

June 6, 2022 – Weekly Notes

Economic Commentary:

Last Friday's non-farm payrolls report confirmed that the US economy is still growing, despite all discussion of an imminent recession resulting from rising interest rates. Furthermore, the report contained some evidence that the labor market pressures that have been pushing up labor costs may be moderating. However, there is nothing in any of the recent data to cause the Fed to deviate from a course of action that increasingly seems committed to a series of 50bps increases in the Fed Funds rate.

In Europe, the ECB continues to prepare for its own inflation-fighting actions: a more gradual increase in rates than being witnessed in the United States but still representing a significant change in direction. European interest rates have been negative for a number of years and returning to a more "normal" regime is clearly going to feel abnormal to some. This week, the ECB will be working on a plan to support government credit markets if disarray materializes as the ECB cuts back on bond purchases— something planned but not yet formally put in place.

Data to Watch:

1. US Exports and Imports for April, released **Tuesday, June 7**
2. US Consumer Price Index for May, released **Friday, June 10**
3. Michigan Consumer Sentiment Survey for June (Preliminary), released **Friday, June 10**

Suggested Reading:

<https://www.ft.com/content/e14d4cba-10a4-49f5-a4f2-dd14b65f5dd2?emailId=629dcdefb91ca10023766a9f&segmentId=13b7e341-ed02-2b53-e8c0-d9cb59be8b3b>

https://www.wsj.com/articles/pension-funds-push-for-more-disclosure-rules-for-private-equity-hedge-funds-11654507801?mod=hp_lista_pos5

<https://www.nytimes.com/2022/06/05/business/biden-oil-saudi-arabia.html>

Investment Commentary:

Market Considerations

If you think a recession is imminent, there's an opportunity in bonds; if you think central banks can achieve a softish landing, then there's an interesting opportunity in stocks — although certain index valuations remain fully priced despite a rising 10-year Treasury yield. At these valuation levels, investors much take the view that earnings growth will reaccelerate later this year. As a result, integrating deliberate stock and credit selection to portfolio construction is prudent.

Tighten Your Belt

With inflation at a 40-year high and the labor market still tight, the Federal Reserve last week pulled another instrument from its monetary policy toolbox, "balance sheet shrinkage," or quantitative tightening. The official start of the Federal Reserve's balance sheet shrinkage is a \$15 billion basket of Treasury securities set to mature -- without reinvestment -- on June 15. The Fed's portfolio is projected to drop to \$5.9 trillion by mid-

2026 vs. \$4.2 trillion in January 2020, with the balance sheet shrinking by an average of \$80 billion per month through 2024.

This is only the second time in modern history that the Fed has embarked on quantitative tightening; there are several important questions. For example, what does the runoff imply for the economy and fighting inflation? According to Fed Governor Christopher Waller, it's "highly uncertain."

Perhaps a harder question is what shrinking the balance sheet will mean for trading conditions in Treasuries. Liquidity in the \$22 trillion market has deteriorated over the past few months, with the Bloomberg US Government Securities Liquidity Index -- a gauge of deviations in yields from a fair-value model -- hovering near the highest levels since March 2020.

Fed officials are seemingly aware of the risk as the portfolio shrinks. The minutes from May's meeting showed that several policymakers "noted that the tightening of monetary policy could interact with vulnerabilities related to the liquidity of markets for Treasury securities."

Layer in the fact that capital requirements have kept the big US banks from adding to market-making capacity in Treasuries over the past few years, and the outlook appears consistent with Fed Waller's "highly uncertain" perspective.

Outlook

As a result, the range of potential outcomes remains very large. A few scenarios are described below.

1. If inflation is more supply-chain driven than it is demand-driven, then the Fed will be challenged to 'hike inflation out' of the system. That means real austerity, getting to a neutral target faster and higher than consensus expectations.
2. If inflation, while partially supply-driven, ends up being largely driven by demand, then the Fed is more able (with the help of China's re-opening- recent evidence ports are much more active) to dampen inflation enough without crushing the economy or the consumer.

Today's investment environment is more complex than it has been in recent years. How effectively policymakers remove accommodations from global economies will remain a crucial theme for 2022 and beyond. In the near term, the Investment Office believes economic growth and the labor market will moderate but remain strong toward year-end. Core measures of inflation (removing volatile food and energy prices) are similarly expected to moderate throughout the year but to stay at levels well above the Fed's 2% target.

A lot of negative news is already reflected in the first-half performance of global risks assets, except potentially broad-based second-half negative earnings revisions. Unexpected good news from the Fed, China, or the Russia/Ukraine invasion — or data that suggests inflation has peaked — could spark a relief rally in risk assets later in the year. When constructing portfolios for the second half of 2022, it's prudent to:

1. Emphasize High-Quality Value in the Core
2. Limit Duration in Pursuit of Real Income
3. Consider Inflation-Sensitive Alternatives

Wealth Planning Commentary:

It's Wedding Season

Much of today's financial conversations are around inflation, interest rate hikes, recession risk, and whether we've hit the bottom yet. One may forget a very financially devastating event...the wedding.

According to *the Knot*, the average cost of a wedding in 2021 was \$34k, but we observe that many of our clients are paying substantially more, \$100-300k. Over half of couples who are about to marry receive financial help from their parents. Whoever decides to pay, consider avoiding a potential gift tax.

If you are covering all or a portion of the cost of your child's wedding, we recommend paying the vendors directly. It will likely avoid gift tax treatment. In some cases, the pending newlyweds may want to control the payments. Try to keep these transfers to the engaged below the annual exclusion: \$16k for individuals or \$32k for married couples per recipient. Any gift above this amount each year will require you to file Form 709 and, it will likely reduce your lifetime exclusion amount.

Estate Planning House-Keeping

A reminder that estate planning documents: wills, trusts, durable powers of attorney (DPOA), advanced medical directives (AMD), living wills, and health care proxies should be properly stored and accessible to the executors and agents at the appropriate time.

Some examples of secure locations for the original signed documents are a safety deposit box at a bank or a fire/waterproof box at home. The lawyer who drafted the documents should also have a copy, and we recommend confirming that this is the case.

We encourage clients to keep an electronic copy with their wealth manager. The documents may be stored on secure servers or in your online document vault, which is secure and may be accessed at anytime from anywhere. The executor and agents, who are hopefully aware of their role, should know where the documents are located.

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:

- Quarterly estimated taxes are due June 15th
- 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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