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May 9, 2022 – Weekly Notes

Economic Commentary:

Economic forecasters – and investors—are increasingly incorporating the pain of inflation-fighting into the near-term world view. As inflation erodes consumer pocketbooks globally, a spending response may be emerging, showing up in everything from the demand for Chinese exports to plans for summer vacations. The Federal Reserve made a strong statement last week about the strength of the US economy and how that strength should be able to absorb the negative impact from rising interest rates, but much is yet to be determined about end-market resilience in the face of higher borrowing costs, Russian sanctions and (possibly) shrinking profit margins. Housing price increases have been a major contributor to inflation acceleration and the market is now cooling as mortgage rates rise, but inflation pressures less responsive to Fed actions --- rising energy costs and sharply higher prices for agricultural commodities – continue to make it difficult for policy makers to slow inflation, which is what they need to be able to turn their attention to protecting economic growth. One positive already released this week is that US consumer inflation expectations have declined slightly from March.

Data to Watch:

1. US Consumer Prices for April, released **Wednesday, May 11**
2. US Producer Prices for April, released **Thursday, May 12**
3. US Michigan Consumer Sentiment, preliminary for May, released **Friday, May 13**

Suggested Reading:

https://www.wsj.com/articles/chinas-trade-slows-as-demand-drops-and-covid-lockdowns-hit-supply-chains-11652088372?mod=hp_lead_pos4

https://www.nytimes.com/interactive/2022/05/08/business/economy/inflation-calculator.html

https://thehill.com/policy/national-security/3481527-former-national-security-officials-push-for-green-card-cap-exemption-for-immigrants-with-advanced-stem-degrees/

Investment Commentary:

Investment markets continue to struggle with the implications of:

1. the ongoing war in Ukraine and the commodity price shock,
2. the zero-COVID policy in China and its impact on growth,
3. recession concerns in Europe and the contagion risk across the world,
4. and the U.S. Fed's ability to balance the growth-inflation tradeoff.

The elevated levels of volatility in equity and bond markets reflect near-term pessimism and uncertainty. Most notably, credit spreads for both investment grade (IG) and high yield (HY) bonds have widened. The IG spread is almost equivalent to the Great Financial Crisis (GFC) average of 140bps and HY is ~100bps below the GFC average of 480bps. Equity prices have fallen to a 13-month low, and mortgage rates have risen by more than 2.5%, with the 30-year fixed-rate mortgage at the highest level since

2008. Year to date, Bitcoin (BTC) is down 32.5% and Ether is down 37.3%. From all-time high, BTC is down 54.5% and ETH is down 52.8%. BTC has become increasingly correlated with equities since the beginning of 2021 and the correlation is now at an all-time high since 2012. Higher borrowing costs and overall costs of capital are growth headwinds that will weaken near-term excess demand, while the supply-constrained shocks will take longer to heal, increasing the probability of stubborn inflation.

The Fed's ability to "stick the soft landing," while not impossible, will be difficult, as many gold medal Olympic gymnasts can attest. While the degree of difficulty for the Fed is high, the fundamentals, as reported by the Q1 earnings reports are encouraging. The current S&P500 blended earning earnings growth rate for the quarter is 9.1% (year-over-year) compared to the expected 4.6%, according to Bloomberg. The valuation of the benchmark S&P500 has fallen to the 5-year average level of ~17x forward estimates, however, large cap growth continues to trade above their long-term averages. In essence, the markets are repricing risk as the Fed removes excess liquidity. As the Fed looks to "stick the landing," investors should focus on tax-loss harvesting and allocations to more defensive and real assets.

Wealth Planning Commentary:

The Long-Term Perspective

Last week was a bumpy ride for the markets and that will rattle even the most stalwart investors. It may be helpful to look at short-term events in the context of your long-term wealth plan particularity if the current level of volatility is causing anxiety. It's likely that some of the success of your wealth plan is based on avoiding any potentially rash decisions such as liquidating your portfolio. Our investment office and many industry experts emphasize that trying to time the market by selling out and buying back in 'at the right moment' will likely result in a less than optimal outcome.

What may help maintain a long-term perspective is reviewing your wealth plan and stress test if for resilience. Our team will analyze your plan with you and help identify potential weaknesses under a range of market and economic scenarios. The visualization of how market events may impact your financial security is insightful. If there are issues, we may adjust to fortify the plan, maximize the potential to achieve long-term objectives, and give you the confidence to stay invested.

https://rscapital.com/2022/02/28/when-markets-roil-stop-drop-and-run-simulations/

Given current market downturn consider these opportunities:

Loss Harvesting - Capital losses may be used to off-set 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. Avoid the "wash sale," and 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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