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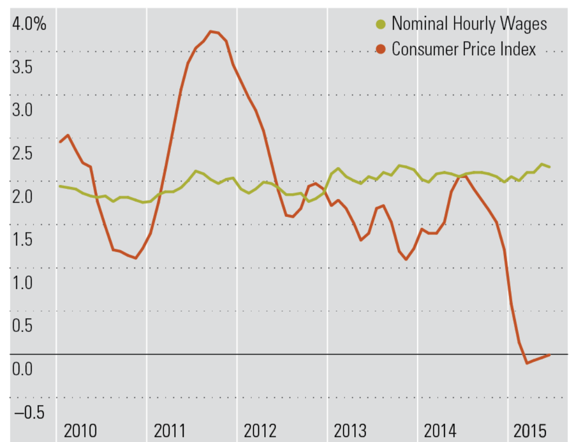
Inflation and Hourly Wage Growth

Inflation and Hourly Wage Growth, Y/Y, 3-Month Average



Source: Bureau of Labor Statistics, Morningstar.

Wage growth is an important leading metric of consumer behavior, as higher wages increase disposable income, which in turn drives more spending. The chart depicts nominal hourly wage growth and the inflation rate (represented by the consumer price index) since 2010. Both metrics are on a year-over-year basis, and averaged for 3 months in order to smooth out the monthly seasonality.

What really stands out is that nominal hourly wages have been growing at a steady 2% rate for many years now, and they have recently accelerated just slightly to about 2.2%. What contributed to a huge increase in the real wage growth (not shown on the chart), however, was the collapse of the inflation rate that began in the second half of 2014, driven by lower oil and gasoline prices.

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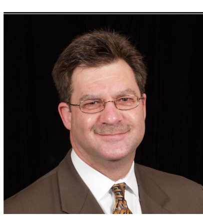

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Our wealth management services include investment management, retirement and gift planning, education funding, and other advisory services.

We take pride in offering you expert financial advice along with personalized service. Assisting you in reaching your financial goals is our business and we take that responsibility very seriously.

For details on the selection criteria used to determine the recipients of the Five Star Wealth Manager award, please visit our web site.

Success Factors for Retirement, Part 1

OK, folks, here's what we're asking you to do. First, save as much money as you can while you're working, despite ongoing expenses. Next, figure out how to invest the money and, once you've gained critical mass on your savings, determine if it's going to be enough. Is it any wonder so many pre-retirees are overwhelmed by retirement planning?

However, there is good news, as well. Some of the key success factors that have the power to make or break a retirement plan can be simple if understood correctly. While investors don’t need to hit the mark on every last one of them, handling the majority of them correctly increases the chances of a successful retirement plan.

Success Factor 1: A Flexible Retirement Date. For investors who analyzed the numbers on their retirement plans and found that their nest egg could come up short, one option to consider is working longer. Doing so can be advantageous on a few different levels. Investors will have more years to save and fewer years to draw from their portfolios. They may also be able to defer Social Security, which can be profitable, especially for people with a longer-than-average life expectancy. Another option to consider is a hybrid strategy, shifting into a lower-paid, but more rewarding and/or less stressful, career. Alternatively, investors could stay put in their current positions but spend (rather than bank) additional retirement-plan contributions. Such a strategy could allow some people to pay for retirement dreams, such as exotic travel, while still working. Additional retirement-plan contributions in your 60s benefit less from tax-deferred compounding than do contributions made earlier on. Of course, working longer isn't always a possibility: Health considerations (for oneself, a spouse, or a parent) may interfere, or aging employees may not be able to hang on to their jobs. That's why working longer can't be the only fallback plan; investors need to make sure they have other success factors working in their favor, too.

Success Factor 2: A Well-Considered Social Security Strategy. Deciding when to file for Social Security is one of the most consequential financial decisions most Americans will make about their retirement. The 1980s and 1990s were all about maximizing portfolio returns. But the specter of twin bear markets in the 2000s, as well as ultra-low interest rates, shone a light on more mundane matters, including trying to get the most out of Social Security. Even casual students of Social Security planning have heard the admonition to not take Social Security at age 62, when they're first eligible, as doing so will result in a permanent cut to benefits. And for people who have longevity on their side, it may be better to delay benefits for as long as possible, because benefits increase for every year from full retirement age until age 70. Keeping those rules of thumb in mind is a great first step toward getting a Social Security plan moving in the right direction, but retirement planners can also take advantage of more sophisticated strategies, especially if they’re part of a married couple. More and more financial planners are focusing on Social Security maximization, and there are also a number of online tools that can help craft a prudent Social Security plan.

Success Factor 3: A Large Enough Stock Allocation. The traditional lifetime glide path calls for accumulators to hold very high weightings in stocks, and then gradually peel back equity exposure as the years go by. But make no mistake: Pre-retirees and retirees may need plenty of stocks, too. The key reason is purchasing-power preservation. If inflation runs at 3%, it's hard to see how a portfolio of nominal bonds and cash yielding 2% to 3% is going to be able to hold up. Of course, there are other ways to hedge inflation risk, but stocks are the asset class with the highest probability of out-earning inflation over time. That argues for most retirees holding at least half of their assets in stocks coming into retirement.

Success Factors for Retirement, Part 2

Of course, holding a higher equity weighting also means higher short-term volatility, but that may be an acceptable trade-off when considering the bigger risk of running out of money prematurely.

Success Factor 4: A Sensible (and Dynamic) Spending Strategy. The size and composition of a retirement portfolio are just one side of the ledger. On the other side? The strategy used for extracting the cash needed from that portfolio on an ongoing basis. Even very large portfolios aren't big enough to last for an entire retirement if the withdrawal, or spending, rate is too high. That's why financial-planning researchers have been focusing so much energy on this area in recent years. Many experts think that the old 4% rule, which involves taking 4% of a portfolio's balance in year one of retirement and inflation-adjusting that amount thereafter, still gives a person with a 60% equity/40% bond portfolio good odds of not outliving their money over a 30-year retirement. But there's also widespread agreement that retirees can greatly improve their portfolios' longevity if they're willing to be flexible about withdrawals, reducing spending in lean years for the market and potentially taking a bit more in good ones. In addition to being willing to adjust their withdrawal rates, retirees may also want to be flexible about withdrawal strategies, using an income-centric approach in more yield-rich eras and relying more on rebalancing proceeds in others.

Success Factor 5: Flexibility on In-Retirement Living Expenses. Even people who aren't in the habit of driving 16-year-old cars (and don't plan to) can make their retirement finances better if they're willing to contemplate a less costly in-retirement lifestyle. One of the easiest ways to bring costs down without throwing quality-of-life considerations out the window is to consider downsizing homes. Like working longer, downsizing can have a positive impact on a few different levels. Even if you own your home free and clear, you're apt to have lower outlays for taxes, utilities, and maintenance costs than you did in your larger home. And the sale of a home that realizes a profit means more money for retirement.

Success Factor 6: Vigilance on Portfolio Costs. As a portfolio's asset allocation gets more conservative over time, its return potential declines as well. This means that investment-related costs, on a percentage basis, will extract an even bigger toll than they did when the portfolios was younger and earning a high return. Let's say a 50% stock/50% bond portfolio earns a 4.5% annualized return, on a pre-expense basis, over the next few decades. Assuming a 3% inflation rate, that's just a 1.5% real return. And unless investors are careful, nearly all of that return could disappear in investment-related and tax costs. After all, it's not unusual for funds to have expenses over 1%, and they're just one piece of the expense pie. The good news is that investment costs are one of the easier factors for investors to control. Another area to focus on is tax management. Retirees may want to hang on to tax-advantaged accounts for as long as possible. When it comes time to pull money out, investors should carefully consider which accounts to withdraw from, with an eye toward staying in the lowest possible tax bracket.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than other asset classes. Investing does not ensure a profitable outcome and always involves risk of loss.

Asset allocation is a method used to help manage risk. It does not ensure a profit or protect against a loss. This is for informational purposes only and should not be considered tax or financial planning advice. Please consult a tax and/or financial professional for advice specific to your individual circumstances.

This article contributed by Christine Benz, Director of Personal Finance with Morningstar.

Monthly Market Commentary

Majority of the needle-moving economic indicators over the past month were roughly in line with expectations, and the chances of an interest rate increase at the next Fed meeting remain high. Nonetheless, the interest rate hike is not a done deal, and the potential of a bad economic report, such as low August employment numbers, could delay the Fed's move.

Employment: According to the BLS the economy added 215,000 jobs in July, close to the consensus estimate of 220,000 jobs. The pace was a bit off of the 249,000-per-month average of the past 12 months, which Morningstar economists never viewed as sustainable. Two barn-burner months at the very end of 2014, especially the 423,000 jobs added in November, are still having a dramatic impact on the averages. Also, the revisions to the prior two months were minimal. After a big drop in June, the unemployment rate remained steady at 5.3% even as the labor force increased by more than 100,000 people.

This headline data should be enough to keep the Fed on pace to raise interest rates in 2015, most likely as early as September given that the employment market looks healthy and inflation is moving slowly toward the Fed target. However, the July data, which is relatively stable with small seasonal adjustment factors, was never really our worry in terms of derailing the Fed. It is the August report, which will be the last report to come out before the Fed's September meeting, that remains the last major impediment for a September rate hike. The August jobs report has been a very rough one over the past several years. This has been especially true for the first version of the August labor report, with subsequent revisions eventually eliminating some of the shortfalls. One recent report actually showed a job loss on the first cut and just last year the originally reported August data was below 100,000 jobs. If this August's job report shows 150,000 or fewer jobs added, the Fed may choose to delay action at its September meeting. Again, it seems extremely likely that rates will be increased in 2015, but the exact meeting date at which it happens is largely irrelevant to the longer-term outlook for the economy.

GDP: Headline GDP growth rate for the second quarter on a sequential, annualized basis increased a modest 2.3% versus expectations of an increase of 2.8% and Morningstar economists' forecast of 3.0%. The metric also ran below the long-term average of 3.1%. However, the goal posts were moved substantially, as the first quarter now showed growth of 0.6% instead of shrinkage of 0.2%, a rather substantial swing of 0.8%. Adding that 0.8% revision to the reported growth rate of 2.3% produces 3.1%, which seems more like an apples-to-apples comparison. So the second quarter wasn't the disappointment that some commentators are making it out to be. In addition, it was a relatively clean quarter with minuscule and offsetting adjustments for inventory and net exports. These two categories have often wreaked havoc on the interpretation of the GDP reports in many recent quarters. For example, falling exports and rising imports deducted almost 2% from the first-quarter GDP report.

China: After moving sharply higher over the past several years, the Chinese government devalued its currency by 1.8%, which is just a drop in the proverbial bucket. If it did one of these each week for the next five, then we might be more concerned. Nevertheless, it is recognition that Chinese growth is not nearly as robust as the government had hoped. And that weakness is not great news for other emerging-market trading partners or commodity producers. Meanwhile, the U.S., which receives just 1% or so of its GDP from sales to China, stands to benefit from cheap commodities more than it will be hurt by weak sales to China. Also, because China has kept such tight control over foreign investment, financial dislocation in China will not reverberate around the world financial markets in the way that U.S. subprime mortgages did.

The Back Page

**"Here's our new retirement plan —
At age 65, we'll get divorced then marry
other people who planned better."**

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