RBC Wealth Management™

July 20, 2015

"I'm as mad as Hell and I'm not going to take this anymore!"

News anchor Howard Beale in the 1976 film, Network

Dear Friends,

We readily concede that to be in the profession we are in *and* to be mad as Hell after a six year run-up in stocks seems rather odd. Aren't these the times when the corks should be popping and yachts launched? The short answer is, of course, yes. But the absence of champagne is not why we are in a snit. (Although we can think of few better reasons to be snitty than no bubbly.)

For our younger readers who were not around or who were reading Dr. Seuss in 1976, the movie *Network* was about a television station with declining ratings which resorted to broadcasting a variation of the news which required only a passing relationship to reality. As we have watched recent developments in Greece, China, Puerto Rico and elsewhere we find ourselves anxiously waiting for Howard Beale to stick his head out the window and scream, *I'm as mad as Hell and I'm not going to take this anymore!*

A Rant

Capital is precious. Not just the capital you have worked so hard to accumulate, nurture and protect. The capital we are talking about here is the universal kind. It is the stuff which provides financing for factories, roads and bridges, new technologies (venture capital!), creates jobs, carries inventories, and simply facilitates paying bills. If you will, capital is the most basic and necessary of all raw materials required to build and sustain anything of economic value. When we see capital abused, debased or confiscated "legally" because "they" can, we take it as a personal affront. And we worry. It is important to note that how many chips you have in the game is not the issue. We would argue the fellow who has fewer chips actually has a greater need for society to nurture and respect his capital than the woman who has a massive pile-o-chips. Of late there have been a number of developments around the world which indicate that capital is increasingly at risk. With your indulgence, allow us a global rant.

Beware of Greeks Asking for Gifts

The Grecian economy is one-quarter of the size of L.A. How in the world did they manage to accrue $540 billion in loans, bond obligations, central bank liquidity assistance and interbank balances? The short answer is, because they could. Who will bear these losses? You won't find it on the balance sheet of Germany or France or other countries because they used off balance sheet entities to guarantee the loans, loans that don't exist until the guarantee is called upon. Bonds will be sold by the European Monetary Union to cover these promises. Since these creditors are public entities, any losses will ultimately be borne by tax payers. On the domestic front, Greece's four largest banks reported in the first quarter that fully one-third of their loans were non-performing. As a result of this and massive withdrawals, banks closed and ATM withdrawals were limited to sixty euros a day, regardless of how much money was held in an account. Which raises the question, whose money is it? How did Greece, the cradle of democracy, get into this mess? The short answer is that the Grecian government fibbed about its finances, pretended to collect taxes and created a massive bureaucracy in which more than one in every four people worked for government. The government also made commitments to its people it could not keep. Example: it was possible for some people to retire at age 52 after 30 years on the job and then line up for a full pension for maybe another 30 or 35 years. The problem with this largesse is that funds were not set aside to pay for these promises. Nor was the public at large blameless. According to the Wall St. Journal, when Greece entered the Euro in 2001, Grecian banks had extended 24 billion euros in credit to consumers. By 2010, loans had surged to 99 billion euros, a *four fold* increase in borrowing in nine years. If all of this sounds like some form of a national Ponzi scheme, you are correct. Had the normal checks and balances designed to safeguard capital been in place along with competent leaders, lenders and an aware public, it is very unlikely this Greek tragedy would have occurred.

A Misfortune Cookie

Current Wall St. Journal byline: *"China's growth remained at 7% last quarter, Beijing's target for the year, a level economists deem unlikely"*. The story went on to say this announced figure could renew a debate about the reliability of Chinese statistics. Is fudging about the results of an economy a capital offense or just offensive to capital? What we can say is that some very troubling messages are emanating from the world's second largest economy. While it is possible that the 30% drop ($2.4 trillion in losses) in the Chinese stock market over a three week period was just the bursting of a bubble, the government's policies designed to pump up stocks and keep them aloft are both worrisome and consequential. Consider the following steps taken by the government as panic selling accelerated: a $19 billion government fund was created to stabilize stock prices, margin requirements were relaxed, apartments were approved as collateral for stock loans, initial public offerings were halted, rules were changed allowing and mandating that pension funds own stocks, short selling was banned and trading was halted indefinitely in over half of the listings on two major Chinese exchanges. The People's Daily newspaper, the mouthpiece of the party, reported that stock prices would stabilize and "rainbows always appear after rains." For those of us living in the Pacific NW, we know that sometimes floods follow rainstorms, not just rainbows.

The bigger question about this manipulation is why. Why phony figures and why national economic policy includes serving as the huckster-in-chief? Short answer: a highly political agenda fueled with debt. Barron's Magazine opines, "In recent years, the government's overweening control of capital allocation has badly malfunctioned creating white elephant infrastructure projects, a mammoth real estate bubble and other capital spending excesses. That's to be expected in a system rife with self-dealing." State owned enterprises make up a huge portion of the Chinese economy. These businesses are very heavily indebted. A robust stock market provides access to equity capital which in turn could be used to deleverage. Whether the information offered to investors is accurate or if valuations are determined by unfettered markets is secondary to the needs of the state. We doubt that China requires its senior elected officials to file annual wealth disclosures. If they did, it would be interesting to see how large their portfolios are and what was in them. Even more interesting to see would be *what is not*. No particular talent is required to abuse other people's money.

Puerto Rico

Sometimes you just get lucky. In searching for the right metaphor to introduce this transgression, we went online to get the translation of the Spanish word "rico". Sit down for this, it is… *rich*. Puerto Rico translates to Rich Port. At one time, we have no doubt that Puerto Rico did indeed live up to its billing. Just not so much of late. In fact, not at all. Puerto Rico is broke. Its single, non-voting representative in Congress recently lobbied for a change in the law which would permit the commonwealth to file bankruptcy. Think about this for a moment. Government is searching for a vehicle permitting it to simply repudiate debt. How big a number is the debt? $72 billion. How large is this figure in relation to Puerto Rico's economic output? Nearly 70%. How does this figure relate to the states? The most indebted state in relation to its GDP is Rhode Island at 19%. Where do Oregon and Washington stand? About 6 and 8% respectively*.

*Source: World Bank (population, GDP)

How did PR get so far in the hole? Congress failed to renew corporate tax breaks for manufacturing in Puerto Rico in 2006. Factories closed leading the island into a deep recession from which it has not recovered. Real estate prices imploded. Banks failed. Uniquely, Puerto Rican citizens carry US passports and are free to emigrate to the US causing the population to shrink and along with it the economic and tax base. The government's answer was to run massive deficits and step up borrowing. The enabler to this process was Uncle Sam who permits interest paid on Puerto Rican debt to be free from federal, state and local taxes making them seductively attractive to investors. Interest payments on these juiced tax free returns were simply serviced by more borrowing. The proverbial house of cards.

Capital does not vote. It is a storehouse of value and a medium of exchange, not an owner or shareholder. The failure here as much as anything is greedy bond buyers taking inappropriate risks in purchasing the debt issued by the profligate Commonwealth. As we said previously, capital is precious and requires protection. Lending to entities showing deadbeat tendencies certainly does not fit this agenda.

Another Island

Cyprus. The very word conjures up a warm, sleepy Mediterranean clime home to a hard working and welcoming citizenry. Guess again. Cyprus' economy was oddly based on a banking industry which dwarfed in size its economic and population base. Think here: a home for secret bank accounts for shady characters from around Europe. As even money has to be somewhere, the largest Cypriot banks made massive purchases of Greek bonds with deposits. The assumption was that if Greece got into trouble, the EU would stand ready to bail them out. Hence investments in Greek sovereign debt would be a great place to park money deposited by shady characters earning the banks nifty profits. Losses on these investments put literally the entire Cypriot banking industry on the precipice. The solution? In exchange for a 10 billion euro EU bailout, Cyprus officials agreed to close the country's second largest bank among others, impose a "deposit levy" on uninsured deposits (those above 100,000 euros) and a similar *48%* deposit levy on deposits held at the largest commercial bank in Cyprus. These large deposit accounts were largely held by oligarchs and wealthy Russians looking for a tax haven to squirrel away capital for *"safekeeping"* outside of Mother Russia. Bad plan. Let's call this the Bonnie and Clyde solution to a financial crisis. Was there a clause in the new account agreements permitting such a confiscation? We doubt it. Was there a legal basis for the "nationalization" of depositors' money? None that the media has reported. Occam's razor states the simplest explanation is usually correct which meant officials knew there would be little empathy for flight capital stashed in Cyprus. Therefore, simply confiscate it. Despite our lack of compassion for shady characters, the fact remains that governments are clearly able and, in this case, were encouraged by the EU to confiscate private capital when the need arose. Speaking for ourselves, we find such actions disturbing as theft is theft, regardless of the legitimacy of the thief.

Closer to Home

We have saved this miscreant for last as it is the least obvious and therefore the most difficult topic to address: The Federal Reserve. This Washington institution is, in its own way, as powerful as the Central Planning Committee of the People's Republic of China. What it wants is what we all get. At issue is the fact that our central bank long ago committed to maintain microscopic rates only so long as unemployment remained above 6 ½ percent and inflation below 2 percent. These goals have been reached yet the unprecedented and artificial rate environment continues. You fairly might ask, what in the world is wrong with cheap money? Are there unintended consequences? The honest answer is that no one really knows for certain. At this point in our rant, it will not surprise you to hear we have a few theories.

- The current rate policy distorts the economy in ways we cannot fully understand. Not only because it is unprecedented but also because of the massive scope of the US economy. For example, are we building yet another real estate bubble driven by artificially low interest rates?

Stories of homes selling tens or even hundreds of thousands of dollars above asking price in bidding wars are commonplace. Is the culprit hyper low mortgage rates? What *are* the good folks at the Federal Reserve thinking?

- Stock repurchase plans are the order of the day by companies looking to return capital to their holders. The process involves buying back stock and thereby increase reported earnings per share on the remaining shares, commonly funded with cheap debt. Is this temporary demand for shares pumping up stock prices in much the same way as the real estate discussion above? We believe it's fair to state risk becomes elevated when assets are effectively purchased on margin.
- Pensions, particularly those in the public sector, are chronically underfunded. In some states and cities the portion of annual budgets going to feed these pension monsters gobble up more than one third of annual tax revenue. Other needs such as education and infrastructure suffer greatly. What does this have to do with interest rates? Typically over half of pension funds are invested in bonds or mortgages. When rates are forced down by the Federal Reserve, interest earned is below what is required to maintain viable pensions. Riskier assets are purchased as an alternative at a time when risks are elevated. Taxpayers will have to eventually cough up the funds to meet the pensions through higher taxes which, in turn, will dampen the economy. Poor equation.
- Is it lost upon the Federal Reserve that it's a zero sum game between borrowers and lenders? The lower the rate paid by borrowers, the lower the return earned by bond holders and CD buyers. Think about a hypothetical couple living on the coast that retired debt free years ago, and had a small pension and Social Security as their primary sources of monthly income. They also relied upon their $500,000 in savings accumulated over the years invested in CDs at a 5 ½% rate yielding $27,500 per year. Five years later those same CDs paid 1.5% or $7,500, a $20,000 loss in annual income. Who benefited? Borrowers. Clearly the Federal Reserve is picking winners and losers. Is this a business we want them in as opposed to the free market to sort out this equation? Are we the only ones who find it ironic that the Justice Department is negotiating a settlement with large banks which are accused of rigging Libor/interest rates to suit their needs when the Federal Reserve is engaged in the same activity?

Cassandra

Wikipedia describes a Cassandra thusly: "The term originates in Greek mythology. [How convenient for our rant!] Cassandra was a daughter of Priam, King of Troy. Struck by her beauty, Apollo provided her with the gift of prophecy, but when Cassandra refused Apollo's advances, he placed a curse ensuring that nobody would believe her warnings. Cassandra was left with the knowledge of future events but could neither alter these events nor convince others of the validity of her predictions."

We are about to be five pages into this Letter (a dubious record) and have done our level best to convince you, unlike Cassandra, that our concerns have validity. Assuming we have had a degree of success, let's cut to the chase. What does all of this mean for your capital? We are not calling for an imminent bear market (though surely we'll experience one again at some point… all good things eventually come to an end). Nor are we attempting to frighten anyone. Rather, our concerns are already reflected in your accounts in the form of a higher than typical allocation to short term bonds, CDs and cash. Are short term bond returns sexy? No. Will they keep up with stocks if stocks continue to march higher? No. What they will do in uncertain times is to preserve a portion of your capital for the future for a time when valuations are more reasonable and your funds will go farther. Until that time, patience and discipline are the orders of the day. Herewith follows some other action oriented ideas we all may wish to consider adopting.

- As we have seen, taxes are likely to go up. Capital is generally taxed at a lower rate than income: plan on that distinction disappearing. We will attempt to blunt the impact of this dilution of your capital by simply attempting to stretch out holding periods to the greatest extent possible.

- We believe any rise in interest rates is likely to be disappointingly slow. Lower-for-longer will depress the interest earning power of your capital. Do not attempt to solve for this issue by extending out the maturity of the fixed income instruments in which you invest. It's a trap.
- Continue to fund 529 college savings accounts as aggressively as your needs and available resources dictate. President Obama floated a trial balloon at the start of the year to eliminate this program as 529 plans were only used by the wealthy (not true) and duplicated existing programs to fund education (student loans). While this trial balloon was quickly pulled down, the announcement represents the view of at least some elected officials as it relates to these plans.
- President Obama also spoke of revising downward the $10 million exemption for married couples from federal estate taxes literally months after Congress passed this reform and he signed it into law. If you have not done so already, open a dialogue with your attorney as to avenues which may be available to limit future estate taxes by virtue of arrangements you make today. That could include gifting to those you deem worthy during your lifetime.
- Most recently the president also proposed an unspecified form of tax on retirement accounts (IRAs and 401-ks) which were unfairly "too big". How much is too big? We don't know. A place to start would be $2 million, but that is a raw guess on our part. For those of you whose collective family assets in these plans exceed this number, you may wish to start taking out funds prior to the mandatory commencement of payments at age 701/2 in order to limit the growth in your collective plan balances. The logic is simply to attempt to limit exposure to any surtax which could eventually come about on these assets. A corollary to this concept for those of you with charitable intent and who are over age 70 would be to make charitable gifts out of your IRA, currently permitted under the law. You do lose the ability to deduct gifts for tax purposes but you meet your required annual distribution in the process.
- Spend a little less. Save a little more. Work a bit longer. We concede this is the wet blanket solution, but having more capital could come in handy in the event the government comes calling.
- Be glad, very glad that you live in the Good Old USA. While we are clearly on the same track as victims recounted early in this letter, relatively speaking we are on the early laps. A stronger economy and higher taxes balanced our budgets for a short period twenty years ago. As a society we are capable of living within our means if that is the insight and will of the voters. This is not rocket science. And to be fair to the Federal Reserve, Chair Janet Yellen and her predecessor have literally been begging Congress to pick up the fiscal ball and run with it to no avail.

End of rant. Thank you for bearing with us. For all but first time readers, you know we are fond of closing our summer letter with financial counsel as to how to prudently budget for your summer vacation. Last year following two good years we suggested it was time to splurge for Provence and the Cote d' Azure but cautioned you NOT to put a non-refundable deposit on your suite for this year. It was good counsel. Returns on the Dow Jones between Labor Day 2014 and July 1 of this year are 6/10ths of 1% before dividends. As a result, this year we suggest you get the deposit back and use the funds to rent a beach shack for a week at Washington State's Cape Disappointment. Look at the bright side. The summer has been a scorcher, the fog usually burns off by 4 pm at the Cape, and you can play the 9 hole municipal course north of Astoria for about what a beer costs at Bandon Dunes. We are here to help!

Warmest regards,

Steve Spence	Marcia Hull	Kip Acheson	Chris Klavins
Senior Vice President	First Vice President	First Vice President	First Vice President
Sr. Portfolio Manager	Financial Advisor	Financial Advisor	Financial Advisor
Financial Advisor			

The Klavins Report – Musings from Outside the Corner Office

Dear Friends,

I'll leave the investment comments to Steve and instead comment on a less interesting but no less important topic that affects each of you…withdrawal rates. I can anticipate your excitement as you read those words, so I'll type them again: WITHDRAWAL RATES!!!

After a 6+ year bull market during which most accounts posted returns above plan, to include those with more conservative, retiree-appropriate asset allocations in the range of 50-70% stocks or lower, we are seeing evidence among our clientele that the wealth effect is taking hold. The wealth effect is an economist's way of saying that as the stock market rises people *feel* richer and therefore tend to spend more. They take that extra trip. They buy the expensive watch. They consider the Audi A6 instead of the A4. You get the idea.

It is natural to splurge a bit when the market has marched higher for an extended period. However, it is important to guard against meaningful increases in regular, recurring spending. From an actuarial standpoint people expecting their money to last 30-40 years in retirement should typically plan around a 4% distribution rate from their investment accounts. Those planning for a shorter, 20-25 year retirement, or those with 20-25 years remaining, can more realistically plan on a 5% distribution rate and still have a high likelihood of not outliving their capital. To the extent taxes are due as a result of distributions, as they are on IRA withdrawals, taxes must be provisioned for *out of* the 4% or 5% mentioned above, and not *in addition to*.

Keep in mind that the good times are supposed to provide the buffer to help get you through the bad times, and we never know when lean times will hit. We didn't know it in 2007, and what has happened of late in China, wherein a formerly hot market suddenly fell 30% or more in about a month, is a cautionary tale as well. The resurfacing of the Greek debt crisis also has markets on edge. China and Greece we are not, and I have no reason to believe a bear market is at hand in the good ol' US of A, but as we've said over the past year we are somewhat concerned about stock market valuations domestically. That means that we are expecting modest returns over the next few years. And someday, though we wish it weren't so, we will have a correction and another bear market…probably several over the course of our careers.

As a partner on a team that loves to abuse metaphors, I'll take a crack. The root cellar is overflowing after a bumper crop and it is now late November. You've had a few big meals to celebrate your hard work and good fortune, but resist the urge to host the neighborhood for a weekly supper club. The larder must remain well stocked in order to guard against the possibility of a late winter. Let's not run out of potatoes! Metaphor abuse complete.

CK