Investor Insights & Outlook

October 2016 3rd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

We are pleased to provide the following overview of the domestic and international economic backdrop and the financial markets that impacted our investment policy and strategy during the Third Quarter of 2016, as well as other articles of interest.

The average length of economic expansions since 1900 has been 46 months and we are in our 88th month. This is currently the 4th longest expansion in the last 116 years. The problem with this expansion is the slowness, both perceived and real, of its velocity. The year over year change of real GDP growth is 1.3%, best among the developed world economies. Curiously, right before the election, early Q3 numbers show an annual real rate of 2.9%, with a trade surplus contributing 0.83% of the number. That counts as expansion even though it feels like the U.S. is stuck in the mud. Regulatory burdens, increased health care costs, and uncertainty due to the upcoming election are all contributors to anemic growth. How does an economy break the cycle of slow growth? It has become increasingly clear that this issue cannot be solved by monetary policy. Monetary policy can only dampen effects experienced by the economy.

Any economic cycle of increased activity must impact the 3 pillars of our GDP. As our readers may recall, GDP is driven by consumer spending, corporate investment, and government spending. One idea floated by economists and pundits is 'helicopter money', essentially the government handing out money to the citizenry. This is novel policy meant to stimulate the consumer spending portion of the GDP stool. The problem with helicopter money is it is fleeting. One-time stimulus effects do not work for the long term. Think of the cash for clunkers program and the 1st time home buyer credit. No real impact to the economy other than short term pops in those respective areas. What the U.S. economy needs is tax reform for consumers and corporations combined with increased infrastructure spending.

continued on next page

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Domestic Economic Overview (continued)

Companies will continue choosing the financial engineering aspect (stock buybacks, etc.) of capital allocation vs. reinvesting in their business until they see increased demand from consumers. We remain pessimistic that the economic gridlock facing the U.S. will be solved by bipartisan efforts in Washington, especially after what is playing out as a very contentious election season.

The consumer, on the whole, looks healthy, but constrained from a lack of growth in real wages in years. Global household debt service as a ratio to disposable personal income is approximately 10%. This is down from the peak of 13.2% at Q4 2007.

Household net worth is sitting at $90.3 Trillion, rising from $67.7T before the financial crisis recession of 2008-2009. Housing starts are almost back to their 20-year historical average. We continue to look for positive aspects of the economy to present themselves but we remain apprehensive about the possibility of a breakout in growth without meaningful reforms.

International Economic Overview

Japan's year over year real GDP is 0.8%, in line with their 20-year average, China grew at 6.7% which sounds like a good number until we realize it is their lowest growth rate in a decade and built on massive infrastructure spending that is likely to slow down in the future. In 2015, China consumed 12% of the world's oil, 47% of the Zinc, 49% of the Nickel, 50% of Copper, 55% of Aluminum, and 60% of Iron ore! Those consumption levels are bound to drop off and will impact any emerging market economies built on exporting commodities to China. The Eurozone's real GDP was 1.2% and that was prior to pricing in any of the currency effects of Brexit (more discussion below). Our overall view of slow growth globally has not changed.

The immediate effect on equity prices associated with Brexit were short-lived. The pullback in equity prices rebounded almost immediately and have since surpassed levels prior to the referendum. The Pound, however, has continued to sink. Immediately post Brexit, the Pound weakened relative to the U.S. Dollar to the range of 1.30 to 1.35. Once we got into October it dropped to the low 1.20's. This should help British exporters, help tourists visiting the UK, and any UK firms that earn abroad. Any firms that trade with the UK will feel the effects of the weaker Pound in a negative sense because their goods will cost more and therefor they may sell less to the UK. UK citizens will see the cost of goods increase (food, gas, etc.) and inflation will creep higher in tandem with the expectation of a slower growing or shrinking economy. While the new Prime Minister, Theresa May, has indicated a Q1 2017 election for the actual legal start of the UK exit from the EU, politicians from all countries are already positioning for the negotiations. It should be noted that for the EU to survive in its current form the powers that be do not want any other countries to leave the EU. That means the negotiations could be difficult for the UK and the ultimate effects are still unknown. The uncertainty of the actual process will weigh on the UK, the markets and the UK trading partners.

Equity Markets

The third quarter provided gains across the board both domestically and in most international markets. Sectors or countries which had been weakest in early 2016 had the largest gains. In the U.S. markets, growth oriented sectors and indices recovered stronger and several emerging market country indices also performed well, such as the Hang Seng in Hong Kong, South Korea, and Brazil. Domestically the growth oriented NASDAQ rose 10.0% resulting in a positive 7.2% year to date gain. Regarding valuations, collectively the U.S. markets still appear to be within a fair valuation range, even assuming a modest increase in risk free bond yields which drive intrinsic value, fundamentals based analysis. Earnings for the S&P 500 have turned positive quarter over quarter for two periods now after a five quarter slide. Year over year change is still slightly negative although this should turn positive in the third quarter.

Internationally the largest positive is the impact of stabilizing commodity prices for many emerging markets. Risk in Europe increased with the Brexit vote, but very slow growth still appears the most likely scenario over the next year. For the U.S. markets, the largest risks appear to be the earning rebound that is currently anticipated and an increase in bond yields that could surface, even temporarily, if inflation numbers surprise to the upside in early 2017. We believe this surprise is possible and could present a buying opportunity for equity markets where portfolios have room to add or rebalance. Even without a broad market correction, opportunities in reasonably valued companies can be found, particularly in the financial, industrial, and consumer discretionary sectors.

2016		
	QTD	YTD
S&P 500	3.9%	7.8%
NASDAQ Comp.	10.0%	7.2%
MSCI EM	9.2%	16.3%
MSCI Europe	5.7%	0.4%
Hang Seng (HK)	12.9%	10.0%
		Source: Morgan Stanley & Co.

WEB PRESENCE AND CLIENT LOGIN

Last year we launched our website www.concordeco.com. If you have not already done so, please take a few minutes to explore the website. On the site you will find information about our firm, services, certain literature, and access to client portals. Notice that our "Client Access" tab has a pathway to a "Concorde Login". To obtain your personal login information, please contact Greg Wood at gregwood@concordeco.com or 972-701-5412 and he will work with you to get your account set up.

Fixed Income

Although much of the focus in fixed income markets has fallen on the projections for U.S. Fed policy normalizations via the Fed Funds rate, we may be entering an adjustment period higher for Treasury bond yields based on underlying fundamentals. Inflation indicators such as the core PCE favored by the Fed and headline CPI are trending higher and could reach levels in early 2017 that may surprise bond investors.

In addition, domestic wage growth is trending above 2.5% and some analysts believe the market for skilled employees is already tight. Treasury yields, in particular 5-year and longer maturities, have been steadily trending higher since early July. The implications are that the continuation of this spike in yields could not only damage holders of medium to long term bonds, but also cause volatility in equity and other risk markets. Increasing demand for U.S. fixed income securities from domestic and international sources, particularly investment grade corporates, should contain any increase in rates. We think an increase in 10-year Treasury yields to the 2.00-2.25% level could create angst, even though we traded there in late 2015/early 2016.

U.S. Treasury Yields				
	9/30/15	12/31/15	Recent Lows July 2016	9/30/16
2-year	0.63%	1.05%	0.55%	0.76%
5-year	1.36%	1.76%	0.95%	1.15%
10-year	2.04%	2.27%	1.35%	1.59%
				Source: Morgan Stanley & Co.

Politics and Investment Performance

by Alina Lamy

With President Obama's time in office coming to a close, here's the result of an investigation into the relationship between the composition of the legislative and executive branches of the U.S. government and market performance. The 'unified' situation refers to years when the Senate, the House of Representatives, and the White House were all controlled by the same party. The 'partially divided' situation represents years when the House and Senate were controlled by the same party, but the White House was held by a different party. The 'completely divided' situation uses data from years in which the two houses of Congress were divided. Both the S&P 500 and the diversified portfolio (60% stock/40% bond) averaged the highest returns during unified years, lower returns during partially divided years, and the lowest under completely divided years.

Average Annual Returns, 1926–2015	S&P 500	Diversified portfolio	Number of years
Unified government	14.8	10.1	45
Partially-divided government	11.1	9.4	30
Completely-divided government	5.1	6.6	15

Source: Morningstar Direct, Morningstar calculations.
Stocks are represented by the Ibbotson SBBI Large Company Stock Index.
Bonds—Ibbotson SBBI U.S. Intermediate-Term Government Bond Index.

How Your Investment Income Is Taxed

by Timothy Strauts

This article provides a quick rundown of how the income produced by different investment types is treated at tax time. While this is by no means an exhaustive list, it covers some of the main categories of income-producing investments and how the income they produce is generally treated by the IRS at tax time. Please note, though, that because every investor's tax situation is unique, you should consult your accountant for verification of your tax status and tax treatment of any investment product mentioned below.

Also, we won't go into capital gains taxes in this article because the tax treatment of them is largely the same regardless of asset class.

Stocks

Stocks With Qualified Dividends

For most stocks that pay qualified dividends, the tax treatment is pretty straightforward: Investors would report the income on a 1099-DIV in the Qualified Dividends box. Investors in the 10% and 15% brackets will have a zero tax rate on dividends. For individuals in income tax brackets greater than 15% but less than 39.6%, qualified dividends are taxed at 15%. Individuals in the 39.6% tax bracket are subject to a 20% tax on dividends. Higher-income taxpayers are also subject to a 3.8% Medicare surtax on investment income.

In order to be a 'qualified dividend,' the dividend must be issued by a U.S. corporation or a foreign company that either trades on a U.S. exchange, such as an ADR, or is eligible for benefits under a U.S. tax treaty.

Note that in order for the dividend to be 'qualified,' you must have owned the investment for at least 60 days of the 121-day period that begins 60 days before the ex-dividend date, or the day the stock trades without the dividend priced in.

Foreign Stocks With Nonqualified Dividends

If you're considering a foreign stock for a taxable account, do your homework on whether the company's dividends are qualified. You can find out more about this by consulting IRS Publication 17.

Preferred Stock

In many (but not all) cases, preferred-stock dividends are treated as qualified dividend income for tax purposes, even though they have many bondlike characteristics such as a stated par value and fixed coupon.

Some dividends paid by U.S. companies are not eligible for lower tax rates, however. Here are a few examples:

REITs

Real estate investment trusts do not pay income taxes at the corporate level, but they are required to pay annually at least 90% of their taxable income in the form of shareholder dividends, which is one reason they pay out such large dividends.

Different types of REIT payments are taxed at different rates. In the majority of cases, REIT dividends are considered nonqualified and taxed at ordinary income rates; therefore, they are probably best held in a tax-advantaged account. But there are

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other types of income payments, such as those distributed from taxable REIT subsidiaries or out of long-term capital gains, which could be subject to lower tax rates; investors should consult with their tax advisors in these cases.

MLPs
Master limited partnerships are partnerships that trade on a public exchange. They may offer certain tax benefits but also some tax complexity. Unlike with REITs, however, it's best to hold MLPs in a taxable account, because owning them in a tax-deferred account can result in something called unrelated business taxable income, which then requires the account to pay taxes.

MLPs pass through their taxable income to unitholders, who then pay taxes on that income at their own marginal tax rates, often only when the units are sold. These can be a little complicated at tax time, owing to the fact that you don't use a 1099 form to report the distributions but instead have to use a K-1.

Another interesting feature of MLPs is that cash distributions are not directly taxable: The IRS looks at them as returns of capital, so it reduces the investor's cost basis in the MLP. In practical terms, that means that the investor will have to pay taxes on the spread between a lower cost basis and the MLP's price at the time of the sale, but most of the income the MLP distributes from year to year is effectively tax-deferred.

Exchange-traded products can sometimes sidestep tax-reporting complexities, but oftentimes at the expense of the tax benefits one would get if the MLPs were held directly.

Bonds
Taxable Bonds
Bond income is generally taxed at investors' ordinary income tax rates in the year it was received. The income is taxable at the federal level in all cases, but Treasury bonds are not subject to state and local income taxes.

TIPS
As with Treasury bonds, interest payments from Treasury Inflation-Protected Securities, and increases in the principal of TIPS, are subject to federal tax but exempt from state and local income taxes. One additional thing to remember about TIPS, however, is that the amount by which the principal of your TIPS increased because of inflation is taxable for the year in which it occurs, even if your TIPS hasn't matured (in other words, before you would receive an actual payment of principal).

Municipal Bonds
Muni bonds are issued by state and local governments to finance public projects. In the vast majority of cases, the income paid out by these bonds is not taxed at the federal level. In some instances (particularly if the bond is issued by a state or municipality in which you reside), muni income is not taxed at the state or local level, either. It's also worth noting that income from private-active munis is subject to the Alternative Minimum Tax.

Other
Commodities
There are typically no dividend or interest payments paid to investors who get exposure to commodities through exchange-traded note (which is an unsecured debt obligation) or grantor trust (which often holds physical commodities) structures. However, if you bought a commodity-futures-based ETN, you might have to report income using a Schedule K-1.

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This is for informational purposes only and should not be considered tax or financial planning advice.

Stocks are not guaranteed and have been more volatile than the other asset classes.

Holders of preferred stock are usually guaranteed a dividend payment and their dividends are always paid out before dividends on common stock. In event that the company fails, there's a priority list for a company's obligations, and obligations to preferred stockholders must be met before those to common stockholders. On the other hand, preferred stockholders are lower on the list of investors to be reimbursed than bondholders are.

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. Bonds in a portfolio are typically intended to provide income and/or diversification. 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.

A municipal bond investor is a creditor of the issuing municipality, and the bond is subject to default risk. Only insured municipal bonds are guaranteed as to the timely payment of principal and interest by issuer. However, insurance does not eliminate market risk. Municipal bonds may be subject to the Alternative Minimum Tax and state and local taxes, and federal taxes would apply to any capital gains distributions.

Returns and principal invested in REITs are not guaranteed. REITs typically provide high dividends plus the potential for moderate, long-term capital appreciation. A REIT must distribute at least 90% of its taxable income to shareholders annually. Real estate investment options are subject to certain risks, such as risks associated with general and local economic conditions, interest rate fluctuation, credit risks, liquidity risks and corporate structure. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, liquidity risks, and differences in accounting and financial standards.

Transactions in commodities carry a high degree of risk and a substantial potential for loss. In light of the risks, you should undertake commodities transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. Trading in commodities is not suitable for many members of the public. You should carefully consider whether this type of trading is appropriate for you in light of your experience, objectives, financial resources, and other relevant circumstances.