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BFAS Money Line

Recovery?

The economy is giving many indications of having **positive growth this quarter** after four straight quarters of negative growth. If so, it will mark the **probable end of the longest and deepest recession since WWII**. The total drop in Gross Domestic Product (GDP) is 3.9% thus far, slightly more than the 3.7% drop in the 1950's but nowhere near the 26.7% drop in the Great Depression.

Manufacturing has grown to replace depleted inventories. Housing, so important to employment, is showing signs of recovery. However, foreclosures, which continue at high levels, as well as the continuing loss of jobs, are head winds to housing's recovery. Although interest rates are low for mortgages, banks are hesitant about lending. **Home prices are near a bottom, or will bottom in the next twelve months**.

Another problem facing housing is the large number of Adjustable Rate Mortgages due to adjust in the coming year. In many cases, the homeowner could refinance into a lower fixed rate mortgage; but the value of the house is lower than the mortgage balance and no bank will write a mortgage for more than about 80% - 90% of the current value of the house.

Thus, some of these ARM holders will default and add their houses to the already large stock of unsold houses; putting additional downward pressure on house prices

Jobs will continue to be lost for some time. **Companies are only profitable currently if they slashed expenses (usually personnel) more than the drop in their sales**. **Companies are going to be slow to add jobs due to higher minimum wages, economic uncertainty, uncertain health care expenses, possible Cap & Trade costs, and higher taxes on income.**

If, in fact, the recovery is imminent, the next question is **what kind of recovery will it be?** Past recoveries were "V" shaped with a sharp upswing after the bottom of the recession. The economy and the stock market rapidly (typically in a little over a year) recovered the losses sustained in the recession.

This recovery is more likely to be "U" or "L" shaped. That is, the recovery will be slower or much, much slower. A slower recovery will probably mean a slower rise in the stock market. As of early August, the S & P 500 would need a 58% return to reach its October 2007 peak. That is unlikely to happen in one year.

More likely, three to five years of above average returns would be needed to re-attain those October 2007 highs.

Thankfully, **most clients had diversified portfolios that did not decline nearly as much as the stock market. Thus, they are looking at needing 15% to 25% to re-attain their market highs (probably in a year or two) instead of 58%!**

The **inflation/deflation issue** is on a lot of minds right now. Many of the government's actions are highly inflationary. Some think we are on the way to the hyper-inflation seen in third world countries like Zimbabwe. Others argue that all of the things discussed above, that will delay our recovery from the recession, are deflationary.

Deflation is a serious threat because people delay purchases while waiting for the prices to come down. This slows the economy even more and feeds the deflation. The Federal Reserve is dedicated to fighting deflation, but deflation can be tough to halt.

I think we are probably in for deflation in the next year or so. After that inflation will become a problem. The Federal Reserve will have to walk a fine line to raise interest rates at just the right times and amounts to hold the line on inflation without putting the economy back into recession!

Inflation can be very problematic for those who have been burned by the stock market and have retreated to fixed income vehicles like bonds, fixed annuities, CDs, Money Market and checking accounts. These fixed income assets are not bad in moderation since they can limit the downside of another market swoon. However, they can lose purchasing power in an inflationary environment. Thus, too much of them can be hazardous to your financial health!

Investment-wise, **emerging markets and technology continue to perform very well**. The one year numbers below don't reflect this since the fourth quarter losses in 2008 still drag down one year returns:

Asset Class	1 Yr Rtn (04/30/09)
S & P 500	- 19.96%
NASDAQ	- 14.92%
Lg Cap Gwth	- 20.01%
Lg Cap Val	- 20.15%
Mid Cap Gwth	- 22.79%
Mid Cap Val	- 18.84%
Sml Cap Gwth	- 20.93%
Sml Cap Val	- 17.71%
Foreign	- 22.60%
Interm Corp Bds	+ 3.71%
Foreign Bds	+ 3.97%
Commodities (DJ – AIG)	- 38.03%

Odds and Ends

Homes – With the housing market nearing a bottom, **now might be a good time to buy**. While it's still difficult to sell (since home prices are down 32% nationwide), **renters and young people just entering the housing market have a pretty unique opportunity in the next year or two**.

Mortgage rates are low and first-time home buyers are eligible for an $8,000 refundable tax credit if the purchase is made before December 1, 2009. As long as you have not owned a house during the last three years, you are eligible for first-time home buyer status. Since the credit is refundable, the IRS will write you a check even if you don't pay taxes. There are phase-outs at $150,000 for married couples and $75,000 for other taxpayers.

The tax credit comes no matter who pays the mortgage. Thus, **if you are in a position to help your children or grandchildren buy their first home, they can receive the tax credit!**

Social Security – With personal retirement accounts still down due to the market drop, social security might make up a larger percentage of retirement income than before. Social Security has one of the best websites in all of government at www.ssa.gov .

Now they have added a **Retirement Estimator**. Using your actual earnings, **you can take a look at your estimated retirement income based upon different retirement ages and different earnings estimates going forward**. For those who might want to consider working a little longer or working part-time, this tool could really help you make the best decision. You can find it at www.socialsecurity.gov/estimator .

Roth IRAs - With IRA accounts still below their high-water marks, conversion of IRAs to Roth

IRAs should be a consideration. Especially this year, when mandatory IRA distributions are not required, the conversion option can be a winner.

What are some of the considerations? If your tax bracket in retirement will be the same or higher (anybody think income taxes are going down?), the Roth IRA can be a good deal. If you have some unusual tax situation such as charitable deductions, tax loss carry-forwards or investment tax credits, the Roth IRA conversion can be a good deal.

If you don't need your IRA money to support your living expenses, you might want to convert (since you are not required to make mandatory annual distributions from Roth IRAs). Also, if you want to provide an income-tax-free inheritance to heirs, the Roth IRA conversion can make sense.

Since mandatory IRA distributions are suspended this year, many of you will have Adjusted Gross Incomes of less than the $100,000 maximum that allows you to make a Roth IRA conversion in 2009. **Current law eliminates the $100,000 limit starting in January 2010 and allows you to split paying the taxes on the conversion between 2011 and 2012**.

You might pay less tax if you converted this year due to lower account values and possibly lower taxes (no mandatory IRA distribution and tax rates might go up next year). Converting in 2010 spreads the pain of paying taxes over two years but with the possibility of a higher account balance and higher taxes.

Some other considerations about a Roth Conversion include:

- if your income is low, converting could cause more of your Social Security to be taxed that year
- additional income from conversion may push your income too high for current year IRA contributions
- additional income from conversion might affect personal exemption and itemized deduction phase-outs
- you might lose out on educational credits for college age children

In summary, this is a uniquely favorable time to do a Roth IRA conversion; however, see your financial advisor before doing so to make sure it works for you!

Mail Forwarding – Some of you like to take extended vacations, but might worry about missing important mail. Most of us have used the postal service's vacation hold, then received your mail at your home address.

But what about those of you who spend weeks or months at a vacation home? The Postal Service has a Premium Forwarding Service that can get the mail to your vacation location. Check it out at www.usps.com/receive/premiumforwarding/

ID Theft – The recent increases in identity theft has left many of us concerned and spurred the creation of companies, like LifeLock, that will guarantee your credit from theft for a fee.

You can put a fraud alert on your credit reports with all three credit bureaus (Experian, Trans Union, and Equifax) yourself. However, this alert only lasts 90 days. During the alert, lenders must verify your identity before issuing you credit. LifeLock, for a fee, automates the same fraud alert that you can institute yourself. **To get around the 90 day issue, you can put a permanent credit freeze on your account.** This prevents lenders from even seeing your credit report; and ID thieves can't get new credit even if they have every bit of your personal information!

Qualified Disability Trusts

Those of you who have irrevocable Special Needs Trusts (SNTs) may be paying more in income taxes than you should. When you file your personal income taxes, you get a personal exemption of $3650 in 2009. However, trusts only receive an exemption of $100 or $300 before taxes start.

In addition, trusts hit the 35% tax bracket with taxable income of only $11,150. Thus, reducing taxable income for your irrevocable SNT can make a big difference.

Few know that the Victims of Terrorism Tax Relief Act of 2001 includes language that allows a Qualified Disability Trust to use the personal exemption ($3650 this year) rather than the normal trust exemption of $100 or $300. To qualify as a Qualified Disability Trust, the trust must:

- be a disability trust as described in 42 U.S.C. 1396p(c)(2)(B)(iv)
- have only beneficiaries who are disabled as determined by SS
- be irrevocable
- be established solely for the benefit of the disabled beneficiary (while living)
- have beneficiary who is under age 65

In practice, the only SNTs that qualify would be third party SNTs (set up by parents, grandparents, etc.) rather than self-settled SNTs (set up with the disabled person's own money). Self-settled SNTs are generally taxed as grantor trusts where the income is taxed to the grantor, not the trust.

Thus, **if your SNT allows income to be retained in the trust, up to $3650 can be retained tax free. Since the beneficiary also can claim a personal exemption of $3650, the trustee can distribute that amount to the beneficiary tax free each year as well**.

Be sure to alert your tax person to the possibility of your trust being a Qualified Disability Trust!

SBP and SSI

I have written several times about the **negative impact that the military Survivor Benefit Plan (SBP) can have on children with disabilities.** When SBP starts, the amount of SBP is treated as unearned income and the child can lose Supplemental Security Income (SSI) and/or Medicaid.

The good news is that some in Congress are attempting to fix this problem! There are at least two house bills **(HR 2059 and HR 3324)** that have been referred to the House Armed Services Committee. **Both bills would allow SBP money to go into a SNT and not count against SSI/Medicaid**. Any money left in this particular SNT after the child was deceased would go to repay Medicaid.

My sources indicate that Virginia Senator Webb is working this issue in the Senate as well. I have personally been contacted by staffers from the Congressional Budget Office and Senator Byrd's office**. I am cautiously optimistic that this will get fixed this year!**

If you want to follow the house bills, go to http://www.govtrack.us/congress/bill.xpd?bill=h111-2059 . You can track both bills and identify who is serving on the committee/subcommittee. Be sure to contact those committee members with your endorsement of either bill!

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