

April 11, 2022 – Weekly Notes

Economic Commentary:

Investors appear to be moving to a fuller recognition of the strength of the shift, by the Fed, to a robust anti-inflation stance. Whereas at one time this shift would have been described by the Fed as a move to “neutral”, i.e. neither expansionary or contractionary, it seems that the Fed has rather quickly changed tone once again and is now willing to adopt a more explicitly contractionary roadmap. The release of the FOMC minutes illustrated this development in the strong endorsement of starting a balance sheet reduction as soon as May, sharply contrasting with the cautionary remarks of Fed “centrists” (e.g., Brainard, Williams, Barkin) as recently as February about the unknown impact on the US economy of rapidly reducing the Fed’s holdings of bonds on the balance sheet — and suggesting that the run-off would be cautiously attempted in September or October at earliest.

No one at the Federal Reserve wishes to cause a recession— now, late 2022 or 2023. The likely hope is for a choreography that reduces consumer demand for goods and business demand for capital goods and labor for 6-12 months without doing significant damage to an economy that is still in the early stages of economic expansion. Nevertheless, dancers do make mistakes and, as interest rates march upwards, the potential for pratfalls increases. The speed of the increase in rates is just as big a problem as the magnitude of the increase, maybe bigger; second quarter economic activity is going to be watched very closely for signs of economic stress.

Data to Watch:

1. US Inflation for March, Core and Aggregate CPI, released Tuesday, April 11.
2. US Retail Sales for March, released Thursday, April 14
3. US Industrial Production and Capacity Utilization for March, released Friday, April 15

Suggested Reading:

1. <https://www.wsj.com/articles/why-russia-doesnt-want-to-default-even-in-a-time-of-war-11649336269>
2. <https://www.bloomberg.com/news/articles/2022-04-05/job-market-tightness-forces-work-requirements-rethink>
3. https://www.wsj.com/articles/investors-turn-cautious-on-consumer-debt-11649624240?mod=hp_lead_pos3

Investment Commentary:

Market Performance.

As the Fed now reacts to being behind the curve, markets are now also pricing in an 85% chance of a 50bps move at the next meeting in May, with the amount of tightening priced for 2022 standing at 220bps on top of the 25bps from last month. These expectations for aggressive Fed moves saw 10yr Treasuries rise +32.5bps on the week to 2.71%, marking the first time the 10yr yield has closed above 2.5% since May 2019. Over in Europe, 10yr Bund yields rose +15.4bps to 0.71%, its highest level since 2018 as the market implied ECB policy rates by the end of the year increased +6.0bps to +62.3bps, the highest level this cycle in anticipation of persistent inflation.

US equities were also affected by the more hawkish rhetoric where the S&P500 index recouped losses later in the week off the back of a strong recovery in cyclicals. However, technology stocks were among the worst performers last week, declining approximately 3.5% on the week while healthcare generated positive performance of approximately 3.4%.

Volatility will remain elevated in both equity and bond markets, given the uncertainty of geopolitical activity and changing central bank positioning.

Are the equity markets fighting the Fed?

With S&P 500 forward P/E multiple ~20x, there are some ways to reconcile the apparent discrepancy between rising rates and stable high multiples. If, for example, the Fed is successful in staving off future inflation without triggering a recession, and long-term rates hold steady or even start to come back down – that could justify the current P/E multiple. Alternatively, if corporate earnings come in strong (which is likely for this past quarter) and a majority of companies communicate a positive outlook to pass inflation-induced price increases onto consumers – then again, *maybe* current valuations are justified.

Regardless, it is difficult to be broadly bullish on equities at this moment in time. But with that said, it's probably best not to lump all stocks/sectors together for this assessment. We remain diversified across shorter duration assets, including value stocks, for this very reason and support the use of alternative investments in portfolio construction to address an environment of rising interest rates and stubborn inflation. There is also an opportunity to pursue tax-loss harvesting, monetizing losses that can be used to offset current or future capital gains.

Wealth Planning Commentary:

Tax Legislation Updates:

The Secure Act 2.0 is heading to the Senate floor for deliberations. The legislation is expected to pass before year end. The Act encourages retirement savings and provides some benefits to households who do not rely on retirement account distributions to maintain their lifestyle. Some provisions of the Secure Act 2.0 may make a Roth conversion more beneficial.

A couple of weeks ago the Biden administration released the 2023 budget proposal and the Treasury also released the latest version of the "Green book". The book, or long document rather, contains the first comprehensive set of tax proposals since the Build Back Better Act failed to advance in Congress late last year. Some of the proposals negatively impact HNW worth estate planning strategies. There is no cause for alarm at this point. These types of proposals did not appear into the Build Back Better Act and are not likely to be passed given the current Congress.

Planning and Rental Real Estate Considerations

Some clients have a large percentage of their net worth in directly owned real estate, particularly in rental properties. Ageing clients in this situation may have challenges around succession and estate planning. In our experience the property owners may have doubts about leaving rental properties to their heirs. Sometimes the next generation does not have the qualifications or are disinterested in managing the holdings.

Passing away without a disposition plan for the rental properties may lead to estate liquidity issues and a potential a fire sale situation.... perhaps even family infighting. There are reasons why clients hesitate to simplify their estate by selling rental properties:

- **Unrealized Capital Gains** - It's the real estate game – a history of deferring cap gains through 1031 exchanges may generate a large tax bill upon sale. With the right planning strategies and investment options it's possible to minimize the impact of taking capital gains. Note income tax savings today may be outweighed by an estate tax bill later.
- **Preference for Investing in Real Property** - Clients who have had negative experiences with the stock market may prefer real estate investments. Real estate plays a role in a diversified portfolio and can act as an inflation hedge. However, a portfolio that is overconcentrated in real estate is vulnerable to a boom-and-bust cycle.
- **Cash Flow** - Income replacement is a key concern for those who are debating offloading their properties. There are other ways to produce income by investing in public and private REITs, alternative investments, and other cash-flowing producing investments.
- **Tax Alpha** - Owning rental real estate provides tax benefits such as qualified business income, depreciation deductions, and the ability able run some expenses through a business. It's possible to obtain tax alpha through wealth planning and other investment strategies besides rental real estate.
- **Sentimental Value** - It's natural for clients to become attached to properties they have held for many years. This attachment may prevent a sale at an opportune time. Remember that you can't take it with you in the next life!

The above is a general commentary on patterns we see in wealth planning with real estate. Specific planning strategies are tailored to a client's goals for their family and estate. Please feel free to reach out to us with questions.

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