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The Prudent **I** NVESTOR

DECEMBER 2010

The Recession's Impact on Employment

With the recession officially ending in June 2009, it was the longest since 1945. It is also associated with the largest drop in payroll employment of any U.S. recession, with the largest jump in the unemployment rate. From the beginning of the recession in December 2007 to the end of February 2010, total nonfarm payroll employment declined about 8.4 million, or 6.1% (Source: Federal Reserve Bank of Cleveland, March 22, 2010). In the same period, the unemployment rate jumped from 5% to 10.1%.

The Overall Picture

In a typical postwar business cycle, the unemployment rate starts leveling off about 14 months after the start of a recession (recessions typically last around 10 months), but it usually takes more than 30 months to return to prerecession levels. The current labor market downturn presents a drastically different picture. The unemployment

rate did not stop rising until 23 months after the start of the recession, and the cumulative rise is well above the normal range.

Similarly, in a typical recession, payroll employment starts to decline at the start of the recession and takes about 12 months to stabilize. Unlike the unemployment rate, payroll employment goes back to prerecession levels relatively quickly once the recession ends, on average 21 months after the start of the recession. The past two recessions, in 1990-91 and 2001, were exceptions, taking 31 and 47 months respectively for employment to recover. Thus, these recessions have come to be known as jobless

recoveries. The pattern of employment decline in the present downturn resembles the last jobless recovery in many ways, suggesting a large decline over a prolonged period.

The unemployment rate reports the number of workers who are unemployed as a fraction of the labor force, but it does not indicate whether the rate is high because people are staying unemployed longer or because more workers have lost their jobs. That information is found in the job-finding and separation rates. Recessions can differ in how much either of these

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The Market Climbs a Wall of Worry!

Although that thought has circulated for decades, 2010 certainly has given that statement top merit. Throughout the year, LMK Wealth Management has maintained our economic prognostication for "SLOW" domestic GDP growth in the range of 2 to 2.5%. Early in the year, we suggested "Head Winds," the likes of high unemployment, uncertainty over tax rates, little progress in the housing sector, and deleveraging by the consumer, would temper demand and the recovery. Inflation has remained low at around 1% as we anticipated early in the year. QE2 (Quantitative Easing Two) will pump another round of liquidity (\$600 billion) into the money supply and help the Fed to accomplish their goal of reinflating the economy. Be careful what you wish for! Although in the short run inflation should remain subdued, looking out a few years, this may trigger inflation rates that may become counterproductive to stable economic growth. The resulting falling dollar should be beneficial to exports over the ensuing months. However, in the longer term,

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Employment

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rates contributes to the overall increase in unemployment, which affects the course of the recovery.

In general, during recessions, separations start rising as the economy enters a downturn, and job finding rates start declining. After some initial rise in unemployment, mostly in the form of layoffs, separations usually start tapering off before the unemployment rate peaks. What accounts for most of the subsequent rise in the unemployment rate is the low rate of job finding among the unemployed, implying that the average duration of unemployment goes up. This suggests that most firms are not ready to begin rehiring as soon as they stop cutting jobs, even though they may have significantly reduced their payrolls. As the economy finally starts recovering, durations get shorter because firms create new jobs and absorb part of the unemployed.

Though separations increased sharply early on in the past recession, more than 95% of the change in the unemployment rate can be explained by the decline in job finding rates. In other words, the sharp rise in unemployment is not due primarily to a wave of job losses but due to the fact that once unemployed, workers' chances of finding employment have fallen dramatically. This could have a number of important consequences for the recovery.

Long-term unemployment reduces workers' industry- and occupation-specific skills, which reduces productivity when they find a job. Once workers find a job, their new starting wages are lower than similarly educated workers, and this disparity continues for a long time. Additionally, many workers are tempted to take the first job they find after a long period of unemployment, regardless of how good a match the job is for them. They will

also be more likely to change employers when job prospects improve. This excessive labor market churning could be detrimental to overall productivity during the recovery.

Demographic Differences

Although the overall unemployment situation has been bleak, the effects have not been evenly distributed across demographic groups. The difference between men and women has garnered the most attention, because men accounted for 78% of the job losses despite constituting 51% of non-farm employment at the start of the recession. The dominant explanation for this discrepancy is the difference in the severity of the recession across industries. Men predominate in goods-producing industries, such as natural resources and mining, construction, and manufacturing, which accounted for about half of total losses. Women comprise the majority in recession-resistant fields, such as education and health care, which saw an increase in jobs during the recession.

However, men always bear the brunt of job losses during recessions. Between 1969 and 1991, male employment fell by an average of 3.1% during the five recessions experienced during the period. Female employment, on the other hand, tended to rise by an average of 0.3% during recessions (Source: *The Effects of Recession Across Demographic Groups*, September 2009).

Between the fourth quarter of 2007 and the second quarter of 2009, total employment losses amounted to 4%. Male employment fell by 5.7% and female employment by 2%. Employment of single adults fell at more than twice the rate of married individuals, while white employment fell by only two-thirds as much as black employment.

By age, employment fell 14.8%

for those ages 16 to 19, 7.1% for those ages 20 to 24, 5.2% for those ages 25 to 34, 7.3% for those ages 35 to 44, 2.7% for those ages 45 to 54, and increased 3.8% for those over age 55.

By education level, employment fell 8.8% for those with no high school diploma, 5.3% for those with a high school diploma, 3.2% for those with some college, and only .1% for those with a bachelor's degree or higher.

What do these differences indicate? The primary reason cited for the difference between males and females is the change in industries. Men are also less likely to have attended college than women. Single people might have lost proportionately more jobs because the average single person is younger, thus less experienced and less educated, than the average married person.

At this point, whether we have a muted, jobless recovery or a rapid one featuring full employment will depend on the demand for labor. The unemployment rate is stabilizing, but the demand for workers has not been showing any signs of major improvement yet. Of course, some kinds of slack might exist that prevent rising demand for labor from translating immediately into new jobs. Employers could demand more hours from current employees before hiring new employees. The average weekly hours of production workers, which stands at 33.1 hours, indicates that this is likely to happen. Similarly, part-time employees can be made full-time employees.

No two recessions are the same. Structural changes, such as labor force participation, the skill level of workers, and the shift from manufacturing to services, can make comparisons with prior recessions difficult. However, one thing is for sure — this recent recession is unusual in the depth and breadth of employment losses. ○○○

Distributing Your Estate to Grown Children

When your children were young, your primary concern was probably how to provide for them in the event you and your spouse died. Even though they may now be grown, your children are probably still the center of your estate plan. Just because they are adults doesn't mean that you have to leave their entire inheritance to them outright. Consider these factors first:

✓ **Do you want to distribute your estate gradually?** If substantial assets are involved, you may want to set up trusts to distribute your assets gradually, such as in thirds when each child reaches ages 25, 30, and 35. You can always give the trustee power to make early distributions for items like paying for college, starting a business, or purchasing a home.

✓ **Have you selected a trustee carefully?** If trusts are involved, you want a trustee who is impartial and will deal fairly with all your children. Think twice before naming one of your children as trustee. One sibling in a position to decide what happens to another sibling's inheritance can cause disagreements between siblings.

✓ **Have you thought about the consequences of a child divorcing?** You probably don't want a portion of your assets distributed to an ex-daughter-in-law or ex-son-in-law, so special provisions may need to be added to trusts.

✓ **Have you considered how assets will be distributed among children?** Perhaps one child is better off financially than your other children. Do you divide your estate equally or give less to the financially well-off child? Children often feel a right to an equal share of their parents' estate, even if they have a substantial estate of their own. If you decide to make unequal distributions, be sure to explain why personally or in a

letter left with your estate planning documents. Hopefully, this will prevent hurt feelings or disagreements among siblings.

✓ **Do you need to make special distributions to even out inheritances?** Perhaps you have paid all college costs for some children, while other children have not attended college yet. You may want to ensure that all children receive a college education, and then distribute the rest of your estate equally among your children.

✓ **Should you coordinate your estate plan with your children's estate plans?** If your children have substantial estates of their own, it may not make sense to leave additional assets to them. They may prefer those assets go directly to their children, helping to minimize family estate taxes.

✓ **Have you explained the need for estate planning to your children?** Especially if you are leaving a substantial estate to your children, they may need to plan their own estates. You don't need to dictate what they should do with their estates, but gently remind them why they need an estate plan. After major life events, such as marriage, divorce, or a child's birth, remind your children to revise their estate plans. ○○○



Calculating an Investment's Basis

Your capital gain or loss on the sale of an investment equals the proceeds from the sale less your basis (the cost of acquiring the investment). When you purchase an investment, your basis equals the price you paid plus any fees or commissions. While the calculation is fairly straightforward, other factors can affect your basis calculations:

✓ Reinvested dividends are added to your basis at full market value plus any fees or commissions.

✓ The basis of any investment received as a gift is the donor's original basis plus any gift tax paid by the donor. However, if you then sell the investment at a loss, your basis is equal to the lesser of the donor's basis or the investment's fair market value on the date of the gift.

✓ For inherited investments, the basis is the market value on the date you inherited the investment, typically the date of the donor's death.

✓ Your basis in stock that has been split is the same as your basis before the stock split. Your per-share basis, however, will now equal your total basis divided by the number of shares you own after the split.

✓ When you exercise a stock option, your basis equals the price you paid for the shares plus any fees or commissions, which may be lower than market value. Shares must be retained for at least one year after purchase and for two years after receipt of the option, or any gains will be taxed as ordinary income.

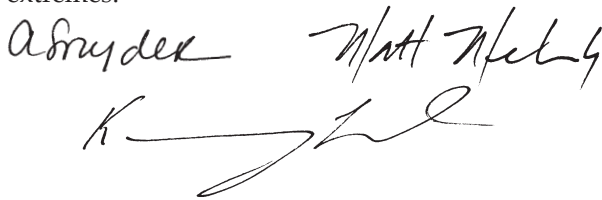
Please call if you'd like help calculating your basis in an investment. ○○○

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debasement of the currency will be unsettling to the confidence necessary to achieve solid economic growth in the out years.

Reflecting on the September issue of *The Prudent Investor*, LMK suggested that "IN THE END, WE BELIEVE IT IS EARNINGS THAT DETERMINE STOCK PRICES." Although we don't forecast earnings, we suggested that through productivity and expense reduction, earnings growth would continue to do quite well. As the reports came in, the markets responded nicely with gains in the equity markets for September and October. The earnings growth comparisons for 2011 may be less exciting than those experienced in 2010, yet still acceptable. Companies are limited as to further cost reductions. One of the downsides to the falling dollar is an increase in material costs. Subdued demand by the consumer makes it difficult to pass the increased costs through price increases. Hence, profit margins may be squeezed looking forward. The elections are over. Compromise on tax increases are in the wind. QE2 has started. The market has anticipated a lot of favorable events since the summer soft patch. That news is baked into current levels. Around the election, investor confidence was once elevated. Sovereign Debt Problems in the Euro Zone are starting to once again get the attention of the daily news cycle. Although LMK believes the sluggish recovery continues into 2011, a market adjustment could be in the cards. Taking some profits, increasing cash a bit may be prudent. If the market corrects, there may be opportunities at lower valuations. Avoid the crowds at the extremes!



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Income Tax Basics

Realize you can exert some degree of control over how much you pay in income taxes. While you do have to file and pay taxes every year, how much you pay depends on the tax strategies used. Discuss your tax situation with a tax professional, reviewing ways to help reduce your income tax bill.

Understand basic tax concepts.

You don't have to become a tax expert, but you should have a basic understanding of the tax laws so you recognize when you need assistance. Before any major financial transaction, review the tax ramifications.

Don't make decisions solely for tax reasons. While you want to minimize the payment of income taxes, that is only one factor in most financial decisions. You should first make sure the transaction is economically beneficial and then decide how to minimize tax effects.

Keep good tax records. During the year, file any records with possible tax ramifications. That way, when it comes time to file your income tax return, all your tax records will be located in one place. ○○○

Financial Thoughts

Among men age 65 and older, 53% received either a retirement annuity or a pension in 2008, with a mean annual amount of \$19,557. However, just 29% of women in the same age bracket received work-related income, and their annual payout was significantly lower at \$12,137 (Source: Employee Benefit Research Institute, 2010).

A new study found that just

42% of employers have adopted an automatic enrollment feature to help ensure that their employees are regularly saving for retirement. The majority of those employers who do offer this option make the feature available only to new hires, with just 11% extending it to include existing employees (Source: AARP, 2010).

In a recent survey, 39% of respondents defined financial

success as being debt free. The appeal of being debt free varied according to age, with half of those age 65 and older citing no debt as a measure of success, compared with only 30% of those between the ages of 18 and 34. Nearly one-third of all respondents defined financial success as being able to save for long-term goals such as education and retirement (Source: TD Ameritrade, 2010). ○○○