

May 23, 2022 – Weekly Notes

Economic Commentary:

The tension between the Fed and the outlook for economic growth continues. As yet, traditional macroeconomic measurements show few signs of a sharp slowdown in economic activity. Most notably, April consumer spending remained robust, and the Atlanta Federal Reserve GDPNow real-time barometer of second quarter US growth was raised to 2.6 percent (from less than 2% two weeks ago.). Yet many of the earnings reports coming forward have cautioned slower sales in the months ahead, and retailers have noted shrinking profit margins, presumably reflecting rising labor costs and product costs meeting consumer resistance on final product prices. While the Fed remains stalwart in its anti-inflation stance, it will be interesting (and important) to see how the growing concern over economic growth is addressed.

Data to Watch:

1. US New Home Sales, released **Tuesday, May 24**
2. US Durable Goods Orders, released **Wednesday, May 25**
3. Initial Claims for Unemployment, released **Thursday, May 26**

Suggested Reading:

<https://www.wsj.com/articles/jpmorgan-says-u-s-consumers-are-doing-just-fine-11653327789>

<https://www.nytimes.com/2022/05/23/business/economy/china-trade-tariffs-biden.html>

<https://www.cnbc.com/2022/05/24/last-in-first-out-risks-of-joining-great-resignation-in-a-recession.html>

Investment Commentary:

Market Concerns

Investors are scared of inflation and slowing growth. In sum, the markets anticipate interest rates going higher, growth stocks going lower and value stocks outperforming growth. The new investing environment is faced with a more restrictive monetary policy where there is an increasing focus on fundamental earnings and the “fair value” for that stream of cashflows. Additionally, housing starts and building permits fell last month as higher mortgage rates muted demand for new construction, while materially constrained supply dampened sales of existing homes. Nonetheless, equity valuations have declined this year as investors price in higher recession risk given restrictive Fed policy and broad and elevated inflation. As a reflection of higher recession risk, credit spreads are up this year, although investment-grade spreads are still only around their long-term averages and high yield spreads remain below their long-term averages measured since the Great Financial Crisis.

Given these recession concerns Jamie Dimon, CEO of JP Morgan (JPM) the largest bank in the United States, spoke yesterday, providing a comforting near-term perspective that included expectations that credit losses will likely remain low into 2023, greater net interest margin from higher rates and stronger loan growth driven by strong credit card and corporate revolver utilization. However, Walmart (WMT) and Target (TGT) missed expectations. Both companies reported lower margins on the back of cost problems, bringing to light the risk

that elevated inflation eats into corporate margins. Moreover, retail company profit weakness was seen as a reflection of flagging consumer spending. However, both companies noted that broad consumer spending remains strong, and retail sales data reported earlier in the week suggested healthy consumer behavior.

Portfolio Considerations

In sum, mixed macro and fundamental signals make it difficult to definitively declare the ultimate destination and time of arrival for this volatile journey. As a result, our portfolio construction deliberately includes defensive equities like quality dividend stocks, and within fixed income, we favor higher quality, shorter, duration credit. Taxable investors have opportunities to evaluate attractive municipals and real assets with tax advantages. Finally, we remain cautious regarding adding interest-rate sensitive duration, given the prospect of “lower but still high” inflation and a Fed determined to fight it.

Wealth Planning Commentary:

Watch your securities-based lines of credit

With the S&P 500 down approximately 20% from the 52-week high, portfolios are likely lower than when investors originally drew on their lines of credit. Like margin, a securities-based line of credit (LOC) is offered through a bank or custodian. The line is borrowed against the value of the portfolio, usually at variable interest rates. Unlike margin, these non-purpose credit lines may not be used to purchase securities or pay down margin loans, nor can the funds be deposited into any brokerage account.

If the value of the portfolio drops below a certain threshold, typically when the loan to asset ratio is above 70%, there is a maintenance call. The loan to asset ratio threshold is based on the lender, and the securities pledged. One could imagine a portfolio of volatile ‘meme’ stocks having a lower maintenance call threshold than one that holds triple AAA bonds.

So, what can be done if you are close to or have received a maintenance call? To quote the Hitchhiker’s Guide to the Galaxy: “First of all... don’t panic”. Secondly, be proactive. If you do not act, you run the risk that the custodian, if they underwrote the line of credit, may sell securities. Selling at a market low is likely not advantageous and may also trigger undesirable tax consequences.

Here are a few actions to consider:

- Contribute cash or transfer securities to the pledged account. This will decrease the loan to asset ratio. Cash will also act as ballast on the collateral.
- Pay down the LOC. Dollar for dollar, reducing the loan has more of a positive impact on the loan to asset value ratio than increasing the collateral in the account.
- Sell securities and harvest a loss to offset gains. The cash may be used to reduce the LOC or offer ballast to the collateral.
- Apply for a HELOC if it is available and use an IRA rollover as an interim source of funds. You can take a penalty-free IRA distribution for up to 60 days and contribute it to the pledged account. The money will need to go back into the IRA, but at that point, you may have a HELOC in place.

Maintenance calls can be avoided, and there are likely multiple options to address them.

Wealth Planning Opportunities

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

- Loss harvesting and rebalancing
- Roth conversion
- Wealth transfer
- Review your lines of credit and position to avoid a maintenance call

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

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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