revert to old, lower limits and (less generous) rules of application. Also gone in 2013 is the ability to deduct interest on student loans after the first 60 months of repayment.

- *Marriage penalty relief:* Tax changes that were originally made to address a perceived "marriage penalty" expire at the end of 2012. If you're married and file a joint return with your spouse, you'll see the effect in the form of a reduced 2013 standard deduction amount, as well as in lower 2013 tax bracket thresholds in the tax rate tables (i.e., couples move into higher rate brackets at lower levels of income).

New taxes effective in 2013

Two new Medicare-related taxes created by the health-care reform legislation passed in 2010 take effect in 2013:

- *Additional Medicare payroll tax:* The hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% (from 1.45% to 2.35%) for those with wages exceeding $200,000 ($250,000 for married couples filing jointly, and $125,000 for married individuals filing separately). The rate for self-employed individuals increases from 2.9% to 3.8% on any self-employment income that exceeds the dollar thresholds above.

- *Medicare contribution tax on unearned income:* A new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals. The tax generally applies to the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing jointly, and $125,000 for married individuals filing separately).

New tax being considered

- *The Buffet Rule:* This would establish a minimum 30% tax rate for individuals with adjusted gross income in excess of $1 million.

Fund in the News: John Hancock Alternative Asset Allocation Fund

Goal
The fund seeks long term growth of capital.

Strategy
The fund will seek to achieve its objective by investing in "alternative asset classes" such as international small-cap stocks, emerging market equity, commodities, market neutral (long/short), global real estate, natural resources, TIPS (Treasury Inflation-Protected Securities), global bonds, high yield bonds, bank loans, foreign currency trading strategies, managed futures, arbitrage strategies, tactical investment strategies and emerging market debt. These alternative or non-traditional asset categories generally have a low correlation with the broad U.S. stock and bond market.

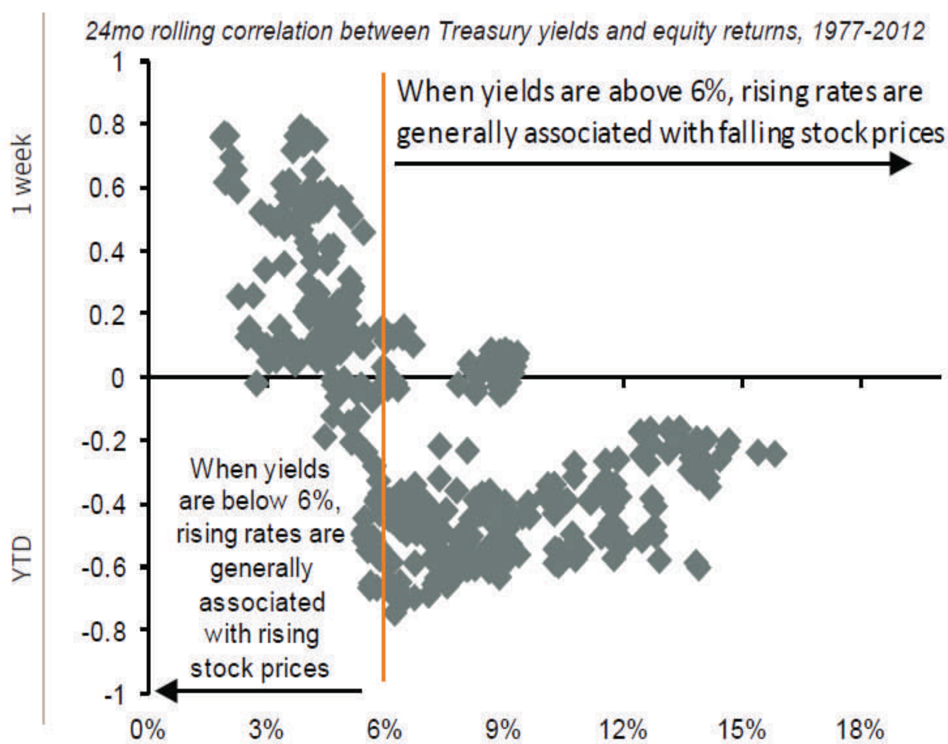
Key Facts:

- John Hancock Asset Management has been managing asset allocation portfolios for over 10 years and currently has over $88 billion in assets in these portfolios.
- Alternative assets have the potential to improve the risk/return profile of a traditional portfolio.
- The fund provides diversification across alternative asset classes and investment strategies.
- 5 Star Morningstar Rating.

Sources: John Hancock, Morningstar

Equity Returns Depend on the Level and Direction of Interest Rates

With U.S. Treasury yields rising recently, some investors have become concerned that rising rates could negatively impact equity returns. However, history shows that the impact of rising rates on equity returns depends on the level of interest rates prevailing at the time. The following chart illustrates this relationship, highlighting that when yields are below 6% and rising, equity prices tend to increase, as in this case, rising yields are signaling that the economy is improving. However, when yields are above 6% and rising, stock prices have historically fallen, as rising yields may be signaling higher inflation or Federal Reserve tightening. At the current juncture, we are clearly in the former scenario, which suggests that the stock market may not be negatively impacted by rising rates and could continue pushing higher as the economy continues to strengthen.



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