3Q12

# The Financial Solutions Advisor

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## Economic & Market Perspectives

**European Progress Depends on Political Compromise**

The stock market gains over the past month can be largely attributed to the perception that policymakers in Europe have been making some progress combating the ongoing debt crisis. Political leaders have continued to discuss a variety of ways to recapitalize the banking system to prevent further contagion, and the European Central Bank did recently announce an additional cut in interest rates.

The problem with the European crisis is that the speed at which policymakers are acting continually appears to be slower than what the markets would like. There have been some tentative signs that Europe will move toward a tighter fiscal and political union (a step we believe is critically important), but the means of implementation are still murky. In our view, the euro zone has the ability to stem the crisis, but politics remain the biggest question mark. Looking ahead, it seems clear to us that signs of political compromise in Europe would be bullish for risk assets (stocks), while political bickering and policy paralysis would equate to heightened volatility and a more bearish environment.

**Uncertainty Remains for the US Economy**

There is a broad sense of uncertainty over the state of the US economy, and that uncertainty is making investors, companies and consumers wary about the future. To some extent, this type of environment can become circular and lead to a self-fulfilling prophecy. Compared to where it was earlier in the year, the US economy appears to have entered a soft patch in recent months. The June payrolls report was a near-perfect indicator of how the economy has been trending. The headline numbers were relatively disappointing, showing that only 80,000 new jobs were created for the month. Yet, the silver lining is that jobs still are being created and there were some improvements in terms of hours worked and average hourly earnings. The labor report reinforces our view that the economy will be growing, but will be doing so at a modest pace.

Investors are also starting to focus on second-quarter earnings, as the earnings season begins to kick off. From our perspective, the combination of modest levels of economic growth, weaker growth outside of the US and some renewed strength in the US dollar should mean that profits will be relatively muted. Expectations for earnings and profits have declined compared to where they were at the beginning of the year, which suggests that companies should be able to meet these expectations, but that is not a foregone conclusion.

**Markets Remain in a Balancing Act**

At present, the macro environment appears to be balanced between a range of positive and negative forces. The negatives are well-known and are the same ones that have been in force for some time: the euro zone debt crisis, the potential slowdown in China and the looming fiscal cliff in the US. For the positive factors, we would cite easing monetary conditions around the world, falling gasoline prices that should benefit consumers in the second half of the year, improving credit conditions and a modest recovery in housing.

We expect this tug-of-war environment will continue to dominate the economy and the world financial markets. The euro debt crisis and weak global growth should continue to cast a shadow on the global economy, but the positives we mentioned should also encourage some investors to engage in additional risk taking. Our sense is that the global economic recovery should continue, if unevenly. The US economy is likely to continue to expand and Chinese growth should remain relatively high. The problems in Europe are a long way from being solved and will likely remain a drag on risk assets.

For stocks, the softness in the global economy is likely to continue to make for a difficult environment, but that has been the case for some time. Stocks have come a long way since the market bottom in October of last year (marked by 1,075 for the S&P 500) and an even longer way since the nadir of the credit crisis (666 for the S&P 500 in March 2009). Equity gains from here are likely to be uneven, but we think the bull market should remain intact.

**2012 Returns**

| | |
|---|---|
| *S&P 500* | *9.49%* |
| *NASDAQ* | *13.28%* |
| *Russell Small Cap* | *8.53%* |
| *Russell Mid Cap* | *7.97%* |
| *MSCI EAFE* | *3.38%* |
| *MSCI World* | *6.29%* |
| *Barclay US Agg* | *2.37%* |
| *Barclay Muni.* | *3.66%* |

*Source: BlackRock*

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## Non-Equity Alternatives to Rock-Bottom Yields

As interest rates have fallen to record lows and stayed there in recent years, the yield on your savings may be stuck in neutral. If you've focused on capital preservation and kept your assets in U.S. Treasuries, a money market account, or certificates of deposit, you may have minimized the chance of the financial equivalent of a car crash. However, you also may not be happy letting your portfolio's engine idle forever.

Dividend-paying stocks are one solution, but last year's volatility has made many investors wary of committing more money to equities. Though past performance is no guarantee of future results, for those who need something more than 2% 10-year Treasury yields and who can handle the additional risks involved, there are other alternatives that could potentially boost overall yield.

**Corporate bonds**

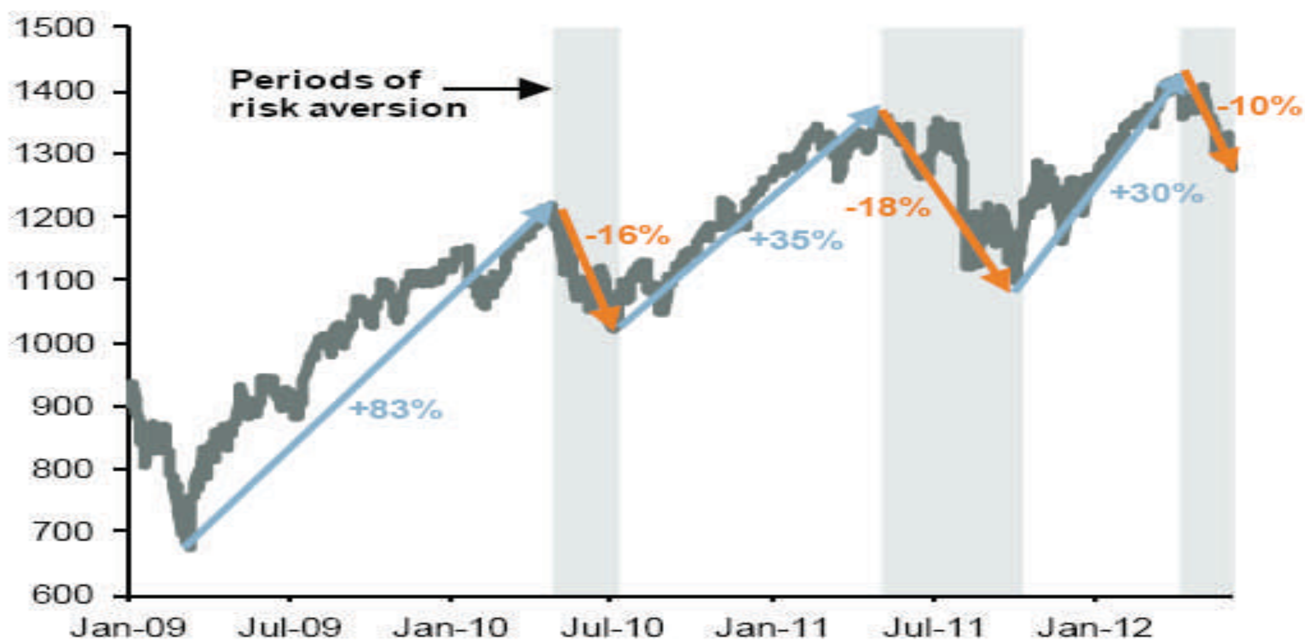
Many corporations have taken the opportunity presented by low rates to refinance their corporate debt and lower borrowing costs. Though any company could still default on its obligations, of course, and all bonds face market risk, stronger balance sheets have helped lower the overall risk of corporates as a whole. The spread between the yield on Moody's Aaa-rated industrial bonds and 10-year Treasuries at the end of 2011 was roughly 2 percentage points. For a Baa bond (one notch above noninvestment-grade), the difference was over 3 percentage points. Yields on noninvestment-grade bonds (so-called high-yield or "junk" bonds) were higher still, roughly 5% above 10-year Treasuries.

**Bank loans**

Floating-rate bank loans (also known as senior loans, leveraged loans, or senior secured loans) are a form of short-term financing for companies that usually do not rate an investment-grade credit rating. The rate is typically tied to the London Interbank Offered Rate (LIBOR) and adjusts with it, generally quarterly. As with high-yield bonds, the lack of an investment-grade credit rating means bank loans must offer a higher yield.

As with all debt, investors still run the risk of default. However, because bank loans typically are a company's most senior debt obligation and are secured by some form of collateral, investors have typically recovered a higher percentage of their investment in the event of default than with high-yield bonds secured only by a company's promise to pay. As with all bonds, as bond yields rise, the price falls, which could cut overall return enough to offset any yield advantage. For the majority of investors, the most accessible way to invest in floating-rate bank loans is through a mutual fund or exchange-traded fund.

## Since March 9, 2009 the S&P 500 has Returned 89%




It is easy to view the glass as half empty, particularly when things seem like they may never improve. However, when it comes to investing, it is important to maintain perspective. As shown in the above chart, although, the S&P 500's climb from its March 2009 lows has not been uninterrupted, the declines have paled in comparison to the rallies. Additionally, these periods of risk aversion have been driven by a variety of factors such as the situation in Europe, higher oil prices/Arab Spring, the U.S. debt downgrade and a possible hard landing in China. Although it can be difficult to remain invested during market declines, equities have shown their ability to rally despite these issues, suggesting investors could benefit from staying the course and not panicking when markets become volatile.

*Source: JP Morgan*

## Of Taxes Past, Present, and Future

With the 2011 tax filing season behind us, much attention is being paid to the expiring "Bush tax cuts"--the reduced federal income tax rates, and benefits, that will expire at the end of 2012 unless additional legislation is passed. In fact, though, several important federal income tax provisions already expired at the end of 2011. Here's a quick rundown of where things stand today.

### What's already expired?

A series of temporary legislative "patches" over the last several years has prevented a dramatic increase in the number of individuals subject to the alternative minimum tax (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.

**Other provisions that have already expired:**

- *Bonus depreciation and IRC Section 179 Expense limits*-- If you're a small business owner or self-employed individual, you were allowed a first-year depreciation deduction of 100% of the cost of qualifying property acquired and placed in service during 2011; this "bonus" depreciation drops to 50% for property acquired and placed in service during 2012, and disappears altogether in 2013. For 2011, the maximum amount that you could expense under IRC Section 179 was $500,000; in 2012, the maximum is $139,000; and in 2013, the maximum will be $25,000.

- *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.

### What's expiring at the end of 2012?

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%). The rates that apply to long-term capital gains and dividends will change as well. Currently, long-term capital gains are 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.

**Other provisions expiring at the end of the year:**

- *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.

### New Medicare Taxes in 2013

New Medicare taxes created by the health-care reform legislation passed in 2010 take effect in just a few short months. Beginning in 2013, the hospital insurance (HI) portion of the payroll tax--commonly referred to as the Medicare portion--increases by 0.9% for high-wage individuals. Also beginning in 2013, a new 3.8% Medicare contribution tax is imposed on the unearned income of high-income individuals.

Who is affected? The 0.9% payroll tax increase affects those with wages exceeding $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately). The 3.8% contribution tax on unearned income generally applies to the net investment income of individuals with modified adjusted gross income that exceeds $200,000 ($250,000 for married couples filing a joint federal income tax return, and $125,000 for married individuals filing separately).

### Qualified charitable distributions

*A 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 towards satisfying any required minimum distributions that you would have had to take from your IRA for the year.*

### Return of the "marriage penalty"?

*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).*

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## American Tower REIT Inc. (AMT)

AMT is a leading wireless and broadcast communications infrastructure company, deriving the majority of its revenue from leasing antenna space on communication sites to wireless services providers, radio and television broadcast companies and wireless data providers. Generally, tenants own, operate, and maintain their respective antenna, backhaul and base station equipment on AMT's properties, while AMT provides the real estate and tower structure to support them. AMT has over 46,000 communication sites, of which approximately 21,600 were in the US, 16,000 sites in Latin America / Emerging markets and 9,000 sites in India. Approximately 98% of AMT's total revenue is generated from leasing these properties to tenants, such as AT&T, Sprint, Verizon, T-Mobile, Clearwire, Metro PCS, Leap Communications and the US Government. AMT also owns 260 distributed antenna system networks, and manages rooftop and tower sites for property owners under various contractual arrangements. AMT's portfolio also includes 1,810 property interests that they lease to communication services providers and third- party tower operators.

Our favorable view of AMT is based on several factors:

-First, we believe that AMT stands to greatly benefit from rapid growth in wireless usage by consumers, both in the domestic and international markets.

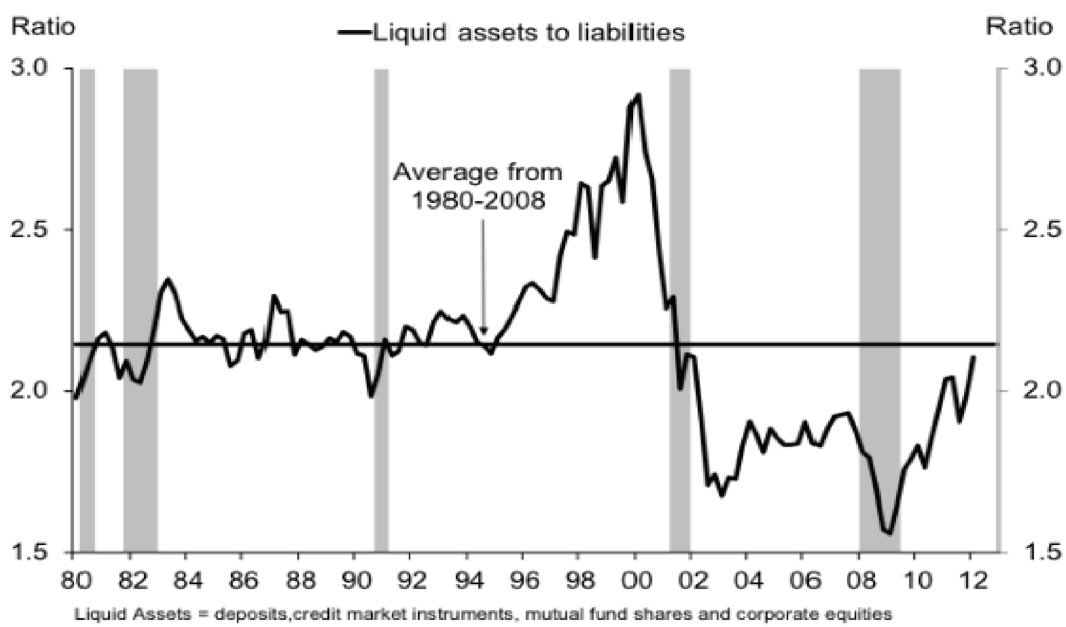
-Second, typical contracts in the tower industry include an initial non-cancellable term of five to ten years with the option for multiple five-year renewal terms, and over the life of the contract prices are typically increased on a fixed escalation schedule or in relation to an inflationary index.

-Third, we expect AMT to generate strong adjusted funds from operations, which should allow it to continue to invest in capex and acquire additional communication sites.

-Finally, the company maintains a healthy balance sheet, with a solid liquidity position (cash on hand of $471 million, revolver capacity of $2.0 billion). Partially offsetting these positives is the high level of consumer concentration and risks associated with expanding its international footprint. Moreover, AMT has recently completed the transition to a REIT, which requires the distribution of 90% of its taxable REIT income.

*Source: Goldman Sachs*

## Household Balance Sheets Are in Much Better Financial Shape Today Relative To Recent History




**Is the worst finally over?** At present, the latest Flow of Funds report on US households is showing a noticeable improvement in household finances. Our work has shown that household buying power is currently at its highest reading since 2005, and the ratio of liquid assets to liabilities is at its highest reading since 2001. The positive trends in both series should keep consumer spending growing on a modest course, even if the economy, overall, continues to grow at a slow and uneven pace. To be sure, household fundamentals suggest that the worst of the deleveraging process is over in the US. Looking ahead, if the labor market strengthens somewhat later this year, improving household finances should get an added lift.

*Source: FRB, Haver Analytics & DB Global Markets Research*

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