# The COMPASS Chronicle

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## Market Rally Endures

By Louis E. Conrad II, CFA

- The stock and bond markets have both rallied year-to-date, with the bond market's gain especially noteworthy, as interest rates have unexpectedly declined.
- COMPASS' outlook for the capital markets for the balance of 2014 is relatively subdued, however, given the gains already enjoyed by investors and the underlying economic backdrop.

As of late August, the S&P 500, a proxy for U.S. stocks, had advanced 8.0% year-to-date, while international, developed market stocks had gained only 0.4% and emerging market stocks had risen 8.4%. The U.S. bond market also continued its 2014 rally, increasing 4.8%, as the interest rate on the 10-year Treasury unexpectedly declined by 0.70% from 3.0% at year-end 2013.

This year's unexpected bond rally has been supported by less issuance of Treasuries (i.e., less supply) as federal tax receipts have improved with the economy, as well as Treasury purchases by foreigners (i.e., more demand) as yields on European sovereign debt fell below comparable maturity Treasuries.

Stock Market Outlook

COMPASS' expectation for stocks this year is for appreciation roughly in line with underlying earnings, or in the mid- to upper-single digit area. Consequently, given the stock market's gains year-to-date, COMPASS does not expect much further appreciation during the balance of 2014.

For nearly one year, COMPASS has believed the stock market was susceptible to a pause or even a correction (a decline of 10% or more) due to its unusual strength in 2013 and a lack of a meaningful correction since the summer of 2011. However, the largest decline we have experienced over the past twelve months was a six percent decline in early 2014. Corrections are a normal occurrence; in fact, according to research by Capital Research and Management Company, corrections occur, on average, about once per year and last nearly four months.

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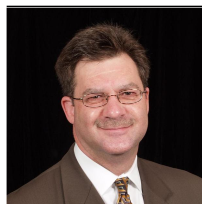

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# Reduce Your Mortgage Payment

By Louis E. Conrad II, CFA

- As mortgage rates have declined over the past several years, many homeowners have refinanced their mortgages to benefit from the drop in interest rates.
- However, for those who wish to pay-down their mortgage balance to benefit from a lower monthly mortgage payment, especially in a rising interest rate environment, another technique can be pursued, called "recasting".

Recently, a client was interested in paying down their mortgage with the goal of reducing their monthly mortgage payment. As I explained to the client, you have two general options to reduce your mortgage payment: (1) refinance your existing mortgage at prevailing interest rates for a term of your choosing or (2) request that your current mortgage company "recast" your mortgage.

You could also make a lump sum payment to the mortgage company and request that the payment be applied to your outstanding balance. However, such a request will reduce the principal due on your existing mortgage and the remaining term (that is, the years left on your mortgage), but it will not reduce your monthly payment. To reduce your monthly payment without refinancing, you would need to pursue a recasting of your mortgage.

Since most people are familiar with the refinancing process, but many are unaware of the recasting process, the focus of this article is on recasting your existing mortgage.

What Is Recasting?

To recast is to ask your mortgage company to re-amortize your existing mortgage while incorporating your lump sum payment. The lump sum payment is often the result of receiving an employment bonus or inheritance. Whether you are allowed to recast is dependent on your mortgage company or the investors who may have purchased your mortgage from the original mortgage company. If a mortgage is allowed to be recast, a non-refundable processing fee of $150 - $250 is normally charged.

Since recasting is really a re-amortization of an existing mortgage, depending on how much you pay-down your mortgage, as well as your remaining term and interest rate, you could end up paying greater interest subsequent to the recasting. How? When you take out a fixed-rate mortgage, your total monthly payment of principal and interest is fixed. However, the interest portion of that payment dwarfs the principal portion of that payment in the early years of the mortgage. As time passes, the amount of your monthly payment that is dedicated to your principal increases and the amount dedicated to interest declines. When you proceed with a recasting, you are resetting this amortization process, whereby the mortgage payments in the initial years (following recasting) are heavily weighted to interest once again, but are calculated on a lower principal balance (because you have pre-paid a portion of the prior principal balance).

The mortgage servicer should be able to provide you with a summary of the interest you would pay under your existing mortgage versus how much you would pay if the existing mortgage was recast. Remember that the interest that you pay on your mortgage is normally a tax-deductible expense and that a recasting does not change your existing mortgage's interest rate or remaining term.

Recast Versus Refinance

The traditional means of reducing your monthly mortgage payment is to pay-down and refinance your existing mortgage. As interest rates have declined over the past few years, this has been a favored technique. However, this option requires a successful underwriting process and has greater up-front costs than a recasting (for example, appraisal fees and closing costs).

In addition, as current mortgage rates may now be higher than the interest rate on your existing mortgage, you may want to recast rather than refinance if you have cash to pay-down your mortgage balance and wish to reduce your monthly payment.

# Should You Buy or Lease Your Next Vehicle?

By Louis E. Conrad II, CFA

- Though many drivers lease their vehicle, this may not be the most advantageous financial decision.
- For those interested in leasing, however, COMPASS has provided some of the key factors to consider.

Each year about 20% of new vehicle transactions are leases, but is leasing the best option? Other than when business use is involved, purchasing a vehicle is usually the better financial decision, though for some, a decision based on lifestyle may trump a decision based purely on economics.

The monthly lease payment will be less than the loan payment for the same car because with a lease, in the most basic terms, you are paying for the vehicle's depreciation during the lease term, whereas with a purchase, you are paying for the entire vehicle cost. In essence, a lease obligates you to pay for the vehicle's depreciation without the benefit of receiving any of the vehicle's equity. A lessee always has a monthly payment and never has any equity. A vehicle owner enjoys the equity, or the difference between the vehicle's value less any loan outstanding. This equity can ultimately be used as a down payment on the next vehicle's purchase.

If you plan to hold onto a vehicle for five or more years, then a purchase is likely to be a better financial decision than a lease. However, factors such as whether you finance a purchase, the available interest rates for purchases versus leases, and how much money is used as a down payment can impact the holding period before a vehicle purchase is less costly than a lease.

Owners hold onto their vehicles for six years on average, according to R.L. Polk & Co. An analysis conducted by Edmunds Inc. determined that the total out-of-pocket costs over six years of purchasing a new vehicle were less than leasing when the equity of the (owned) vehicle was included. Edmunds' analysis assumed the purchase was financed over five years and leasing was comprised of two 3-year leases. The cost difference equated to 28% of the vehicle's original purchase price.

The Decision to Lease

If your circumstances warrant leasing a vehicle, you should be aware of several factors regarding the terms of your lease. First, from a financial perspective, your monthly lease payments should not be the focus. Just as with a vehicle purchase, you should negotiate the lowest purchase price possible (this is known as the "capitalized cost" in the leasing world). The lower your capitalized cost, the lower your monthly lease payment.

But you should also focus on and negotiate two other numbers: the "money factor" and the "residual value." The money factor specifies how much you will pay in finance charges during the lease term. The lower the factor, the lower your monthly lease payment. To convert the money factor to an equivalent annual percentage rate, multiply by 2400. The residual value is the vehicle's predicted value at the end of the lease. The higher the residual value, the lower your monthly lease payment.

Though there are other fees and terms to be aware of, the foregoing are the most critical to determining the cost of your lease. If you exceed the miles allowed in your lease, you will be charged $0.20 - $0.30 per excess mile at the end of the lease. However, if you expect to drive more than the allotted miles, you can elect to pay a higher monthly lease payment from the outset that effectively charges a lower rate for excess miles.

One last suggestion to consider is Guaranteed Auto Protection (GAP) insurance. GAP covers the difference between the insured value of the vehicle and the higher amount you may owe the leasing company if your vehicle is totaled or is stolen. Basically, it covers the immediate depreciation a vehicle suffers upon leaving the dealer's lot. This insurance is usually included by dealers, but not by all banks.

# Monthly Market Commentary

The U.S. market was up 4.19% in August after a modest pullback in July. Some of the drivers of the stock market included monetary policy news from Europe as well a number of generally positive economic news out of the U.S.

Europe: The ECB announced it was reducing several key lending rates and raising the amount it charges banks leaving reserve balances at the central bank. It also revealed that it would be purchasing some covered bonds and asset-based securities. The details on the new programs were sketchy as to timing and amount. Although these were significant and unexpected actions, the ECB did not make the full move to purchase government securities in the area (so-called quantitative easing, or QE). Indeed, by charter, it would be difficult if not impossible for the central bank to buy sovereign debt, a move Germany strongly opposes. In the short run, all of these moves could modestly help the European economy. However, our economists fail to see how moving interest rates that are already so near zero by small fractions is going to change much. Programs to encourage lending, to be implemented shortly, could help slightly more.

Employment: The August jobs report showed employment grew by a puny 142,000 workers compared with the 207,000 workers added on average for the prior 12 months. The figure was well below the consensus of 228,000 jobs and even below Morningstar economists' more modest forecast of 200,000 jobs. Our economists don't view these results as reflective of the current state of the economy and the August jobs report seems inconsistent with other improving labor market indicators. Year-over-year, three-month averaged employment data showed that the private sector employment continued to grow at 2.1%, which is the pace that is consistent with 2.0–2.5% full year GDP growth.

Manufacturing: An array of U.S. manufacturing indicators released in August has shown that the sector is doing incredibly well. Both industrial production and Markit PMI indicated strong growth. U.S. automakers, particularly, are showing signs of strength as both production and sales have risen to 12.85 and 17.50 million units annualized respectively. It is important to note that while manufacturing typically reflects the state of the overall economy, its direct effects on GDP and employment are unfortunately limited, as it is now just a small part of the U.S. economy.

Housing: August was a strong month for the U.S. housing market as starts, permits, existing sales, and pending sales all exceeded expectations. Those great numbers combined with the moderating home price increases (slowing to 8.1% year over year growth in June, according to S&P/Case-Shiller Index) show that the housing market is poised for a health recovery. The slowdown in the price increases is, in particular, a positive development as slowly rising prices help to recover some of the underwater mortgages without drastically ruining affordability. Because of the rapid price increases we experienced throughout 2013, Morningstar economists expect that the price growth moderation will continue at least through the end of 2014.

Retail sales: Consumption is a very important part of the GDP report (about 70%) and often sets the tone for overall economic activity. Retail sales make up about a third of consumption. Excluding the auto industry, which is measured from manufacturers data (and not dealer retail sales), retail sales grew just 0.1% month to month after growth of 0.2% the previous month. Expectations were for growth to accelerate given better employment data. In fact, the consensus, excluding autos, was for growth of 0.4%. Therefore, Morningstar economists are a little suspicious of the July numbers. Weather was good, employment was good, and weekly chain-store sales had shown a marked improvement. Therefore, it is suspected that the July numbers will be revised or August numbers will appear to be unusually strong.

# Market Rally Endures, continued

Stock market corrections that reflect a pause in a bull market advance are not of great concern to COMPASS. However, stock market corrections that reflect the end of a bull market, normally due to an economic decline, are of concern as they will often cause COMPASS to reallocate a client's portfolio. Deciphering which type of correction the stock market is telegraphing is then the key judgment.

Any stock market correction in the near term is expected to be just a pause in the current bull market advance. The U.S. economy is now on solid footing and economic data bears this out. Despite the fact that the current economic expansion has entered its sixth year, COMPASS does not expect an economic recession in the U.S. for at least 1 – 2 more years.

Economic and market cycles have historically lasted about five years on average, so this economic expansion is long in the tooth. However, the growth experienced during the current expansion has been subdued as leverage has been withdrawn from the financial system and the economy has healed from the Great Recession. COMPASS believes this will lead to a longer economic expansion this cycle.

Bond Market Outlook

In regard to the bond market's prospects, the underlying fundamentals of the economy and U.S. bond market point to higher yields, but the lingering effect of the Federal Reserve's policies, low European sovereign debt yields, and a reduction in Treasury debt issuance, have allowed Treasury yields to drift lower year-to-date, leading to an unexpected Treasury bond market rally. COMPASS believes these influences will subside and bond yields will again rise, leading to pressure on bond prices, especially longer term maturities.

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