Investor Insights & Outlook

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April Employment Report: Mixed News

The April employment report wasn't so strong that it created worries about economic overheating and Federal Reserve tightening, and it wasn't as weak as to create concern that the economy was about to slide back into a recession.

Looking at private sector job growth, which excludes the much slower-growing government sector, the three-month average, year-over-year growth rate remains relatively high at 2.6%, which is down just a touch from recent highs and still above the 2.4% average growth rate of the past 12 months. Overall, it seems the jobs report was strong enough to keep a rate increase on the table for September, but weak enough that a June rate increase now appears unlikely.

Private Sector Employment and Wage Growth

	Employment Growth (%)	**Hourly Wage Growth** (%)
April 2014	2.1	2.1
May	2.2	2.1
June	2.2	2.0
July	2.3	2.1
August	2.3	2.1
September	2.4	2.1
October	2.4	2.1
November	2.4	2.1
December	2.5	2.0
January 2015	2.6	2.1
February	2.7	2.0
March	2.7	2.1
April	2.6	2.1
Average (12 months)	**2.4**	**2.1**

Source: Bureau of Labor Statistics. Growth rates are calculated on a year-over-year, 3-month average basis.

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Advisor Corner

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I Bonds Versus TIPS, Part 1

Most investors looking for a low-risk hedge against inflation automatically think of Treasury Inflation-Protected Securities, or TIPS. But under the right circumstances, I Bonds, which also offer an inflation-adjusted interest rate, may be just as useful—provided that investors understand how they work and how they differ from TIPS.

One reason that investors don't hear more about I Bonds is that, unlike many other bond types, they are not traded on a market. Only the person in whose name they are registered may redeem them. As such, I Bonds are not found in bond funds' portfolios. These are securities you have to invest in directly.

There are two ways to purchase I Bonds. You can buy them in electronic form directly from TreasuryDirect.gov or you can instruct the IRS (using Form 8888) to use some or all of your federal income tax refund to buy paper I Bonds or to send the money to your TreasuryDirect account, which you can then use to purchase them.

One drawback of I Bonds is that annual purchases are limited to $10,000 per Social Security number for electronic versions and $5,000 per year for paper versions. So, investors who hope to make I Bonds a cornerstone of their inflation-protection strategy and who have a large amount of assets may have to build a suitable position over time. Also, electronic I Bonds may be purchased in any amount of $25 or more, while paper I Bonds are only issued in denominations of $50, $100, $200, $500, $1,000, and $5,000.

Difference in Inflation-Adjustment Methods

Like TIPS, I Bonds are designed to adjust for inflation, although they do so in different ways. For one, TIPS adjust the value of their principal and, thus, the yield, while I Bonds adjust the yield directly with no change to the principal value. Both adjust for inflation semi-annually, and for I Bonds, this happens on the six- and 12-month anniversaries of the date they were issued (the rate of the adjustment is determined every May and November). Both security types use the Consumer Price Index as the basis for their inflation adjustments.

The fact that I Bonds adjust their yields only twice a year and are not tradable means that they can be less sensitive than TIPS to near-term changes in the rate of inflation. For example, if inflation spikes in June of a given year, an investor holding I Bonds would have to wait at least another five months, until November, for the yield on the I Bond to reflect this change (and possibly longer if the anniversary of the I Bond's purchase falls after November). With TIPS, that's not an issue because market prices will adjust to reflect more recent changes to the rate of inflation. Of course, if inflation heads lower, the delay in the adjustment could potentially provide a short-term advantage for I Bonds relative to TIPS.

The interest rate paid by I Bonds includes both a fixed rate that remains constant for the life of the bond plus the inflation adjustment. With interest rates as low as they are right now and inflation relatively low as well, newly issued I Bonds aren't paying much. In fact, the fixed-rate portion of new I Bonds is paying 0%, while the inflation rate for the full year ending with the most recent adjustment last November is 1.48%, for an overall composite rate on the bond of 1.48%. However, one advantage that I Bonds have over TIPS is that their composite interest rate is guaranteed to never fall below 0%, meaning the bondholder is guaranteed to never lose principal. With TIPS, yields can turn negative, potentially leading to losses for the bondholder.

I Bonds Versus TIPS, Part 2

Interest Payments and Tax Advantages

I Bonds continue to earn interest for up to 30 years but can be redeemed as soon as after 12 months. However, a three-month interest penalty applies. They can be redeemed after five years with no penalty. Unlike with TIPS and other bond types, which pay out periodic interest payments, I Bond interest accrues until the bond is redeemed, compounding twice a year while offering no periodic payments.

For those looking for an inflation hedge to be held in a taxable account, I Bonds offer some tax advantages relative to TIPS. The most important of these is that I Bond-holders may defer paying taxes on interest until they redeem the bond. The holder of a TIPS, on the other hand, must pay taxes each year on the interest as well as on any adjustment to the value of its principal (sometimes referred to as "phantom income"). As with TIPS, the interest on I Bonds is taxable at the federal level but is exempt from state and local taxes.

For some college savers, I Bonds also offer a tax advantage in that interest is tax-free if used to pay for college tuition and fees. However, income restrictions do apply. For 2014, the tax break began phasing out at $113,950 in modified adjusted gross income for married couples filing jointly and phased out completely at incomes of $143,950 and above. (For single filers, the tax break starts to phase out at $76,000 and goes away at modified adjusted gross income above $91,000.)

Are I Bonds for You?

If you are an investor looking to add inflation protection to your portfolio and willing to hold on to a security for the long term, I Bonds may be worth a look. But remember that they are designed to serve primarily as a principal-preservation tool rather than a source of periodic income. If you're looking for inflation protection that also pays regular income, you might want to consider TIPS.

On the other hand, because I Bonds are not traded, they are essentially immune to interest-rate risk because changes to prevailing rates have no impact on their value. The same cannot be said of TIPS, which are traded and, therefore, susceptible to prevailing interest-rate movements.

If you are considering I Bonds as a long-term holding, it might be worth waiting until interest rates begin moving higher so that you can attempt to lock in a fixed rate that is above 0% in addition to the inflation rate on the bond. The I Bond's fixed rate hasn't reached 1% since 2007, and there's no telling when rates will return to that level. But for an investment you plan to hold for many years, any fixed rate is better than nothing.

Debt securities have varying levels of sensitivity to changes in interest rates. 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.

TIPS are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. TIPS are subject to risks which include, but are not limited to, liquidity risk, credit risk, income risk, and interest-rate risk.

An investment cannot be made directly in an index.

Home Prices on the Rise Amid Low Inventory Levels and High Demand

The latest report from CoreLogic showed that home prices continued to rise at a much faster pace than previously expected, growing 2.0% in March. On a year-over-year basis, the growth stood at 5.9%, the fastest pace since last July. CoreLogic predicts that prices will rise 0.8% in April, and that the year-over-year growth will tick down to 5.4%.

Unusually low inventory levels and a coinciding increase in demand are driving the prices of existing homes higher. Faster-growing prices are both good and bad news. The bad news is that the higher pace of home price increases may put a dent in the affordability of existing homes, which is something that has the potential of slowing down the housing recovery. The good news is that it is reassuring to see many new buyers who feel financially secure and confident enough to buy a home, even at higher prices. Faster price growth also helps existing homeowners to emerge from their underwater mortgages. According to CoreLogic, current home prices are still 11% below their April 2006 peak. More important, as faster-growing prices hurt the affordability of existing homes, the demand might shift toward new homes. The gap between existing-home prices and new home prices had grown unusually wide and declines in that gap could bolster the construction sector. That, in turn, could provide a direct boost to the GDP and employment. CoreLogic predicts that the price growth of existing homes may moderate later this year and that the prices may increase by about 5.1% from March 2015 to March 2016.

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