ANDERSON
FINANCIAL STRATEGIES

Quarterly Playbook

3rd Quarter 2022

Current Financial Planning and Investment Themes

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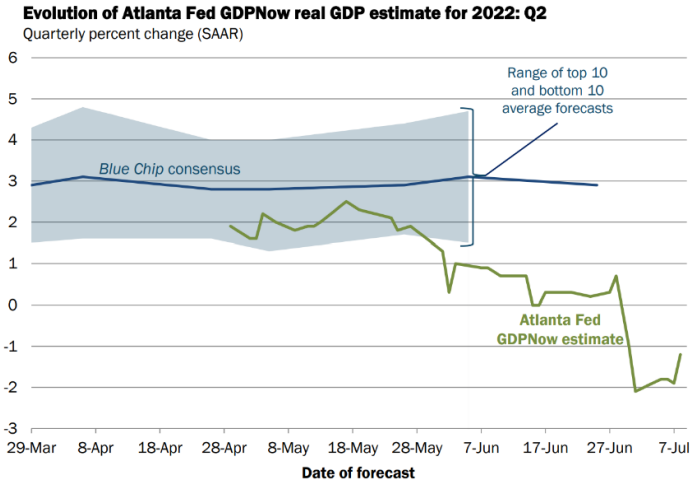
"Waiting on the world to change…"

The first half of 2022 saw inflation at 40-year highs, the Federal Reserve tightening monetary policy at the most aggressive pace in recent history, an ongoing war in Ukraine, lingering supply chain problems, and massive pessimism in the markets. The results were the worst start to a year for the stock market in 52 years and the biggest selloff in the history of the bond market! The good news is that much of the underlying fundamental data has remained promising and signals relief in the second half of this year. So…in our best John Mayer voice, "we keep on waiting, waiting on the world to change."

US Economics

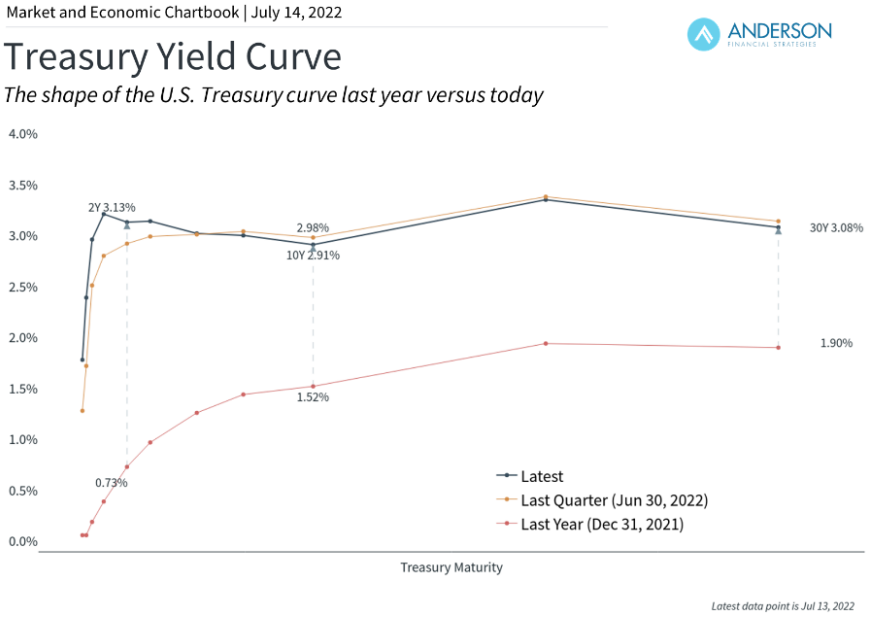


So, it looks like we are on the brink of recession (kind of, sort of, maybe). GDP is expected to decline by -1.2% for the second quarter according to GDPNow, which is the informal understanding of recession (two consecutive quarters of negative growth). However, the official definition of recession is a "significant reduction in economic activity" determined by the NBER (National Bureau of Economic Researchers). So that begs the questions: Is unemployment deteriorating? Is consumer demand slowing? Is the household debt service ratio a concern? As it turns out, these items are still holding steady. So, what is *actually* causing GDP to turn negative? It turns out that the major detractors are equipment purchases, nonresidential structures,

Atlanta Fed GDPNow estimates for 2022: Q2, contributions to growth

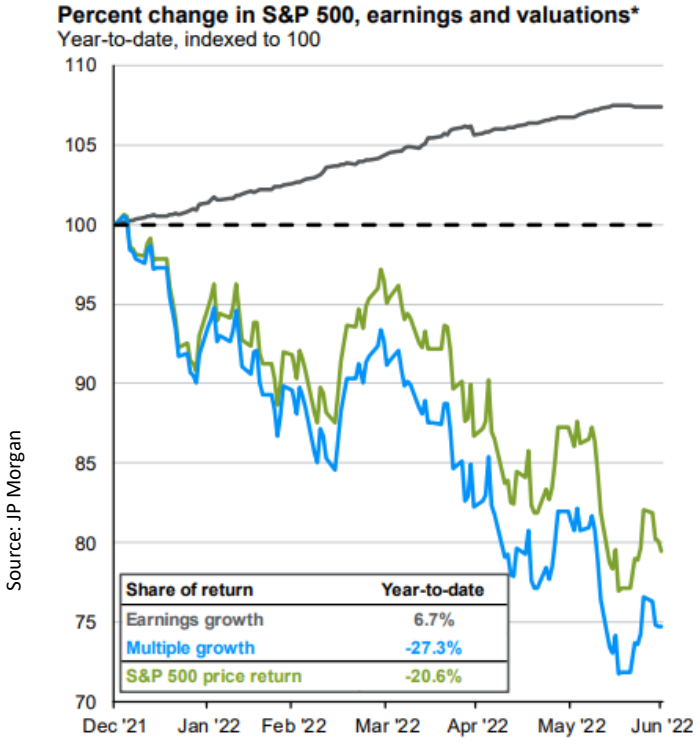
Date	Major Releases	GDP	PCE	Equip-ment	Intell. prop. prod.	Nonres. struct.	Resid. inves.	Govt.	Net exports	CIPI
29-Apr	Initial nowcast	1.9	2.57	0.34	0.32	0.13	0.08	0.24	-0.69	-1.13
27-May	GDP (5/26), Pers Inc/PCE, NIPA tables, Adv Econ Indicators	1.9	3.17	0.16	0.38	0.05	-0.28	0.30	-0.27	-1.59
15-Jun	Retail trade, Import/Export Prices	0.0	1.79	0.03	0.40	-0.09	-0.43	0.15	-0.12	-1.74
16-Jun	Housing starts	0.0	1.78	0.03	0.40	-0.09	-0.38	0.15	-0.11	-1.74
17-Jun	Industrial Production	0.3	1.82	0.03	0.40	-0.05	-0.38	0.15	-0.11	-1.50
21-Jun	Existing home-sales	0.3	1.82	0.02	0.40	-0.05	-0.46	0.15	-0.11	-1.50
24-Jun	New home-sales	0.2	1.81	0.02	0.40	-0.05	-0.50	0.15	-0.11	-1.50
27-Jun	Advance M3 Manufacturing	0.3	1.81	-0.02	0.40	-0.05	-0.50	0.15	-0.11	-1.42
28-Jun	Advance Economic Indicators	0.7	1.81	-0.17	0.40	-0.05	-0.50	0.15	0.35	-1.27
30-Jun	GDP (6/29), Pers Inc/PCE, NIPA tables	-1.0	1.17	-0.08	0.39	-0.05	-0.50	0.14	0.35	-2.44
1-Jul	Construction spending, ISM Manuf.	-2.1	0.51	-0.25	0.38	-0.18	-0.60	0.11	0.38	-2.42
5-Jul	M3-2 Manufacturing, Auto Sales	-1.8	0.72	-0.21	0.38	-0.17	-0.59	0.11	0.38	-2.44
6-Jul	ISM Nonmanuf Index	-1.8	0.74	-0.20	0.38	-0.17	-0.59	0.11	0.38	-2.44
7-Jul	International Trade	-1.9	0.84	-0.21	0.38	-0.17	-0.59	0.11	0.21	-2.44
8-Jul	Employment situation, Wholesale trade	-1.2	1.29	-0.11	0.40	-0.14	-0.46	0.07	0.19	-2.48
Maximum forecast of real GDP growth										
17-May	Retail trade, Industrial production	2.5	3.28	0.49	0.35	0.06	0.06	0.28	-0.80	-1.21
Minimum forecast of real GDP growth										
1-Jul	Construction spending, ISM Manuf.	-2.1	0.51	-0.25	0.38	-0.18	-0.60	0.11	0.38	-2.42

residential investment, and significantly reduced inventories (CIPI)– all of which are impacted by higher interest rates. The reduction in inventory factors in at a massive -2.48% reduction in GDP! The accompanying chart illustrates the evolving *estimate* from the Atlanta Fed's GDPNow forecast. However, the average margin of error is +/-1.25%, so the current estimate of -1.2% is within the possibility of being positive. When we look at other measures of economic strength in the labor markets, we find that the employment situation is still very robust. According to the May JOLTs report, there were 11.3 million job openings with only 5.9 million workers looking for a job in the US. This means that there are nearly two job openings for every one person unemployed, a very strong statistic. The June U-3 (official) unemployment rate was unchanged at 3.6% from March. Additionally, the U-6 (broader definition including part-time) unemployment rate fell to 6.7% in June from the March read of 6.9%. The labor force participation rate moderated a little to 62.2% in June vs 62.4% in March. Lastly, one of the cornerstones of recessionary conditions is the inversion of the yield curve (as measured by the yield differential between the 10-year treasury bond and the 2-year treasury note), which has oscillated in and out of inversion so far this year.

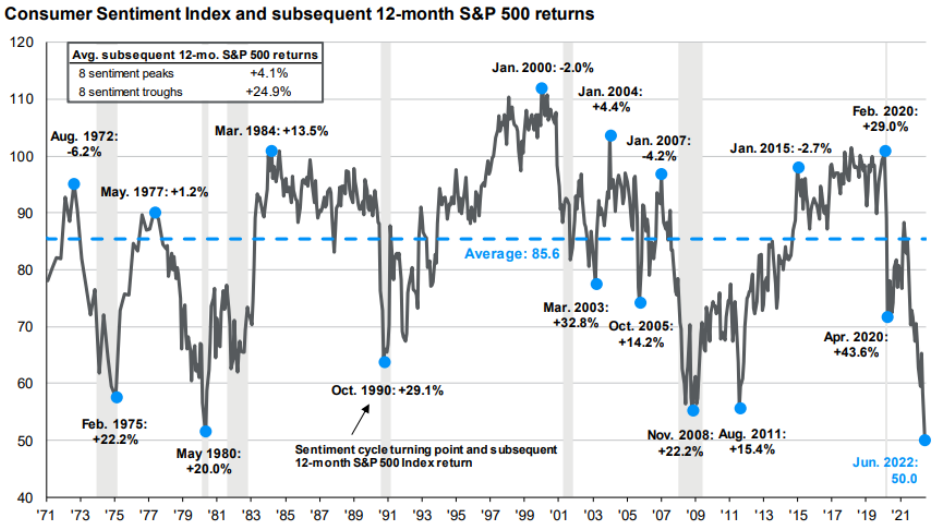


Currently, we are seeing an inverted yield curve that coincides with recession.

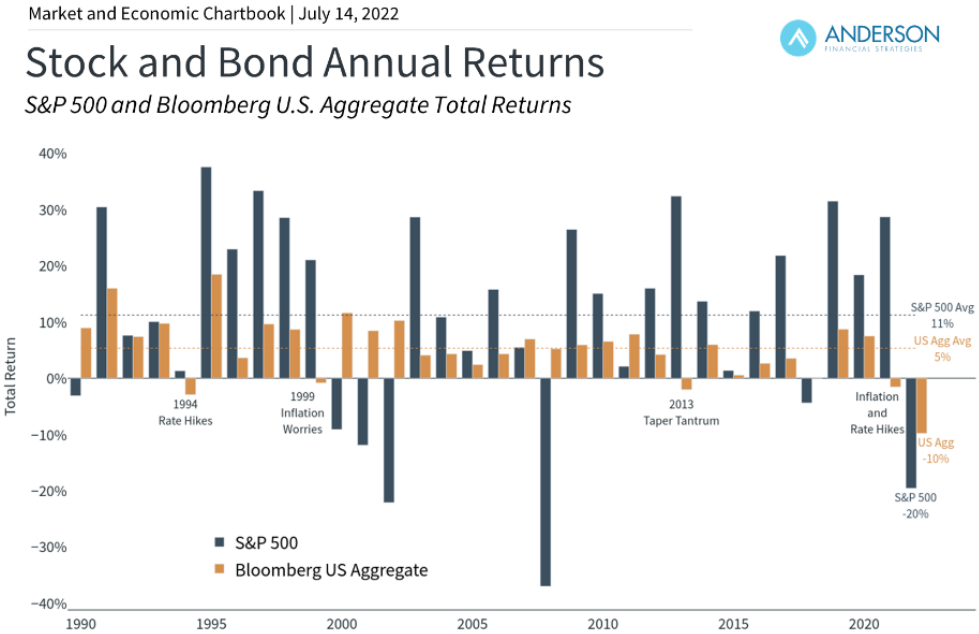
US Equity Markets



Stocks have had the worst start to a year since 1970, yet earnings for the S&P 500 are UP 6.7%! As you can see from the chart, the cause of the -20.6% decline is the -27.3% contraction of the P/E (Price-to-Earnings) ratio. P/E ratio declines are generally a result of fear, and there is plenty to be fearful of: sky-high inflation, recession, war, and a combative Fed. This can be witnessed in the latest consumer sentiment index that is sitting at a 50-year low - lower than the Great Recession of 2008 and lower than when we shut down the economy in 2020. Simply put, people are very fearful. Yet, as the saying goes: "Be fearful when others are greedy and greedy when others are fearful." The chart below illustrates that in gloomiest of times, or when consumer sentiment troughs, the following 12 months performance of the S&P 500 *averages* +24.9%! Right now, it would take a 25.94% rally to get back to the high on January 3rd. We think we could get there sooner than 12 months, but earnings will have to hold up along with a few other positive catalysts. Other areas of the stock market such as Small Caps & Growth stocks have seen much worse conditions. The Russell 2000 Small Cap index fell more than -23% through June. Growth & Technology stocks, regardless of size, are down around -30% through June. However, we see the biggest opportunity in Small Cap Growth with current P/E levels ~35% below the 20-year average. To be sure, this is a very unusual market illustrated by the wide array of S&P 500 year-end forecasts ranging from 3400-5100 according to Barron's. Our call is 4970, so it is certainly at the higher end of the range, but not the highest. We think the worst is behind us and are anxiously "waiting for the world to change" to grind higher in the second half of the year…



US Fixed Income



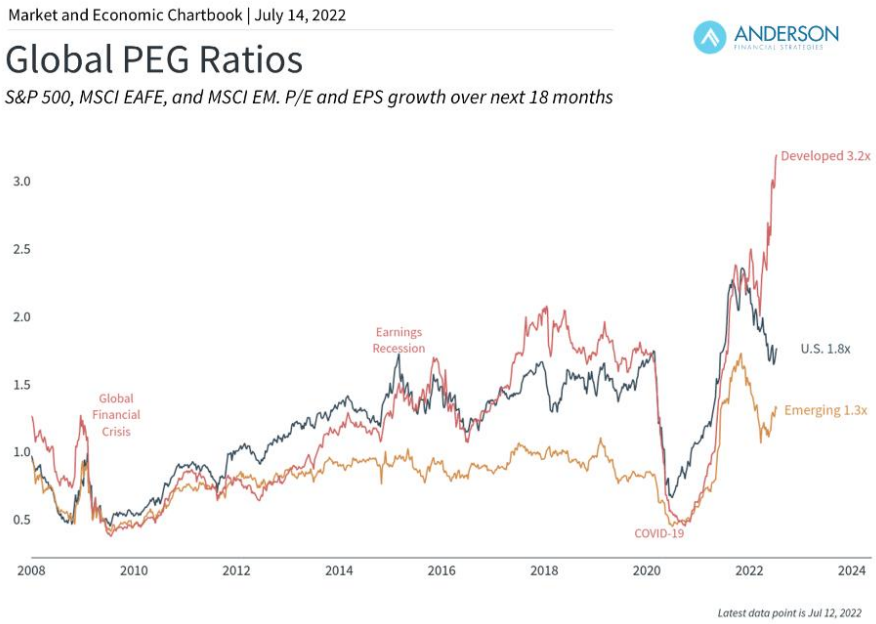
This year has been unlike any other year in the bond markets with bonds having the worst start to a year in history! Rather than helping to minimize overall portfolio-volatility, bonds are exacerbating it. Typically, fixed income is a source of volatility minimization, but not this year. The Bloomberg Aggregate Bond index is down -9.8% so far this year. Even though there are fears about recession, that is not what is driving the bond market down as illustrated by High Yield (Junk) bonds declining -12.8% and outperforming Investment Grade Corporate Bonds which experienced a decline of -13.5%. This can be interpreted as the bond market not being worried about company balance sheets nearly as much as the insanely aggressive Federal Reserve's interest rate hiking campaign. However, our view is that the Fed will have to start moderating the pace of rate hikes through the second half of the year, and with it bond prices will recover to the tune of halving their losses. Tactically, we believe that Convertible and High Yield bonds are best positioned within the current environment.

Sector total returns relative to the U.S. Aggregate Bond Index

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	High Yield 58.2%			EMD Local 17.5%										
	EMD USD 29.8%			EMD USD 17.4%				High Yield 17.1%	EMD Local 14.7%				TIPS 6.0%	
	EMD Local 21.7%	EMD Local 15.4%	TIPS 13.6%	High Yield 15.8%		Munis 9.1%	Munis 3.3%	EMD USD 10.2%	EMD USD 10.3%		EMD USD 15.0%		High Yield 5.3%	Munis -7.7%
	Corp 18.7%	High Yield 15.1%	Munis 10.7%	Corp 9.8%	High Yield 7.4%	Corp 7.5%	MBS 1.5%	EMD Local 10.0%	High Yield 7.5%	Munis 1.3%	Corp 14.5%	TIPS 11.0%	Munis 1.5%	MBS -8.2%
Treasuries 13.7%	Munis 12.9%	EMD USD 12.2%	Treasuries 9.8%	TIPS 7.0%	MBS -1.4%	EMD USD 7.4%	EMD USD 1.2%	Corp 6.1%	Corp 6.4%	MBS 1.0%	High Yield 14.3%	Corp 9.9%	Corp -1.0%	TIPS -8.2%
MBS 8.3%	TIPS 11.4%	Corp 9.0%	Corp 8.1%	Munis 6.8%	Corp -1.5%	MBS 6.1%	Treasuries 0.8%	TIPS 4.7%	Munis 5.4%	Treasuries 0.9%	EMD Local 10.1%	Treasuries 8.0%	MBS -1.0%	Treasuries -8.8%
Agg 5.2%	Agg 5.9%	Agg 6.5%	Agg 7.8%	Agg 4.2%	Agg -2.0%	Agg 6.0%	Agg 0.5%	Agg 2.6%	Agg 3.5%	Agg 0.0%	Agg 8.7%	Agg 7.5%	Agg -1.5%	Agg -9.8%
TIPS -2.4%	MBS 5.9%	TIPS 6.3%	EMD USD 7.3%	MBS 2.6%	Munis -2.6%	Treasuries 5.1%	Corp -0.7%	MBS 1.7%	TIPS 3.0%	TIPS -1.3%	TIPS 8.4%	High Yield 7.1%	EMD USD -1.8%	High Yield -12.8%
Munis -2.5%	Treasuries -3.6%	Treasuries 5.9%	MBS 6.2%	Treasuries 2.0%	Treasuries -2.7%	TIPS 3.6%	TIPS -1.4%	Treasuries 1.0%	MBS 2.5%	High Yield -2.1%	Munis 7.5%	EMD USD 5.3%	Treasuries -2.3%	Corp -13.5%
Corp -4.9%		MBS 5.4%	High Yield 5.0%		EMD USD -5.3%	High Yield 2.5%	High Yield -4.5%	Munis 0.2%	Treasuries 2.3%	Corp -2.5%	Treasuries 6.9%	Munis 5.2%	EMD Local -9.2%	EMD Local -15.6%
EMD Local -5.9%		Munis 2.4%	EMD Local -2.0%		EMD Local -8.3%	EMD Local -5.2%	EMD Local -14.3%			EMD USD -4.3%	MBS 6.4%	MBS 3.9%		EMD USD -21.9%
EMD USD -12.0%					TIPS -8.6%					EMD Local -6.9%		EMD Local 3.5%		
High Yield -26.2%														

Latest data point is Jul 13, 2022

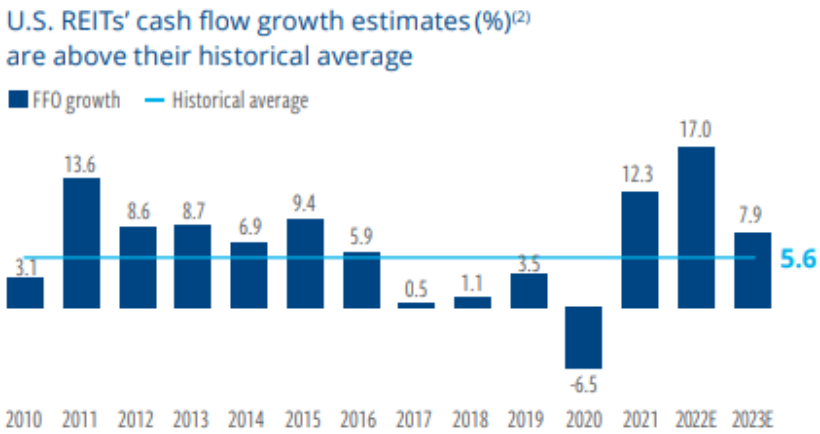
International Markets



The international markets landscape seems to be deteriorating further, although performance has been slightly better than the US, with the MSCI All Country World Index excluding the US declining -18.42% vs the S&P 500 decline of -20.6%. This outperformance is likely attributed to the fact that International Stocks started from a much lower valuation point and didn't have as far to fall. That said, the war in Ukraine, and intentions to shift energy reliance completely away from Russia, place Europe in an economically difficult position that likely won't be solved in the near-term. Even though the absolute P/E ratio is lower, you can see that Developed International stocks are much more expensive when you add in the growth component to the PEG ratio (P/E to Growth, lower is better). However, emerging markets look to be attractive here and could benefit if the US dollar softens should the Fed become less aggressive.

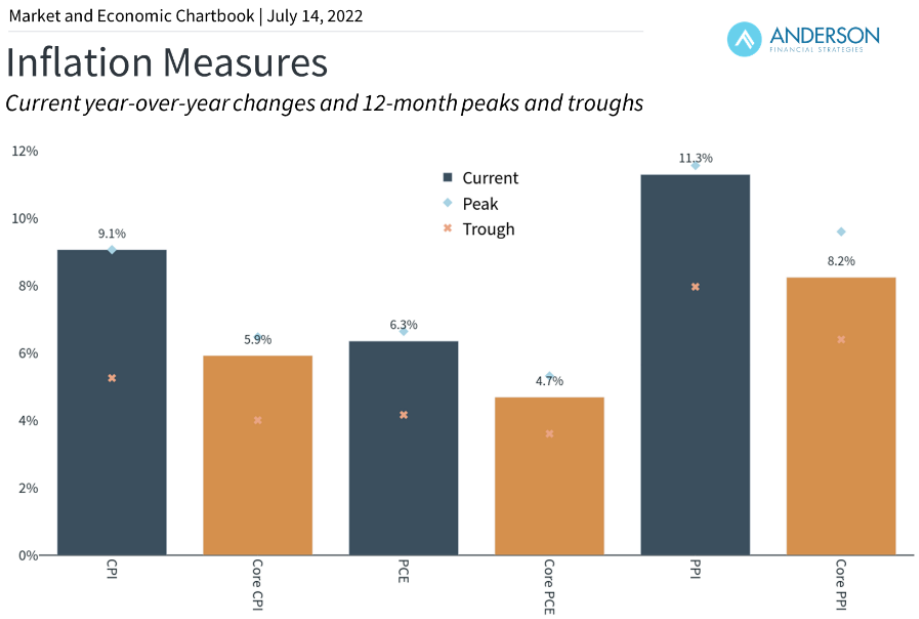
Real Estate

With the "sell everything" environment so far this year, REITs did not escape the downward volatility either, with the FTSE NAREIT Composite Index down -19.2% through midyear. However, REITs have historically outperformed stocks in the following years after interest rates peak. As we have mentioned, REITs benefit from higher inflation due to the ability to raise rents and have been producing strong cash flows with expected cash flow growth of 17% this year, and another increase of 7.9% in 2023.

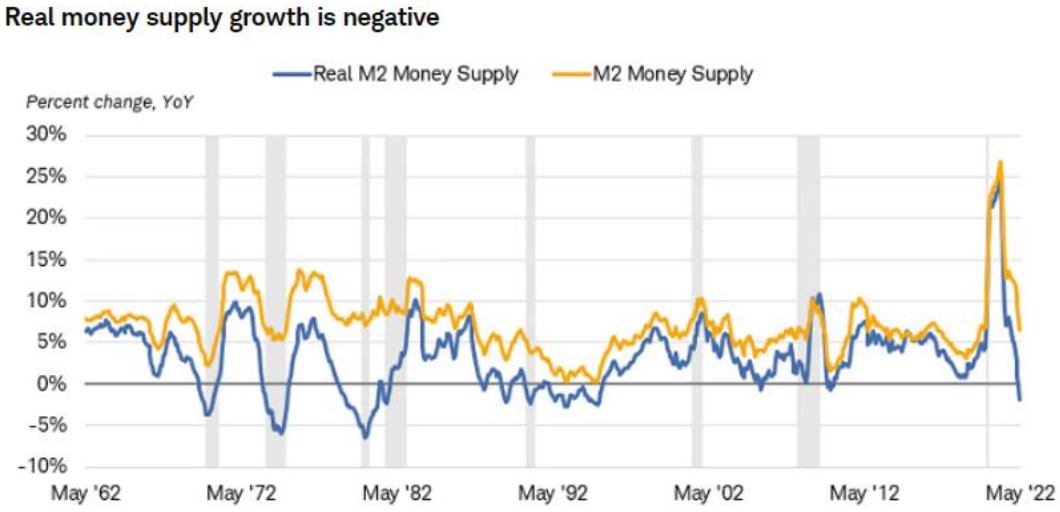


Source: Cohen & Steers

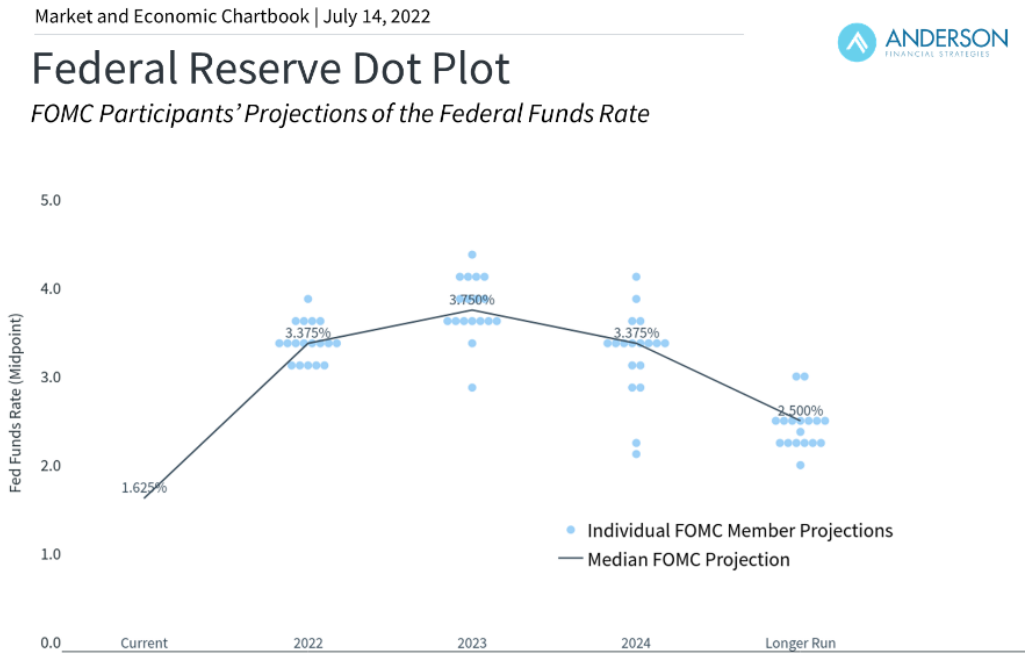
Inflation, Interest Rates & the Fed



The June CPI reading was a massive disappointment with inflation hitting 41-year highs at 9.1%. The vast majority of strategists had thought inflation peaked in May. That said, even though the CPI index grabs most of the headlines, the Fed focuses more on the PCE inflation index and specifically "Core PCE" which removes Food and Energy that are highly volatile. These two inflation measures saw a lower reading in June, although still elevated. Core CPI also saw a lower reading in June. Additionally, we saw the Real M2 Money Supply turn negative indicating there is less excess cash readily available for purchases and therefore is a leading indicator of future inflation. Lastly, according to the University of Michigan's Consumer Inflation Expectations survey, longer term (5-year) inflation expectations fell from 3.1% in June, to 2.8% in July, while the 1-year inflation expectation rate ticked slightly lower to 5.2%, from 5.3% in June. Given the likelihood inflation is beginning to moderate, we don't believe the Fed will feel the need to surprise markets with even more drastic measures. Rather it is likely that they hike 75bps in July and then slow to 50bps or even 25 bps for subsequent meetings.

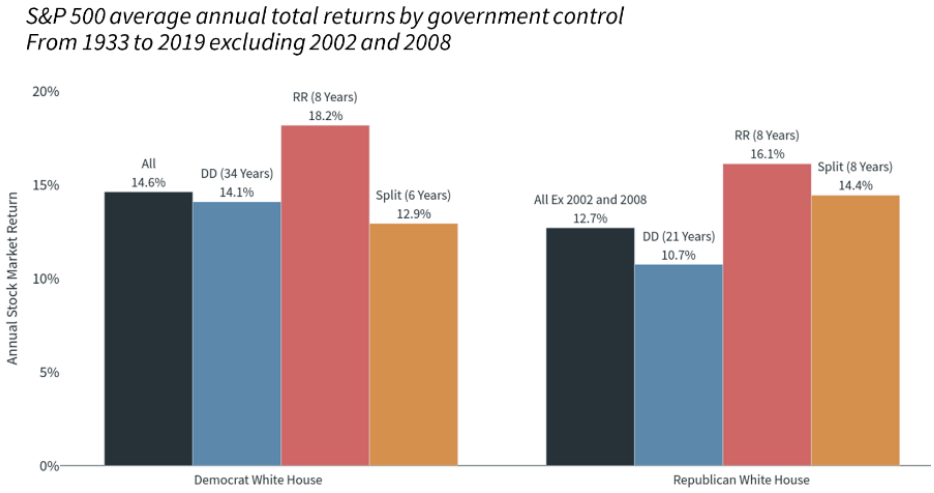


This would fall in line with the Fed's own year-end projections known as the "Dot Plot". Also to note, as you can see from the chart that 2023 has barely any rate hikes assumed. So, the end of this year will likely be



close to, if not the complete end of, the tightening cycle. The "end point" has many economic and market implications and will be closely watched to see if the Fed can thread the needle to not move too far.

Legislative Affairs



In Washington, we are still waiting on the Senate to pass its version of the Secure Act 2.0, which made its way out of committee in mid-June with only minor changes to the House version. Notably it changed the 401k catch-up limit to an extra $10,000 for those ages 60,61,62 or 63 instead of those ages 62,63, or 64. Meanwhile, Senate Democrats have been working on a so-called "economic package" that raises taxes and includes climate provisions. However, Senator Joe Manchin, the Democrat from West Virginia told Senate Majority leader Chuck Schumer in early July that it was out of the question. Instead, Sen. Manchin is focused on inflation and the economy and appears not willing to support anything that could cause any further harm. All this is happening with the backdrop of the mid-term elections coming up in November, where Republicans still hold a clear lead but has narrowed recently. As you can see from the chart, if Republicans take control of both House and Senate, this has been the best environment for stocks when there is a Democrat President.

Financial Planning Corner

Life Insurance: How much and what kind?

The Different Types of Life Insurance
There are two main types of life insurance: Term and Permanent. Permanent life insurance can be broken down into four different segments. There is general whole life, variable life, universal life, and variable universal life.

Term Life
Term life insurance is designed to do one thing: pay out a sum of money if the person who is insured dies within the term of the policy. It's really the brass tacks when it comes to the purpose of life insurance, which also makes it the lowest cost form of life insurance.

For the most common use of life insurance, which is to replace someone's income if they die prematurely (typically to provide for the spouse and/or children), Term life insurance is the most economical choice. With Term life insurance, we always recommend a "level term" policy, where the premiums never increase over the duration of the policy.

The best part about Term insurance is that you're only paying for the life insurance need you have, and therefore it costs less than permanent. You can invest the difference between the premium cost you pay for term and what you would have paid for permanent. (Investing the difference would be the equivalent of paying into the cash balance portion of a whole life policy).

Pros:
- Cheaper premiums
- Better returns in the long run for a vast majority of people (exception for the extremely wealthy)
- You do not have to pay it permanently (if you decide your beneficiaries of the policy no longer need coverage from your death, you can cancel the policy or change the amount)

Cons:
- Discipline to invest the difference
- Risk of outliving the policy term (more of a risk when trying to cover estate tax liabilities with the policy)

Permanent Life

Whole life is a permanent form of life insurance that remains in place as long as you pay the premiums. It's the most expensive life insurance option because you are paying for the life insurance benefit that lasts as long as you pay, and it accumulates a cash value that you can borrow from. The cash value earns interest at a fixed rate. The idea with whole life is that you can pay a larger premium to cover the life insurance cost and contribution towards your cash value account within the policy. Then, if you need to borrow funds for something, you can tap into your cash value. Note that when you do this, the amount you borrow typically reduces the life insurance face value by that amount until it's paid back.

Pros:

- Premiums stay the same
- Low risk
- Permanent
- Guaranteed cash value that's easy to access

Cons:

- Expensive (on average 20x more expensive than term)
- Cash value grows slowly (due to being at a fixed interest rate rather than investment options)
- Takes time to build cash value
- Accessing cash value decreases life insurance benefit for duration of the loan

Universal life is a similar concept as whole life, except the premiums are flexible. Premiums can be paid in a consistent manner to grow the cash value, but adjustments can be made as needed. For example, if money was tight for a while, the premiums could be lowered to keep the policy in place but not grow the cash value as much or could even be paid from the cash value if needed.

Pros:

- Easier to manage than a generic whole life policy with more flexibility in premiums
- Cash value guarantees growth
- Permanent

Cons:

- Very expensive compared to Term life
- Cash value grows slowly
- Death benefit can fluctuate based on cash value used
- Cash value can deplete easily if you dip into it to help cover premiums

Variable life is similar to whole life, but how the cash value grows is different. It is essentially like an investment account. Policy owners can determine how the cash policy is invested giving more control over the growth.

Pros:
- Cash policy can grow quickly (like more traditional investments, such as mutual funds)
- Permanent
- Cash value can be managed giving greater opportunity for growth

Cons:
- Greater risk since the cash value relies on the market
- Expensive
- Premiums are not flexible
- Cash value is not a guaranteed amount
- Death benefit can fluctuate based on cash value used

Variable universal is a hybrid of variable and universal meaning the premiums are flexible and the cash value can be managed. It works the same way the other permanent life insurance policies work in terms of a death benefit and having a cash value.

Pros:
- Cash policy can grow quickly
- Permanent
- Cash value can be managed
- Flexible premiums

Cons:
- Again, it's another expensive policy
- Greater risk since the cash value relies on the market
- Flexible premiums can dip into the cash policy which can affect growth of cash value
- Death benefit can fluctuate based on cash value used

	policygenius offers Basic Term Life	Basic Whole Life	Universal Life	Variable Life	Variable Universal
Duration	1 - 30 years	Life	Life	Life	Life
Guaranteed Death Benefit	✓	✓	✓	✓	✓
Guaranteed Cash Value*	✗	✓	Protected from risk, but can be depleted to pay premiums	✗	✗
How Cash Value Grows (or Shrinks)	—	Earns interest at a predetermined fixed rate	Variable rate determined by the insurer	Subaccounts - pool of investor funds offered by the insurer	Subaccounts - pool of investor funds offered by the insurer
Premiums	Can increase periodically OR be guaranteed level for the duration of the policy	Level	Varies, up to the customer (subject to federal tax laws)	Level	Varies, up to the customer (subject to federal tax laws)
Notes	No risk of losing coverage, but no cash value when term ends	No risk compared to other permanent types, but you can probably find better investment options elsewhere	—	Risk of ending up with expensive insurance policy with little to no cash value	Risk of ending up with expensive insurance policy with little to no cash value

* All permanent policies can be surrendered for their current cash value after a certain number of years, at which point the insurer will pay the accumulated cash value minus any loans and fees.

https://quotesbae.com/20-fixed-term-life-insurance-quotes/fixed-term-life-insurance-quotes-05/

How to determine how much life insurance is needed

There are four primary methods for determining how much life insurance is needed:

1. Income Replacement Method (our personal favorite)

Using this method, you take some important data points: your current income, the percentage of income that will need replaced (we like 70% -- we need to replace net income, not gross, and some expenses could be reduced away with one less person), your current age and desired retirement age, and an inflation-adjusted rate of return. We can then determine the amount needed today that would replace your income for all those years until you retire (assuming the lump sum could be invested and earn the inflation-adjusted return). This method really gets to the heart of the original purpose of life insurance – to replace an income from a premature death so the family is taken care of.

2. Multiple of Income Method

This method is the simplest, but the drawback is it has the most potential to be inaccurate. You simply take your current income and multiply it by a number. Common rules of thumb out there are to get 10-12 times your annual salary. But since it's not based on either replacing an income for the full period of work before retirement nor any financial goals, it could easily be not enough. It's better than nothing, but it's our least favorite method.

3. Human-Life Method

This method is similar to replacing an income, but it tries to capture the full financial loss a family would have if a worker died today. There are more steps to this process, and it requires some speculation. To use this method, you must: estimate the insured's remaining lifetime earnings (including future pay increases), subtract estimates of taxes and expenses for the insured (many use 70% of the gross income to replace), determine the length of time to replace earnings (not necessarily to retirement, but for as long as it's expected to be needed – could be kids out of college, etc.), determine an inflation-adjusted rate of return the proceeds could earn, then determine the present value.

4. Capital Needs Analysis

Using this method, you usually end up with the highest death benefit compared to other methods. That's because you factor in all your future income, lump-sum needs at death of paying off debts and funeral expenses, future expenses such as weddings, college educations, retirement plan funding, and long-term care for a surviving spouse. This goes far beyond replacing income, and in our opinion, can commonly end up with purchasing more life insurance than one may need.