Quarterly Playbook

2nd Quarter 2022

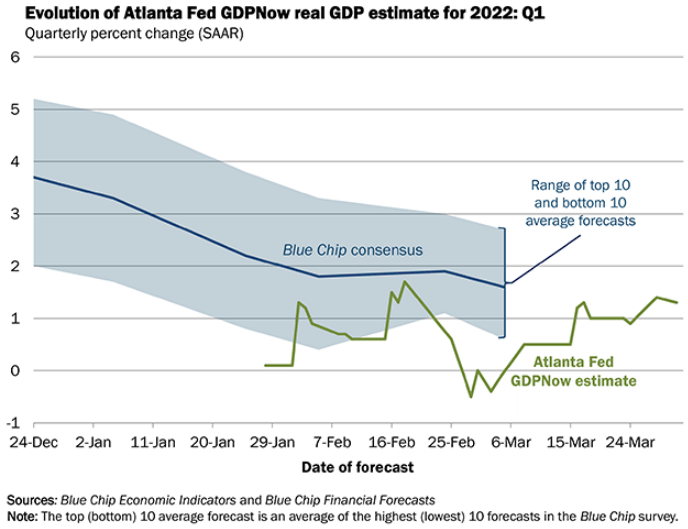
Current Financial Planning and Investment Themes

By Shon P. Anderson, M.B.A., CFP, CFA
President & Chief Wealth Strategist

"Searching for clarity in bizarre times"

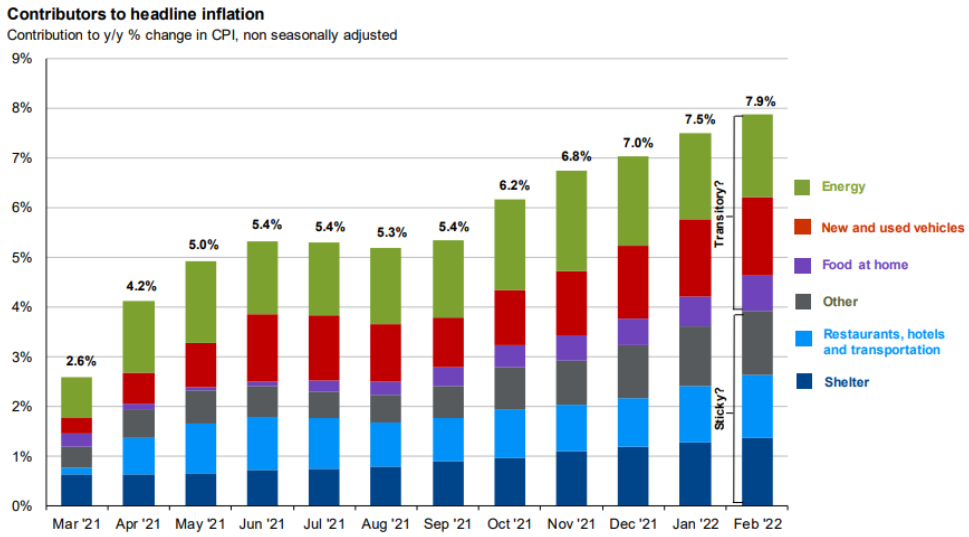
Will inflation ever moderate? How many interest rate hikes are in store? To what extent will GDP growth slow? Are stocks in for a down year? How is the war in Ukraine affecting markets? Lately it seems like there are more questions than answers, but unusual times call for a thoughtful framework in plotting the path forward. Although there has been a multitude of bizarre factors coming into play, the view through our lens has only changed a little. We still hold the same year-end targets; however, the path appears to have changed….

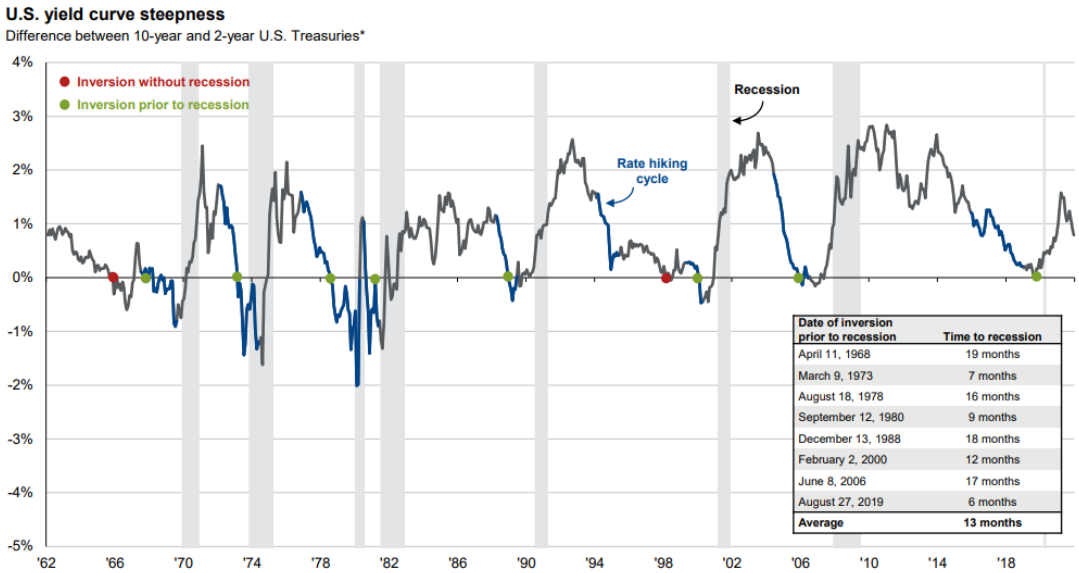
US Economics



The big economic question is how much is the economy slowing? In addition, with parts of the yield curve inverting, does that predict recession? We don't think so. However, the ultimate factor will be how well the Federal Reserve can thread the needle of raising interest rates to thwart inflation, while not wrecking the economy. Many economists have said that every recession since WWII has been caused by the Fed. We are hopeful that the Fed governors are aware of this observation and will proceed with caution. First quarter GDP is expected to slow, but still remain positive. The Atlanta Fed's real-time GDPNow assessment is indicating a 1.2% growth rate. However, we do think inflation will remain a

headwind until the end of 2023, with the February CPI coming in at a whopping 7.9%. Yet still, the US consumer remains in good position with strong balance sheets and a healthy 6.3% savings rate as of February. In addition, the job market also continues to improve. The labor force participation rate increased to 62.4% in March, up from 61.9% in December – inching closer to the 63.4% recent peak in January of 2020. The March U-3 (official) unemployment rate came in at 3.6%, falling from 3.9% back in December. Additionally, the U-6 (broader definition including part-time) unemployment rate also fell to 6.9% from the December read of 7.3%. The February JOLTS (Job Openings and Labor Turnover Survey) report shows even more job openings, 11.3 Million, than the November record of 10.5 Million. Furthermore, 4.4 Million people quit their jobs in February, down slightly from the November record of 4.5 Million. These two metrics can be seen as very good signs since a key measure of recession is a rising unemployment rate. Typically you would see employers reduce hiring i.e. lower the amount of job openings before laying off existing employees. Also, the high level of quit rate indicates employee confidence in their own personal financial situation along with confidence in the ability find another job if needed. In summary, we believe that inflation and supply chain issues remain and will slow economic growth to 2-3% but the US will avoid a recession. The biggest risk to the economy, in our view, is the Federal Reserve actions and the effects on the yield curve.



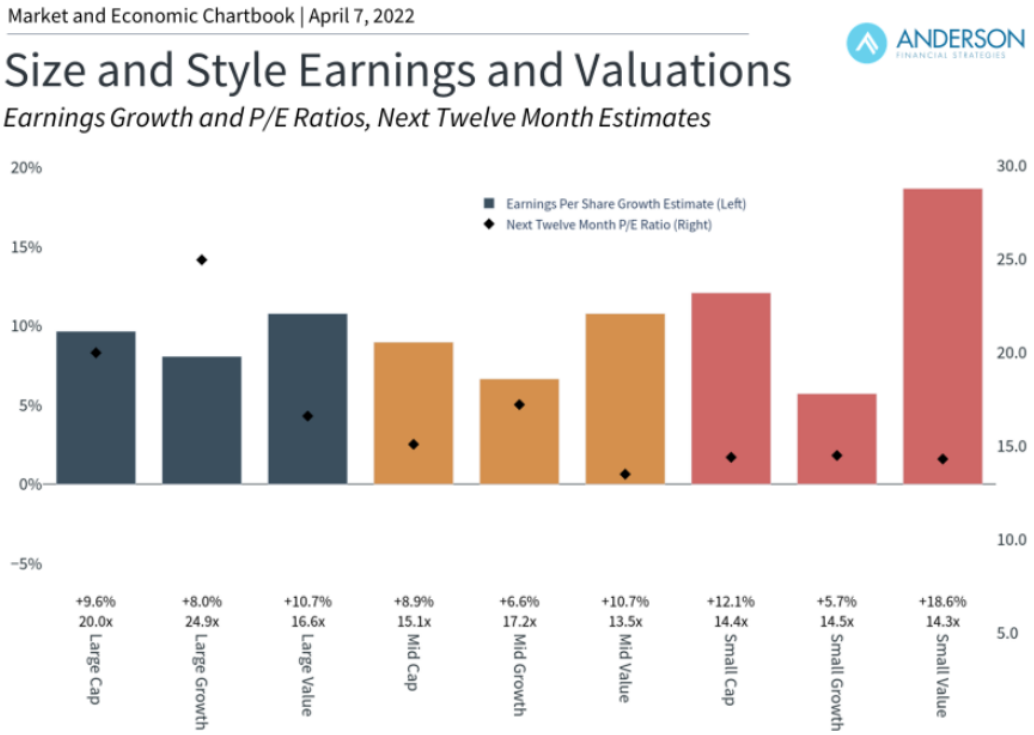


Date of inversion prior to recession	Time to recession
April 11, 1968	19 months
March 9, 1973	7 months
August 18, 1978	16 months
September 12, 1980	9 months
December 13, 1988	18 months
February 2, 2000	12 months
June 8, 2006	17 months
August 27, 2019	6 months
Average	**13 months**

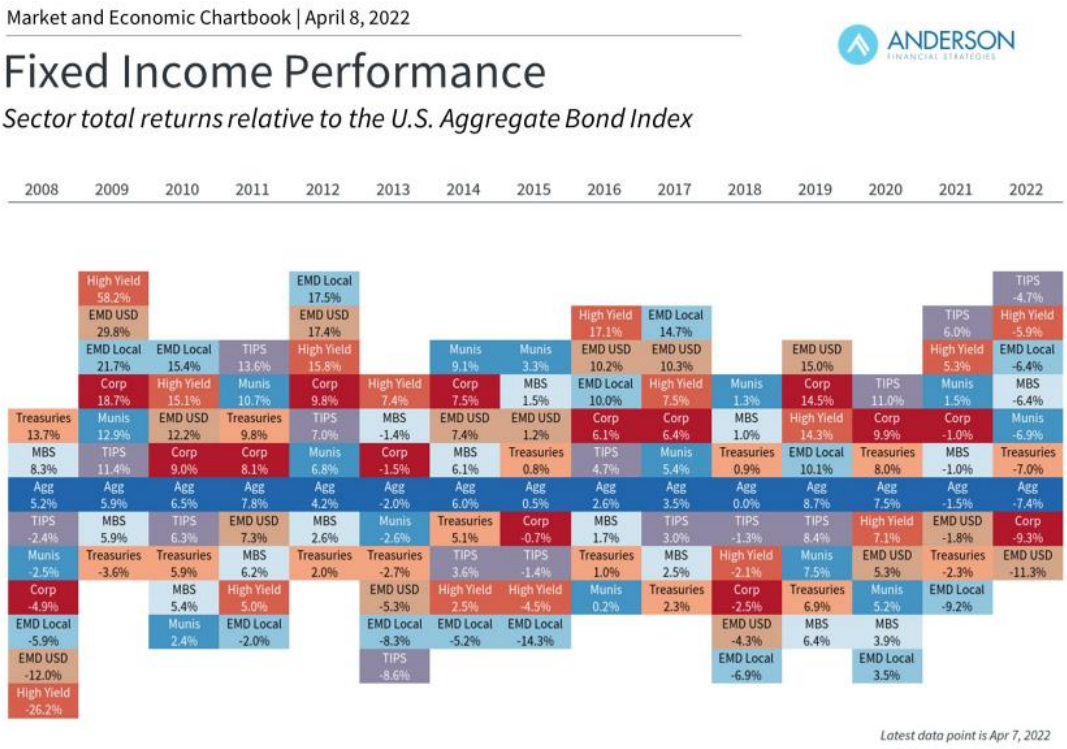
Source: JPMorgan Guide to the Markets

US Equity Markets

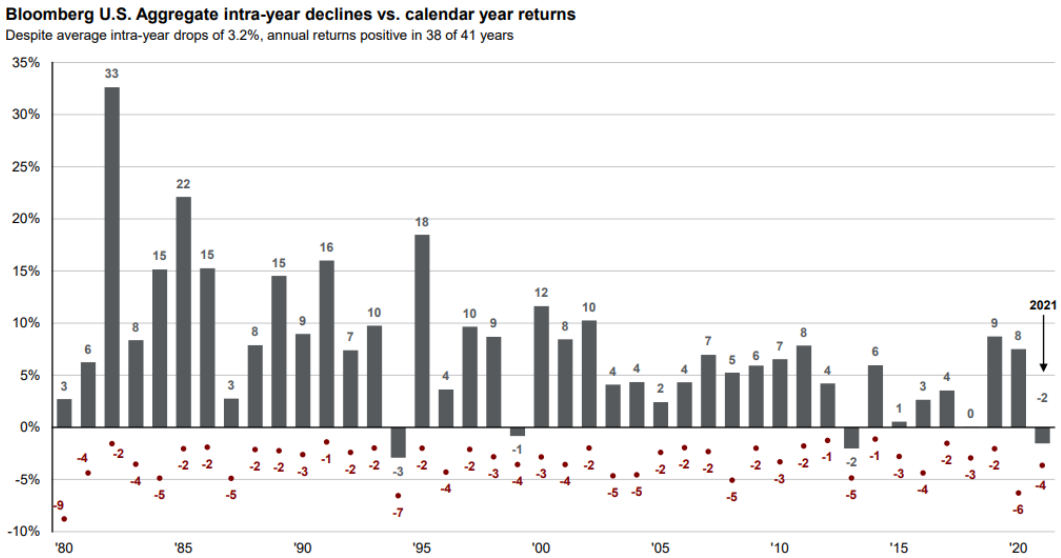
Despite experiencing a volatile start to the year, the US stock market has been one of the better environments for portfolios comparatively. We believe that we are in the later stages of transitioning from a pure "risk-on/risk -off" environment which favors growth stocks and has higher volatility toward more of a "grind through" posture with internal rotation away from flashy high P/E growth stocks toward names with more solid fundamentals and valuations. Glaring evidence of this shift is the -29.92% YTD return for the Ark Innovation ETF managed by Cathie Wood (the poster child for the growth/tech bubble). In addition, our view is that a cycle of "good news" events for the stock market should continue through the 2nd quarter. As we know, markets don't like uncertainty and we have already seen the first step in removing some of that uncertainty with the first interest rate hike by the federal reserve on March 16. Next, the March CPI reading to be released on April 12th, which we believe will come in better than expected. Following that will be "earnings season" which despite a messy quarter, consensus earnings estimates have been revised ***upward.*** This will be followed by 1st quarter GDP announced on April 28th which should alleviate equity markets fears about recession. Lastly, the Fed announcement on May 4th will likely be positive as we expect them to Under Promise/ Over Deliver (i.e. say they'll raise by 50bps but only raise 25bps). The kicker could possibly be the end of the Russian/Ukrainian war. Our view is that it is very unlikely that they will still be fighting past May of this year. That's not to say that we will be "off to the races", far from it! But we do think we will start making our way out of the valley and start grinding in a choppy but upward fashion. That said, when we look for areas of the US stock market that are best positioned, Value and Small Caps are certainly looking good with respect to expected earnings and valuations.



US Fixed Income

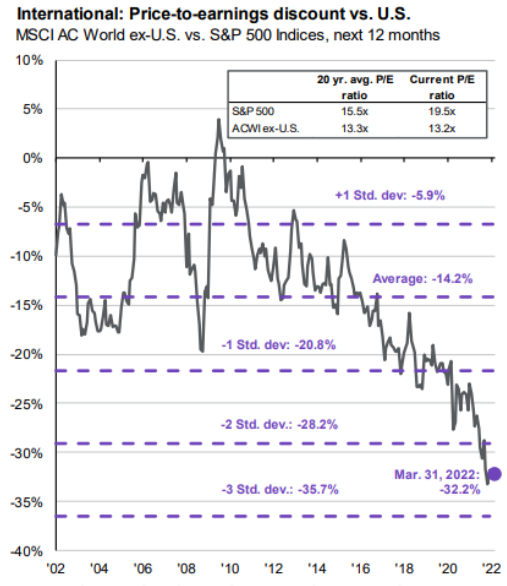


This chart says it all. There was nowhere to hide from negative volatility even in the bond market. High inflation readings and the fear of aggressive Fed interest rate hikes have sunk bond prices across the board. In many cases, underperforming stocks. TIPS (Treasury Inflation Protected Securities) and High Yield Corp bonds have held up the best compared to core fixed income such as US Treasuries and Corporate Bonds. However, we believe the bond market is a touch oversold in the near term and that yields are likely in a choppy, range-bound environment. Of course, yields will have pressure to the upside from the Fed, but that pressure should be met with higher global demand due to more attractive yields.



Source: JPMorgan Guide to the Markets

International Markets

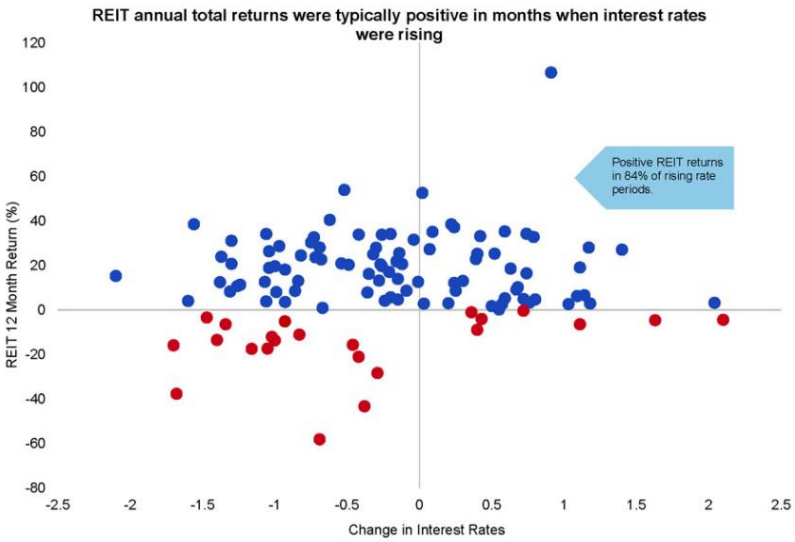


Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management. *Guide to the Markets – U.S.* Data are as of March 31, 2022.

Just when international markets were poised to outperform, Vladimir Putin engaged in the horrific war in Ukraine. Aside from the human atrocities, the economic effects are being felt around the world, and the effects on Europe are acutely damaging. Surging commodity prices, especially Russian supplied natural gas which shot up over 44%, have placed enormous cost pressures on the European population. In addition, the disruption of supply chains and infrastructure will have lasting negative effects for the region. That said, economies and markets are not one in the same. Even though the risk of recession across Europe has increased significantly with the war, companies operating in the capital markets are likely to navigate the disruptions better than the economies. For those reasons, we are changing our outlook for International Stocks to a slight underperformance compared to the US, down from a slight outperformance.

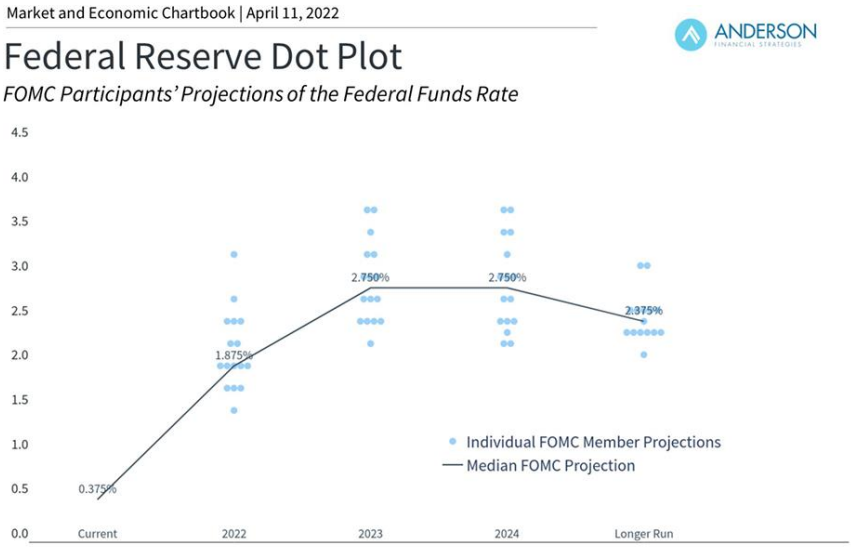
Real Estate

REITs have held up quite strong given the "sell everything" market mentality that we started the year with. We still see several strengths in the REIT industry such as 1.) REITs are still earlier in the cycle than equities 2.) Strong forecasted NOI (Net Operating Income) growth and 3.) The positive return relationship with higher-than-expected inflation. In addition, REITS have a positive return relationship in rising rate environments 84% of the time, as you can see in the chart to the right. Recently we have seen REIT performance strengthen even with the acceleration in the rise in interest rates…

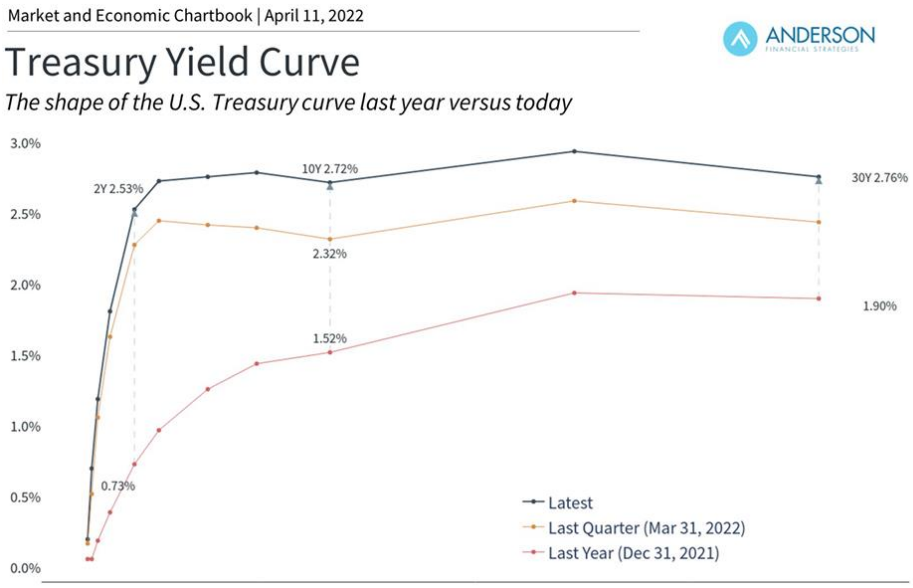


Source: Nareit analysis of FTSE Nareit All Equity REIT Index via FactSet, 10 Year Treasury Constant Maturity Rate via FRED from Q1 1993 through Q2 2021. Quarterly intervals of 12 month rolling returns.

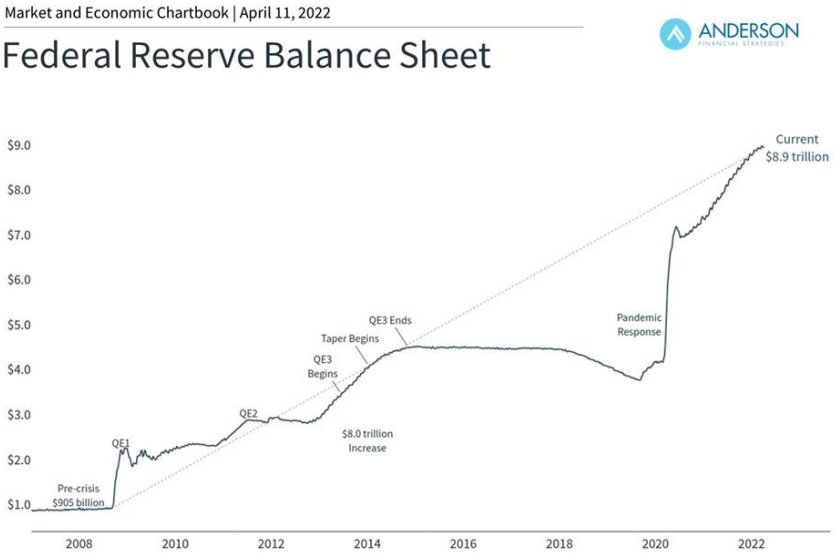
Interest Rates & the Fed



Recent market surveys show that investors feel that the biggest risk to the market is overwhelmingly the Federal Reserve. Not a slowing economy, not raging inflation, not a substantial increase in commodity prices – but the chance that the Fed will increase interest rates too fast. You may not think about it, but the Fed can raise rates in multiple ways, not just its Fed Funds borrowing rate. Ben Bernanke popularized the theory that the Fed's largest tool is its communication to the market, rather than the direct Fed funds rate. This is what has been impacting market rates far more as we have seen the 10-year treasury yield rise 1.20% so far just his year, when the Fed funds rate has only gone up by 0.25% - almost 5 times greater. And the 2-year Treasury yield has risen 1.80% year to date! This is directly because of what the Fed members have been ***talking*** about, not actually doing. It is our theory that much like a basketball player grabbing a rebound and "clearing the lane", the Fed is talking tough to give them enough room to "under promise and over deliver" – meaning that they can positively surprise the market by raising rates less than expected. They have certainly created enough room on the short end, but the long end hasn't moved as much. This *should* hand-cuff the Fed somewhat as they are running up against an inverted yield curve which is seen as recessionary. For this reason, even though the Fed talks about raising the Fed Funds rate more aggressively, we think they will take a more slow and steady approach. The Ukraine-Russia war has also given them *cover* to back from their aggressive posture. The other side of the table is the Feds balance sheet, which is still bulging at $8.9 TRILLION. There are reports that they have come to an agreement that they are



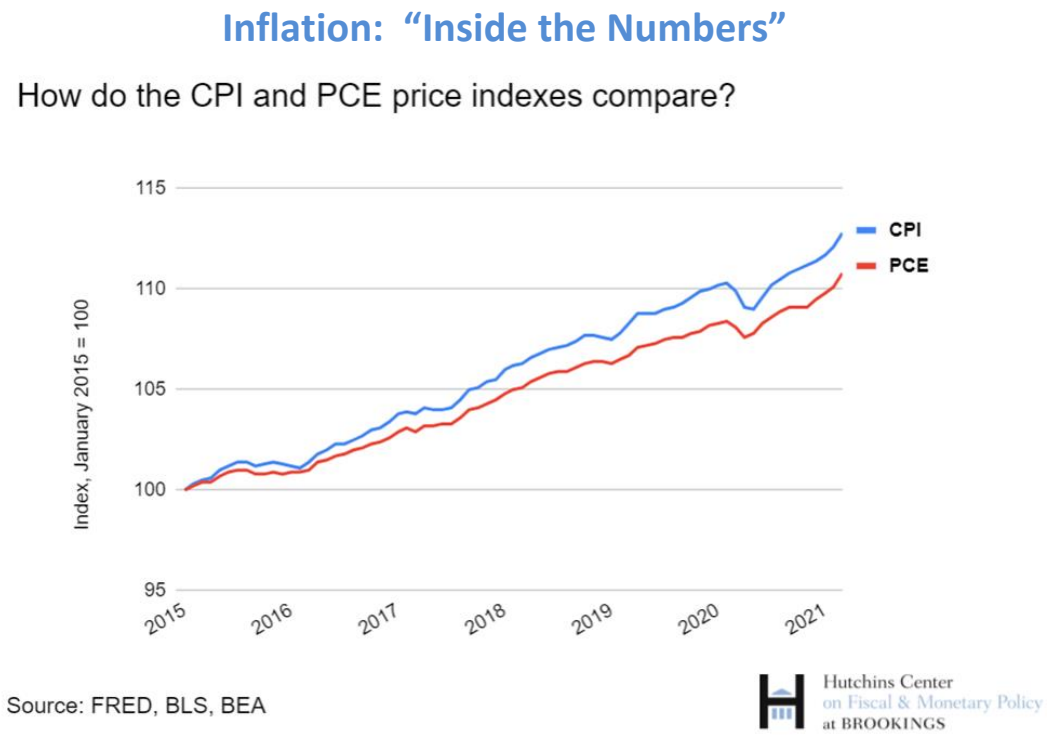
willing to let $95 Billion per month roll off of the balance sheet and the *"back of the napkin"* math suggests that amount would be mostly incoming interest payments. Therefore, they wouldn't actually be "selling" any bonds but rather not reinvesting the proceeds. This is a good start and shouldn't rattle markets much. It could be seen as removing the "support" for low interest rates but not actively pushing longer term yields higher. However, the timing and communication of their strategy will be very important.



Legislative Affairs

Despite having failed to garner enough support to pass the "Build Back Better" plan in 2021, President Biden 's budget proposal once again put forth many of the tax hikes and spending ideas found in the previous plan. This includes raising the corporate tax rate to 28%, restoring the top income tax rate back to 39.6%, and apply a 20% minimum tax for Americans with a certain Net Worth. However, most political experts describe the President's budget as "dead on arrival" and is more ideas than actionable substance. Meanwhile, over in Congress the House of Representatives passed a retirement bill called "the Secure Act 2.0". Among other items, the bill includes automatic enrollment and automatic escalation for new workplace retirement plans with more than 10 participants. It changes the age for Required Minimum Distributions (RMDs) from 72 to 75 over the course of 10 years. In addition, the catch-up contribution maximum would be increased to $10,000 for those employees ages 62-64. Oddly though, at age 65 the limit reverts to existing limits though. Additionally, all catch up contributions would be required to be made as Roth, pre-tax catch up contributions would not be allowed. This is a rare bipartisan area of agreement and is expected to pass the Senate in coming months.

Financial Planning Corner



Inflation Rate… What Does that Mean for the Average Consumer?

It's easy to see a headline inflation reading of 7.9% and begin thinking that everything you buy is now 7.9% more expensive.

But that's rarely ever going to be the case. In fact, even the Bureau of Labor Statistics, who oversees reporting the Consumer Price Index (CPI), says:

"*The CPI does not necessarily measure your own experience with price change. It is important to understand that BLS bases the market baskets and pricing procedures for the CPI-U and CPI-W populations on the experience of the relevant average household, not of any specific family or individual*."

In other words, CPI is a national average based on a static basket of goods intended to represent millions of individual price experiences of the "average American household". Not so much your personal inflation experience…

The Real Superstars Behind Today's Inflation: Used Cars, Gasoline and Gas Energy, and Fuel

You'll see that while the CPI inflation reading last came in at 7.9%...

- Energy prices overall increased 25.6%
- Gasoline and Fuel prices increased 38% and 43.6% respectively
- Gas Utility prices increased 23.8%
- Used Cars and Trucks increased 41.2%!

Even within the "food at home" category, there were wide disparities between the various food indexes. For example, the beef index rose 26.2%, tomatoes rose 1.1%, and cheese rose 1.9%.

The point here is that if you're not purchasing as much from the severely inflated categories of CPI, your personal inflation will likely be much lower than the headline figure.

Is CPI Really the Measure of Inflation You Should Pay Attention to?

CPI gets most of the headlines because it's the number a lot of people pay attention to, including politicians. It's the inflation measure that decides Social Security COLAs and interest rates on inflation-protected Treasury Bonds and Series I Savings Bonds. It naturally gets more media focus.

But CPI has several flaws:

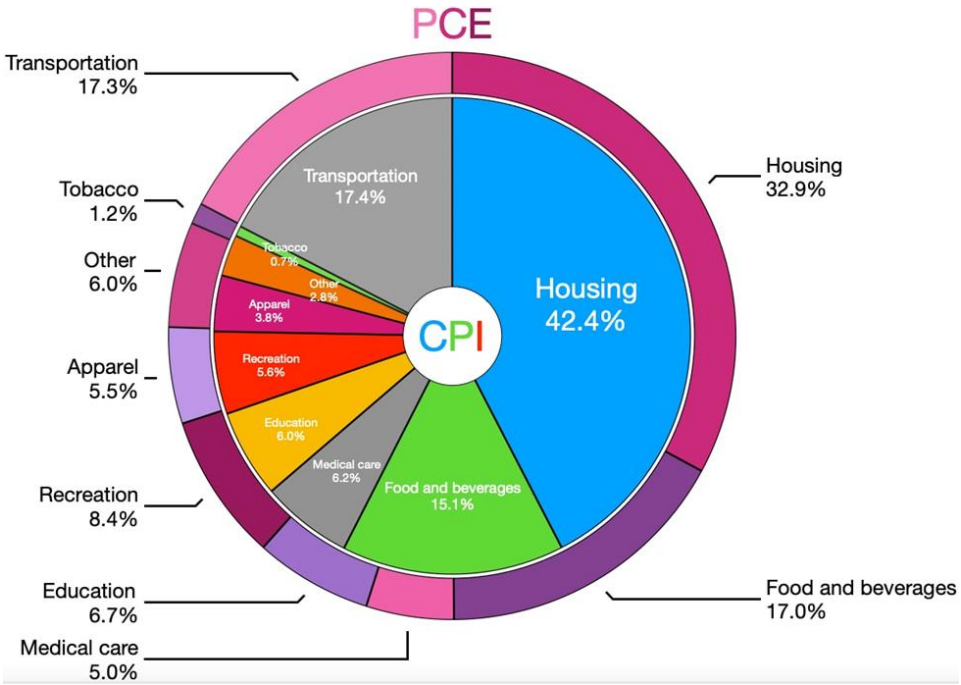
- The static basket of goods is only updated every 2 years
- It relies on survey data which is considered less reliable than business data
- It doesn't adjust for "substitution effects" where consumers shift their consumption to adapt
- It only measures out of pocket costs directly from consumers

So, according to the Federal Reserve, many economists, and others, CPI is considered one of the least reliable measures of inflation. We tend to agree. It's even been estimated that CPI is misleading the true inflation figure by 1-2% of the published inflation rates you see in headlines (3).

Why Personal Consumption Expenditures (PCE) Is Believed More Accurate

Instead of relying on survey responses from individuals on what they purchased, PCE uses actual consumption data from businesses. And whereas CPI only accounts for items paid out of pocket by consumers, PCE reflects what consumers paid for regardless of the source. For medical expenses, CPI would only include out of pocket medical costs, while PCE would include everything, such as health insurance premiums through your employer and the deductible size.

Also, PCE tends to be broader in what data is collected, as well as updated much more frequently (quarterly). This makes PCE more nimble and allows it to capture the consumption changes consumers make in response to inflation.



Final Thoughts…

"Core" inflation figures remove the two most volatile categories: Food and Energy – which tend to exaggerate inflation figures compared to other goods and services price changes. And they are rarely linear – we see Food and Energy prices go up and down over time.

So, if we remove Food and Energy (whose currently increased prices typically don't hold long-term), along with some of the most inflated categories (like Used Cars and Trucks), the true inflation figure you're personally experiencing could easily be 2% (or more) less than you see in the headlines.

1) https://www.brookings.edu/blog/up-front/2021/06/28/how-does-the-government-measure-inflation/
2) https://imageio.forbes.com/specials-images/imageserve/621674b1684429552b4b2484/Various-Measures-of-Annualized-Inflation-for-December-2021/960x0.jpg?fit=bounds&format=jpg&width=960
3) https://www.forbes.com/sites/georgecalhoun/2022/02/23/the-31-flavors-of-inflation-do-we-really-understand-these-numbers/?sh=59fa57111166
4) https://en.wikipedia.org/wiki/Personal_consumption_expenditures_price_index