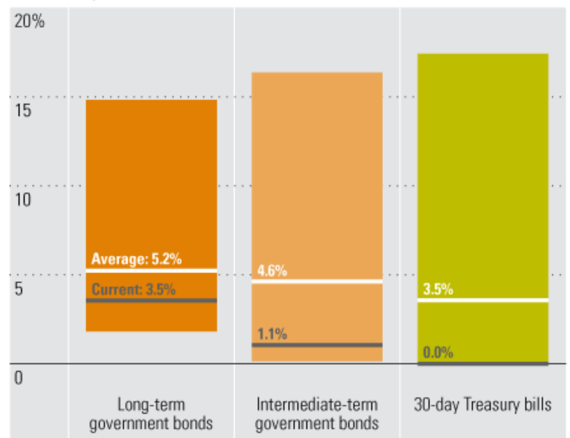
History of Interest Rates

It is commonly known that interest rates have been at historically low levels for a few years now. But how low are they? The image illustrates the characteristics of interest rates of various maturities. On average, long-term government bonds delivered the highest yield of 5.2%, while intermediate-term government bonds and 30-day Treasury bills provided an average yield of 4.6% and 3.5%, respectively. Current interest rates are positioned relatively close to the all-time lows, especially on the lower end of the maturity curve.

A rising interest rate environment seems to be the generally accepted forecast for the future. While rates can't drop much lower from their current level, the timing and magnitude of the rise still remains highly uncertain.

History of Interest Rates
January 1926–November 2013



Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. Indexes are unmanaged and not available for direct investment. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. U.S. government bonds may be exempt from state taxes and income is taxed as ordinary income in the year received. With government bonds, the investor is a creditor of the government. In general, the price of a debt security tends to fall when interest rates rise and rise when interest rates fall. Securities with longer maturities and mortgage securities can be more sensitive to interest-rate changes.

Data: The long-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Long-Term Government-Bond Yield Index. The intermediate-term government-bond yield is represented by the monthly Ibbotson SBBI U.S. Intermediate-Term Government-Bond Yield Index. The 30-day Treasury bill yield series uses annualized monthly Ibbotson SBBI U.S. 30-Day Treasury Bill Total Return Index.

Canandaigua National Bank & Trust

Economic Outlook for 2014

As the end of 2013 draws near, the U.S. economy appears very much like an ocean liner, finding it very difficult to change either speed or direction. As the table illustrates, overall GDP growth rates, employment growth and consumption have all been stuck in a very narrow range for the last three years.

Morningstar economists expect little change in the overall GDP growth rate for 2014, although the composition of that growth is likely to be somewhat different. Inventories should be a much smaller contributor to growth, net exports are likely to be a larger subtraction from GDP as imports grow, and government spending should be a much smaller negative in 2014.

Consumption, housing and business investments (excluding inventories) are likely to change little from their 2013 growth rates. Other forecasts may be more bullish on overall GDP growth, but Morningstar economists suspect growth rates in autos will decelerate, existing home sales will likely be flat, and government spending will still be a drag, albeit smaller than the rather large subtraction in 2013.

With little change in the 2% GDP growth rate, employment growth may not change that much, either. Slow growth, a wide output gap (a fancy capacity utilization measure) and a bumper farm crop should all keep inflation in check in 2014, though medical costs may rise faster than in 2013, bringing up the overall rate of inflation. With the Fed now officially tapering bond purchases, 10-year Treasury bond rates should move up to reflect the inflation rate plus a spread. Auto sales should continue to do well in 2014 with continued employment growth, new models, and an aging fleet. Unfortunately, auto sales are now approaching previous highs and the law of large numbers is beginning to set in, with year-over-year growth rates likely to slow. An acceleration in housing starts may still occur, as it has taken home builders some time to gear up for increased demand (zoning, land acquisition, etc.). However, existing homes will be hard pressed to grow much with higher rates, more competition from new homes, tight inventories, and lower affordability.

Probably the biggest news in the fourth quarter was that the Fed would begin tapering its large $85 billion bond purchase program. This program was a truly extraordinary measure; never before has the Fed reacted so boldly and so beyond its sphere of short-term interest rates. Given extraordinarily tight fiscal measures and a slow-growth economy, the program was both helpful and necessary. With the economy at least a little better and an easing of the fiscal tensions, however, it was probably time for it to end. Markets had already anticipated the tapering last spring, and interest rates had previously made their move up. Further rate increases are possible, but the worst may be behind us.

Economic Outlook for 2014

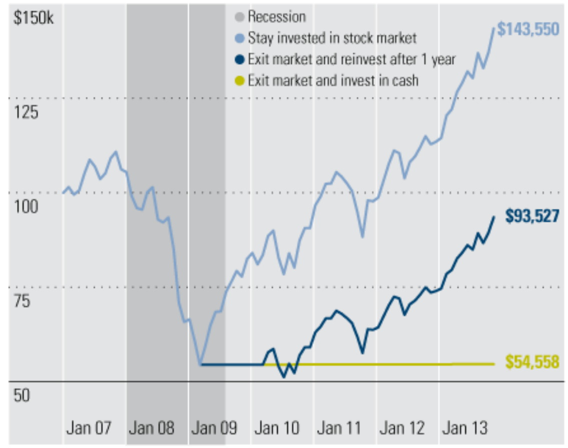
	2011	2012	2013E	2014E
GDP	2.0%	2.0%	2.3%	2%–2.5%
Inflation	3.0%	1.8%	1.3%	1.5%–1.8%
Employment Growth (mo. avg.)	202,000	189,000	190,000	190,000
Unemployment Rate	8.5%	7.8%	7.1%	6.2%–6.5%
10-year Treasury	1.9%	1.8%	2.9%	3.5%–4.0%
Auto Sales (millions)	12.8	14.5	15.7	16–16.5
Housing Starts (thousands)	624	830	925	1,050–1,100
Existing Home Sales (millions)	4.3	4.7	5.1	5.1

Source: St. Louis Federal Reserve. Numbers for 2013 and 2014 are estimates. These estimates are based on Morningstar calculations and economic analysis. They (and the opinions expressed in this article) are not intended to be used or interpreted as investment or financial advice. Please consult with a financial professional for advice specific to your situation.

The Importance of Staying Invested

Investors who attempt to time the market run the risk of missing periods of positive returns. The image illustrates the value of a $100,000 investment in the stock market from Jan. 2007 to Oct. 2013, which included the global financial crisis and the recovery that followed. The value of the investment dropped to $54,381 by Feb. 2009 (the trough date). If an investor remained invested in the stock market, the ending value would be $143,550. If the same investor exited the market at the bottom to invest in cash for a year and then reinvest in the market, the ending value would be $93,527. An all-cash investment would have yielded only $54,558. The continuous stock-market investment recovered its initial value over the next three years, and provided a higher ending value than the other two strategies. Investors are well advised to stick with a long-term approach to investing.

Ending Wealth Values After a Market Decline
January 2007–October 2013



Source: The market is represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Cash is represented by the 30-day U.S. Treasury bill. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs. Returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds or cash. Holding a portfolio of securities for the long term does not ensure a profitable outcome and investing in securities always involves risk of loss.

Women and Investing: A Behavioral Finance Perspective

Gender stereotypes exist in the investing world, just like everywhere else. For example, women tend to be perceived as more risk averse than men when it comes to making investment decisions, or as basing these decisions on emotional, rather than rational factors. However, according to a recent study by Merrill Lynch, gender differences among investors tend to be overstated, and the ways in which men and women approach their financial lives are often similar. Where differences do occur, they appear to be shaped more by social and demographic factors (such as education, employment status and financial circumstances) than by innate characteristics.

The study surveyed 11,500 respondents (out of which 5,000 were women) using a questionnaire to reveal how they thought and felt about investing. The findings do support the idea that women don't make investment decisions exactly as men do, and that women tend to be more risk-averse than men. The research also shows, however, that both men and women are subject to strong emotional influences that can have both positive and negative implications for their investing habits. These emotional influences, in themselves, don't predict either success or failure as an investor. What matters is how each person puts his or her natural tendencies to work in the pursuit of personally meaningful financial goals.

The gender difference that seems to have the most significant impact on investor behavior is men and women's reported level of financial knowledge. More than half of women agreed with the statement, "I know less than the average investor about financial markets and investing in general," compared with only a quarter of men who said they felt that way.

Source: "Women and Investing: A Behavioral Finance Perspective," Merrill Lynch Wealth Management Institute, November 2013.

Morningstar Research Examines Retirement Costs

Morningstar Investment Management published new research in December that examines the most common assumptions used to estimate retirement needs and lays out a framework for investors to take a more personalized approach to setting retirement savings goals.

"There are three common assumptions that many software tools and financial advisors use to come up with a retirement savings goal—a 70 or 80 percent replacement rate based on pre-retirement income, an income need that rises with inflation, and a 30-year retirement time horizon," David Blanchett, head of retirement research for Morningstar Investment Management, said. "When we looked at actual retiree spending patterns and life expectancy, however, we found that these assumptions don't hold true for many people and, on average, can significantly overestimate how much people will actually need to fund their retirement."

Many expenses disappear after retirement, such as Medicare taxes, Social Security taxes, and retirement savings. The paper first demonstrates the effect on replacement rate calculations of accounting for taxable and non-taxable expenses that are no longer paid after retirement. Next, using government data, the analysis explores the actual spending patterns of retirees, and finds that they grow at a rate lower than inflation through most of retirement and then accelerate in later years because of higher health care costs. While the difference between the actual spending growth rate and the inflation rate is relatively small, it has a material effect over time. When the researchers modeled actual spending patterns over a couple's life expectancy, rather than a fixed 30-year period, the data showed that many retirees may need approximately 20% less in savings than the common assumptions would indicate.

Results from this research show the actual replacement rate is likely to vary considerably by retiree household, from under 54% to over 87%. Retiree expenditures do not, on average, increase each year by inflation or by some otherwise static percentage; the actual "spending curve" of a retiree household varies by total consumption and funding level. Specifically, households with lower levels of consumption and higher funding ratios tend to increase spending through the retirement period and households with higher levels of consumption but relatively lower funding ratios tend to decrease spending through the retirement period. When consumption and funding levels are combined and correctly modeled, the true cost of retirement is highly personalized based on each household's unique facts and circum¬stances, and is likely to be lower than amounts determined using more traditional models.

"While a replacement rate between 70 and 80 percent may be a reasonable starting place for many households, we find that the actual replacement rate can vary considerably," Blanchett continued. "Take, for example, a high-income couple, living in a high income tax state like California, and saving a significant amount for retirement each year. If that couple retires in Florida or Texas, where there is no income tax, the replacement rate might be closer to 60 percent. By contrast, a low-income couple saving very little for retirement and retiring in California could have a replacement around 85 percent. It's important for investors to consider their level of pre-retirement household income, expenses that discontinue after retirement, and post-retirement taxation."

These findings have important implications for retirees, especially when estimating the amount that must be saved to fund retirement. A more advanced perspective on retiree spending needs can significantly change the estimate of the true cost of retirement.

Source: David Blanchett, CFA, CFP, Head of Retirement Research, Morningstar Investment Management: Estimating the True Cost of Retirement, Working Paper, Nov. 5, 2013.

The End of the Recession

In September 2010, the National Bureau of Economic Research announced the long-awaited news: an end date for the recession that had begun in December 2007. The NBER determined the official end date as June 2009, quieting down (if not completely silencing) double-dip fears. NBER defines a recession as a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. Looking back at the performance of the main asset classes during the recession and in the years following the official end date, gold was the best overall performer, and long-term government bonds offered consistent positive returns. Out of the investments with the worst performance during the recession, REITs posted the most impressive return in the four post-recession years.

Returns During and After the Most Recent Recession

	Recession Dec 2007 to Jun 2009*	Aftermath Jul 2009 to Oct 2013*
Gold	19.3%	41.7%
Long-term government bonds	8.4%	33.0%
Treasury bills	1.9%	0.3%
Small stocks	–33.8%	147.9%
Large stocks	–35.5%	109.4%
International stocks	–39.7%	65.8%
REITs	–48.1%	159.9%

**Returns in table represent cumulative returns during time periods indicated, not annualized returns.*

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Source: Gold—Wall Street Journal London P.M. closing price. Long-term government bonds—20-year U.S. government bond. Treasury bills—30-day U.S. Treasury bill. Small stocks—Ibbotson® Small Company Stock Index. Large stocks—Standard & Poor's 500® Index, an unmanaged group of securities considered to be representative of the U.S. stock market. International stocks—Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. REITs—FTSE NAREIT All Equity REITs Index®.