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*Frank*ly Speaking©

Welcome to the Q1-2023 issue of *Frank***lySpeaking**©, now in its 31st year. The purpose of this newsletter is to keep you informed of current issues and global events that could impact your finances. Please feel free to share your thoughts with us, as we welcome your comments.

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In This Issue

Economic and Market Commentary

2022 had the highest inflation in 40 years, increasing recession fears, skyrocketing interest rate and increasing valuation risks.

How inflation comes down, demand vs. supply-side, and how much longer until it returns to target, will influence whether it hurts economic potential productivity and financial market risk premiums.

2023 outcomes are likely to influence overnight real interest rates, longer-term inflation risk premiums and cycle longevity expectations and thus equity risk premiums for the rest of the decade.

This struggle with inflation is compounded by a war entering its second year that is dangerous and the most divisive between the great powers of the east and west since the rise of the Berlin Wall.

How and what kind of peace Russia and Ukraine find will affect Europe and U.S.-China relations for the rest of this decade.

We can expect a small U.S. and European recession in the first half of 2023 led by declines in goods consumption and manufacturing and disinflation, not deflation.

We expect a relatively soft landing in the U.S. jobs market due to resilience in services and tightness in labor supply.

Because we expect limited damage to employment and household assets, we think 2023 presents opportunities in credit investing and banks.

We are sticking with short duration bonds and net interest income sensitive banks until there is more economic clarity and stability in the 10-year Treasury yield.

We think the Fed could raise rates to between 5% and 5.25%. Since 1982, the average hiking cycle was near 300 basis points over about 15 months. If interest rates began plateauing towards the end of first quarter of 2023, it would be a 500+ basis point increase in one year.

This should slow inflation and the economy unless the recession is deeper or longer than expected. Rate cuts are unlikely before 2024 to ensure inflation has been suppressed.

Long-term interest rates are expected to rise to the pre financial crisis range with the expected 10-year Treasury yields at about 4.20% by the end of 2023 and long-term inflation expectations at around 3.0%.

There will be strong secular trends that are resistant to cyclical disruptions such as healthcare solutions for an aging world, productivity enhancers for a tight labor market specifically in tech services and industrial capital goods, experience providers for in-person social and business gatherings, aerospace and defense, clean energy, and electrification plays offering fair equity returns.

The preferred industry remains banks because of higher interest rates, higher normalized earnings per share and return on equity.

Competitive U.S. corporate tax rates, a strong dollar, and higher interest rates are robust supports for small vs. large cap secular performance. Banks and Industrials are big sectors for profitable small caps.

Foreign equities provide opportunities for value and lower correlations. Exposure to China as it gradually reopens; including its premier digital enterprises which are heavily discounted for government risk.

Mortgage Rates Inch Up

MCLEAN, VA, January 5,2023 (GLOBAL NEWSWIRE) - Freddie Mac (OTCQB: FMCC) today released the results of its Primary Mortgage Market Survey® (PMMS®), showing that the average 30-year fixed-rate mortgage averaged 6.48%.

The 30-year fixed-rate mortgage (FRM) averaging 6.48% for the week ending January 5, 2023, was up from the previous week when it averaged 6.42%. A year ago, at this time, the 30-year FRM averaged 3.22%.

The 15-year FRM averaged 5.73%, up from the previous week when it averaged 5.68%. A year ago, at this time, the 15-year FRM averaged 2.43%.

(Beginning in November 2022, they no longer publish fees/points or adjustable rates.)

The PMMS is focused on conventional, conforming, fully amortizing home purchase loans for borrowers who put 20% down and have excellent credit.

Average commitment rates should be reported along with average fees and points to reflect the total upfront cost of obtaining the mortgage.

(Borrowers may still pay closing costs which are not included in the survey.)

Sam Khater, Freddie Mac's Chief Economist stated that mortgage application activity had sunk to a quarter century low at the end of December as high mortgage rates continued to weaken the housing market.

He added that while mortgage market activity has significantly shrunk over the last year, inflationary pressures are easing and should lead to lower mortgage rates in 2023 and noted that homebuyers are waiting for rates to decrease more significantly.

When they do, a strong job market and a large demographic tailwind of Millennial renters will provide support to the purchase market and, if rates continue to decline, borrowers who purchased in the last year will have opportunities to refinance into lower rates.

Bullish on Bonds in 2023

2023 is poised to be a comeback year for fixed income. The driver of fixed income will shift from rate hikes to the economy and possibly recession.

Rate hikes and tighter financial conditions drove fixed income returns lower in 2022, but heading into 2023, the economy is expected to slow dramatically.

We don't think that we'll see a repeat of 2008 or 2020, in which the slowdown was extraordinarily deep in specific areas of the economy.

We feel economic pain will affect companies and consumers with too much leverage, and sovereigns that are not well-positioned to deal with elevated levels of currency volatility because financial conditions have tightened so much.

Quality and credit selection will be important risk mitigation factors for investors.

Investors no longer have the benefit of policy-based shock absorbers, like quantitative easing or artificially low rates, to protect their portfolios.

In the absence of monetary and fiscal stimulus, investors will need to find new buffers to cushion the impact of market and economic volatility by selecting higher credit quality instruments and companies with strong fundamentals, a healthy cash flow and lower leverage.

It can also involve turning away from certain risks, including securities that are overexposed to the low end of consumer credit, and owning asset classes like municipal bonds and agency mortgage-backed securities. Higher yields can mean portfolio protection.

The yield curve is very flat and very high, which means even if investors are not comfortable with longer duration bonds, there are attractive opportunities in short-term corporate bonds, which are yielding 5.5% to 6%.

Investment-grade bonds, which were down 20% in 2022, could provide better outcomes because they represent companies that don't necessarily need to refinance in a less conducive environment.

Looking at international bonds, this is probably the first time in many years that opportunities in Europe appear more attractive relative to the U.S., particularly in investment-grade bonds, which have already priced in geopolitical risk.

There are risks associated with fixed-income investments, including credit risk, interest-rate risk, and prepayment and extension risk.

Generally, bond prices rise when interest rates fall and drop when interest rates rise.

This effect is usually more noticeable for longer term securities.

Retiree Health Care Costs Rise

Earlier last year, retirees celebrated dual announcements that Social Security benefits would increase by 8.7% in 2023, the largest annual increase in more than 40 years, while Medicare premiums, which are usually deducted directly from Social Security benefits, would decline slightly, resulting in more spending income in 2023. But will it?

HealthView Services, which provides health care cost data to the financial services industry, published a report in December emphasizing the importance of Medicare and the Social Security Administration's long-term projections for premium increases and cost-of-living adjustments for retirement planning purposes.

The report highlighted the impact of the scheduled 8.7% increase in Social Security benefits in 2023 noting that it isn't a windfall, but a reflection of the increased cost of living because of the highest inflation in 40 years.

And the $5.20 decline in monthly Medicare Part B premiums, only the third time in the program's history that premiums have declined, follows an outsized 14.5% increase in 2022.

The lower premium for Part B coverage, which pays for outpatient services and doctors' fee, reflects lower expected costs related to the Alzheimer drug Aduhelm.

But Medicare Part B premiums are only one component of future health care costs.

The HealthView paper notes that premiums for Medicare Part D prescription drug coverage, supplemental Medigap insurance and dental insurance, and out-of-pocket spending on deductibles and co-pays are all expected to increase in 2023.

In fact, the $62.40 savings in annual Part B premiums amounts to less than 1% of total projected health care costs for a healthy 65-year-old individual in retirement next year, the paper found.

The report specifically noted that, Medicare premiums will continue to rise at a faster pace than COLAs and over time, a greater portion of Social Security benefits or other sources of retirement income will be needed to address health care needs.

Using updated Medicare Part B premiums and Social Security COLAs for 2023, the HealthView Services Retirement Healthcare Cost Index shows that at the start of retirement, average health care costs, including all premiums and out-of-pocket expenses, will account for about 45% of Social Security income, before taxes, for a healthy 65-year-old couple retiring and starting Medicare and Social Security next year.

Assuming we all live to 89, health care expenses will consume almost their entire Social Security check by the end of retirement, the issue brief said.

The estimate does not include long-term care costs, taxes, or Medicare high-income surcharges.

Learn About Social Security Online

Social Security programs touch the lives of millions of people working hard to ensure you have access to critical benefits and services.

Consider the start of the new year as an opportunity to engage with them online by creating a free and secure my Social Security account at www.ssa.gov/myaccount.

Once you create an account, you can apply for retirement, spouses, or disability benefits, apply for Medicare, check your application status, or request a replacement Social Security card.

If you do not receive Social Security benefits, you can also use your personal my Social Security account to get personalized retirement benefit estimates or get your Social Security Statement.

Additionally, you can get estimates for spousal benefits or confirm instantly that they do not receive benefits.

If you do receive benefits, you can use your personal Social Security account to update your address and set up or change your direct deposit information (for Social Security benefits only).

You can instantly get proof of benefits and print your SSA-1099.

Each account has a secure Message Center where account holders can choose to receive annual cost-of-living adjustments and other secure communications online.

You will continue receiving these notices additionally by mail until you choose to opt-out.

Your personal my Social Security account offers easy access to features that save time when doing business online.

Check out all your available resources at www.ssa.gov/onlineservices.

If you did not apply for Medicare Part B medical insurance within three months prior to or after turning age 65, you will have another chance each year during the General Enrollment Period which runs from January 1st to March 31st every year.

Your coverage will begin on the first day of the month after you sign up.

Cryptocurrency

You may not know exactly what it is, but chances are you've heard of cryptocurrency by now.

It is a digital or virtual currency secured by cryptography and based on a network that is distributed across a large number of computers, according to Investopedia.

Types of cryptocurrencies include Bitcoin, Ethereum (ETH), USD Coin (USDC) and others.

You may have followed the recent news regarding the bankruptcy of FTX, a major cryptocurrency exchange.

Prosecutors in New York and the U.S. Securities and Exchange Commission are examining the firm's collapse, which unleashed a new wave of financial stress in the cryptocurrency industry.

Cryptocurrency has gained traction in the retail world, getting a big boost in 2021 when Elon Musk announced that he would accept cryptocurrency as payment for Tesla vehicles.

Since then, major players including Microsoft, Starbucks, Whole Foods and others have followed suit.

But while its use as currency in exchange for goods and services is growing, its use in employment circles as a form of payment for employees is far less common, at least for now.

Interest tends to be higher in the tech industry where a lot of workers already have crypto wallets.

Crypto also has applications for global employers. As an entirely decentralized form of currency, crypto has the potential to play a huge role in the future of global payroll and can remove the barriers of international hiring, allowing companies to easily manage globally distributed teams.

One of the drawbacks is the volatility of cryptocurrency value. The value of crypto is constantly changing, so figuring out how much to pay someone is a real headache because in the morning it might be one price and by the afternoon it might be double or one-half that value.

Another issue is security. In September 2022, the White House released a Fact Sheet warning that "Digital assets pose meaningful risks for consumers, investors, and business."

The Fact Sheet goes on to say that: "Outright fraud, scams, and theft in digital asset markets are on the rise: according to FBI statistics, reported monetary losses from digital asset scams were nearly 600% higher in 2021 than the prior year."

Realistically speaking, plenty of things can go wrong in transferring crypto.

User error could result in the crypto being sent to the wrong address and it may then be unrecoverable.

Companies using third parties to facilitate payment would be subject to processing fees and additional counterparty risk.

Because of high price volatility there could be issues related to who bears the risk if the value declines rapidly between when a payment is due, made and ultimately received.

Employees compensated in crypto would have to report it on their taxes, which would be more complicated than reporting traditional payments.

There are legal risks as well. The legal status of crypto is still in flux and may vary depending on the cryptocurrency.

Some states, such as California, require that employers pay wages in cash or negotiable instrument in the form of U.S. currency, which crypto is not.

The IRS does not recognize crypto as legal currency, but rather as property.

The Securities and Exchange Commission treats some cryptocurrencies as securities, which raises other legal issues regarding compensation in securities.

Any company considering paying workers in crypto should engage a compliance expert to make sure they are complying with applicable state and federal laws.

Employees should engage a tax advisor familiar with crypto to make sure they report it correctly to the IRS, or alternatively familiarize themselves with the IRS guidance on this issue. Just because others are doing it doesn't mean they're doing it correctly.

We may consider crypto in the future when it becomes better regulated, more stable and there are more established practices, but for now, we are steering clear.

Essential Tax Prep Info

Whether you have a professional prepare your annual tax returns or you do it yourself, you will need to compile all the necessary documentation.

In most cases, you won't technically need your previous year's return to file this year's taxes but having it handy and reading through it can help jog your memory when it comes to paperwork you'll want to include again.

Not every state collects state income tax. If yours does, have a copy of your state return available in addition to your federal return.

If you were employed last year, your employer will provide you with a W-2 form that reports your income as well as the tax contributions made from each paycheck.

If you get money back from your taxes each year, the W-2 report is a major source of that refund. Make sure you include it when you are preparing your return.

If you want to file your return early, most employers will let you view your W-2 online so you don't have to wait for USPS delivery.

Collect your 1099 forms which cover other sources of income that don't come from an employer's paycheck, such as self-employment income, income received as an independent contractor, capital gains/losses from stock trades or mutual fund distributions, interest & dividends, investment property rents and Social Security income.

In most cases, you'll receive a 1099 form automatically from the source of the income, such as your brokerage account. But the IRS 1099 rules don't require every company to report your 1099 income to the IRS in every situation.

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In any case, you are required to report that income, whether you received a formal 1099 from the source of that income.

Unemployment benefits are taxed by the IRS and federal taxes are withheld prior to your receipt. Benefits are also state taxed so you will need to follow their guidelines separately. Make sure you have a 1099-G form for any benefits you received.

If you made estimated tax payments in 2022, be sure you have your 1040-ES forms available.

For student loans or mortgage, be sure to get a 1098 form showing how much you paid in interest on those loans last year.

If you attended college during 2022, a 1098-T form reports your tuition and related expenses.

Any 401(k) contributions you made will be reported on the W-2 you receive from your employer.

If you have a traditional IRA, make sure you get a record of those contributions. They reduce your taxable income now in exchange for paying taxes on that money later, when you eventually withdraw from the fund.

Get receipts for any charitable contributions you made throughout the year. If you donate to a cause and get something in return, the organization will issue you a receipt showing the portion of your donation that is tax deductible.

Not every charity is a registered 501(c)(3), so check with your specific charities or organizations for the tax-deductible value of your contributions. Most schools and alumni organizations are 501(c)(3)'s.

Gather your receipts for any itemized deductions. Check with your accountant for the kinds of things you should look for and it is beneficial for you.

The standard deduction can save you more money, as well as saving you the effort of itemizing all your deductions

Proof of medical insurance should be mailed to you directly by your health insurance company. Be sure to gather records of that spending. if your medical expenses were significant last year,

Gather records of other taxes you paid during the year including federal taxes, state taxes, property taxes, other ad valorem taxes (like vehicle registration) and sales tax on big-ticket items

Be sure you have your records for childcare payments, gambling income, trust income, royalty income, alimony payments, Health Savings Accounts, and long-term care reimbursements.

Keeping track of all your tax documents can be a daunting task. However, missing an important tax document can result in costly mistakes.

A simple way to make sure you have all of your most important documents is to access your IRS Wage and Income transcript.

This report lists all of the tax documents filed by third parties on your behalf (W-2s, 1099s, 1098s, etc.). You can access your transcript directly from the IRS at https://www.irs.gov/individuals/get-transcript.

If you have a small business or are managing rental property, here's a brief list of some of the information you'll need to gather.

Your Profit & Loss report for 2022, the End-of-year balance sheet, a list of company assets that were bought, sold, or depreciated, your company's inventory (if any) and any loans the company holds.

Frankly Funny

My wife brought it to my attention recently that I might consider adopting healthier foods including fresh fruits and vegetables to my current diet.

I accepted the fact that I had everything to gain and nothing to lose, except some weight, so it probably was a good idea to implement her suggestions.

I got excited that it was a great idea for my continued health, not to mention, it would clearly make my wife happier. A win-win proposition. I was so looking forward to starting.

So, while enjoying a treasured luncheon entrée from my new menu choices this afternoon, I choked on a carrot and all I could think was, "I bet a donut wouldn't have done this to me."