Robshaw & Julian Associates, Inc.
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended September 30, 2016

Stock Market Limbo

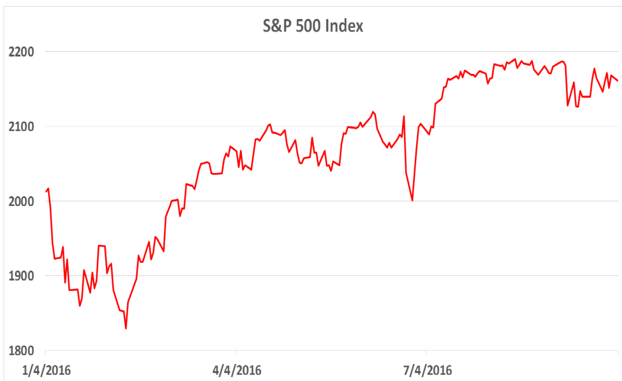
As the accompanying graph makes clear, the S&P 500 Index has been flat since about mid-July. Although many investors are worried that the market has topped out, it is just as likely marking time until things change for the better or the worse.

Stock prices are largely determined by two things: the expected future earnings of stocks, especially in the next six to twelve months and the expected rate of interest used to discount the value of those earnings.

Today, most of the attention is on interest rates. Everything which the Federal Reserve governors say is carefully analyzed for clues as to how soon the Fed will next raise rates and how quickly subsequent increases will occur.

The upshot of this is the current consensus opinion that the Fed will raise the short term rate one quarter of 1% at their December meeting and two or three more times next year. As interest rates rise a little, earnings are valued slightly lower and, in the absence of other factors stock prices will fall, although not very much.

But the other factor in the equation is earnings expectations. Corporate earnings declined in 2015, largely due to the precipitous drop in the price of oil which went from $106 per barrel in June of 2014 to $27 in February of this year. This decline produced big losses among energy companies which dragged down overall profits for the entire economy. With the price of oil now apparently stabilized between $40-50 per barrel, energy companies are expected to stop being a drag on corporate earnings. The overall effect is that corporate earnings should recover over the next 6-18 months.



The S&P 500 Index is likely to resume its upward move as better earnings are reported over the next 6-9 months.

While this is no doubt happening, it has developed more slowly than expected. Earnings are no longer going down but they are not yet rising very much.

With interest rates expected to rise slowly and with corporate earnings sputtering along stock market investors see little opportunity for immediate gains. Buying and selling is evenly balanced and stock prices are in limbo.

Limbo is temporary. As more time passes the trend of rising interest rates and the direction of earnings will get clearer and stocks prices will establish a new trend. With continued low inflation and consistent efforts by business leaders to increase profits the new direction should be up. Stronger earnings growth will overpower rising interest rates and stock prices will rise.

For a complementary review of your investment portfolio please call our office at (716) 633-6555 to schedule an appointment at your convenience.

Why Are Interest Rates So Low?

In June of this year the yield on the U.S. 10 year Treasury bond reached a low of 1.37%, the lowest yield in post-war history. In Germany government bonds are being issued with negative interest rates. The situation is similar in Japan.

Low interest rates hurt savers. Borrowers however are happy. Negative real interest rates means they pay back their loans with cheaper money.

Blame for low rates has been placed on the Federal Reserve and other central bankers around the world or on fundamental causes such as imbalances in the supply and demand for saved money.

Interest is the price you pay for borrowing money. If there are too many lenders (savers) and not enough borrowers, rates must fall. The build-up in savings is huge, especially since China became more integrated into the world economy. A billion Chinese save 40% of their incomes, more than seven times the U.S. rate. China has small families and no social security system. This has forced them to save furiously for many years.

The worldwide rise in average age has also forced more saving. Although people still work about the same number of years they did in the past, retirement is much longer than before, forcing people to save more during their working years.

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Interest rates: Cont.

While savings were rising the demand for investment spending was falling. With so many improvements in digital devices and software, and with the increased importance of service industries, business can now add productive capacity with little capital spending.

The low economic growth which the world has experienced since the 2008 -09 financial crisis, either from fear, secular stagnation or ineffective government policies, has also reduced the demand for money.

Those who focus the blame on the Fed and other central banks have an attractive argument but they are left to explain why low rates have not caused economic over-heating and rising inflation, as they always have in the past. Central banks argue that they are trying to create more inflation to sop up some of the worldwide glut. So far they are unsuccessful and rates remain low.

Be Careful of Variable Annuities

Variable annuities are insurance company contracts that marry life insurance with mutual-fund-like subaccounts. They are sold by banks, stockbrokers, insurance agents and mutual fund companies. There is no tax on the earnings from an annuity until you take withdrawals. Annuities can either be immediate or deferred depending on when you start receiving monthly income. Deferred annuities allow investors to grow savings on a tax-free basis until they start withdrawals. The gains or losses that you experience with a deferred annuity depend on the investments which your annuity holds. Losses as well as gains are possible.

There are two basic problems with deferred variable annuities: first they are complicated contracts written in insurance company legalize. Most people do not read or fully understand what they are getting into. Second, annuity salespeople are paid high commissions to sell these products, typically 7% of the money invested. High commissions can attract unscrupulous salespeople.

In 2009, the Financial Industry Regulatory Association (FINRA) issued an Investor Alert, "Variable Annuities: Beyond the hard sell." warning investors, especially seniors, about the inappropriate tactics used to sell variable annuities.

Annuities are very illiquid. They charge high "surrender charges' for investors who want to get out of their contract in the first seven years. When you cash out of an annuity you must pay taxes on your investment income at regular income tax rates rather than the lower capital gains tax rate. If you cash out before age 59½ you will also owe the government a 10% early withdrawal penalty. Sadly, many annuity investors do not realize these drawbacks until their investments perform badly or they need cash for a family emergency.

Variable annuities may also impose a variety of fees. 2% per year is not uncommon. These can include annual management fees, guaranteed death benefit fees, guaranteed minimum income fees, long term health insurance and portfolio protection insurance.

While earnings from a deferred variable annuity accrue on a tax deferred basis, annuities, unlike IRA and 401k investments, cannot be purchased with pre-tax income. Also, the cost of a variable annuity does not receive a step-up when the owner dies like stocks and bonds do. This means extra taxes for the owner's estate.

Additional complexities of variable annuities include so-called bonus credits. While these may look attractive, they are completely offset by higher fees or longer surrender periods. In essence, you pay your own bonus. Buying a variable annuity inside of an IRA also presents special problems as noted in the FINRA Alert.

If you are considering the purchase of a variable annuity you are welcome to call Robshaw & Julian. We would be happy to provide you with a copy of the FINRA report to help you evaluate your options.

The Bottom Line: 9/30/2016

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	2168	15.4%
Small company stocks *(S&P Small Cap Index)*	757	17.4%
Short term interest rates *(3 Month T-Bill Yield)*	0.3%	From 0.01%
Long term interest rates *(10 Year T-Bond Yield)*	1.6%	From 2.1%
Inflation *(Consumer Price Index)*	240.3	1.1%
Energy *(West Texas Intermediate Crude Oil)*	$48.24bbl.	6.4%
The economy *(Inflation adjusted GDP)*	$18.5 trillion	1.3%

QUOTABLE

"Profit is the price paid for efficiency."

Thomas Sowell, Economist."

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