

ParsecFinancial

First Quarter 2007 Newsletter

Financial Advice and Planning

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Special Points of Interest

- ◆ Signs of an economic slowdown?
- ◆ Parsec welcomes Leslie Fay and Stephen Mobley
- ◆ First quarter Parsec Prize awarded to Pisgah Legal Services

We are often asked, "What is the best way to save for my child's education?" Whether it's UNC Chapel Hill (\$13,500/year) or Duke (\$46,000/year), many parents are ill prepared for the small fortune it will take to pay for four years of education, let alone graduate or even post graduate education. It may come as a shock, but when today's first-grader is ready for a four year education at UNC Chapel Hill, the price tag could be as much as \$105,000, assuming a modest 5 percent inflation factor.

With retirement savings on the minds of many parents, it leaves them with the question of where to save for this future expense. There are several avenues to fund a child's college education; we will address two that we favor.

A 529 College Savings plan is an excellent way to save for your child's education. These plans offer tax deferred growth with competitive investment options ranging from age-based to static funds at reasonable fees and yearly expenses. Although qualified withdrawals are federally income tax free, careful attention should be paid to the type of expense paid. Non-qualifying expenses come with a 10 percent penalty as well as federal and state income tax. Also, these accounts must be for the benefit of your child or a qualifying relative; parents who later learn that their child does not wish to further their education can change the beneficiary to a qualifying relative of the parent; that is, the parent can name themselves or any other child as their beneficiary; other relatives may qualify as well.

There are a variety of favorable plans to choose from, two of which are the North Carolina National College Savings 529 and the Vanguard Nevada 529 savings plans. Currently, the North Carolina plan offers residents a tax deduction depending on their adjusted gross income. (This is a new entitlement and is currently set to phase out in 2010.) Both plans have Vanguard investment options; however, the Nevada plan does not currently allow a tax deduction benefit. The low fees on the investment options through both plans are attractive and parents should bear in mind the maximum gift tax exclusion amount of \$60,000, using the aggregated 5-year contribution rule.

Parents may also be given the choice of pre-paying their child's tuition through the 529 plan. Prepaid tuition is an available option with most colleges and universities and offers parents the ability to pay for their child's education at today's rates, as opposed to the inflated rates in the future.

The second savings vehicle Parsec favors is a custodial account often referred to as an UTMA/UGMA. These accounts are considered the child's asset and therefore must be used for their benefit. Earnings on these accounts are typically taxed according to the "Kiddie Tax" rules. This tax applies to children 18 years old and under, as per the Tax Reconciliation Act of 2005 recently signed into legislation, and is applied to unearned income. Currently, the first \$850 is sheltered by the standard deduction, the next \$850 is taxed at 10%, and any remaining unearned income is taxed at the parent's

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marginal tax rate. Parents should note that once the child reaches the age of majority (18 or 21, depending on the state of residence) the child can authorize the withdrawal of the entire account balance.

The benefit of the custodial account is that it can be used for any purpose that benefits the minor. Parents and family members are free to gift as much and as often as they like. Although attention should be paid the Federal gift tax exclusion of \$12,000 per year, gifts above this amount may incur a gift tax. Funds from this type of account can be used for virtually any expenses related to the child's welfare, including college education expenses.

A key to remember is that although the 529 and custodial account can be used in paying for the child's college education, there are rules that govern the withdrawal procedure. To simplify the rules, the 529 can only be used for qualified educational purposes to avoid the 10% penalty imposed; whereas, the custodial account can be used for anything that benefits the child, education or otherwise.

Which type of account, if either, is best for you depends on your personal situation. We encourage you to speak with your advisor if you have questions or concerns.

Dr. Jim Smith's Economic Commentary

So far in 2007, many indicators of the health of the U.S. economy are flashing warning signs. Whether these simply suggest a short-term slowing in an expansion that will continue for several more years as the overwhelming majority of economic forecasters believe or they are harbingers of a recession coming soon, which is my forecast, remains to be seen. In any event, they are sending out cautionary warnings at the same time the stock market is hitting so many new highs that it has finally recouped all the \$8.8 trillion loss of wealth from the 2000-2002 crash.

One of the most important indicators of the state of the economy is the manufacturing index published on the first business day of every month by the Institute for Supply Management (www.ism.ws). This index is an excellent leading indicator of not only industrial production and the entire manufacturing sector of the economy, but also of the growth rate of real gross domestic product (GDP—the total value of all the goods and services produced for final demand within the borders of a country after adjusting for inflation). Values of the index below 50.0 percent mean the manufacturing sector is generally declining while values above this level indicate it is expanding. For overall real GDP, an index value below 41.9 percent means the economy is declining. Values above that level mean it is growing.

Two of the past four months have registered below 50.0 percent. November was 49.9, December rose to 51.4 and January fell back to 49.3. The ISM reported on Feb-

ruary 1 that an index level of 49.3 is consistent with annual real GDP growth of 2.3 percent. The ISM reported a rebound to 52.3 percent in February on March 1. They said the January/February average was consistent with real GDP growth of 2.8 percent while the February level alone, if continued for a year, would fit with 3.2 percent real GDP growth. This is certainly not at recession levels, but the index definitely will bear watching in coming months. Most observers expect it to fall a lot soon.

A second weak indicator is industrial production. Data released by the Board of Governors of the Federal Reserve System on February 15 showed that industrial production fell by 0.5 percent in January to 111.9 (2002=100). This was 2.6 percent above a year earlier, less than half the average increase during the second half of 2006. The decline was led by motor vehicle production, which was down 6.0 percent. However, the rest of manufacturing fell by 0.3 percent.

More bad news came from the U.S. Department of Labor on February 15. They reported jobless claims up by 44,000 to a level of 357,000, the highest level since the week of November 25. The four-week moving average, a less volatile measure of claims, rose to 326,500. If the average stays here or continues to rise, then employment will fall and the unemployment rate will rise. This would be soon followed by cuts in the target Federal Funds rate by the Federal Open Market Committee (FOMC).

Consumer sentiment is also declining. On February 16 the University of Michigan reported that its Index of Consumer Sentiment (ICS) slipped to 93.3 (March 1966=100) in the first half of February from 96.9 in January. The January reading was the highest since December 2004 so this could be just a small "correction." However, further declines in consumer sentiment, which is an excellent predictor of actual spending, would be very worrisome. This is because real personal consumption expenditures make up a little over 70.0 percent of real GDP.

The data on housing starts in January were terrible, although weather could be a factor as is always the case in the November-to-March period. Nevertheless, the Census Bureau on February 16 reported that total housing starts were at a seasonally adjusted annual rate of 1,408,000 in

January. This was down 14.3 percent from December and 37.8 percent from January 2006. Of course, that number was the highest since March 1973 so some decline should have been anticipated.

Somewhat less disappointing news came from the National Federation of Independent Business on February 13. Their chief economist, Dr. William C. Dunkelberg, reported a partial rebound in Small Business Optimism Index in January from the December decline to 98.9 (1986=100). He reported that this suggests real GDP growth of 2.8 percent for the first quarter of 2007.

My forecast remains 2.2 percent for the first quarter and 1.4 percent for the entire year. This includes a short, mild recession in the second and third quarters.

SIGNS OF AN
ECONOMIC
SLOWDOWN ARE
MULTIPLYING

Stock Market Outlook

After reading the economic forecast by Dr. Smith, you may be wondering how a weakening economy will affect your portfolio of stocks, and to a lesser extent, bonds. The first absolutely critical tenet of Parsec philosophy is that retirement investing, by definition, has a longer time frame than the typical economic cycle. Timing the economic cycle, by selling before expected economic weakness or buying before expected strength, is exceptionally risky and not recommended. This is because the stock market is a leading economic indicator. As a result, the market's daily and weekly movements are affected more by the future expectations for corporate profits and economic activity, one or two years in the future. Obviously, expectations can be wrong and need to adjust to the reality as it unfolds into the present. This is where a great deal of volatility stems from, as the adjustment occurs. It is possible that stocks may rally during a mild recession where GDP declines less than expectations (or not at all), with strong growth expected to follow.

Instead, we feel it is best to analyze long-term trends for the economy and in particular corporate profits and divi-

dends. It is our opinion that the long-term trends are positive for earnings and dividends, and a slight recession is unlikely to derail them. The worldwide adoption of capitalism is experiencing tremendous growth, as indicated by the many new foreign stock exchanges. Corporate earnings are rising nicely, which is fueling increased dividend pay outs, stock buy backs, and robust merger and acquisition activity.

Though it may seem perverse, a slowdown in the economy could be a good thing. Evidenced by seventeen increases in the Fed funds rate, clearly Fed officials want the economy to slow. With a slowing economy should come a decrease in inflation that has remained a concern for policy makers and economists. When economic activity and inflation drop enough, the case will be made to lower the Fed funds rate. The real estate and commodity markets have slowed, and yet that has not widely affected corporate earnings or employment. Moderate economic growth, low inflation, and reasonable expectations are very good ingredients for a rising stock market.

Parsec Welcomes New Staff Members



Leslie Faye
Client Service Specialist

Leslie Fay is our new Client Service Specialist. She has been an Asheville resident since 1995. Before joining Parsec, she ran her own landscaping company. Leslie gradu-

ated from Haverford College after spending a year abroad at Oxford University studying Middle English Literature.

Stephen Mobley
File Clerk

Stephen Mobley is our new file clerk. He is a retired chaplain and

social worker and an Asheville resident since 2004.

Parsec Prize

The first quarter Parsec Prize has been awarded to Pisgah Legal Services (PLS). The School Partnership Project is a key strategy to allow PLS to reach our community's most vulnerable children, partners with children, their parents, teachers, and child care providers to ensure that their basic needs are met and that they can reach their potential in school and in life.

Poverty-related issues have a clear and dramatic impact on academic achievement. Research has shown that when a child changes schools mid-year, he or she loses an average of four months of academic progress.

The School Partnership Project is part of the larger Children's Law Project which helps disadvantaged children avoid homelessness; access essential services such as medical care and public education; and escape situations of abuse. One thousand five hundred and fifteen children were assisted by the Children's Law Project last year.

Pisgah Legal Services is a community-based nonprofit organization providing free civil legal assistance to low-income people in Western North Carolina since 1978.

ADV Offer

Parsec's Form ADV, a disclosure document, describes services provided to our clients and is available upon request. If you would like a copy, please contact us.

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