FINANCIAL CONNECTIONS
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For Clients and Friends of Financial Connections

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We live in a time of global uncertainty with unusually high levels of risk. News is transmitted instantaneously and investors react. This all leads to increased market volatility.

The first quarter zoomed upward, the second quarter down. If it weren't for the last day of June, the second quarter would have been dismal.

The one-day rise on June 29 was:

- Wilshire 5000 gained 2.5%
- S&P 500 gained 2.5%
- NASDAQ gained 3%

Did the intrinsic value of companies on the stock exchange really change in one day? No. Then what led to the sudden jump in investors' enthusiasm for stocks on the last day of the quarter? A reaction to the preliminary news from Europe that Germany agreed to a more flexible approach for bailout money (see "Less Publicized Issues for the European Union").

Some of this enthusiasm will decline as investors read the small print. While Germany's willingness to be a little more flexible is positive, there is a long way to go. It has become a well-traveled path—the markets go from panic to enthusiasm and vice versa.

Another fear reflects the slowdown in China and the emerging markets. Developed country stocks were down 7% in the second quarter and emerging market stocks were down 8%.

The U.S. economy is not generating as many new jobs as needed to reduce unemployment. But summer is a notoriously slow period of job growth. Meanwhile, housing is showing a modest but upward trend.

Emotions drive short-term results. Long-term returns are based on the fundamentals of each company. One of our goals is to find mutual fund managers whose compensation is based on the long view, not short-term results.

Our balancing act is to weigh lower-volatility investments, which may return less, against the growth you require to meet your financial needs. Please contact us to discuss your situation.

HEALTH CARE REFORM TAX UPDATE

TAX UPDATE

High-income taxpayers may be subject to an additional federal income tax of 0.9%–3.8% beginning in 2013. Here is a brief summary of how the tax will work:

Income Limits

This tax will apply to most single individuals whose adjusted gross income (AGI) exceeds $200,000 and to married taxpayers filing jointly with AGI exceeding $250,000.

Tax Rates

An additional tax of 0.9% will apply to salaries and self-employment income exceeding the thresholds above. Your employer should withhold this additional 0.9% tax from your salary if the employer pays you more than $200,000 or $250,000.

An additional tax of 3.8% will apply to investment and net rental income exceeding the thresholds above. However, income from tax-exempt bonds will *not* be subject to this tax.

Exclusions

The tax will not apply to withdrawals from IRAs or other retirement accounts, Social Security or veterans' benefits, or pension income.

If your income approaches or exceeds the limits above, please contact your tax advisor for more information about how this may affect your 2013 tax situation.

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LESS PUBLICIZED ISSUES FOR THE EUROPEAN UNION

The headlines about Europe's difficulties tell us little. At a Financial Planning Association conference, Jill attended a session on the European Economic and Monetary Union (EMU) conducted by Andrew K. Rose, professor of international business in the Economic Analysis and Policy Group, Haas School of Business at UC Berkeley. Here are insights on two aspects based on the presentation.

- Membership requirements to join the European Union
- Is it practical to have a single currency in Europe?

Membership criteria—Treaty of Maastricht

- Inflation rates—no more than 5%
- Annual government deficit—ratio of government deficits to gross domestic product (GDP) must not exceed 3%
- Government debt—ratio not to exceed 60% of GDP or must sufficiently decline from previous year
- Exchange rate—countries applying should not have devalued currency from last two years
- Long-term interest rates—must not be more than 2% higher than those in the three member countries with lowest inflation

These criteria were not difficult to meet. According to Dr. Rose, Greece lied about its numbers and, after being admitted, "restated" the numbers.

But more detailed criteria are rarely talked about (excerpt from Wikipedia—Copenhagen criteria).

Membership requires that candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights, respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union.

Since democratic governance is a requirement to join the EMU, one of its benefits has been to avoid conflicts such as arose in the former Yugoslavia from 1991–95 and 1998–2001. The central and eastern European block was able to achieve membership and, in light of this requirement, will try to prevent further instability.

Continued on next page

LESS PUBLICIZED ISSUES FOR THE EUROPEAN UNION
(Continued)

Optimum Currency Area

One of the ongoing questions is whether it makes sense for so many countries in Europe to have a single currency? As we've stated in previous newsletters, it is difficult to formulate one policy when each country has its own government, fiscal and monetary policies. Britain, while part of the Eurozone, is NOT part of the European Economic and Monetary Union and maintains its own currency.

In 1961, Robert Mundell won the Nobel Prize in economics for his work on Optimum Currency Area. Dr. Rose compared Mundell's work as it applies to America and Europe. Below is an abbreviated synopsis of the four main criteria:

1. Labor mobility
2. Capital mobility—price and wage flexibility, supply and demand moving across areas
3. Risk-sharing system—mechanisms to redistribute money, usually in the form of taxation (i.e., tax higher earners to redistribute to lower earners and unemployed)
4. Asymmetric business cycle—one area may have a boom but another area does not

If we apply the above concepts we find the following.

Criteria	United States	Europe
Labor Mobility	People can move from one region to another where jobs are available	High unemployment in southern Europe has not resulted in people moving to northern Europe where jobs are available
Capital Mobility	Costs shared through federal government	No central government to redistribute. Multiple governments with multiple policies
Risk sharing	Ability to tax to and redistribute money	Multiple countries with no centralized fiscal policy
Asymmetric business cycle	Government adjusts monies for different business cycles across regions	Deep trade links reduce transaction costs but cannot easily adjust cycles between regions

France and Germany tend to be the leaders in the EMU but have distinct policies. Germany wants an economic union while France wants currency control. Germany has an ingrained fear of inflation based on its history, so its answer to current problems is austerity but not stimulus, which it fears would trigger inflation.

Hints of progress are to be found. Germany is beginning to be more flexible on its austerity demands in return for suggesting a fiscal union. Given the criteria above, it is questionable whether one currency covering so many different countries with so many different policies is viable over the long term. It seems the best case is some combination of fiscal and monetary consolidation.

THE UNLIKELY SCENARIO OF LIVING OFF INTEREST

Decades ago, living off dividends and interest without touching the principal was an accepted investment practice. However, as interest rates declined and stayed low, this philosophy lost much of its relevance.

Based on interest rates in the date ranges below, annual income on $1,000,000 invested was/is:

	Oct.–Nov. 1994	**Jan.–May 2000**	**Today**
10-Year US Treasury	$82,800	$67,950	$15,000
10-Year AAA-Rated Corporate Bond	$87,400	$80,700	$24,800

It isn't difficult to see why it is rarely practical to "live off the interest." The phrase being used today is Risk On/Risk Off. In order to earn more, you have to assume more risk because buying Treasuries won't keep up with inflation or produce enough interest to live on.

For people not yet retired, saving more will be necessary because investment returns are low. Alternatively, if you spend less in retirement, you don't require as much money.

Once retired, how much risk do you need to take to fund your withdrawals? It is a fundamental question to investing your money. We welcome the opportunity to discuss it with you.

ON SALE—BUY IN THE UNITED STATES

Foreigners, especially Europeans, are investing heavily in what they perceive to be the safe haven and "stable" United States.

The Commerce Department reported that January–March 2012 was the 12th consecutive quarter of increased foreign investments. This includes corporate acquisitions and real estate. Canadians, Europeans, and Latin Americans seem to think buying real estate in the U.S. is a good investment.

International buyers purchased 8.9% of residential real estate over 12 months through March. According to the National Association of Realtors, that is up 24% over the previous-year period. Kenneth Rosen, chairman of the Fisher Center for Real Estate Research at UC Berkeley said international buyers "are either looking for safe havens or bargains, so we're seeing it at both ends of the spectrum."

Continued on back page

LOW INTEREST RATES AND INFLATION

What are negative "real" rates of return? They result when interest rates are lower than inflation and are also known as negative "real" returns. We are currently experiencing such a phenomenon today. How else can you explain government interest rates that are in some cases negative? It occurred with U.S. Treasuries—that is, you buy a bond for $1,010 and get $1,000 back. The same negative real returns recently occurred in Germany and France.

Long-term government bond yields are in the 2% range in the U.S, Britain, and Germany. Would you lend the government money for 30 years for a 2% return?

Policies that facilitate these low returns discourage individuals from saving (see "Living off Interest") but encourage businesses toward borrowing in the hopes they will invest to stimulate economic growth. So far, businesses are borrowing at the low interest rates but holding onto the cash (rather than investing it in equipment, additional jobs, etc.).

The Bank for International Settlements reports potential problems with negative real rates.

1. Companies may borrow money because rates are low—which leads to larger debt than normal on their balance sheet.
2. Pensions using bond yields to value their fund see the liability rise when interest rates are low—and need to put in more money because their return is so low. Britain's pension fund obligations rose thirteen times over the previous year.
3. Collateral damage in the emerging economies can also cause slower growth.

Monetary policy by central banks can't solve all the problems. While no one is advocating immediate interest rate increases, capitalism depends on earning a positive return on capital.

On Sale—Buy in the United States

(Continued from inside page)

For example, an oceanfront condo in Rio de Janeiro costs 50% more than an equivalent residence in Miami. Such opportunities are leading to an increase in the Miami real estate market of 2.5% in March 2012 over the same period last year.

Residential real estate is not back to its earlier levels, but at least prices are increasing instead of decreasing!

It is interesting that Americans worry about how bad things are here, and foreigners want to buy our Treasuries, corporations, and real estate because they are a "safe haven and stable." Like many things, we guess it depends on your perspective.

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