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May 16, 2022 – Weekly Notes

Economic Commentary:

Housing market data released this week may provide more insight into the resilience of the residential real estate market in the face of rising mortgage rates. However, realtors indicate that it might be a bit too soon to assess based on April's data, with the threat of further mortgage rate increases pushing buyers – and inventory—onto the market in the last four weeks in some of the faster-growing areas of the country. Data on US Industrial production is likely to more reflect the impact of higher commodity prices, including energy, the factory closures in China resulting from the "Zero Covid" policy, and sluggish export sales impacted by the strength of the US dollar. Interestingly, the war in Ukraine has become something of a background issue in the United States, as the adjustment to higher input costs (and even higher prices at the gas pump) continues, annoying but manageable; in Europe, it is quite a different story altogether. The European Commission has cut its 2022 growth forecast for the EU to 2.7%, from 4%, and raised its warnings on accelerating inflation, accompanied by the caveat that a cessation of Russian natural gas imports would push growth perilously close to 0% and inflation into double-digits for some member countries (especially the Eastern European countries, some of which are aggressively fighting a proposed ban on all Russian energy supplies.) Chairman Powell has recently cautioned that fighting inflation will involve "some pain"; so it is, too, that the war in Ukraine will exact an economic toll in many regions and industries.

Data to Watch:

1. US Retail Sales for April, released **Tuesday, May 17**
2. US Manufacturing Production for April, released **Tuesday, May 17**
3. US Housing Starts for April, released **Wednesday, May 18**
4. US Existing Home Sales for April, released **Thursday, May 19**

Suggested Reading:

https://www.wsj.com/articles/for-tech-startups-the-party-is-over-11652710330?mod=hp_lead_pos4

https://www.ft.com/content/d490ef4e-3187-471e-84ff-9c065871a1a5

https://www.nytimes.com/2022/05/10/business/economy/federal-reserve-inflation.html

https://www.usnews.com/news/business/articles/2022-05-16/eu-cuts-forecast-for-economic-growth-as-wars-fallout-widens

https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/spring-2022-economic-forecast_en

https://www.cnbc.com/2022/05/16/china-economy-covid-lockdowns-weigh-on-retail-industrial-production-data.html

Investment Commentary:

Market Action

We expect volatility to remain elevated in both the fixed income and equity markets as the probability of an economic recession is increasing, and the prospect of a "Fed put" (precedent for the Fed to lower rates in times of stress) is likely absent short of a substantial recession (not our base case). We are going through a period of slowing economic growth, increasing cost of equity and debt capital, challenging labor supply, and geopolitical complications contributing to a 20-year high in U.S. dollar.

The stock market is off to its worst start through mid-May in several decades. In some ways, the most remarkable aspect of the current regime is not how difficult things have gotten but how easy financial conditions were. Bear markets (20%+ declines) are normal where there have been 10 since 1950 and 5 more that were a fraction short of the 20% threshold. In other words, there is a bear market approximately every 5 years. The average downturn has taken more than 2 years to get back to even, and a handful have taken about 4 years. The entire Generation Z and most of the Millennial investors haven't experienced a bear market that has taken more than 6 months to bounce back. The tech-heavy NASDAQ 100 hasn't had a down year since 2008. Bonds are supposed to help during downturns, but they are largely "price down/yield up" because the Fed has been raising rates and will soon sell down their balance sheet. Currently, investors expect inflation to average approximately 2.9% per year over the next 5 years and 2.6% per year over the following 5 years.

Trying to time the bottom of risk markets is futile. However, there are several metrics we are monitoring including:

1. Wage growth where it will be critical to see wage gains declining as a key indicator for the persistence of inflation.
2. Dollar strength where the primary factors contributing to its year-to-date strength of ~10% need to reverse such as interest rate differentials (higher U.S. rates vs. other developed economies), growth differentials (China Covid shutdowns and Ukraine invasion slowing non-U.S. economies due to elevated prices) and flight to quality (global recessionary concerns and "risk off" behavior favor more stable currencies)

Portfolio Implications

As various asset classes realign their valuations, investors are increasingly focused on fundamentals and developing reasonable expectations for earnings growth. Within equities, the Investment Office prefers dividend payors. Historically they have outperformed the broader U.S. equity market during Fed rate hiking cycles and in periods of heightened volatility.

As we've seen throughout 2022, duration assets have failed to provide a cushion against risk-off market declines. However, the Investment Office is cautious regarding materially increasing interest-rate sensitivity, as the Fed has only recently started the rate hiking cycle and will soon begin to shrink its balance sheet. Overall, we see strong fundamentals across corporate sectors, but we prefer to maintain quality as spreads continue to widen. Tax-sensitive investors can still take advantage of dislocations in the municipal bond market. At the front end of the muni curve, yields are the highest they've been in years, and at the long end, muni/Treasury ratios exceed 100%.

Sources: Bloomberg, Morningstar

Wealth Planning Commentary:

Tax Updates

On April 26th, the Treasury proposed new regulations that impact a few estate tax mitigation strategies. Some media outlets may have overemphasized the impact of these proposals given they target a small selection of strategies.

Recall that when the Tax Cuts and Job Act (TCJA) expires in 2025, the lifetime and estate exclusion will reduce from $24.12mm today to around $13.2mm for couples. Bequests and gifts above the exclusion are subject to a flat 40% tax.

The proposed regulations impact incomplete gifting strategies executed during the TCJA, from 2017-2025. The strategies may be subject to additional gift or estate tax if the gift was above the pre-TCJA exclusion amount adjusted for inflation.

Here are two examples of where the new regulations could negatively affect the strategies:

> Note or other obligation of the taxpayer is given as a gift - The taxpayer gives a promissory note to their heirs when the TCJA is in effect and the taxpayer passes away after TCJA expires. The promissory note is likely subject to the reduced, post TCJA exclusion amount.
>
> Grantor of a GRAT dies before the term - The second situation is where the grantor of an active GRAT, that was created during the TCJA, passes away after the TCJA expires. In any GRAT circumstance, the assets are included in the grantor's estate if they pass away before the term ends. The proposed regulations subject the GRAT assets to the post-TCJA exclusion amount.

These situations may occur, and they also can be avoided. The regulations are proposals and there's little reason for concern at this point. We will continue to monitor this situation as it develops.

Wealth Planning Opportunities

The current market conditions offer multiple planning opportunities you may want to consider:

- Loss harvesting and rebalancing
- Roth conversion
- Wealth transfer

Please reach out to your Wealth Manager if you have any questions.

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Sources;

- https://public-inspection.federalregister.gov/2022-08865.pdf
- https://www.financial-planning.com/news/new-treasury-proposal-would-hammer-wealthy-investors-using-clever-tax-strategies
- https://www.forbes.com/sites/alangassman/2022/04/28/irs-clawback-proposed-regulation-causes-confusion-in-the-playing-field/?sh=c327f9031dbc
- https://www.jdsupra.com/legalnews/irs-confirms-no-clawback-for-gifts-made-17786/#:~:text=On%20November%2026%2C%202019%2C%20the,(the%20%E2%80%9CAct%E2%80%9D).
- https://legalresearch.usfca.edu/c.php?g=523831&p=3581100

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar
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