Tarheel Advisors Newsletter

Volume 4, Issue 4

October 2012

It's a Long Way to the Top

The Fall season has arrived and ushered in some cooler temperatures, but global equity markets remain red hot. Through the end of the third quarter, U.S. stocks remain right at four year highs with the broad market advancing more than 16% year-to-date.

But, it hasn't been smooth sailing all the time. In fact, some readers may recall that in early April we were also up double digits across various indices only to see all of the gains evaporate into the red by early June as a result of the spreading sovereign debt crisis in Spain. Since early Summer, global markets have moved back in black largely as a result of various measures instituted by central bankers. There have been a few hiccups along the way, but easy monetary policy by both Mario Draghi, head of the European Central Bank (ECB), and Fed Chairman Ben Bernanke, have proved once again successful in driving asset prices higher.

It would seem that Mr. Draghi has thus far earned his "Super Mario" moniker, as he has been able to ease fears about the intensification of the Euro crisis. Through a series of statements and promises, Super Mario has pronounced that the "euro is irreversible" and declared Outright Monetary Transactions (OMT) in the form of unlimited government bond purchases for beleaguered countries to help them maintain manageable yields on their debt. Like his European counterpart, Mr. Bernanke also embarked on a third round of Quantitative Easing (QE3) in September, promising to expand the Fed's balance sheet by purchasing up to $40 billion dollars of mortgage backed securities a month, indefinitely. These stimulative measures were designed to continue to drive mortgage rates down and help a domestic housing market that has yet to fully rebound from the '08 financial crisis.

Some of you may be asking yourself a very rational question. —Why are equity markets at four year highs when economic conditions around the globe dictate that central banks must act to stabilize the situation? Simply put — money talks. Traders and investors around the world have seen this scenario play out several times over the last few years, and the halo effect of stimulative monetary policies has been very positive for just about all asset classes. So, it doesn't pay to fight the Fed. As a result, I believe that many investors have held onto and even added to their positions despite a global slowdown because of the so-called "Bernanke Put." Given two scenarios: either the economy improves on its own and corporate profits continue to increase, or, the economy does not improve, but the Fed swoops in to save the day. Hypothetically, either outcome leads to a positive result for markets.

That being said, now that the Bernanke Put has been deployed, don't expect the same effect as previous iterations. In the past, QE has been deployed in connection with weaker stock market performance and has led to stocks retracing their losses within a few months. Since QE3 was announced at a time when markets remained strong, there is likely to be less enthusiasm this time around. In fact, don't feel thunderstruck if focus returns to the sagging economic indicators, overbought conditions, and looming fiscal cliff sooner rather than later. Think of it this way — if you throw together a pile of sulfur, a pile of saltpeter, and a pile of charcoal, neither item by itself is of much concern, but what you may not realize is you are sitting on dynamite!

So, lest you think the dirty deeds by central bankers come without future consequences, we would advise remaining cautious on the short-term horizon. The end of the year is likely to be much more volatile as we head into the presidential election, and a wise investor should look to tone down the risk level of their portfolio. At the very least, rebalancing your asset mix by selling some of your outperformers (likely stocks) and adding to your lagging performers (likely bonds) makes a lot of sense. It's been a long way to the top, and let's hope that we stay here at least for a little while.

-Walter Hinson, CFP ®

2012 Market Update

S&P 500	**+16.4%**
DOW	**+12.2%**
NASDAQ	**+19.6%**
MSCI World	**+5.7%**
BONDS	**+4.0%**
GOLD	**+12.5%**

Mortgage Rates

15-Year	**2.85%**
30-Year	**3.41%**
5/1 ARM	**2.95%**

Did You Know?

*For those of you scoring at home, there were 6 different references to AC/DC songs in this Quarter's column.

*France just enacted a 75% income tax rate on those making over $1 million Euros per year. They still have room to grow if they want to match the 94% rate the US had in 1944-1945.

*Fantasy Football is estimated to cost employers $6.5 Billion in lost employee production. A good reason to make sure the boss always gets an invite to your league.

Taxmageddon—Part Deux

There is an old saying from Mark Twain that "history doesn't repeat itself, but it does rhyme." Well Mark must have been fortunate enough to have lived in a time where Congress wasn't as bumbling and short-sighted as the loveable bunch we currently enjoy.

At the end of 2010, Congress voted to extend the George Bush tax cuts of 2001 for an additional two years, in what has been one of very few bi-partisan agreements struck during the past four years. Thanks to this band-aid approach, taxpayers are stuck in the exact same situation we saw two years ago—tax limbo.

The only real difference this time around is that we are in the middle of a presidential election cycle. So, a greater possibility exists for voters to elect politicians that may bring tax changes with permanence. For your viewing pleasure, the proposed tax rates from both party platforms is provided below, in addition to the inherent changes should Congress do nothing.

Income Taxes—In the base case, 2013 will bring marginal tax rates that are around 3% higher for households making over $70,700. This segment of the population currently pays over 85% of all federal income taxes. Capital gains rates will also climb 5%, and dividend taxation will count as ordinary income once again.

Estate Taxes—Currently, federal estate taxes are due for estates over $5 million in net worth ($10 million for married couples). If no changes are made, this exclusion amount drops to $1 million per person. In addition to the lowered exemption, the estate tax rate spikes up an additional 20% to the 55% level.

Medicare "Unearned" Income Tax—This tax has nothing to do with the Bush Tax cuts, but still takes effect next year. This tax only affects single filers making over $200,000 and joint filers with $250,000 or more in income. This 3.8% surtax will apply to most dividends and capital gains, but only for high earners.

The real problem here crosses party lines. Whether you feel that taxes should be 7.5% or 75% (enjoy, France!), is less relevant than the legitimate need for investors and business owners to know what tax rates and policy will be in the future. One would also think that an astute Congress would benefit from knowing what tax rates and provisions will be for budgeting purposes. I suppose when you stop issuing budgets that stops being an issue. Arbitrary expiration dates on tax policy really is just bad practice.

All in all, these changes in the tax code are expected to cost taxpayers an estimated $400 billion in the new year. With another trillion dollar deficit on the books for 2012, one can make the case that this revenue is sorely needed. However, with GDP growth hovering around an anemic 1%, one can also make the case that this tax burden will push the U.S. into recession, which typically means lower tax collections even with higher tax rates.

With some of the most drastic changes in taxes being related to investment income, we could see significant side-effects in the markets as the year and political season come to a wrap. One particular sticking point will be how investor appetites change due to the potential for a dramatic increase in dividend taxation. Over the last year, some of the best market performers have been companies that have large dividend yields. These so-called "safe-haven" stocks have seen heavy in-flows as yield-starved investors look for income. These yields would not be as attractive should the taxes on them double, which could lead to a significant sell off in these assets in the coming months.

Don't run for the gates just yet with your portfolio. The situation moving forward should be quite fluid with the presidential debates right around the corner. Don't forget that the real risk could be another party split in the House and Senate for another two years. This would be the scenario least likely for Congress to put in a permanent policy and most likely to enact yet another band-aid solution. Should that be the case we'll all be kicking these problems down the road again, and in another two years you can look forward to reading "Taxmageddon 3—This Time We Mean It".

-Ryan Glover, CFP®

Our Advisors

Walter Hinson, CFP® (919) 439-0383

walter_hinson@tarheeladvisors.com

Ryan Glover, CFP® (336) 510-7255

ryan_glover@tarheeladvisors.com

Income Married Filling Jointly	Current Tax Rate 2012	New Tax Rate 2013	Proposed Tax Rates Obama	Romney
Over $388,350	35%	39.6%	39.6%	28%
$217,450 - $388,350	33%	36%	36%	26.4%
$142,700 - $217,450	28%	31%	28%	22.4%
$70,700 - $142,700	25%	28%	25%	20%
$17,400 - $70,700	15%	15%	15%	12%
$0 - $17,400	10%	15%	15%	12%
Top Dividend Tax Rate	15%	43.4%*	43.4%*	15%
Top Capital Gains Tax Rate	15%	20%	30%	15%
Estate Tax Rate	35%	55%	45%	0%

* Includes 3.8%Investment Tax under the Affordable Care Act

Data Source: Wall St. Journal 7/9/2012