Parsec Financial

Third Quarter 2011 Newsletter

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Special Points of Interest

- **The slowdown in most economic data in the past few weeks is mainly due to concern about higher oil prices.**
- **It is safe to say that the income tax, estate tax, capital gains tax, corporate rates, tax on qualified dividends and alternative minimum tax rates are all likely to see changes.**

Qualified Charitable Distributions

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Many of our clients enjoyed the Qualified Charitable Distributions they made during the period of 2006 to 2009, only to be disappointed to learn that the provision was not extended in 2010. However, legislation has extended this benefit through 2011. This may be good news to some taxpayers, as the QCD counts toward your Required Minimum Distribution (RMD).

When savers with individual retirement accounts turn age 70½, the government requires that a certain amount of money come out of this account and be subsequently taxed. The initial required amount, for someone of this age, is about 3.6% of the end of the prior year's account value. If the RMD is not withdrawn from the account (in part or all), the IRS applies a 50% excise tax on the missed distributions. In the case of an investor who has diligently saved over their lifetime and finds that their wealth is such that they do not need these funds, they quickly find themselves frustrated because they are required to take out the funds, pay tax and then reinvest elsewhere.

Enter an interesting piece of legislation called the Qualified Charitable Distribution (QCD), which is ideally suited for such a person who is charitably inclined. According to QCD rules, an account owner who is 70½ or older may distribute up to $100,000 of their RMD to a qualifying charity while meeting the RMD rules at the same time. As an example of the value presented here, imagine an IRA owner whose RMD is $125,000 this year. For example, consider a person with no deductions or QCD. The distribution would be taxed at an approximate rate of 25% (or $31,250 in taxes). Alternatively, because the QCD will qualify as meeting the RMD (up to $100,000), the investor still must withdraw $125,000 from the account, but claims $100,000 for QCD (which is not taxed) and $25,000 to be taxed at a much lower rate of 15%, or $3,750 in tax liability. Naturally, a person's real tax rate would vary depending on the facts and circumstances involving their situation. However, when coupled with proper planning can significantly reduce one's tax liability, including lower taxes on Social Security income.

The account owner must work with the IRA custodian by identifying a qualifying charity and instructing the custodian to make a direct transfer of funds to this charity. Although the QCD will generate a 1099-R, the QCD is not considered income for tax reporting purposes. It is not intended as a means of getting a deduction either, since the account owner has already avoided paying income tax on the QCD.

Other rules to keep in mind: First, the account owner may not use previously distributed funds as part of the QCD, the funds must be distributed directly from the account to the charity. However, the investor may rollover distributions received within the past 60 days. The rule specifies that funds must be distributed to a "qualifying charity" which is a charity set up as a 501(c)3 organization that is eligible to received tax-deductible contributions. Finally, the QCD provision specifically excludes SEP and SIMPLE IRAs.

We find the QCD to be a valuable tax benefit and investors should work with their financial and tax advisor to create a distribution strategy to maximize its potential as it relates to their personal situation. More information may be obtained from IRS Publication 590.

Dr. Jim Smith's Economic Commentary

Dr. James F. Smith

CHIEF ECONOMIST

The Economy Is Still Growing

As pointed out in my essay in the last issue of this newsletter, the U.S. economy is growing most of the time. Furthermore, once it starts growing again after reaching the trough (bottom) of a recession, which happened in June 2009, it tends to grow for a long time.

Of course, there will be another recession in the U.S. some day. No one knows when that day will come, but you should be confident it probably won't be for several years.

So many people (8,624,000 on a net basis to be precise) lost employment from November 2007 to December 2009 that it will take a long time to get back to new record levels. Similarly, so many net nonfarm payroll jobs (8,750,000 from January 2008 to February 2010) disappeared that we are unlikely to regain them all before the end of 2013. Some pessimists think the date might be 2016 or even later, but it's hard to believe we won't beat that forecast handily.

Through May 2011 we have seen a net gain of 1,819,000 people employed from the nadir and 1,797,000 new nonfarm payroll jobs. That's definitely moving in the right direction.

There are many positive aspects to increases in the total number of people employed and net growth in nonfarm payroll jobs. For one thing, most people in the U.S. define themselves by their occupation. Just think of all the parties you've been to where the first question a stranger asked you was, "Where do you work?" or "What do you do for a living?" People in other parts of the world tend to describe themselves by where they're from geographically or the family or tribe of which they are a part.

In economic terms, growing employment means higher levels of income. Since consumers in the U.S. tend to spend about 95 percent of their incomes, this means that rising incomes usually cause increases in personal consumption expenditures (PCE) and retail sales. Since PCE accounts for about 70.0 percent of GDP, it's clearly crucial to economic growth that consumers keep spending.

The old mantra, "Shop 'til you drop and fall to the floor, then rest a while before you pick yourself up and go shop some more," is an apt description of what the U.S. needs to keep the economy going. Total retail and food services sales hit their old peak in November 2007 at a monthly seasonal adjusted total of $378.4 billion.

We did not see a new record until the $379.3 billion of January 2011. The current high mark is the $388.0 billion of April 2011.

On June 14 the Census Bureau reported that retail and food services sales fell 0.2 percent in May from April to $387.1 billion. That's the second best level ever and was 7.7 percent above a year earlier.

Only two major categories of retail and food services sales did not increase in the year from May 2010. Sales at "Electronics and appliance stores" fell 0.3 percent. This mostly reflects declining prices, especially for big screen television sets. Sales at "Department stores" were down 0.5 percent from a year earlier.

The impact of rising food prices showed up at both grocery stores (up 5.8 percent from a year earlier) and "Food services and drinking places," more commonly known as bars and restaurants, which posted a 5.3 percent increase. Clearly, eating remains a very popular activity.

The slowdown in most economic data in the past few weeks is mainly due to concern about higher oil prices. They have clearly not had much impact so far on consumers as demonstrated by the strong retail sales data this year, but they have raised business costs and hurt the confidence of managers and small business owners.

This has crimped business spending on new plants and equipment, which ought to be booming at this stage of the expansion. Even more importantly, it has held back hiring.

We ought to be seeing monthly net job growth of 250,000 or more. So far, we can only dream of such strong growth in the number of nonfarm payroll jobs.

It would appear that oil prices have peaked and are now retreating below $100 for a barrel of West Texas Intermediate. Most energy analysts think the current equilibrium price is $70 to $80 a barrel.

Oil prices function exactly like a tax on consumers. As one of my friends so clearly put it, "It's just not feasible to drive halfway to work." What he means is that in the short run, it's very hard to make a big enough adjustment in your driving patterns to realize significant savings. That means you spend whatever it takes to keep your vehicles moving. For most people, that means they have less money to spend on other things.

A decline in oil prices works in exactly the opposite way. Less money spent on fuel means more can be used to purchase other goods and services.

There Is Plenty Of Good News Out There

Probably the best news is that there really is no reason to fear inflation. The Bureau of Labor Statistics (BLS) told us on June 15 that the consumer price index for all urban consumers (CPI-U) had risen by 0.2 percent in May from April and was 3.6 percent above May 2010.

Of course, that was a huge acceleration from 1.1 percent on a comparable basis last November. However, it was mostly due to oil prices and food.

While food prices overall were up 3.5 percent for the year ending in May, the price index for food at home rose by 4.4 percent, which contrasted with a 2.2 percent increase for food away from home. The "Meats, poultry, fish and eggs" and the "Fats and oils" categories rose the most with 8.5 percent increases.

Gasoline prices were up 36.9 percent. Healthcare, in contrast, was up only 3.0 percent for the year ending in May.

The CPI-U for all items excluding food and energy was up 1.5 percent from May 2010. That is not bad at all. This is the concept known as "core inflation."

It will give you some feel for how much inflation we've had over the long run to look at the levels of the CPI-U in May. The current base period for the index is 1982-1984=100. The index on that basis was 224.804 in May. The BLS helpfully translates that for you. A basket of goods that cost you $100.00 in May 2011 only cost $44.30 in 1982-1984. That means that any money you hid in the mattress back then has lost more than half its value.

Using the old index base of 1967=100 gives even more depressing results on inflation. That index value in May 2011 was 676.887. That means that the basket of goods costing $100.00 in May only cost $14.80 in 1967.

The principal determinant of inflation is growth in the broad money supply aggregate known as M2. The narrow money supply (M1) is made up of 1) currency outside of banks, the Treasury and the Federal Reserve, 2) travelers checks of nonbank issuers, 3) demand deposits and 4) other checkable deposits. The broad money supply M2 consists of M1 plus 1) savings deposits, 2) small denomination time deposits of less than $100,000 (a limit that has not changed in over 35 years), and 3) retail money market mutual funds.

Total M2 exceeded $9.0 trillion for the first time in April 2011. You can follow these measures in the weekly H.6 "Money Stock Measures" release that the Board of Governors of the Federal Reserve System publishes every Thursday unless that's a holiday.

For the 52 weeks ended on June 7, the 13-week average of M2 ending June 6 was 4.9 percent above the same period one year earlier. Most monetary economists consider an annual rate of growth of M2 of 5.0 percent to be what the economy needs to allow both decent real GDP growth (consistent with the 1929-2010 average of 3.3 percent a year) with core inflation of less than 2.0 percent.

We are all very fortunate that the Chairman of the Board of Governors of the Federal Reserve System is Dr. Ben Bernanke. He is the leading living scholar of the causes and consequences of the Great Depression of August

1929 to March 1933.

Most economists agree that the primary cause of turning what should have been a garden-variety recession into a depression was the actions of the Federal Reserve. They did not understand that in a system with no deposit insurance (the FDIC was not created until 1933), the money supply shrinks when banks fail unless the Fed takes steps to prevent that.

They allowed the money supply to shrink by one-third from the August 1929 peak to the March 1933 trough. As explained in detail in the monumental work, *A Monetary History of the United States,* by the late Milton Friedman and Anna J. Schwartz, this resulted in declines in real GDP of 26.7 percent. Since prices fell throughout the period, nominal GDP fell by 45.6 percent.

Ben Bernanke knows this history well and is determined not to allow deflation to occur on his watch. What normally keeps M2 growing is growth in commercial and industrial (C&I) loans, since banks usually give a company money in its account for whatever the loan amount is.

However, during the recession of December 2007-June 2009, few businesses wanted to borrow and few banks wanted to lend. After pushing the Federal Funds rate (the interest rate that bank and other depository institutions charge each other for overnight loans) down to its current low of 0.0-0.25 percent, the Fed had no further way to encourage economic activity by lowering interest rates.

Thus, they turned to quantitative easing. That meant they purchased assets in the open market. Because the Fed has the power to create money, these actions were the only thing that keep the money supply growing in 2008 and 2009.

When economic growth faltered in 2010, they came up with a second program of quantitative easing known as QE2. This program ended on June 30, but it did keep the M2 money supply growing.

Most analysts think it also caused a big decline in the value of the dollar and a large part of the concomitant increase in the prices of oil and other commodities. Because of this, it's quite unlikely we will see a QE3 unless economic growth slows further and unemployment rises substantially.

The Outlook Is Pretty Good

You should be glad to learn that every one of the 68 forecasters in the Bloomberg panel for June as well as all 54 of us in *The Wall Street Journal* panel have positive real GDP forecasts for the rest of 2011. The 66 of us in the Bloomberg panel for 2012 also were uniformly positive for that year. The 33 of us who were willing to offer a forecast for 2013 were also all positive.

For 2011, the median forecast of the Bloomberg panelists is 2.8 percent. The range was from 1.9 to 3.3 percent. My forecast of 3.0 percent on a year-over-year basis was tied with one other person for the second-highest forecast among the group.

It won't take much for me to turn out to be right. Consumers need to keep spending and businesses need to both increase hiring and spend more on new plants and equipment to maintain their competitive edge.

If oil prices keep falling and end up back in the $70-80 a barrel range, that would really help spur growth. So would an agreement in Congress to seriously reduce future budget deficits—for sure.

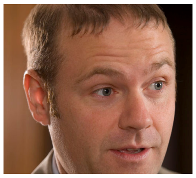
Hey, miracles can happen. The state of North Carolina completed its budget process on June 15 with the legislature overriding a veto from Governor Bev Purdue. That's the earliest budget completion for the fiscal year that starts July 1 since 1979.

It will be an interesting summer. I hope it's a good one for you.

Parsec 5k—Give till it hurts!

On October 15th of this year, we are having our first ever charity 5k race. Festivities will start at 8:00 a.m. on Wall Street in front of Parsec Financial. This event is to benefit the four Parsec Prize recipients of 2011 with 100% of the entry fee going to one of the four non-profits. We hope to see you out there to run, walk, support, or to stop by and make a quick donation. More information about the race, including registration, will be available on August 5th and you can contact Ashley Woodring at Parsec to hear more. Stay tuned and we'll see you at the finish line!

Taxes—Nothing is Certain



Rick Manske, CFP®

Managing Partner

Ever since Congress approved continuing the Bush-era tax cuts, I have wondered what will be next. There are many types of taxes and tax rates, most of which sunset at the end of 2012. It is safe to say that the income tax, estate tax, capital gains tax, corporate rates, tax on qualified dividends and alternative minimum tax rates are all likely to see changes as part of the coming election year's legacy. As we move closer to the election, it seems like a large tax reform act is likely to be serious and central to each party's platform. Fiscal policy is important in how it affects sentiment, capital formation and budgetary entitlements. It is inherently a very complex topic that causes many taxpayers heads to swim. As much as we all dislike paying tax, it is good that we have a central fiscal authority. A much worse scenario can be seen in the Euro zone that has no central taxing authority. This leaves them only monetary policy to address their economic cycles. Without consensus each member country can embark on different tax policy, often at odds with one another.

Tax policy can have many unintended consequences and is oftentimes misrepresented by elected politicians who spread many half truths and embellishments to get elected. The environment for bipartisan tax reform seems hopeless as the election year rhetoric draws near; this despite the mutual agreement that the status quo is unsustainable. I believe a major reform act is likely and you can look to history to see the many tax acts and how change is about the only thing one can count on. How the government taxes people and businesses may be the most paramount ingredient towards creating an economy that is organically growing. Giving the people the confidence to make investments is the hallmark of past tax reform success stories. Uncertainty stemming from tax reform has a paralyzing affect on the forces that drive entrepreneurship and innovation.

Another point of uncertainty arises from the Patient Protection and Affordable Care Act and how it will be paid for. It will be expensive to pay for the expansion of health coverage to all. Effective January 1, 2013 income from self-employment and wages of single individuals in excess of $200,000 annually will be subject to an additional tax of 0.9%. The threshold amount is $250,000 for a married couple filing jointly. In addition these higher income earners will pay an additional tax of 3.8% which will apply to investment income (dividends and interest).

It is an unknown if President Obama's health care plan will be fully implemented. This uncertainty might be even worse than the actual tax itself. Potential employers do not know how to anticipate the costs of healthcare or the underlying tax structure for either themselves as the employer or personally as taxpayers.

As a pragmatic financial planner, I understand that taxes are going to be a key part of my client's success. But without clarity, the fear of the unknown is allowed to bloom into an outright paranoia amongst some taxpayers. I believe a thoughtfully crafted tax proposal that balances our needs as a nation will be critical. This cannot happen soon enough as any ongoing uncertainty only helps to slow our nascent economic recovery.

Changes to the North Carolina 529 Plan

We have exciting news to share regarding recent legislation passed by the NC General Assembly. As mentioned in our Fourth Quarter Newsletter (2010), income earners with adjusted gross income of more than $100,000 enjoy a state income tax deduction for contributions to the NC 529 plan through the end of this year. However, Governor Bev Perdue recently signed legislation that permanently removes the income cap. The maximum annual contribution deductible from NC taxable income remains at $2,500 (individual filers) and $5,000 (married filing jointly).

Parsec Spotlight: Mickie Rose

If you are a client of Parsec's Charlotte office, you are undoubtedly familiar with the woman with an accent that is a quirky mix of Southern drawl and Long Island-ese. That accent belongs to Mickie Rose, Charlotte's Client Services Specialist.

Mickie joined Parsec in 2005 after working in both the hospitality and health care industries. After earning her B.S. in Criminal Justice from Pfeiffer University in Misenheimer, North Carolina, Mickie fell in love with the South, and decided to make Charlotte her home. A Registered Paraplanner℠ designee, Mickie provides service with not just a smile, but with efficiency and thoughtfulness.

Mickie is married to David Rose and is the proud mother of three boys: Phillip (12), Patrick (8) and Peter (3). She has been a volunteer soccer coach for the Siskey YMCA for the past 4 years and is the Committee Chair for her son's Scout Pack 15. In addition to these duties, she serves as the Social Committee Chair for her homeowner's association. In her spare time (and there's not much of that!), Mickie enjoys gardening, scrap booking and spin class.

Cost Basis on Schwab Statements

Have you noticed a change to your Schwab statements? Schwab has enabled a new feature on Parsec client account statements. You should find that the cost basis on your Schwab statement matches that of your Parsec statements as well. We hope you find this feature a valuable and beneficial tool.