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WEALTH ADVISORY GROUP
The Polaris Perspective

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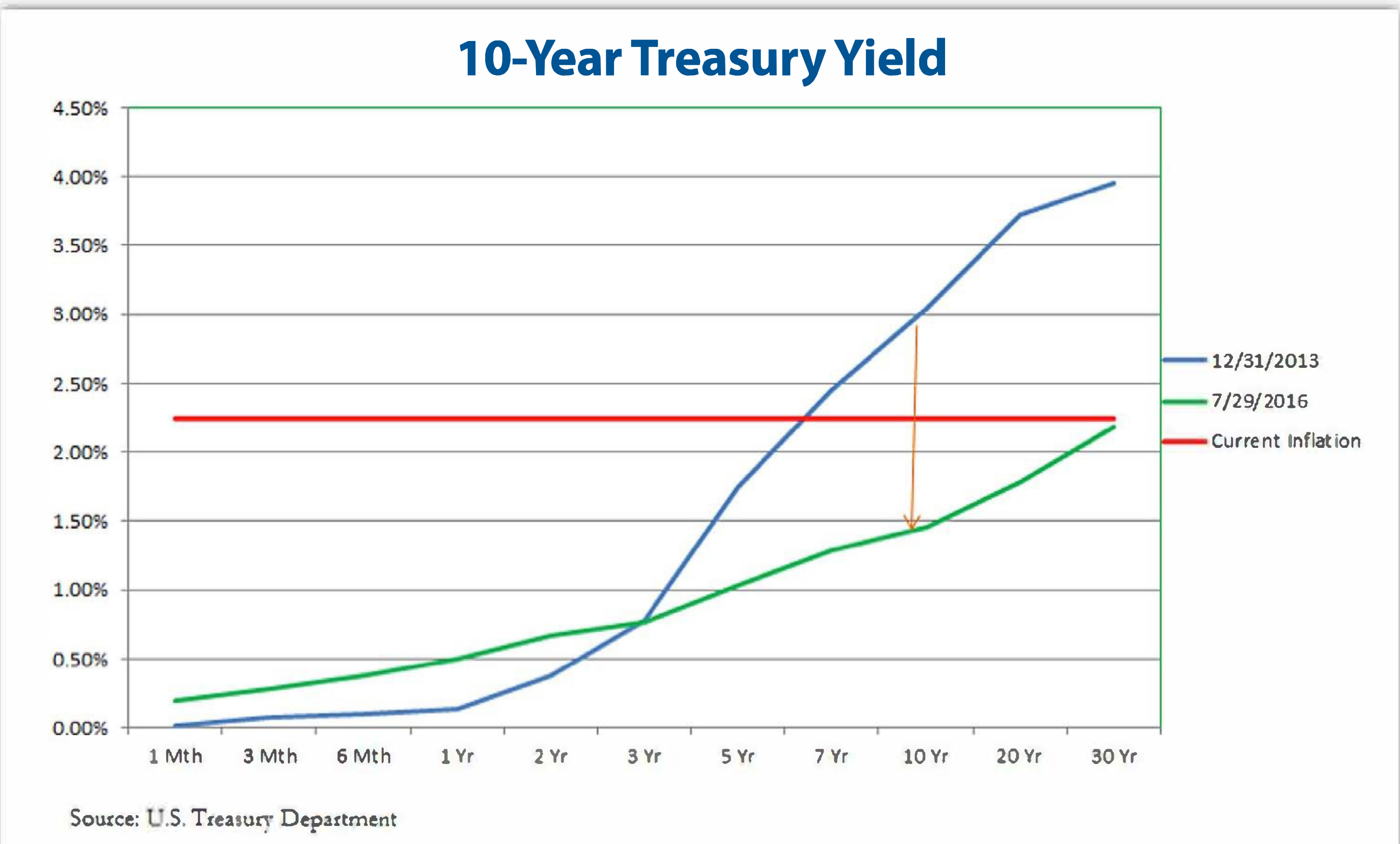
The Retiree Predicament

According to U.S. government census data, there were 76 million people born in the United States between the years of 1946 and 1964. This generation is widely known as the baby boomers. Currently, approximately 10,000 baby boomers retire every day. This generation is entering retirement during one of the most challenging investment time periods in our country's history.

The financial industry is full of easy-to-remember adages designed to help investors better manage their portfolios. One such adage is "have the same percentage of bonds in your portfolio as your age." Historically, this has been fairly good advice. This advice encourages an investor to become more conservative with their portfolio the closer they get to retirement. Unfortunately, due to current market conditions, this advice could lead to tremendous losses.

The yield on the 10-year Treasury has dropped from approximately 3%, at the end of 2013, to under 1.50% by the end of July (see chart below). This unprecedented move has occurred despite the Federal Reserve raising rates for the first time in seven years at the end of 2015. This should lead most investors to a few questions: **1) why has yield dropped so much; 2) what impact does it have on me as an investor;** and **3) how should I invest from here?**



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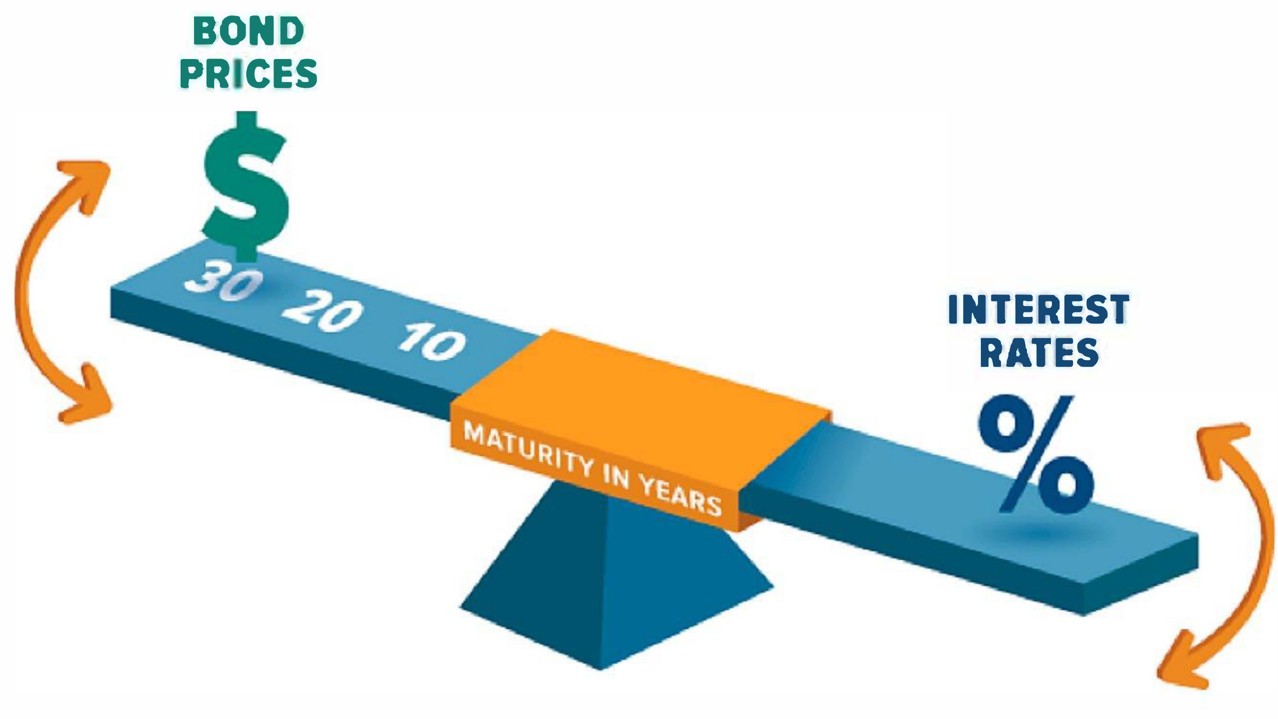

Source: U.S. Global Investors

1) Why Has Yield Dropped So Much?

Typically, if the Federal Reserve raises interest rates, bond prices drop (as shown in the example above). This is not what has happened this time. Bond prices have skyrocketed, forcing bond yields down, due to the monetary policy taken on by many central banks. Across the globe, central banks are trying to stimulate their economies through quantitative easing (just as we did to recover from the Great Recession). In 2016, stimulus packages have been announced by a number of foreign central banks, including: the People's Bank of China, the Bank of Japan, the European Central Bank, and the Bank of England. The dollar has strengthened against most major currencies as a result. For example, the British pound to dollar exchange rate in 2014 was as high as $1.71 per pound. As of August 15, 2016, the pound had dropped to $1.28. The euro has dropped from $1.39 in 2014 to $1.11 on July 31, 2015. As you can see on the next page, the euro was as high as $1.47 back in 2011. The Chinese yuan, the Canadian dollar, the Australian dollar, the Mexican peso, and the Russian ruble are just a few examples of currencies that have all dropped significantly to the dollar in the past few years. Only the Japanese yen has strengthened against the dollar in the past two years.

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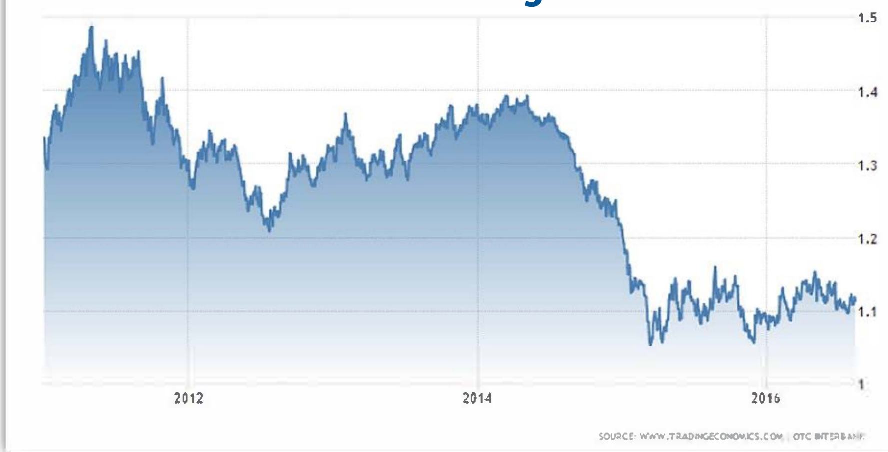
The dollar's strength is only part of the picture. Another significant reason foreigners are investing so heavily in the 10-year Treasury is due to the bond yields they are receiving at home. As you can see to the right, a 10-year German bond has a negative yield, costing an investor -0.07% per year. Japanese 10-year bonds will cost you -0.09% per year. According to the Financial Times, as of August 12th there was a $13.4 trillion universe of sub-zero yielding debt, primarily of government bonds in Europe and Japan.

What investor would decide to invest in either bond? For every $100,000 that you invest in German bonds, you will get $99,300 back in 10 years' time. I don't know many people who would sign up for that investment.

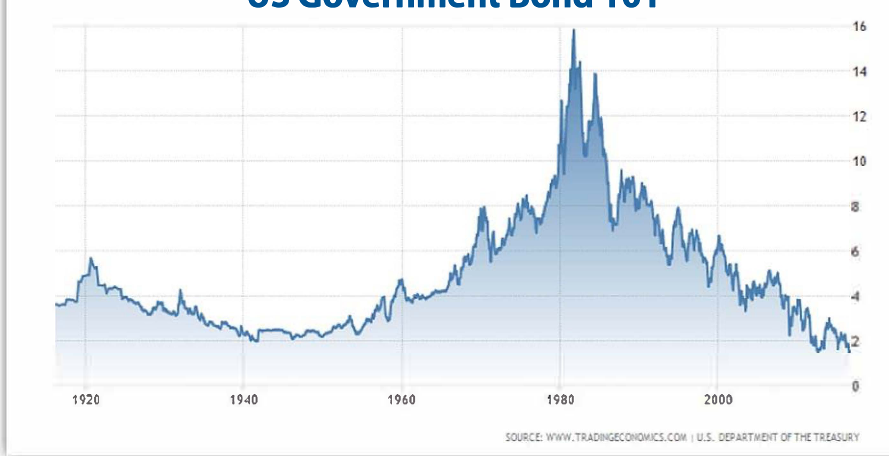
The result has been a flood of foreign investors looking for "safe," dollar-denominated bonds that pay a decent yield. This excess demand has pushed prices up and yield down to historic low levels. As you can see from the graph to the right, bond yields have not been this low in over 100 years.

EURUSD Exchange Rate



Germany Government Bond 10Y

US Government Bond 10Y



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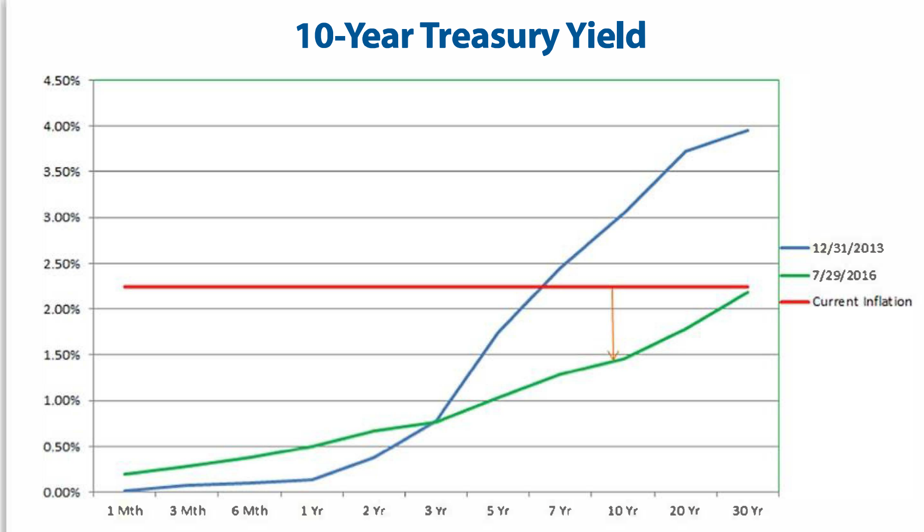
2) What Impact Does It Have on Me as an Investor?

There are several ways that this historic move in the bond market might impact you as an investor.

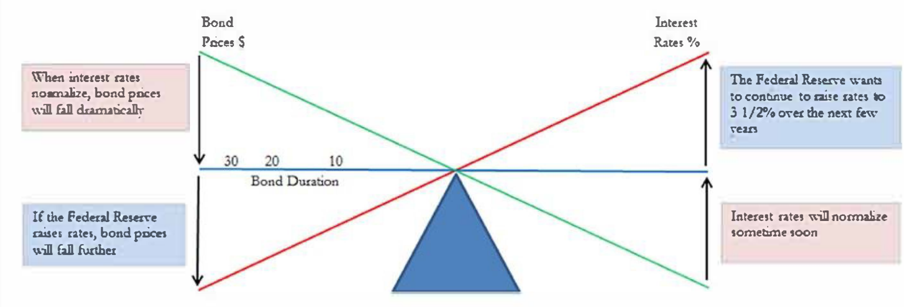
1 **Loss of Buying Power:** Right now the 10-year Treasury is paying a current yield of approximately 1.50%. Current inflation is approximately 2.25%. Assuming that inflation remains at its current levels, an investor buying a 10-year bond is losing 0.75% of their buying power each year (see below), or 7.5% of buying power over a ten year time period. While your statement will show an account that is growing, in reality you are losing buying power. A $100,000 10-year treasury portfolio would only be able to buy $92,500 worth of goods 10 years later.

2 **Normalization of Yields:** According to Polaris Wealth Advisory Group research, if 10-year treasury yields normalize and go up to their 2013 levels, current bond holders could see a price drop of almost 13% of the value of their investment. Owners of 30-year Treasuries would experience a 30% loss of your principal value.

3 **Fed Raises Rates:** Janet Yellen publicly stated that the Federal Reserve would like to raise rates to 3.5% by the end of 2018. There is debate if the U.S. economy could withstand such a move or if the U.S. government could afford the interest payments if rates got this high. What we know for certain is that the Federal Reserve wishes to continue to move rates higher, which could have a material and negative impact on intermediate and long-term bonds. If bond yields normalize and then the Federal Reserve moves fed fund rates to 3.5%, a 10-year treasury could lose up to 35% of its value and the 30-year treasury could lose over 60% of its value.



Source: U.S. Treasury Department



Source: Polaris Greystone Financial Group

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3) How Should I Invest From Here?

This is an extraordinarily difficult question to answer for all readers. It truly depends on what percentage of your portfolio you need to draw upon in retirement to support your lifestyle needs and/or what legacy you wish to leave to heirs or charity at your passing. If you are unclear what your needs are or wish to get a second opinion, please arrange a time to have your wealth advisor at Polaris Wealth run an up-to-date financial plan for you. This is a complimentary service of our firm.

Our unprecedented markets require a progressive way of thinking of how to invest for one's long-term financial needs. Polaris Wealth has conducted several studies of how to invest in low and rising interest rate environments. Please reference our **February 2015 report, "What is Risk?"** for more detail. In summary, an investor who is looking to preserve their buying power must grow their portfolio in order to offset inflation during rising interest rate environments. This means that an investor should allocate more of their portfolio to stocks than they would typically have thought or have been guided by an advisor who is relying on what worked in days past.

Why You Should Consider Increasing Your Stock Exposure

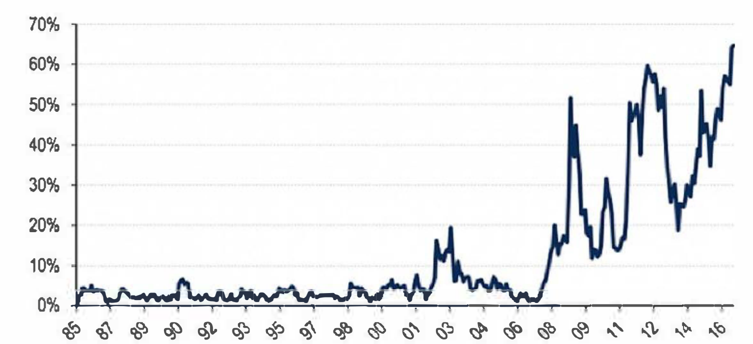
1 According to Standard & Poor, the current dividend yield of the S&P 500 is 2%. Owning these stocks would result in a 33% increase in income over the 10-year Treasury.

2 The percentage of S&P 500 companies paying a higher dividend yield than the 10-year Treasury yield is at a 30 year high (see to the right). This means that you have a lot of stocks to choose from that can provide you with better income than the 10-year Treasury, plus there's the potential growth of the underlying value of the stock.

3 The S&P 500 corporate earnings per share peaked in the 3rd quarter of 2014. Since then, we have been in a six quarter earnings recession. While Q1 2016 earnings were below what they were a year ago, they are above Q4 2015.

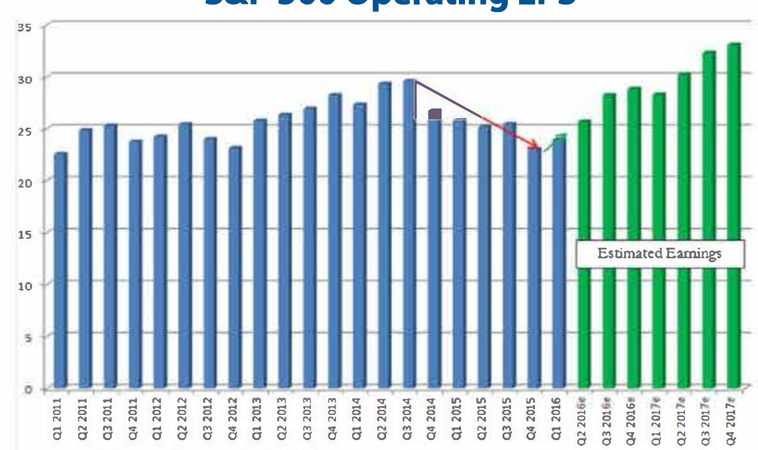
Consensus analysts estimate project an earnings resurgence for Q2 2016 and beyond (the bars in green). Their projections are that earnings will improve dramatically over the foreseeable future.

Chart 1: % of S&P 500 Stocks with Trailing Dividend Yield > 10-yr Treasury Yield



Source: BofAML US Equity and Quant Strategy, Standard & Poor's, Bloomberg

S&P 500 Operating EPS



Source: Standard & Poors, Polaris Wealth Advisory Group

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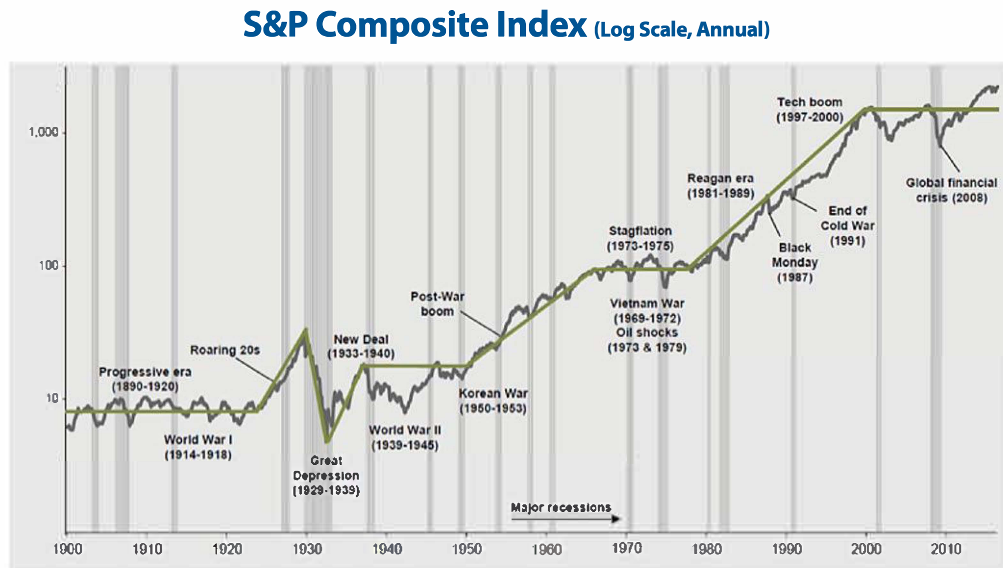
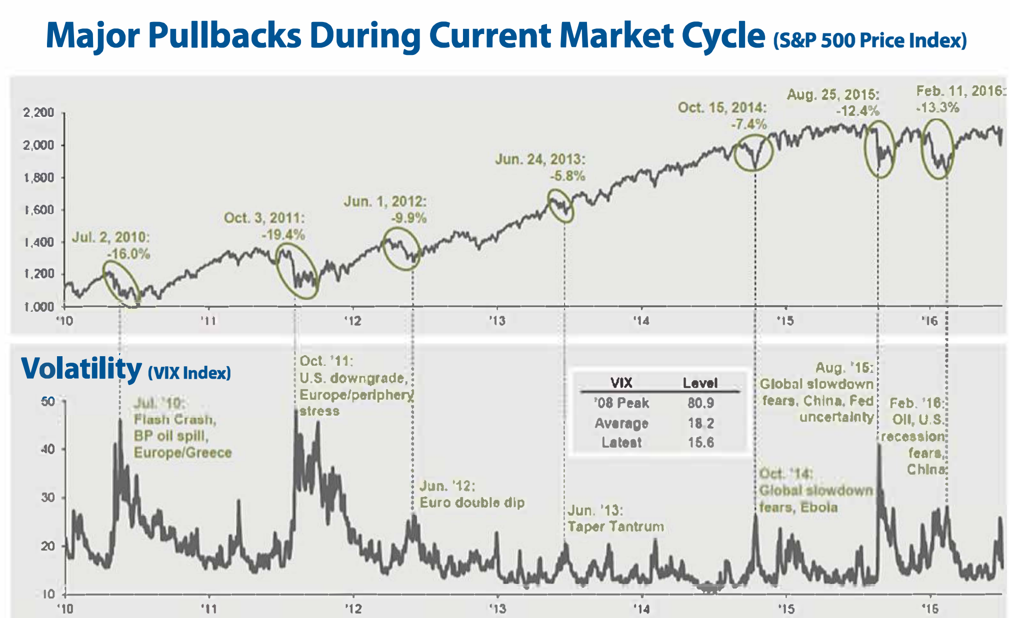
4 We are several years into a secular (long-term) bull market for stocks. As you can see from the chart to the right, these tend to be long, profitable times for stock investors. The average secular bull market lasts 14 years, with the shortest lasting 9 years. Some analysts say we began our secular bull market in 2009 while others argue that it began in 2013. Either way, it would appear that we have many more years of good markets ahead of us.



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of June 30, 2016.

5 Drops in the equity market should be viewed as a buying opportunity during a secular bull market. If you take a look at the chart to the right, the pull backs that we've experienced over the past six years have been short-lived.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management; (Bottom) CBOE.
Drawdowns are calculated as the prior peak to the lowest point.
Guide to the Markets – U.S. Data are as of June 30, 2016.

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Conclusion

I hate to continue to use this phrase but we are truly dealing with "unprecedented" times. While bonds are normally thought of as a "safe" investment, some types of bonds could prove to be the unraveling of traditional portfolios. Retirees are at greatest risk, due to their typical reliance on bonds to provide current income during their non-working years.

The intermediate and long-term U.S. bond market will normalize. When this happens, bond prices will fall. It not a question of if it will happen, just when. Why am I so certain?

Here are a Few Facts:

- Over the past two years, prices have been driven up due to excess demand for U.S. bonds. This has been due to the introduction of near zero and sub-zero yielding government debt issued by many countries in Europe and Asia. The strength of the U.S. dollar has made the investment in U.S. bonds more attractive for foreign investors.
- The U.S. Federal Reserve has publicly mapped out its desire to move fed fund rates to 3.50%. They are currently at 0.50%. This move would cause substantial losses for intermediate and long-term investors (as we've discussed).
- The euro has stabilized and started to strengthen against the dollar. The yen has been strengthening against the dollar for the last year. While both currencies are still low to the dollar in historical terms, their strength will evaporate the higher income that a foreign investor would experience by investing in a U.S. Treasury.
- Domestic investors have begun to seek out other alternatives to provide their income needs. The 10-year Treasury has a -0.75% real annual return.
- It's already starting. The 10-year Treasury was as low as 1.32% in early July. As of August 19th, rates have popped up to 1.58%. According to Reuters, foreign investors have sold over $200 billion in Treasuries this year. This is more than twice the rate in which they sold last year.

As we discussed, price and yield have an inverted relationship. When demand subsides, prices will plummet as yield normalizes. When it does, there will be tremendous losses experienced by investors who extended the maturity of the bonds in their portfolio in an attempt to get more yield from their portfolio.

These complex times require a retiree to truly understand the interconnectivity of all markets and how they influence each other. Unusual times require an investor to think outside the conventional box to have a prosperous retirement. We would highly recommend that you re-evaluate the percentage allocation of bonds in your portfolio, the types of bonds you own, and the maturity of bonds in your portfolio. Please arrange a time to meet with your wealth advisor at Polaris Wealth to start this process.

As always, I welcome your questions or comments.

Sincerely,

Jeffrey J. Powell
Managing Partner