

## February 22, 2022 – Weekly Notes

### Economic Commentary:

Reassurances last week from several Federal Reserve Presidents that the Fed is inclined to move forward on interest rate increases carefully and gradually offered only a brief respite from market volatility, quickly overwhelmed by the Russia-Ukraine fighting. With economic sanctions by the US and EU still to be determined, assessing the impact of the conflict on economic fundamentals is difficult. The EU and Britain will be directly affected by disruptions in trade (especially agricultural and food products), transportation services and energy supplies, with current estimates projecting a hit of as much as 1% of EU GDP. For the US and other countries, the major economic issue may be commodity prices and supplies, as Russian production of copper, palladium, rare metals used in semiconductors, etc. has some influence on the global commodities market, especially in this supply-chain challenged environment. Interestingly, China has been moved to line-up with Western nations in criticism of the Russian actions (voicing disapproval, not condemnation) and may use events to increase its ties with the US, EU, Israel, Australia and emerging nations, reversing emerging criticism and trade restrictions.

Unlike the EU and Britain, expectations for US economic growth in 2022 continue to be robust, rebounding from a weak January due to Omicron. Consumer spending appears strong, despite (or as a result of) rising prices. One thing to watch will be the response of consumers to sky high prices at the gas pump, which may cause them to either curtail driving or curtail other expenditures to accommodate the hit to pocketbooks – or both. Restaurants, already challenged by rising food costs and labor supply problems, may be the first to see this kind of consumer response.

### Data to Watch:

- US Markit Composite Purchasing Manager Index (PMI) “Flash” report for February, released Tuesday, Feb. 22
- US API Crude Oil stock change for the week of February 18, released Wednesday, Feb. 23
- US Initial Jobless Claims for the week of February 19, released Thursday, Feb. 24
- US Durable Goods Orders for January, released Friday, Feb. 25
- Michigan Consumer Sentiment Survey for February, released Feb. 26

### Suggested Reading:

- <https://www.wsj.com/articles/russian-escalation-in-ukraine-raises-global-economic-risks-11645535764?mod=mhp>
- <https://www.telegraph.co.uk/business/2022/02/22/vladimir-putin-controls-supply-chain-western-technology-bluffing/>
- <https://www.nytimes.com/2022/02/21/opinion/22cotton-student-loan-debt.html>
- <https://www.nytimes.com/interactive/2022/02/21/headway/peat-carbon-climate-change.html>

### Investment Commentary:

#### Macro Considerations

Global equity markets continue to be influenced by two primary macro factors: (i) rising geopolitical risk and (ii) changing central bank policies. Even as the fundamental outlook for economic growth and growth in corporate

earnings remains encouraging, markets are volatile as investors search for answers to two key questions where both questions are equivalent to walking a tightrope.

*First*, will Western governments response be able to find the proper balance, responding in a way that is forceful enough to be taken seriously by Russia, while also maintaining other actions in case Putin moves further to a full-scale war?

*Second*, will the Federal Reserve embark on a tightening cycle that finds the proper balance between fighting inflation without pushing the US economy into a recession?

Additionally, the tightrope walking exercise is complicated by the fact that these questions are not mutually exclusive but rather intertwined. Such that, increasing Russian geopolitical issues are contributing to higher oil prices which are inflationary and potentially demand destructive longer term. Central bank policy cannot increase oil supply or other supply constraint issues and the Fed's decisions today have a lag effect. The Fed needs to be mindful of tightening financial conditions with the potential of further geopolitical risk and weakening demand due to persistently high energy prices.

### **Market Context**

Historically, market drawdowns due to disputes between nations are usually short lived. In the past, the greatest challenge facing globally diversified investors from such crises has been the behavioral risk to overreact, exit markets and incur unnecessary taxes.

Let's look at various wars and the associated market declines from peak to trough.

1. 1990 Gulf war (~19%)
2. 2018 Trade war w/ China (~19%)
3. 2014 Russia's annexing of Crimea in 2014 decline (~3%)

The other side of a decline is how long does it take to recover where history suggests 1.5 months to 6 months as in the case of the Gulf War.

Notwithstanding the Russian crisis, the Investment Office anticipates above trend economic and earnings growth as well as higher overall equity markets this year especially for a portfolio with U.S. equity exposure that includes high quality dividend growing stocks and value stocks. Year-to-date those tactical decisions have generated smaller declines of ~4% vs. growth stocks of ~13%.

### **Valuation Multiples and Credit Spreads**

Valuations are elevated in the risk asset markets, with the price of the S&P 500 at ~19 times earnings, compared with the 10-year average price-to-earnings of ~17x. That would suggest another 10% decline at the index level everything else being the same. Additionally, in February 2020 (pre covid pandemic declaration) the U.S. 10 year was ~2.6% vs. ~2% now (escalating geopolitical risk will likely pressure yields lower) and the S&P 500 was at ~3,400 or ~20% lower than recent levels.

If you are worried about these scenarios...

- You may want to discuss with our firm put spread collars to monetize volatility and capture more upside vs standard collars.
- In addition, those with concentrated equity risk can explore this type of historical hedge analysis on single stock positions.

The Investment Office anticipates a decline in the price ("P") investors are willing to pay for a given basket of earnings ("E"), however, we believe the decline in valuation will be offset by aggregate earnings growth of ~10% in 2022. We are actively monitoring credit spreads, where we have seen some spread widening off tight levels for both investment grade and high yield. Credit quality, however, remains relatively strong within each of these sectors, with the default rate in 2021 for high yield bonds expected to be approximately 0.5%, below the record low of 2007 and well below the historical average of ~ 4%.

## **China**

A discussion of the markets must also be mindful of the second largest economy. Recently, China's top finance minister vowed to further cut corporate tax rates and strengthen targeted fiscal spending. Additionally, the head of the People's Bank of China (PBOC) said that the central bank would maintain supportive monetary policy this year. However, news from real estate developers continue to highlight the financial troubles weighing on the property sector. Finally, Meihua International Medical Technologies Co. became the first China-based company to have an initial public offering (IPO) in the U.S. since July 2021 after ride-hailing app Didi Global's IPO sparked a regulatory backlash in China. The medical device maker priced its IPO at the midpoint of a marketed range, raising hopes that its share sale might lead to the resumption of Chinese companies seeking to go public in the U.S.

## **Wealth Planning Commentary:**

### **Given enough time and planning, estate taxes are elective**

A recent Bloomberg article reported that Harold Hamm, also known as the Shale King, completed a transfer of \$2.3 Billion of company stock, Continental Resources, to his 5 children. It is believed that this transfer was largely tax free.

How do Harold accomplish this? He planned and used two common strategies very effectively: 1) the minority valuation discount and, 2) a sale of assets to an Intentional Defective Grantor's Trust (IDGT).

The key to the IDGT is to structure transactions so assets are not technically treated as gifts, and this is best accomplished through loans. The Shale King also timed well: when oil prices were relatively low, he transitioned stock through discounting and incomplete gifts and when oil prices rebounded the appreciation was outside his estate.

If possible, it's best to plan far ahead to ensure the wealth is transferred to heirs or charity and avoids taxes...look at what the Shale King achieved!

### **Gambling losses and sports betting**

New York recently became the 18<sup>th</sup> state to legalize online sports betting beginning in January 2022. Bets worth \$1.6 billion were placed on mobile apps in the first month and the state outpaced Nevada and New Jersey to become the most lucrative online sports betting market in the country.

During the Super Bowl, many bets were made and of course we either ended up winning or breaking even. In the off chance that you lost money remember that gambling losses are tax deductible if you itemize. You can deduct up to the amount of gambling income you report.

## Don't forget this very large tax exclusion

If you are a founder, early-stage employee or investor and the company is or may be experiencing a liquidation event you may be eligible to for the QSBS exclusion. QSBS allows for a federal capital gains tax exclusion of the greater of \$10mm or 10x basis for married filing jointly and single filers.

Ask the company CFO or legal counsel if the company and your stock qualify as QSBS. If you are expecting a realized gain of greater than \$10mm or 10x basis, there may be strategies available to you to multiply the number of QSBS exclusions.

Please reach out to us if you have any questions.

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