

May 2, 2022 – Weekly Notes

Economic Commentary:

As discussed in the latest Economic Outlook ([click here](#)), much has happened in the first quarter that is now spilling into April/May. It would seem to be only a matter of time before a consumer and business response to the Federal Reserve's aggressive inflation-fighting comes into play, as well as various business responses to Russian sanctions and a sustained elevation of oil and gas prices. On May 4, the Federal Reserve is expected to announce both a 50bps increase in the target Fed Funds rate and the commencement of a quantitative tightening that will run-off the Fed's bond holdings (including mortgage-backed securities) at an accelerated pace. These actions, anticipated by investors for several weeks, now will be scrutinized against the backdrop of a possible sharp deceleration in US economic activity and a notable reduction, by the IMF, World Bank and others, in the outlook for global economic growth. Increasingly, developments in China are also a concern, as economic growth in that country appears to be slowing more than anticipated.

Data to Watch:

1. ISM Manufacturing PMI (Purchasing Managers Index) for April, released **Monday, May 2**
2. FOMC meeting announcement and press conference, **Wednesday, May 4**
3. Non-Farm Payrolls for April, released **Friday, May 6**
4. ISM Non-Manufacturing PMI (Purchasing Managers Index) for April, released **Wednesday, May 4**

Suggested Reading:

https://www.wsj.com/articles/china-economy-recession-covid-lockdowns-11651434168?mod=hp_lead_pos7

https://www.wsj.com/articles/americans-are-showing-inflation-fatigue-and-some-companies-see-a-breaking-point-11651410002?mod=hp_lead_pos10

<https://www.nytimes.com/2022/05/01/upshot/pandemic-housing-market-wealth.html>

<https://www.nytimes.com/2022/05/02/climate/biden-electric-car-batteries.html>

Investment Commentary:

Where Are We?

Worries over an increasingly hawkish Fed have helped drag the benchmark S&P 500 index down 13.3% in Q1 2022, its steepest four-month decline to start any year since 1939. April marked the S&P 500's biggest monthly fall since the onset of the COVID pandemic in early 2020, while the tech-heavy Nasdaq generated its largest monthly drop since the 2008 financial crisis. Bear markets are notoriously unpredictable, and so are the subsequent recovery rallies. Trying to time the market by selling with the expectation of knowing when to reenter has proven over time to be very difficult.

While investors have increased expectations of how aggressively the central bank may tighten monetary policy, many are concerned the Fed will not be able to keep the economy out of a recession as it battles the

worst inflation in nearly four decades. Compounding concerns over monetary policy, investors have been upset by everything from rising bond yields to the war in Ukraine and more recently lockdowns in China.

Back to Basics

The Investment Office is leaning on first principles to apply a “sanity check” to the recent market behavior. Specifically, if you believe...

1. high valuations were justified by low interest rates, you should also believe lower valuations should accompany rising rates.
2. that interest rates have been held down by the Fed's policy of buying bonds, then it seems logical to believe rates will have to rise, not only because of the high level of inflation but because the Fed will be selling large amounts of bonds, removing liquidity from the market.
3. the repression of interest rates led to investors increasing their tolerance for risks (to increase returns, as safe bonds were yielding zero or close to it), then you should believe the reverse will occur as the Fed tightens policy, putting pressure on not only bond yields but credit spreads and equity prices.

Several months ago, equity Investors began to believe these market tenets and started to initially apply more discipline to speculative excesses such as meme stocks, SPACs and many stocks in the Russell 1000 Growth Index where 70% of the companies have negative earnings. During Q1 2022, the broader market indexes began to decline due to weaker fundamentals and outlooks. With just over half the members of the S&P 500 reporting first quarter earnings, overall results have been mixed especially amongst the tech giants. Many companies are still beating earnings per share (EPS) estimates but by smaller margins, as pandemic-era strength begins to fade. Investors are remembering that many business models are more cyclical than secular in their growth patterns and not all great businesses are great stocks.

What To Do

If you step back and think about investing in the “big picture”, there are only two things that drive asset prices higher, it's either rising cash flows or rising multiples. And in an inflationary rising rate environment, multiples tend not to go up and long duration assets are less valuable. Therefore, the importance of owning assets where cash flow will grow is important. In credit, we've increasingly focused on floating rate debt and managers with expertise to invest in stressed market environments. In real estate, our portfolio managers invest in sectors with attractive fundamentals and short-duration leases. In private equity, we focus on “old economy” cash generative companies.

In sum, we are transitioning away from a Fed and Fiscal induced complacent market to where fundamental earnings matter and the price investors assign to earnings increasingly incorporates the interest rate outlook. The transition of the risk markets “performance baton” from the Fed to fundamentals isn't helped when cash flows stumble. Ultimately, that means taking no more risk than you have the ability, willingness or need to take. In doing so instead of panic selling, you can rebalance in the context of a financial plan.

Wealth Planning Commentary:

Loss Harvesting

With the S&P 500 down 13+% and large cap growth indices down 20+% year to date, now may be a good time to review positions and consider loss harvesting. Capital losses may be used to offset capital gains. If the losses exceed capital gains in any tax year you may use up to \$3,000 of capital losses to offset ordinary taxable income. Any losses beyond this may be used to offset future gains and are carried forward **indefinitely** until the amount is exhausted.

We recommend staying invested as market timing is likely to lead to a less than optimal outcome. To benefit from the loss and stay invested according to your asset allocation you may need to replace the position. There is a risk that your replacement may be considered a 'wash sale' and the benefits of taking the loss are no longer available. To avoid a wash sale you may wait 30 days to repurchase the same security or purchase a different security within this time period that is not considered "substantially identical." There are likely good proxies for the security that are not substantially identical, please reach out to your advisor for guidance.

Roth Conversion

If you are considering a Roth conversion a market downturn may be a good time to execute. The idea is to take assets from an IRA that has been negatively impacted by the market and convert them to a Roth. The market may eventually recover and now all or a portion of the IRA assets are in the tax-free Roth. The conversion is a taxable event and the goal to keep your income below the higher tax brackets. Please reach out to us to discuss this strategy.

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