GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

SEPTEMBER 2015 VOLUME 24, ISSUE 9

William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

As you might imagine, we have fielded several calls lately about China and the resulting global volatility in equity markets. It is natural to wonder how the world can wake up on a particular day and have a very different view of the future and express that view with a herd mentality that erases about 5% of global equity values. Let's try to handle this by focusing first on China's economy.

There tend to be two camps when analyzing China's current economic climate. Those that are very negative and those that remain very bullish. The better position would be to understand the transformation going on in China, the negatives to that transformation as well as the future positives that will play out as the transformation matures.

It was only two decades ago that we began to hear warnings about the pending run up in commodity prices. China was becoming a dominating buyer of nearly all commodities as their manufacturing economy exploded. Cheap labor was in abundance as the rural migration to urban centers provided the backs and hands to build as well as manufacture. An amazing amount of infrastructure was built and 133 cities grew to over one million people with several growing to as much as fifteen million. Many assumed that the labor supply would be infinite and the world's supply of commodities would be consumed by China. The steady drop in commodity prices over the past eighteen months, that have now reached a six-year low, tell a different and some would say troubling story. Part of the demand fall-off, to be certain, was a result of the global recession that started in 2008, but a continuing contribution to the price decline is the 5% reduction in China's GDP. To fully understand the implications of China's slowdown we first must understand the structural reasons for what is really a rebalancing of their economy that ultimately led to a transformation of it.

The Lewis Turning Point is an economic theory that implies higher labor demand, and therefore higher wages, due to a zero balance in rural available labor. When I visited China nearly a decade ago it was common to see rural migrants on a corner early in the morning in any of the larger cities holding signs that identified them as a mason, electrician, plumber

Commentary, continued

or carpenter. By mid-morning most, if not all, of those seeking a job had one. As the migration slowed, particularly over the last three years, employers have been forced to increase wages as well as employment costs related to benefits and working conditions. China's real competitive advantage for manufacturing and exporting goods began to erode and "Made in China" no longer was as cheap as before.

As Chinese state economists began to be more concerned about overcapacity, The State Council initiated a new "Five Year Plan" by setting targets and timelines for eliminating capacity in the industries that had high energy consumption and high polluting enterprises. Keep in mind we are not talking about recession here but rather a slowing of the growth rate of industrial production. Given that industrial production makes up 35% of GDP growth, the slowing of industrial production from 11% to 6.1% had an impact on GDP between 0.4% and 0.7%. Not huge by itself but housing values, real estate investment, construction spending and government investment and financing have also declined.

"China's real competitive advantage for manufacturing and exporting goods began to erode and 'Made in China' no longer was as cheap as before."

Construction and real estate comprise a combined GDP weight of about 13%; however, when considering the value added component of construction that includes chemical, iron and steel, transport, fuels and general equipment, this portion of the economy is closer to 30% of GDP. Housing prices peaked in China around December of 2013 at which time they were experiencing an 8% year over year growth rate. Prices appear to have bottomed at -8%, however, given that the Chinese economy peaked in 2010 at a growth rate of 12%, the decline in housing prices and fixed asset investment over the past twenty months has probably accounted for about 2% of the decline in current GDP growth.

When the global recession began in 2008, China delegated its stimulus efforts to local governments. The strategy was to get "shovel ready" projects started by issuing local government financing vehicles. These projects stimulated the economy, kept employment growing and completed infrastructure improvements that otherwise would have been on the back burner. State Council economists have become concerned that the debt levels of the local governments are not sustainable in the current financing vehicles and therefore the State Council passed a new directive that resulted in the decline of local government debt by nearly $500 billion, putting additional pressure on GDP growth.

Modern China beginning in the early 1980s began an investment and export driven economy that created tremendous growth for nearly three decades which had collateral global growth implications as well. If the Chinese have lost their competitive advantage of cheap labor, what will be their solution to avoid the middle income trap which is another economic phenomena that plagues some developing economies? The advantage that a developing country often has is its low cost of labor and therefore low cost of production — an export advantage over high cost of labor competitors. When low wage labor, usually rural, dries up, the advantage shrinks and new strategies must be executed or the economy will stagnate. Any American company wanting to invest in China over the past three decades would know that the Chinese government was interested in jobs, not productivity. Construction sites were dominated not by equipment but by bamboo scaffolds and human beings. Manufacturing processes used people rather than robots. Today, China manufactures more robots than any country, but most of that production is for export. Their mission now, however, is to become more productive and to balance that productivity with the declining availability of labor and the increasing numbers of dependent populations being supported by a decreasing workforce.

The Mao population boom is retiring and being supported by the children born after the "One Child per Family" directive of 1979. The Chinese have, as a country, the lowest fertility rate globally. A slowing population growth rate and tight labor supply imply higher wage growth in the future and unless investment in productivity increases, global competitiveness will continue its decline. China's policy makers also recognize this need and launched a "Made in China 2025" directive which targets advanced manufacturing and specifically in the following ten core sectors: information technology, numerical control tools and robotics, aerospace, ocean engineering, high tech ship building, railway equipment, medical devices, biological medicine, green energy, new energy and agricultural equipment. To amplify this directive China's investment in R&D has grown from under 1% of GDP in 2001 to 1.8% in 2011, ranking second only to the US in investment as a percentage of GDP. Advanced manufacturing, productivity and innovation can't be produced without a strong investment in education. Focused strongly on science and engineering, the population of Chinese with a post-secondary education has grown from 0.8% in 1982 to 20.6% in 2008. In 2010, 44% of the undergraduate student population was majoring in engineering compared with 15% of their US cohort. These are long term investments for China but are essential in the avoidance of stagnation and "The Middle Income Trap" which have plagued countries like Brazil.

The transformation of state-owned enterprises to the private sector continues at a steady pace. In employment by owner, fixed investment by owner and sources of export by ownership, the private sector now exceeds state owned enterprises and urban as well as higher income employment sectors are dominated by private ownership. The service

"Any American company wanting to invest in China over the past three decades would know that the Chinese government was interested in jobs, not productivity."

Commentary, continued

"The Chinese market crash was due to quickly changing perceptions amplified when their Government decided to surprise the world, without prior notice, that they would allow their currency to be somewhat market-valued."

sector is now the fastest growing segment of the economy and real wage growth as well as consumption have nearly offset the decline in the manufacturing slowdown.

There remain risks to the Chinese economy and most are centered around stimulating the economy with the right directives that have positive impacts on the continued transformation of their economy from the manufacturing - export investment model to the productivity-innovation model. They have a lot of work to do with municipal and local government deleveraging and have just recently begun the process of allowing their currency to have a market based valuation vis-à-vis other currencies.

The Chinese market crash was due to quickly changing perceptions amplified when their Government decided to surprise the world, without prior notice, that they would allow their currency to be somewhat market-valued. The rest of the world thought the implication was that their economy was far worse than what it is and this was a desperate attempt to revive their manufacturing exports with lower priced goods. Markets don't like surprises, and the repricing of Chinese stocks was a quick and resounding response to the surprise by global investors.

So why did US stocks get pummeled? Several reasons. We have a slow growth economy. Global firestorms will always rattle our markets while our economy is mired in a slow incremental growth pattern. Many people assume that we import and export more than we do from and to China. If their demand for goods diminishes then our economy will decline. The facts don't support the argument; however, short term traders and robo trading programs don't stop to look at the facts. Our bull market is in its sixth year and has been fueled by very low interest rates which are about to increase ever so slightly and valuations are on the upper end. Those that entered a market order to sell Apple into the herd mentality of last week and got filled at $92 are wishing they hadn't and those that got filled on their buy order the same day at $92 are very happy they did. We are in a period of increasing volatility. The fundamentals of China are changing but with as many positives as negatives, and in about the same size to offset one another, we think they will continue their transformation. There are still 1.6 billion Chinese people that get up every day in an economy that is growing at between six and seven percent per year which is double the IMF's forecast of total GDP global growth for 2015.

Today's Commodity Storm Clouds Have Been Forming for Some Time...

James W. Gray, CFA
Chief Investment Officer

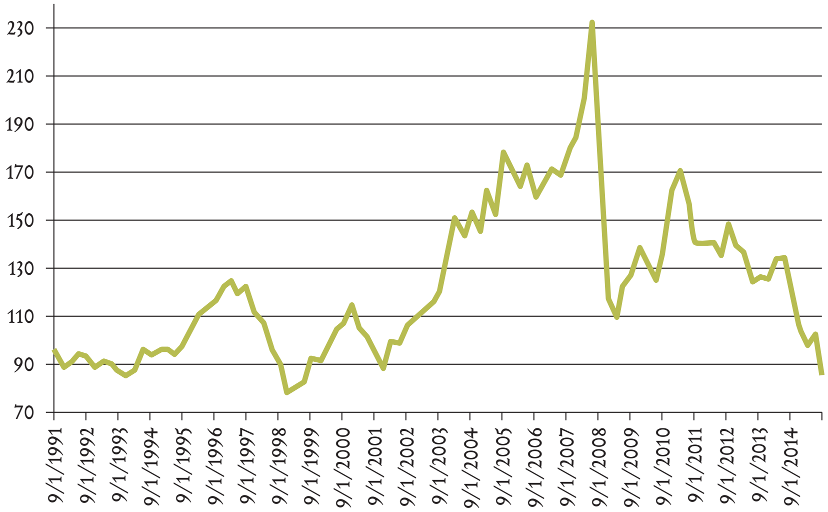
As Bill discusses this month, China is currently presenting a formidable challenge for the global economy. A slower growth outlook for China has dramatically impacted the demand for commodities, causing prices to drop to the lowest levels seen in over 10 years. Although commodities can serve as an inflation hedge over long time periods, we exited our position in 2013 as concerns around inflation spikes waned.

For many years China has served as a significant economic engine, and expectations were that it would continue to generate strong growth that would offset the slower growth rates of many developed economies. The factors driving slower global growth include: high levels of debt, lower corporate capital spending, and demographic shifts, among others. The recent devaluation of the Yuan by the People's Bank of China is just one example of the government's desire to stimulate growth.

The result of this lower growth environment is lower demand for natural resource including copper, iron ore, and crude oil. China is the second-largest consumer of oil behind the U.S. and the largest consumer of base-metals globally. On August 24th, the Bloomberg Commodity Index, as shown in the chart below, traded down to a level not experienced since 1999. The most recent pressure came as sentiment around emerging markets, and China especially, turned weaker.

"A slower growth outlook for China has dramatically impacted the demand for commodities..."

Bloomberg Commodity Index



Source: Bloomberg

Commodity Storm Clouds, continued

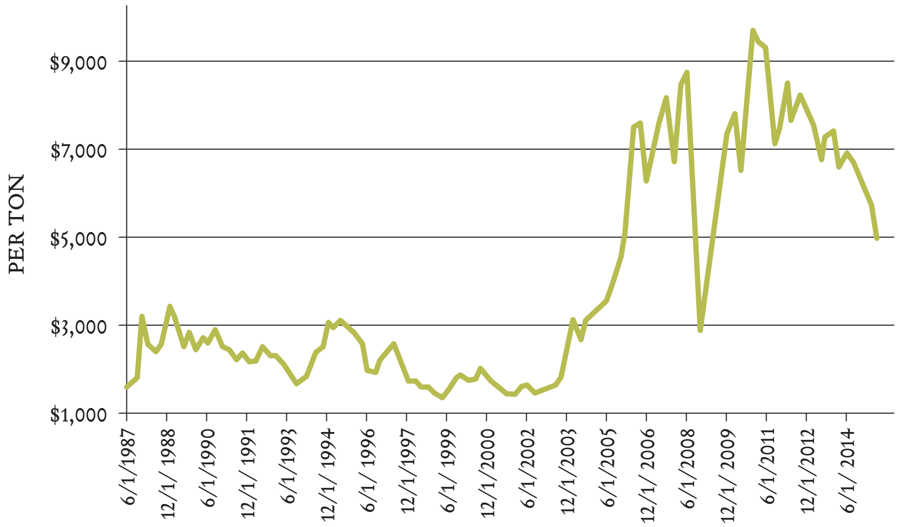
This dearth of demand is driven by not only a decrease in today's economic activity, but also by a change in forward expectations, as markets are currently adjusting to a slower growth outlook. As we have seen many times, markets overshoot the true point of equilibrium, as traders may be required to unwind trades or fear drives market participants to overreact. In some cases, price pressures may be compounded due to oversupply, as we are witnessing in the global oil markets. Regardless, the current price environment for commodities supports the notion that we are in a "slower for longer" growth environment.

"This dearth of demand is driven by not only a decrease in today's economic activity, but also by a change in forward expectations, as markets are currently adjusting to a slower growth outlook."

The down trend in copper prices has been in place for the past four years, while the magnitude of the decline has accelerated since the beginning of the third quarter. To the point regarding rate of decline, copper prices have deteriorated by 17% in the 3rd quarter alone. The third quarter accounts for half of the 32% decline over the past year. As you would expect, the trend in copper is closely aligned to both the overall commodities index and emerging market equity prices for the same period. For the quarter, emerging market equities are off nearly 19%, accounting for nearly three quarters of the trailing twelve month decline of 26%. Many emerging markets have concentrated economies focused on natural resources or manufacturing and their performance is tied to the demand for commodities and global economic growth trends.

This is a significant departure from the boom in industrial commodities during the mid-2000's. During that period, significant levels of construction and infrastructure development in China and other developing nations fueled strong demand for commodities. A 2010 Bloomberg Markets magazine article discussed the use of over ninety pounds of copper for every apartment being constructed in China, of which there were hundreds of thousands built during that period. The sizable demand for commodities led to increased concerns

Copper Prices



Source: Bloomberg — All market data is calculated as of 8/27/15 around higher inflation in the future.

As that story began to wane, our research team began to question whether commodities in general were prudent in the new, post-crisis, slower growth environment. As a result, we looked at the purpose that commodities served within portfolio construction. While we agreed that at certain points in the economic cycle the data supported the benefit of commodities as an inflation hedge, there have also been extended periods where commodities earned little or no return. Based on this analysis, we reduced our commodities holdings in 2011 and exited our remaining positions in early 2013. We replaced a portion of this exposure within the alternatives component of client portfolios with a managed futures fund, which could participate in either up or down markets. This instrument includes futures contracts for commodities, interest rates, equities and currencies.

As you know, we take a long term view of the global markets. Based on this point, in 2014 we shifted a portion of our clients' emerging market equity exposure into the developed markets in order to achieve a more balanced global equity position. So far this year, both the exit of commodities and the more recent reduction in our emerging markets exposure have proven to be beneficial to client portfolio performance. We continue to monitor not only what is happening today but also the factors impacting what happens tomorrow as we position client portfolios to perform through different market cycles.

"... at certain points in the economic cycle the data supported the benefit of commodities as an inflation hedge, there have also been extended periods where commodities earned little or no return."

Sharon A. Conran, JD
Trust Relationship Officer

Charitable Due Deligence

When determining estate plans, many individuals include bequests to non-profit (charitable) organizations. Individuals select charitable organizations based on their beliefs, concerns, and interests.

When you make a bequest to a charity, you believe the gift to the charity will make a difference and, more importantly, be used efficiently in the ultimate mission of the charity. However, once the bequest is made what assurance is there that your bequest will be utilized as you intended? The best assurance is through due diligence in researching the charitable organization prior to donating funds or naming the organization in your estate plan.

By performing due diligence, you can feel confident that the charity you make your bequest to is effectively governed, transparent, accountable, fiscally responsible, and aligned with your core values.

The following is a list of items to research when considering a donation or bequest in your estate plan, to a non-profit organization.

"...once [a] bequest is made what assurance is there that your bequest will be utilized as you intended?"

1. Evaluate the non-profit's mission statement, programs and services to determine whether the non-profit organization is aligned with your philanthropic goals. Check to see if the non-profit is allocating money and staff that are consistent with the non-profit's mission statement and how they represent the non-profit in soliciting donations.
2. Verify the non-profit's tax exempt status and confirm the non-profit organization is in good standing.
3. Review the non-profit's financials. Charities are required to report their largest programs and the funding allocated to the programs. Check to determine if the non-profit is allocating funds in alignment with the mission statement and what is stated on the charity's website.
4. Review the programs and services the non-profit provides. Are the programs and services in line with the charity's mission statement?
5. Find out if, and how, the non-profit evaluates the outcome/success of its programs and services.
6. Determine whether the non-profit clearly explains the problem it intends to address and how it will be accomplished.
7. Determine whether the charity's statement of how their work leads to results seems plausible and reasonable.
8. Determine if the charity addresses how much of their services are required in order to produce results. Is there evidence that demonstrates the approach is effective? Is there data to verify the

program is working? What is the plan for the data collection?

9. Ask if there is a strategic plan and a fundraising plan in place and how each is being implemented.
10. Review the non-profit's investment policy.
11. Talk to board members and other donors in order to determine the non-profit's commitment to donor stewardship.
12. Research external resources that verify the charity's approach and mission objective. If external reports indicate that the charity focuses its attention on results, this could provide an independent source regarding the clarity of the charity's focus.
13. Look to see if the non-profit collects and publishes feedback. If the charity receives feedback from the people it serves, research to determine whether it uses this feedback to improve the quality of services.
14. Research published evaluation reports. These reports are prepared by an independent third party and evaluate the non-profit's efforts.

The due diligence required when making a bequest to a charitable organization, whether it is during your lifetime or after, can be daunting. There are professionals and firms that offer philanthropic advisory services that can assist individuals in learning the language of non-profits so the individual is in a better position to make an informed decision when making a bequest to a charitable organization.

Whether you do a general background check or full due diligence check on an organization, the most important step is verifying the name of the non-profit organization. Accuracy is of the utmost importance as many charities have similar names or, may have a national headquarters when you want your bequest to benefit the local affiliate. You want to make sure your money is applied to the purpose you intended and the first step is to make sure you know the charity you are trusting to fulfill your purpose.

"The due diligence required when making a bequest to a charitable organization, whether it is during your lifetime or after, can be daunting."

Sanford C. Leestma II, CFP®
Wealth Management Advisor

Roll and Be Rocked – Rock and Be Rolled

Change can bring opportunity. Change can also bring challenges that can cause pain, if caught unaware. This year brought IRA rule changes, including a stricter interpretation of the once-per-year IRA rollover rule and a clearer interpretation of rolling before and after-tax amounts to rollovers. If you didn't catch the change in interpretation, your retirement savings could be rocked by a roll.

First, we consider the stricter interpretation of the once per year IRA rollover rule.

There are two ways to move IRA assets to another IRA: direct and indirect. A direct transfer, or a trustee-to-trustee transfer, happens when assets move from one IRA to another without the owner taking possession of the assets. There is no limit to the amount of direct transfers, and is the most common way for IRA assets to be moved from one financial institution to another. An indirect rollover, or 60-day rollover, allows individuals to take receipt of the assets and up to 60 days to redeposit back to the same IRA or into another IRA. The 60-day rollover is only allowed once per year.

"This year brought IRA rule changes, including a stricter interpretation of the once-per-year IRA rollover rule and a clearer interpretation of rolling before and after-tax amounts to rollovers."

For many years, the IRS guidance said that the once-per-year rule applied separately to each IRA, meaning an individual with three separate IRAs could make three rollovers within the same one-year period. Now, an individual only gets one chance a year to make an indirect transfer. This new interpretation of the rollover rule is a significant change from the past.

The old interpretation was revised last year, when the U.S. Tax Court issued a landmark ruling in Bobrow v. Commissioner, stating that the rule applies to a person's IRAs in aggregate. The court stated that Congress put limits on IRA rollovers to ensure that taxpayers don't take advantage of the 60-day rollover rule by repeatedly moving assets in and out of their IRAs, on a tax-free basis, thereby extending the 60-day rollover period. The IRS then issued Announcement 2014-15 which spelled out that the once-per-year rule would mean one IRA-to-IRA rollover (or one Roth IRA to Roth IRA rollover) per taxpayer, per 365 days, regardless of how many different IRAs a person has.

A second 60-day rollover, made within one year of the first rollover, will now cause a taxable distribution plus a 10% penalty, if the individual is under the age of 59 ½. Also, the redeposit will be treated as an annual IRA contribution, which could result in an excess contribution subject to a 6% penalty for every year the ineligible rollover assets remain in the account.

The second rollover could lead to even more tax issues, since the 6% penalty is reported on IRS Form 5329, which is not filed by individuals unless they are reporting a penalty. If the form is not filed, the three-year statute of limitations clock never starts. This could lead the IRS to go back indefinitely and assess the 6% penalty for each year on the excess amounts.

As a side note, the rule does not apply to IRA to Roth IRA conversions. Taking a Roth conversion could potentially be an option for individuals who are in need of a short-term loan. While the IRS allows only one IRA rollover per year, individuals are allowed to convert a portion of their IRA to a Roth IRA as many times as they want and hold the amount for up to 60 days before using the money to open a Roth account.

Now that we've avoided a disallowed roll and being rocked, let's look at rocking a newly allowed roll.

Announcement 2014-15 does not apply to employer retirement plan rollovers either. Also last year, the IRS issued Notice 2014-54, Guidance on Allocation of After-Tax Amounts to Rollovers. This notice allows for pre- and after-tax assets, in an employer plan, to be allocated to different retirement accounts when implementing a rollover. Now, after-tax cash can be directly moved to a Roth IRA tax-free, while pre-tax money can be moved directly into a traditional IRA.

The notice provides that all disbursements from a plan to an individual, that are scheduled to be made at the same time, are treated as a single distribution regardless of whether the individual has directed the disbursements be made to a single account or multiple accounts.

The notice doesn't change the requirement that distributions from a plan must still be made on a pro-rata basis. Rather, the rule allows the pre-tax and after-tax assets that were distributed from a plan, on a prorated basis, to be separated once a distribution is made. That said, the pro-rata calculation for the distribution can only include assets that are eligible to be taken, at that time. If only part of the assets are rolled over, the pro rata rules still apply.

Another important point to consider: When a plan will only do one direct rollover per distribution and participants want to split the pre- and after-tax portions of their plan balances, they must directly roll over the pre-tax portion of their distribution to their traditional IRA and then complete the Roth IRA conversion via a 60-day rollover. It cannot be done in reverse order.

Of course, as always, there are a few potential snares and procedures to follow in order to make this transaction work as intended. Be sure to speak with your tax and/or financial advisor first.

"Of course, as always, there are a few potential snares and procedures to follow in order to make this transaction work as intended."

Stock Market Pulse

Index	8/31/2015	Total Return Since 12/31/2014
S&P 1500	456.65	-2.74%
DJIA	16,528.03	-5.70%
NASDAQ	4,776.51	1.65%
S&P 500	1,972.18	-2.88%
S&P 400	1,416.75	-1.48%
S&P 600	674.86	-2.07%
NYSE Composite	10,176.50	-6.11%
Dow Jones Utilities	562.02	-6.77%
Barclays Aggregate Bond	108.92	0.19%

P/E Multiples	8/31/2015
S&P 1500	17.1x
DJIA	14.0x
NASDAQ	19.5x
S&P 500	16.9x
S&P 400	18.4x
S&P 600	19.4x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.01%
T Bond 30 Yr	2.93%
Prime Rate	3.25%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	456.65	17.1x	2.18%
S&P 500	1,972.18	16.9x	2.24%
DJIA	16,528.03	14.0x	2.55%
Dow Jones Utilities	562.02	NA	3.72%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.76%

MAIN OFFICE:
211 South Rose Street
Kalamazoo, MI 49007
office: 269.388.9800
toll free: 800.416.4555

TRAVERSE CITY OFFICE:
125 Park Street, Suite 495
Traverse City, MI 49684
office: 231.922.1428

BIRMINGHAM OFFICE:
34977 Woodward Ave., Suite 200
Birmingham, MI 48009
office: 248.530.6202

PETOSKEY OFFICE:
331 Bay Street
Petoskey, MI 49770
office: 231.439.5016

GREENLEAF® TRUST

e-mail: trust@greenleaftrust.com
www.greenleaftrust.com