HBK Wealth Management
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WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

February 2014

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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Add More Bond James Bond to Your Portfolio

Could You Be Subject to the Alternative Minimum Tax?

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Weekly Economic Commentary | Week of February 10, 2014

Highlights

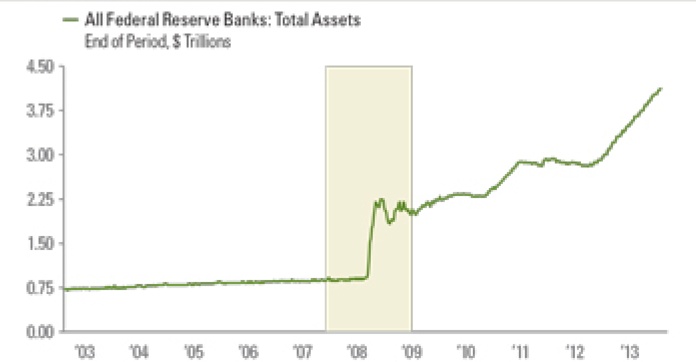
- At her first public appearance as Fed chairwoman tomorrow, Janet Yellen is likely to say that inflation is in more danger of falling below the Fed's target of 2% than accelerating higher.
- Market participants' view of inflation is similar to the Fed's view that inflation remains well contained.
- Food and gasoline prices have soared over the past 30-40 years, and yet consumers (and businesses) hear every day that inflation is "well contained."

The Inflation Conversation: Part I

On Tuesday, February 11, 2014, Janet Yellen will make her first public appearance as chairwoman of the Federal Reserve (Fed). Yellen -- who took over from Ben Bernanke on February 1, 2014 -- will likely "stick to the script" and continue to say that the U.S. economy and labor market are healing and that the scaling back of quantitative easing (QE) that began in December 2013 will continue, but remains data dependent.

Yellen will likely get asked about the recent turmoil in financial markets, slowing growth in emerging markets, and the recent run of weaker-than-expected reports on the nation's labor market, which, in our view, have been negatively impacted by much colder and snowier-than-normal weather in December and January. Yellen will likely make it clear that there is a high hurdle for the Fed to stop or reverse tapering. Although Yellen will likely be peppered with plenty of questions about the labor market, many market participants will want to hear her views on the other side of the Fed's dual mandate -- low and stable inflation.

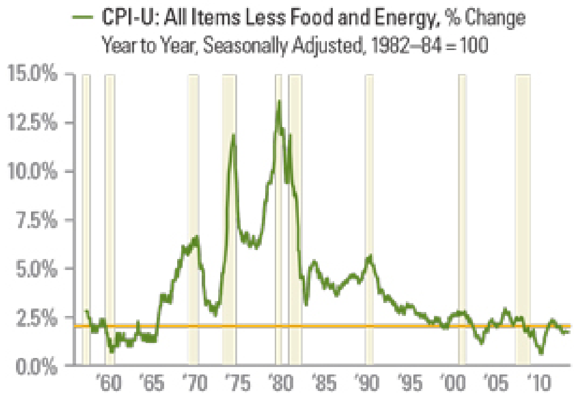
1 The Expansion of the Fed's Balance Sheet Under Quantitative Easing Has Led to Fears of Inflation



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 02/10/14

During her Senate confirmation hearings in November 2013, Yellen noted that "inflation has been running below the Federal Reserve's goal of 2% and is expected to continue to do so for some time." Yellen is viewed by market participants as favoring the "full employment" side of the Fed's dual mandate to promote full employment in the context of price stability, and is more likely to say that inflation is in danger of falling below the Fed's target of 2% than accelerating higher.

2 Inflation Excluding Food and Energy Has Been Decelerating for More Than 30 Years



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

The Discussion: Consumers and Market Participants

But how does that view jibe with the experience of consumers in the U.S. economy making purchases every day in grocery stores, online, and at the gas station? Most consumers would say that there is plenty of inflation, and they have the grocery and gasoline bills to prove it, but the readings on the Consumer Price Index (CPI) suggest that inflation is "well contained," as Ms. Yellen (and other Fed officials) have often noted. Many pundits and politicians however, have been saying since the Fed began its QE program in 2008 that inflation was likely to soar in response. Who is right?

3 The Market's Inflation Expectations Have Been "Well Contained" for Over a Decade

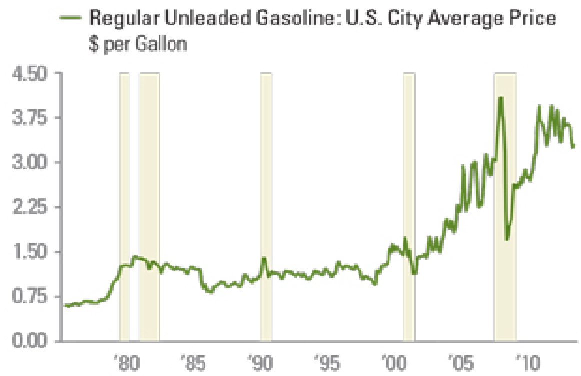
Source: LPL Financial Research, Haver Analytics 02/10/14

Market participants' view of inflation -- as measured by the difference between the yield on the 10-year Treasury note and 10-year Treasury Inflation-Protected Securities (TIPS) -- is similar to the Fed's view that inflation remains well contained. In addition, recent consumer surveys (via the University of Michigan's Survey of Consumers) and professional forecasters (via the Philadelphia Fed's Survey of Professional Forecasts) reveal that inflation expectations remain well contained. The latest (January 2014) University of Michigan survey revealed that consumers expected 2.9% inflation over the next five to 10 years. This reading is taken twice a month every month, and has been in a narrow range between 2.6% and 3.0% for all but a few months over the past 16 years. Similarly, the Survey of Professional Forecasters finds that professional forecasters expect inflation to average 2.3% over the next 10 years. This group has not forecasted inflation over 2.5% since 1999.

The Discussion: Consumers and Businesses

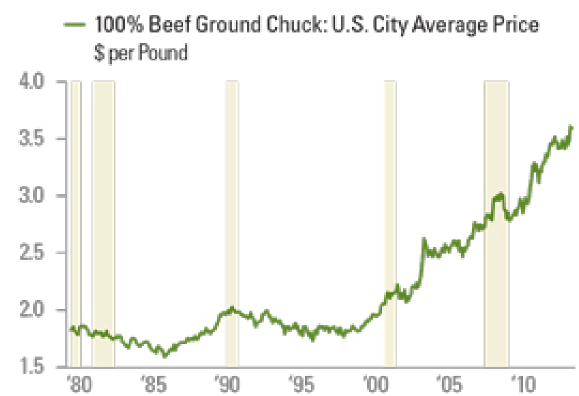
But what about consumers and businesses (small and large) making purchases in the economy every day? Are they seeing inflation? The answer is clearly yes. For example, Figure 4 shows that in the mid-1970s, a gallon of unleaded regular gasoline cost around $0.60. Today, a gallon of gasoline costs just under $3.40. That increase represents a gain of nearly 500%, or an average increase of 4.5% per year over the past 38 years. There has been plenty of inflation at the gas pump over the past four decades. At the grocery store, a pound of beef has increased from around $1.80 per pound in 1980 to nearly $3.60 per pound today, doubling in the past 30-plus years [Figure 5]. That's inflation! Moving over to the bread aisle, the price of a loaf of bread has increased from around 50 cents in 1980 to nearly $1.40 today. Bread prices have nearly tripled in the past 30+ years, and yet consumers (and businesses) hear every day that inflation is "well contained" [Figure 6].

4 Gasoline Prices Have Increased Five-Fold Since the Late 1970s



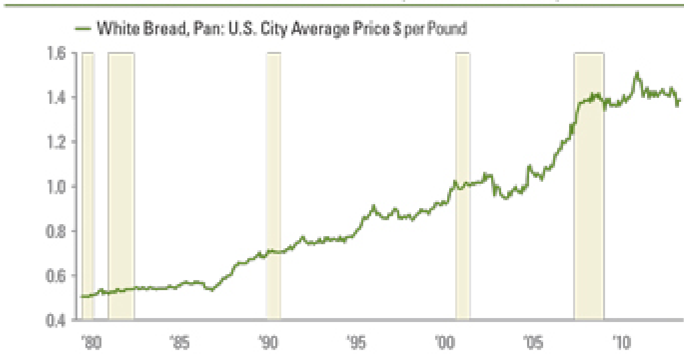
Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

5 Beef Prices Have More Than Doubled in the Past 30 Years



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

6 A Loaf of Bread Cost Three Times as Much Today as it Did in the Early 1980s



Source: LPL Financial Research, Bureau of Labor Statistics, Haver Analytics 02/10/14

We cited just a few examples here, but we could extend the exercise well beyond the gasoline station and grocery store and find many other items that have experienced similar increases in prices in the past 30 to 40 years, including education, and of course, health care. So why the disconnect between what people see (and pay) and what policymakers tell us about inflation? How can prices for gasoline and beef and bread be so much higher, and yet, policymakers and inflation indices (such as the CPI) and even market-based measures of inflation tell us, essentially, that there is no inflation? Part of the explanation is an adjustment for quality, but of course that doesn't apply to a loaf of bread or a pound of beef. But how much we buy of each product, and importantly, definitions of terms like "inflation," "inflation rate," and "the price level" are also a part of the conversation. Stay tuned.

This discussion is all part of the inflation conversation, a conversation that Janet Yellen may be involved in later this week with members of Congress, a conversation that we have looked at in prior editions of the *Weekly Economic Commentary* (most recently in *Inflation Situation Revisited* from March 18, 2013), and a conversation we will continue to pursue in future editions of the *Weekly Economic Commentary*.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI) -- while providing a real rate of return guaranteed by the U.S. government.

INDEX DESCRIPTIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The MCSI uses telephone surveys to gather information on consumer expectations regarding the overall economy. Philadelphia Federal Index is a regional federal-reserve-bank index measuring changes in business growth. The index is constructed from a survey of participants who voluntarily answer questions regarding the direction of change in their overall business activities. The survey is a measure of regional manufacturing growth. When the index is above 0 it indicates factory-sector growth, and when below 0 indicates contraction.

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Tracking #1-244918 (Exp. 02/15)

Weekly Market Commentary | Week of February 10, 2014

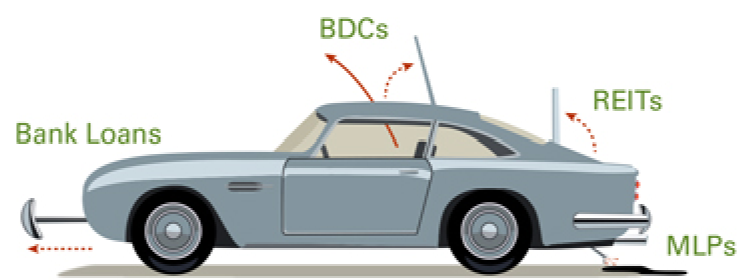
Highlights

50 years ago, in the James Bond movie *Goldfinger*, an alternative to the traditional car helped Bond out of some risky situations. 50 years later, bonds are facing a risky situation -- and alternatives to traditional investments may help to capitalize on it.

Add More Bond -- James Bond -- to Your Portfolio

It was 1964, 50 years ago, that the film *Goldfinger* debuted. It is the quintessential James Bond film and the first one to win an Academy Award. In *Goldfinger*, Q -- the head of the gadget-making "Q-Branch" -- presents Bond an alternative to the traditional car. It can emit an oil slick and has a battering ram, a pop-up rear bulletproof screen, and even an ejector seat. These gadgets helped Bond make the best of some risky situations. Now, 50 years later, bonds are facing a risky situation -- and alternative investments may help to make the best of it.

1 Alternatives to the Traditional

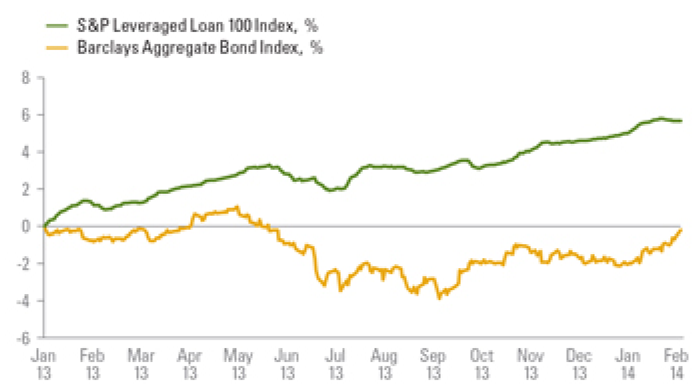


Source: LPL Financial Research 02/10/14

Although not part of the overall bond market measured by the Barclays Capital Aggregate Bond Index, the high-yield and municipal bonds we favor for 2014 are considered traditional investments. As your "Q-Branch," LPL Financial Research would like to present you with some alternatives to traditional investments that may be helpful in 2014 as faster growth may lead to higher interest rates and flat returns for the bond market: bank loans, business development companies (BDCs), real estate investment trusts (REITs), and master limited partnerships (MLPs).

- **Bank loans**. Bank loans are an alternative that seeks to offer an attractive yield and less interest rate risk for 2014. The interest rates on these loans made to businesses float higher with short-term interest rates. While bank loans can suffer losses when economic growth deteriorates and negatively impacts the ability of companies to repay their borrowings, we expect solid economic growth in 2014. Finally, they behaved well in last year's interest rate run-up from May to July, as you can see in Figure 2.

2 Bank Loans Provided a Solid Ride in 2013's Rising Rate Environment



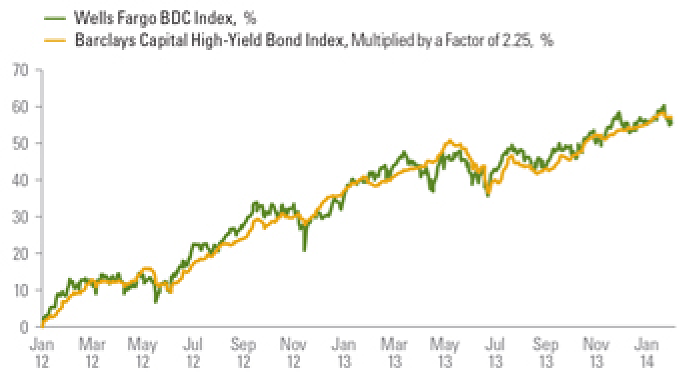
Source: LPL Financial Research, Bloomberg data 02/10/14

All indices are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

Past performance is no guarantee of future results.

- **BDCs**. Business development companies function like banks by lending money to businesses. BDCs have flexibility to go beyond the most senior structured loans, so they can have more credit risk if the economy deteriorates, resulting in companies being unable to repay their debts. Illustrating this heightened leverage and credit exposure, the Wells Fargo BDC Index has behaved like 2.25 times the Barclays Capital High Yield Bond Index, as you can see in Figure 3. It is a good idea to keep the 2.25 factor in mind when considering weighting and overall portfolio credit exposure.

3 Keep the 2.25 Factor in Mind When Allocating to BDCs



Source: LPL Financial Research, Bloomberg data 02/10/14

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- **REITs**. Looking back over the past 20 years, REITs (measured by the NAREIT Index) have generally provided solid yields and strong total returns with the exception of poor relative returns in 1998-99, 2007-08, and 2013. In 2013, REIT returns were similar in magnitude to 2002 and 1994, when they outperformed stocks and bonds, but in 2013 the S&P 500 Index outperformed REITs by a margin of about 30 percentage points. In 2007-08, credit conditions and the bursting of a real estate bubble were the problems contributing to REIT losses -- something we do not expect to see in 2014. However, in 1998-99 and in 2013, we saw rising interest rates and a move by the Federal Reserve to become less bond market friendly. We expect that to be the case in 2014 as well. In 2013, interest rates went up in the late spring and early summer without being accompanied by better economic growth and that led to poor returns for REITs and remains a risk for 2014. However, in 2014 we expect better growth to accompany the rise in rates -- making a better environment for REITs as occupancy and rents rise. From a valuation perspective, REITs are fairly valued on historical metrics like discount to net asset value, price to funds from operations, and spreads to BBB bonds. While they may fare better in 2014 than in 2013, REITs still face headwinds from rising interest rates, making REITs likely to underperform stocks, but outperform bonds.

- **MLPs**. In comparison to REITs, rising U.S. liquid fuel transportation needs may make MLPs that operate pipelines able to re-price rents and keep up with rising rates in 2014. A key beneficiary of the American energy renaissance, pipelines are seeing strong volume growth. In 2013, MLPs provided solid mid-single digit yields and posted double-digit total returns that nearly kept up with the soaring stock market (the Alerian MLP Index produced a total return of 27.6% in 2013, less than 5% below the 32.4% for the S&P 500). The U.S. Energy Information Agency forecasts transportation of U.S. crude oil production will continue to grow in 2014 near last year's growth rate of 16%. Rising transportation demand may help to support another year of solid performance for MLPs in 2014 despite the risk posed by higher interest rates and some degree of commodity price sensitivity.

The alternative features installed in his car that helped to make Bond safer were not safety equipment. But used in the right way, they did help to protect him and provided an advantage when facing certain risky situations. The alternative investments featured here are not safer investments. But, used the right way, they may provide some protection from the risks and the potential to capitalize on the opportunities we believe investors face in 2014.

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Stock and mutual fund investing involves risk including loss of principal.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

Alternative strategies may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Investing in bank loans involve risks including credit, default, interest rate and liquidity risk.

Investing in BDCs involves risks including Credit, illiquidity, leverage, valuations, pricing, capital structure, distribution coverage, and others outlined in the prospectus or if available, summary prospectus.

There are risks specifically associated with investing in real estate products and real estate investment trusts (REITs). They involve risks associated with debt, illiquidity, adverse changes in general market conditions, changes in governmental, tax, real estate and zoning laws and regulations, and for some products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.

Investing in MLPs involves additional risks as compared to the risks of investing in common stock, including risks related to cash flow, dilution and voting rights. MLPs may trade less frequently than larger companies due to their smaller capitalizations which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLP funds.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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Could You Be Subject to the Alternative Minimum Tax?

Unlike regular taxes, you cannot claim exemptions for yourself or other dependents, nor may you claim the standard deduction.

The alternative minimum tax (AMT) was originally created as a fallback tax for wealthy taxpayers who avoided regular taxes by claiming many exemptions and deductibles. Now, however, more individuals are finding themselves subject to the AMT. The mechanics of the AMT are complex. But a general understanding of how the tax works can help you avoid it and even use it to your advantage.

What Triggers the AMT?

The AMT truly functions as an "alternative" tax system. It has its own set of rates and rules for deductions, which are more restrictive than the regular rules. It operates in parallel with the regular income tax system in that if you're already paying at least as much under the "regular" income tax as you would under AMT, you don't have to pay it. But if your regular tax falls below this minimum, you have to make up the difference by paying the alternative minimum tax.

The AMT can be triggered by a number of different variables. Certain circumstances and tax items are likely to trigger the AMT, including the following:

- Your gross income is $100,000 or higher.
- You have large numbers of personal exemptions.
- You have significant itemized deductions for state and local taxes, home equity loan interest, deductible medical expenses, or other miscellaneous deductions.
- You exercised incentive stock options (ISOs) during the year.
- You had a large capital gain.
- You own a business, rental properties, partnership interests, or S corporation stock.

To find out if you are subject to the AMT, fill out the worksheets provided with the instructions to Form 1040 or complete Form 6251, Alternative Minimum Tax -- Individuals.

AMT rates start at 26%, rising to 28% at higher income levels. This compares with regular federal tax rates, which start at 10% and step up to 39.6%. Although the AMT rates may appear to cap out at a lower rate than regular taxes, the AMT calculation allows significantly fewer deductions, making for a potentially bigger bottom-line tax bite.

Unlike regular taxes, you cannot claim exemptions for yourself or other dependents, nor may you claim the standard deduction. You also cannot deduct state and local tax, property tax, and a number of other itemized deductions, including your home-equity loan interest, if the loan proceeds are not used for home improvements. Accordingly, the more exemptions and deductions you normally claim, the more likely it is that you'll have an AMT liability.

Avoiding the AMT

Because large one-time gains and big deductions that trigger the AMT are sometimes controllable, you may be able to avoid or minimize the impact of the AMT by planning ahead. Here are some practical suggestions.

- **Time your capital gains.** You may be able to delay an asset sale until after the end of the year, or spread a gain over a number of years by using an installment sale. If you're looking to liquidate an investment with a long-term gain, you should review your AMT consequences and determine what impact such a sale might have.
- **Time your deductible expenses.** When possible, time payments of state and local taxes, home-equity loan interest (if the loan proceeds are not used for home improvements), and other miscellaneous itemized deductions to fall in years when you won't face the AMT. Since they are not AMT deductible, they will go unused in a year when you pay the AMT. The same holds true for medical deductions, which face stricter deduction rules for the AMT.
- **Look before you exercise.** Exercising ISOs is a red flag for triggering the AMT. The AMT on ISO proceeds can be significant. Because ISO tax issues are complex, you should consult with your tax professional before exercising ISOs.

This communication is not intended to be tax advice and should not be treated as such. Each individual's tax situation is different. You should contact your tax professional to discuss your personal situation.

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