



## THE FEDERAL ESTATE TAX: WHAT MAY LIE AHEAD

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The federal government imposes an estate tax at your death if your property is worth more than a certain amount. All property left to a U.S. citizen spouse is exempt from the tax. Estate tax is also not assessed on any property you leave to a tax-exempt charity.

The estate tax exemption amount is \$2M for individuals dying in 2008. In 2009, the exemption amount is scheduled to increase to \$3.5M. Current law provides for total repeal of estate taxes for one year in 2010 and resumption of estate taxes with a \$1M exemption in 2011 and beyond.

If you give away more than \$12,000 per year to any one person or noncharitable institution, you are assessed federal "gift tax," which applies at the same rate as the estate tax. You will not actually have to pay gift tax on the first \$1M of taxable gifts, but taxable gifts come back into the estate tax due calculation made at your death.

Clients and their lawyers are understandably frustrated trying to plan under a system in which an estate's tax bill will vary hugely based simply on date of death. Most experts expect legislation before full repeal in 2010 to address the situation. Almost no one believes we will see full repeal of the estate tax for 2010, and even fewer believe permanent repeal is possible.

In his article "My Crystal Ball" in the May 2008 edition of the professional journal *Trusts & Estates*, nationally prominent estate planning lawyer Conrad Teitell hazards his very educated guess as to what we can expect. Mr. Teitell is renowned in the estate planning community not only for his technical expertise, but for his ability to bring humor to somewhat dry topics.

Bottom line: The law scheduled to take effect in 2009, and only for that year, will be made permanent—that is to say, there will be a \$3.5 million exemption (\$7 million for a couple) with a top tax rate of 45 percent...

[I]f there is enough dough under the pay-as-you-go (pay-go) rule (or it's tossed out the window, as is often the case), the estate tax exemption will be increased to \$5 million (\$10 million for a couple) with a top rate of 35 percent. But because of the relationship Congress has with the printing and timber industries, the exemption above \$3.5 million and the rates below 45 percent would be phased in --- ever so gradually. An alternative to phasing in a higher exemption would be to index it for inflation...

The unlimited gift and estate tax charitable and marital deductions will remain, as well as the special gift and estate tax marital rules for alien spouses (not to be confused with alienated spouses, who may well be Americans). And the \$12,000-per-donee annual gift tax exclusion (indexed for inflation) will remain.

A penultimate prediction: it's said that the meek shall inherit the earth, and they shall do so with a stepped-up basis. Thus, the carry-over basis rule scheduled for 2010 won't be included in the brand new law.

Given the uncertainty, it generally does not make sense currently to make large taxable gifts and pay gift tax on lifetime transfers. Waiting until death to make significant transfers should give your estate the opportunity to benefit from increased estate tax exemption amounts and possible reduction in estate tax rates. What does make sense, however, is to take advantage of current lifetime opportunities to pass assets to or for the benefit of loved ones without payment of gift taxes. The assets transferred, as well as the future growth on those assets, will not be includable in your estate at your death and will therefore not be subject to estate tax at that time. These opportunities include, among others:

- Annual exclusion gifts
- Direct payment of tuition and healthcare expenses for others
- Gifting your \$1M gift tax exempt amount to start those assets growing outside of your estate
- Grantor retained annuity trusts (GRATS) and charitable lead annuity trusts (CLATS) may have special appeal currently as a result of the government's valuation formula for the individual gift element in these transactions and the recent pullback in the value of assets which could be used to fund these vehicles.

We would be most happy to discuss these and other tax saving opportunities with you, and, working in concert with your estate planning attorney and other professional advisors, help to make sure that your objectives are being accomplished as effectively as possible.

### 2nd QUARTER 2008 INDEX PERFORMANCE

#### Domestic Equity Indices

	QTD	YTD	TTM*
S&P 500	-2.73	-11.91	-13.12
Dow Jones	-6.84	-13.35	-13.24
NASDAQ	0.61	-13.55	-11.92
Russell 1000	-1.89	-11.20	-12.36
Russell 2000	0.58	-9.37	-16.19
Russell 3000	-1.69	-11.05	-12.69

#### International Equity Index

MSCI EAFE	-3.50	-12.70	-13.04
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#### Domestic Fixed Income Indices

Lehman Aggregate Bond	-1.02	1.13	7.12
Merrill Lynch 1-12 Yr Muni	-0.30	1.15	5.40

\*Trailing 12 Months

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<b>Integrity</b>	The core of who we are and the way we live
<b>Expertise</b>	Knowing our profession and practicing it with passion
<b>Advocacy</b>	Being active champions of our clients' financial interests
<b>Confidentiality</b>	Ensuring client privacy

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# PERSPECTIVES

...thoughts and commentary on today's financial issues

Summer 2008

## MARQUETTE ASSET MANAGEMENT, INC.

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### FEATURED

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### ECONOMIC UPDATE

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Many of our clients have expressed concern that the U.S. economy is in serious trouble. And those concerns are understandable. As the two charts below indicate, we are experiencing major economic dislocations – in particular, the deflating housing bubble and tight credit conditions, which, along with increasing food and energy prices, make it more likely that the rest of the economy will be drawn into a period of substandard growth.

While it remains uncertain whether the U.S. economy is officially in recession – for more on what officially defines a recession, see the story on Page 3 – we at Marquette take the view that downturns are an ordinary part of the business cycle, and that they can be weathered by investors with an appropriately long-term asset allocation. Further, we will be watching for the inevitable turnaround, which will be marked by the three indicators of a normally functioning credit market:

- 1) further tightening of credit quality spreads;
- 2) improvement in the relative performance of bank stocks vs. the market; and
- 3) stabilization in the Fed's holding of U.S. treasury securities, indicating a decreased need to swap them for less liquid securities held by banks.

### By The Numbers

Here's a summary of the economic trends we've been watching for the past quarter, and what we look for in the months to come:

- Economic growth is slowing and despite aggressive moves by the Fed. The biggest risk today to financial companies is that the mark-to-market write-downs are coupled with increased loan losses, resulting in a contraction of loan portfolios, a further reduction in appetite for lending, and, consequently, an even more serious credit crunch than what we have already seen.
- The aggressive moves by the Fed since the beginning of the year have yet to stabilize the credit markets. Markets do not expect further interest rate cuts in the foreseeable future, and it seems much too soon to be talking about interest rate increases by the Fed. The Fed will want to see bona fide

evidence of a stabilizing economy and functioning credit markets before increasing rates.

- Core inflationary pressures remain subdued with a slowing economy. Expect inflation concerns to escalate once the economy stabilizes and begins to strengthen, especially if commodity prices remain strong.
- Commercial real estate construction has acted as a counterbalance to the weakness in residential construction, however this is changing. Credit in the commercial real estate market is tightening as reported in the Fed's Senior Loan Officer Survey. The securitization market in commercial mortgages is slowing, making sources of capital harder to come by for new projects.
- The U.S. economy is working through a de-leveraging process that will extend through the year and make the subsequent economic recovery slow to evolve. (The aggressive moves by the Federal Reserve to add liquidity should cushion the severity of the economic slowdown.) The first sign that the path for recovery is developing will be an improvement in the credit markets. Unfortunately, it will be difficult for the financial sector to stabilize until the housing market stabilizes.

### Economic Growth

- The final reading on 1Q-08 Real GDP increased at a 1.0% rate (up from 4Q-07 rate of 0.6%). Real GDP increased 2.5% from 1Q-07 to 1Q-08.
- Real Personal Consumption Expenditures (PCE) increased 1.1% in 1Q-08, compared with an increase of 2.3% in 4Q-07. The last time that Real PCE growth was weaker than the current reading was 1Q-95. Additionally, durable goods declined 6.0% versus a 2.0% increase in 4Q-07. Weakness in the housing sector continued with a 24.6% contraction that reduced 1Q-08 Real GDP by 1.12%.
- Corporate activity is unlikely to increase significantly until consumer spending shows signs of revival.
- Looking forward, the relationship between Real GDP and Leading Economic Indicators suggests that economic activity is likely to remain below trend for the upcoming 2 quarters. The impact of the current liquidity crisis solidifies the likelihood of sub-par economic activity into the fall of 2008.
- Leading indicators in most developed countries are now pointing to slower growth in 2008. World growth is being downgraded to 3.5% - 4.0% due to the ongoing disruptions in the credit markets and the increased scrutiny being employed by lending institutions. While some central banks have lowered interest rates in response to the prospect of slower growth (England & Canada), other central banks are more concerned about budding inflation pressures and have held rates steady (Europe) or actually increased rates (Australia).

### Inflation

- On a year/year basis, the Consumer Price Index (CPI) is up 4.1% through May and the Producer Price Index (PPI) is up 7.2%. Headline inflation



pressures are being reported at elevated levels due to recent strengthening in energy and food prices.

- The rise in headline inflation is eroding the purchasing power of consumers at a time when real wage growth is slowing.
- Core inflationary pressures remain relatively contained, however. For the 12 months ending May, the Fed's preferred measure of inflation, the Core PCE, is at 2.1% - just above the upper bound of the Fed's target range for inflation. Core CPI is 2.3%, and Core PPI is 3.0%.
- Recent statements by the Fed indicate increased vigilance regarding developing inflationary pressures. Nevertheless, in an environment of deflating house prices, credit market stress and weakening economic activity, the Fed still believes that inflation is more likely to fall than to rise.
- Year/year unit labor costs are below 1%. Increased productivity and the lack of bargaining power by labor have enabled unit labor costs to stabilize.
- It is unlikely that a new inflation spiral is taking hold until the employment cost index advances in a sustained fashion.
- Domestically, corporations generally have limited pricing power at a time when consumer expenditures are slowing and labor markets are softening.
- Market-based measures such as the TIPS yield are not indicating any substantial increase in inflationary pressures.
- Globally, headline inflationary pressures are rising, especially in emerging economies. China's inflation is at a 12 year high of 8.5% vs. 3.0% a year ago. Russia's inflation rate has risen from 8% to 14% over the past year; Indonesia's inflation is 9%. Much of this inflation increase is due to higher energy and food prices. Since 2002, 90% of the increased demand for oil and metals has come from emerging countries. Additionally, in emerging countries, food is a larger part of the inflation calculation. Of particular concern is the wage inflation being recorded in emerging countries.

## Employment

- The job market continues to soften. Over the past 12 months, average payroll gains have averaged 20,000 per month. At this time last year, payrolls were growing at an average of 142,000 per month.
- Year/year payroll growth, which peaked at 2.1% in early 2005, is currently at 0.2%. Weakening employment growth corroborated with increasing unemployment claims is an indication of softening economic conditions. Rising initial unemployment claims are generally a precursor to weaker employment statistics.
- Unemployment bottomed in March 07 at 4.4%. The most recently reported figures for May 08 put unemployment at 5.5% - the highest reading since 3Q-04.
- Continuing unemployment claims are running at a 4 year high - over 3 million. The fact that continuing claims are at 4 year high levels while initial claims are still well below levels typically experienced in an economic slowdown is an indication that corporations are not firing en masse, but they are not hiring, either.

## Corporate Profits

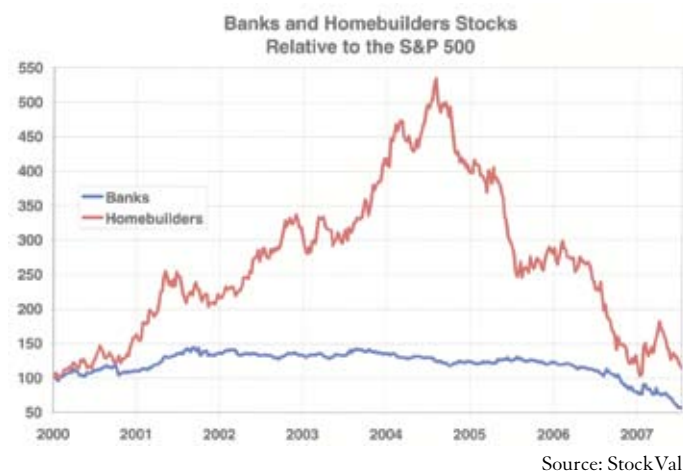
- 1Q-08 S&P operating earnings were 25.8% lower than 1Q-07 - a continuation of 4Q-07's weak results. This number is skewed to the downside by the weakness in the financial and consumer discretionary sectors. Financials remain the most at risk sector. Earnings in the Financial sector were down 82% in 1Q-08. Earnings ex-financials were +11.1% in 1Q-08. Financials are one of the most heavily weighted sectors in the S&P 500, and thus their weakness results in a disproportionate impact.
- Despite lackluster results from Financials and certain areas within Consumer Discretionary, the majority of the remaining sectors (Technology, Energy, Industrials, Consumer Staples and Utilities) have been sufficiently robust to record double-digit profit expansion for the first quarter.
- The two sectors that have exhibited the largest deterioration in earnings expectations over the past 6 months are Financials and Consumer Discretionary.
- Consensus estimates indicate that 4Q-07 was the trough in earnings. Even if that is correct, it is most likely that the earnings recovery will be slow.

## Interest Rates

- Credit spreads remain near historically wide levels indicating that pressures and concerns still exist in credit markets. Most spreads have stabilized over the past quarter, and have started to tighten, but further improvement is required to indicate a more normal credit market environment.
- The Senior Loan Officer Survey indicates a general tightening of lending standards in the major loan categories. Of particular interest is the sharp tightening of lending standards in commercial real estate. This area has been an area of relative strength, but if credit becomes less available, this sector will also become a drag on economic growth.
- The Senior Loan Officer Survey also points out a problem that the Fed is facing - although liquidity is expanding, borrowing is becoming more of a challenge as standards are tightened.

## Housing

- The softness in the housing sector continues to detract from overall economic growth, and is likely to persist as such throughout 2008.
- Up to now, some of the weakness in the housing sector has been countered by strength in non-residential fixed investment, but the continued slowing of the economy and the tightening of the credit markets is causing weakness in commercial construction as well. In 1Q-08, the weakness in the residential sector detracted 1.12% from Real GDP while non-residential only added 0.06%.
- The Case Shiller index for home prices demonstrates that the weakness in home prices is accelerating. The index for the 20 largest metro areas declined by 15.3% from the prior 12 months and an annualized 24% over the previous 6 months. All 20 metro areas experienced price depreciation over the past 12 months. This is the first time that this series of data has experienced such an event.
- Inventories relative to sales remain at historically high levels. Increasing foreclosures are exacerbating the inventory problem.
- Inventories remained high through the traditionally strong spring selling season indicating that demand remains soft and that there will be further downside pressure for prices
- Housing cannot handle higher bond yields. Since the third week of January, conventional 30 year mortgage rates have increased by 1.25%. The inability for mortgage rates to decline is negatively impacting affordability.
- The tightening of lending standards for all types of mortgages creates another hurdle for the industry to overcome as it works its way through the excess inventory.



## Stock Market

- Equity markets are ending 2Q-08 near their lows established in January and March. Concerns about the financial sector, energy prices, and budding inflationary pressures, continue to pressure equity prices and negatively impact investor psychology.
- Equity volatility is likely to remain elevated until these concerns abate. Additionally, earnings expectations are being downgraded to reflect the reality of the slowing economy on corporate earnings - potentially causing further volatility.
- Consumer confidence is at a 16 year low. It's worth noting that, over the past 40 years, such weak readings in consumer confidence have occurred only 5 other times, but each time the equity markets advanced in the subsequent 12 months by an average of 20%.
- The two areas of the market most impacted by the credit situation are the banks and the homebuilders.
- The preceding chart illustrates the relative weakness of the banking group and the homebuilding group compared to the S&P 500 index.
- The banks are an important member of the Financial sector, which is typically one of the leading sectors in a market advance. The deterioration of banks and the Financial sector relative to the S&P 500 in 2007 provided some forewarning of the developing credit issues. Banks and the overall Financial sector appeared to be stabilizing in 1Q-08, but recently have established new relative lows. This is a red flag that needs to be monitored regarding the overall health of the equity markets.
- Homebuilders have been underperforming the S&P 500 index since 2006. On a relative basis, they are now back to levels last seen in the 1990's. The preceding chart indicates that homebuilders appear to be stabilizing relative to the S&P 500, but concerns would re-emerge if they fail to hold the lows established earlier this year.



## ARE WE IN A RECESSION?

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Senior Vice President

The question of whether or not the U.S. economy is in recession seems to be everywhere these days. Although easy to ask, the question is difficult to answer. To begin with, the definition of recession is less precise than most people realize. A commonly offered definition is two or more successive quarters of real gross domestic product (GDP) contraction. In reality, a recession occurs when the National Bureau of Economic Research's (NBER) Business Cycle Dating Committee says it does.

According to the NBER, "A recession is 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. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. Expansion is the normal state of the economy; most recessions are brief and they have been rare in recent decades."

The U.S. Department of Commerce's Bureau of Economic Analysis offers this definition of recession, "In general usage, the word recession connotes a marked slippage in economic activity. While GDP is the broadest measure

of economic activity, the often-cited identification of a recession with two consecutive quarters of negative GDP growth is not an official designation. Therefore, while negative GDP growth and recessions closely track each other, the consideration by the NBER of the monthly indicators, especially employment, means that the identification of a recession with two consecutive quarters of negative GDP growth does not always hold."

In any case, GDP growth through the first quarter of 2008 (the most recent quarter for which data is available) was still positive. Real GDP grew at a 1.0% rate in the first quarter which was slightly higher than the 0.6% rate at which it grew in the fourth quarter of 2007. These are certainly not strong growth rates, but they are positive. Although certain sectors of the U.S. economy have been shrinking (for example, housing and financials), the reduction in GDP due to their contraction has been made up for by strong exports due to the weak dollar.



On the other hand, employment data has been negative in recent months. Recently released data from the Labor Department showed U.S. payrolls shrank for the sixth consecutive month in June. Industrial production also shows signs of weakness. Recent months have been flat or slightly negative. As the accompanying chart shows, declining industrial production has been strongly linked to recessions in the past.

So the question of whether or not the economy is in recession remains unanswered. The data is mixed. Although GDP continues to grow, albeit weakly, other indicators are pointing negative. It is quite possible that in the next few months the NBER will look back on the current environment and announce that, yes, the economy was in recession. Until that happens, however, at least from an official perspective, the economy continues to grow.

An important point to remember is that recessions are an ordinary part of the business cycle. Although they cause short-term anxiety and uncertainty, they are necessary events that help the economy adjust to excesses and inefficiencies. They ultimately lead to stronger subsequent economic growth. Since recessions are impossible to predict with any reliability or certainty, it is essential that portfolios have an appropriate long-term asset allocation. The short-term market downturns that are often the result of recessions can be weathered if the proper allocation is in place.