

June 21, 2022 – Weekly Notes

Economic Commentary:

As the Fed signals its intention to keep raising interest rates through the end of 2022—aiming at a 3% Fed Funds rate by the end of the year, and only re-evaluating their course of action once there are “several months” of data consistently showing cooling inflation--- housing markets are showing signs of strain. Building permits, housing starts, existing home sales and mortgage applications are all down substantially in May, even without the challenge of the latest interest rate increase and its impact on mortgage rates. Both home building and existing home purchases have a significant multiplier effect, impacting commodity prices like copper and lumber and influencing the outlook for vendors of home appliances, furniture, and professional services (accounting, real estate, landscaping, etc.). Further complicating matters for the Fed is a slowdown in industrial production and preliminary evidence that job growth is slowing as well. But then, this is what slowing down and economy to reduce inflationary forces looks like. After the FOMC meeting last week, the Fed made clear that they expect unemployment rates to rise but believe it can be modest and “manageable.” Chairman Powell’s testimony before Congress this week as part of his twice-yearly presentation on monetary policy goals and achievements will no doubt contain some fireworks over how much pain the Fed is willing to tolerate, especially in terms of labor markets, as the fight against inflation continues.

Data to Watch:

1. US Initial Jobless Claims for the week of June 18, released **Thursday, June 23**
2. Kansas City Federal Reserve Manufacturing Index for June, released **Thursday, June 23**
3. Federal Reserve US Banking Industry Stress Tests, released **Friday, June 24**

Suggested Reading:

https://www.wsj.com/articles/russia-slashes-gas-flows-aiming-economic-weapon-at-europe-11655393254?cx_testId=3&cx_testVariant=cx_2&cx_artPos=0&mod=WTRN#cxrecs_s

https://www.wsj.com/articles/u-s-existing-home-sale-prices-hit-record-of-407-600-in-may-11655820516?mod=hp_lead_pos2

<https://www.theguardian.com/business/ng-interactive/2022/jun/21/cost-of-living-crisis-uk-households-charts-inflation>

https://www.wsj.com/articles/florida-homeowners-to-pay-higher-premiums-as-reinsurers-see-risks-and-pull-back-11655763328?mod=hp_lead_pos12

<https://www.nytimes.com/2022/06/21/business/net-power-natural-gas-emissions.html>

Investment Commentary:

Market Update

It has been another volatile week across markets as we saw further rate hikes from central banks where investors are left wondering if a more aggressive policy shift will ultimately succeed in dampening inflation, granting equity markets reprieve from the volatility of 2022. Bear markets can and will occur – since 1929, the S&P 500 has experienced 11 drawdowns of 20% or greater – however, no two are alike. This time around, historically tight labor markets, increasing wage growth, geopolitical/COVID supply constraints, and rapid

valuation compression caused by an increasingly hawkish policy are some of the circumstances that make this bear market unique.

Starting with the U.S., the FED did their first 75bps hike since 1994 while preparing for a much harder landing than they anticipated. During the usual press conference, Powell again emphasized the Fed's commitment to bringing down inflation and admitted the path to doing so, while engineering a soft landing was getting more and more difficult. Powell suggested it would also need help from a supply-side expansion, citing shocks such as the war, runaway oil prices, and supply chains sensitive to China's Covid lockdowns. Another key focus of the press conference was the appropriate pace of rate hikes going forward, with the Chair not explicitly ruling out hikes larger than 75bps.

Moving to Europe, the biggest news came from the Swiss National Bank (SNB), which hiked rates for the first time in 15 years. The 50bps move combined with a change in F.X. policy led to a massive reaction in the Swiss Franc, which strengthened by +2.9% against the U.S. Dollar on the day in its biggest daily appreciation since 2015. Notably, this action by the SNB provides a stronger signal of more persistent inflationary pressures.

Central banks, excluding China, are signaling an increasing willingness to bring inflation under control even at the expense of economic weakness. As a result, major equity indices slumped heavily on both sides of the Atlantic throughout the week, with the S&P 500 (-5.4%) losing more than -3% on two separate days last week, as it also hit its lowest level since late 2020. Elsewhere, the NASDAQ saw an even larger decline, to have now lost more than a third of its value since its all-time closing peak back in November. Last week, the NASDAQ declined (-6.1%). It was a similar story in Europe too, as the STOXX 600 (-4.6%) fell to a one-year low. Government bonds also saw some large swings. 10-year German Bund and U.S. Treasury yields hit intraday highs on the week of more than 1.9% and nearly 3.5% respectively, although they are ending the week at 1.6% and 3.2% respectively, moves of 14bps and 7bps on the week. It's also worth highlighting some notable moves in the Italian BTP/German Bund spread. Having hit levels in excess of 225bps we saw a sharp rally back as the ECB called an emergency meeting to discuss tools to deal with market fragmentation. We also had comments from Italian central bank governor Visco that the spread should be under 150bps based on economic fundamentals. The BTP/Bund spreads is ending the week back below 200bps.

Investor Behavior

Increasingly investors are asking not, "What are the highest returns I can earn" but "What are the best risk-adjusted returns I can sustain for the longest period of time?" In other words, a focus on the power of compounding returns that benefit from time. Time is the factor that does the heavy lifting, where the common themes of growing investment portfolios are endurance and patience. It's the tradeoff between awesome returns regardless of risk for a few years vs. attractive returns for a long time.

There are primarily two kinds of investing fatigue: financial and psychological. The first is when you're leveraged (investing on margin and/or speculation), and your attempt to maximize returns forces you to sell when the market turns. The second is psychological. It's hard to predict how you might feel when markets return to demonstrating sustained volatility.

Persistently high inflation has left the Fed with few options in its playbook other than to accelerate its contractionary monetary policy. The question is whether that play finds the proper balance between cooling inflation while not getting burned by a severe recession. In the meantime, market volatility is sure to remain elevated over the near term.

Our current approach to fight investor fatigue is to construct an investment portfolio consistent with a financial plan that includes a (i) focus on U.S. large caps with a thoughtful allocation of high-quality growth names, dividend growers and value, (ii) municipal bond separate managed accounts, whose lower valuations, higher yields and strong fundamentals now look attractive after a challenging start to 2022 and (iii) selective alternative strategies across real assets and credit managers.

Wealth Planning Commentary:

SECURE Act 2.0

The Senate is aiming to pass the SECURE Act 2.0 in July. As you may recall, the House passed its version of the legislation in March of this year. Senate committees are looking to add the Enhancing American Retirement Now (EARN) and Rise and Shine Act – which incorporates an emergency cash component to retirement plans that will be funded by pre-tax deferrals. The Senate's version of SECURE 2.0 will be reconciled with the House's version. It is expected that the RMD age provisions from the House's version will be included. The RMD age would increase from 72 to 75, phased in over the next decade.

There is a looming IRS clarification that may change the distribution rules for inherited IRAs. It is not part of the SECURE Act 2.0 but is likely to take effect by the end of this year. If the original owner died on or after their "required beginning date" for RMDs, non-spouse inheritors could be mandated to take annual withdrawals from the accounts during a 10-year period. Simply put, if the deceased was taking RMDs then the inheritor will need to take RMDs every year over a 9-year period and empty the account by the 10th year. The good news is that there are no proposed changes to the Inherited Roth IRA 10-year rule; inheritors may keep Roth assets growing tax-free for 10 years. Again, these changes are proposed.

Active Wealth Planning Opportunities and Reminders

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

- Loss harvesting and rebalancing, Roth conversion, wealth transfer.

Reminders:

- Private equity firms tend to increase capital calls in down markets. Consider keeping extra liquidity aside or access to credit if you have outstanding commitments.
- 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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