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May 31, 2022 – Weekly Notes

Economic Commentary:

Suddenly, there is quite a bit of disarray in global economic policy objectives. The U.S. is continuing to fight inflation, possibly at the expense of a significant amount of economic growth. Europe is holding its breath, uncertain quite what to do about inflation and interest rates, as Russia retaliates for economic sanctions by cutting energy supplies to the Netherlands, which is refusing to pay for Russian gas in Russian rubles. And China is talking economic stimulus — again— with the growing suspicion that “official” economic numbers are seriously underreporting the negative consequences of Zero-Covid policies, etc. Small wonder that equity markets seem to be asking, “Where are we?”

In the US, all eyes are on indicators of economic activity, especially housing but also travel, leisure and consumer services expenditures. Close attention to the state of household balance sheets is warranted to better understand the durability of economic growth in the face of rising interest rates.

Data to Watch:

1. European Union Inflation Rates for May, released **Tuesday, May 31**
2. ADP Employment Numbers for May, released **Thursday, June 2**
3. US Non-Farm Payrolls for May, released **Friday, June 3**
4. US ISM Non-Manufacturing Purchasing Managers Index, released **Friday, June 3**

Suggested Reading:

https://www.nytimes.com/2022/05/28/business/economy/immigration-california-farm-labor.html

https://www.wsj.com/articles/robots-pick-up-more-work-at-busy-factories-11653822002?mod=hp_lead_pos5

https://www.cnbc.com/2022/05/30/fed-governor-christopher-waller-says-hes-prepared-to-take-rates-past-neutral-to-fight-inflation.html

Investment Commentary:

Market Performance

History has shown that the worst market days and the best market days tend to cluster together in highly volatile periods. Stocks rebounded last week, with the S&P 500 up 6.3%, it’s biggest weekly gain since November 2020. The Russell 1000 Growth outpaced Value 6.9% to 5.8%, while the Stoxx Europe 600 was up 4.6%. The U.S. 10-year Treasury yield eased 4bps to 2.7% on economic misses. The euro rose 1.6% and the U.S. dollar fell 1.4% (and is down 3.0% from its May 12 high) on the back of Lagarde’s hawkish comments and U.S. softening. Last week, investors perceived a higher chance the Fed will be unable to tighten as much as it wants due to slowing growth which simultaneously relieves inflationary pressures but likely negatively impacts fundamental earnings power.

Let's Keep It Real

The Investment Office continues to be vigilant about monitoring real rates as an important determinant of asset class performance. Any move upward or downward in real rates has consequences on asset prices. As a reminder, a real interest rate is the nominal interest rate adjusted to remove the effects of inflation and gives the real rate of a bond or loan. The 10-year U.S. real yield has since increased quickly, from -1.00% August 2021 to a high of +0.35% on May 10, 2022 to +0.11% last week. Equity markets declined and rebounded with increases and decreases in real rates.

Portfolio Implications

Real yields and certain other broader measures of the monetary policy environment, such as the Financial Conditions Index, are now back at pre-COVID levels. People continue to ask if the correction for pandemic-era excess liquidity is complete or at least largely priced in anticipation of central bank tightening. In short, the markets have been addressing valuations assuming a given stream of earnings – and now investors are questioning earnings outlooks. The ultimate answer will be heavily influenced by confidence in the U.S. and global economy to absorb tighter financial conditions without tilting into a full recession. If investors develop an increasing conviction that the U.S. and global economies are going into a recession, there is very likely more downside risk as markets begin to price in lower earnings at today's lower valuations. As a result, we still believe equity portfolios should include a blend of quality value and growth holdings, shorter duration fixed income and alternative strategies that address persistent inflation and slowing growth such as multi-family real estate, single-family rentals, affordable housing, and active private credit distressed managers.

Wealth Planning Commentary:

Social Security Risk

The 2021 Social Security Trustee Report states that the Old-Age and Survivors Insurance (OASI) Trust Fund, which pays social security benefits, will deplete by 2033. At this time, scheduled social security benefits are expected to reduce by about 25%.

To address the looming shortfall, the House's Ways and Means subcommittee will soon debate a bill called 'Social Security 2100: A Sacred Trust'. The latest proposal applies a payroll tax to wages above $400k, and currently, it is capped at $147k. The bill also proposes that the annual Cost of Living Adjustments (COLA) track the CPI for Americans 62 and older (CPI-E) instead of the CPI for Urban Wage Earners and Clerical Workers (CPI-W). These changes may keep the trust fund solvent through 2038.

Though the bill is in deliberations, it's unlikely that Congress will act until the fund is closer to depletion. We wouldn't rule out a future reduction in benefits. Congress has passed a few bills to encourage retirement savings which may help retirees shift away from relying on social security income. In wealth planning, we err toward being conservative. We suggest testing the resilience of your plan to account for a 25% reduction in social security benefits, especially if you are less than 55 years old.

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Active 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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