WOODSTOCK

Quarterly Market Perspectives

SPRING 2022

A quarterly newsletter offering our views on the market and economic topics of interest to investors.

IN THIS ISSUE

Why Investing Directly in Stocks Serves Investors Well

As the Fed Fights Inflation, Can Recession Be Far Behind?

Tax Update: Extensions, Capital Gains, and Social Security

Why Investing Directly in Stocks Serves Investors Well

William H. Darling, Chairman & CEO

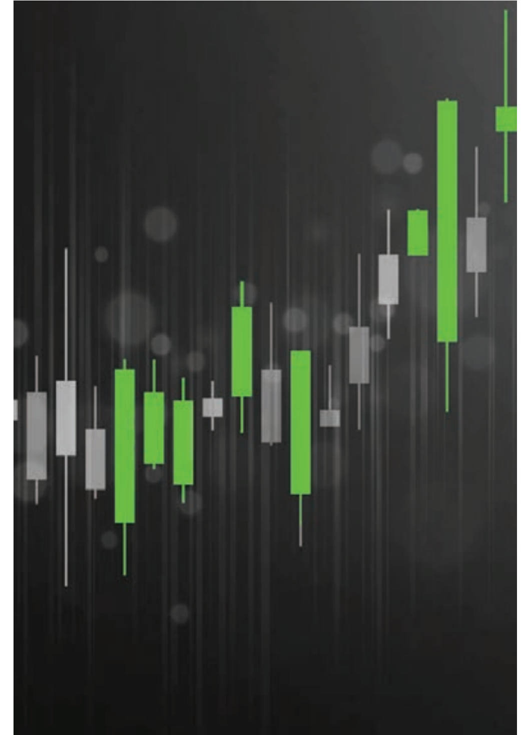
What do you buy when you make high-quality US companies the basic building block of your portfolio? The short definition of a high-quality US company is one "that can grow and thrive under almost all envisioned economic scenarios" with the investment expectation that their "capital will compound at a healthy 'real' rate" meeting "any reasonable investment objective."[1]

Leaving aside for the moment the discussion of "active" versus "passive" (see QMP Winter 2022), for the last twenty years this asset class has received disparaging comments from the endowment model community and from Wall Street investment managers as too predictable and unexciting. They say that with the right professional guidance, an investor could do better. As Charlie Weis, the former professional football coach and now commentator, says about NFL teams' bad decisions: "How's that working out!"

A case in point: Nickel is an important metal in the world economy and will become more important in a "greener" world. If the high-quality company you invest in uses nickel in its processes, it will employ buyers or use contractors to buy the nickel it needs when it needs it, at a good price, if it can. The company knows the market for its raw materials.

The endowment model community and Wall Street investment managers would say that an investor with the right professional advice could, and should, buy the metal directly. We'll steer you to a commodities manager or our own research staff and you can do better, they say.

As you may know, nickel trading on the London Metal Exchange (LME) underwent a rather illuminating meltdown recently.[2] A Chinese company invented a process which they felt would allow their low-grade ("cheaper") nickel to be substituted in



manufacturing processes for higher-grade ("expensive") nickel. In advance of their winning the market, they decided to sell short more high-quality nickel than they had on hand on the LME. Then Russia invaded Ukraine. Since they were naked as the tide went out, they panicked, rightly so. Those of us who are fans of the movie Trading Places might assume we'd know how this works out -- except it didn't. The wrinkle here is that the Chinese government owns the LME and, although the exact decision mechanism isn't known, the nominally independent LME suspended trading in nickel, even "cancelling" trades that had already occurred, to "give the market time to adjust," thereby saving the Chinese company from its bad bet, at least for a while.

---

[1] *"Thinking About Investment Success the Next 20-30 Years," T.C. Stakem, Woodstock Quarterly Newsletter, June 2019.*

[2] *"Nickel Crisis Sends London Exchange Scrambling," Wall Street Journal 3/10/22, and James Mackintosh, "Nickel Market Offers Moral Hazard Lessons," Wall Street Journal, 3/11/22.*

WOODSTOCK

"All of these markets were digesting news of the Russian invasion of Ukraine, high energy prices, surging inflation, and a Federal Reserve turned hawkish with forecast aggressive federal funds rate hikes and open market bond sales to shrink its balance sheet."

"The Federal Reserve and Federal Open Market Committee will attempt to engineer a soft economic landing (rein in inflation without hurting employment) and avoid sparking a recession with the few tools at its disposal."

(Continued from Page 1)

You can buy the pieces of a high-quality US company (which will be operating independently) through the endowment model or through Wall Street investment managers, or you can buy the stock itself. You can pick which set of managers you trust to do the best job for you: those who modestly say that past performance is no guarantee of future success, or those managing the high quality company to "grow and thrive under almost all envisioned economic scenarios."

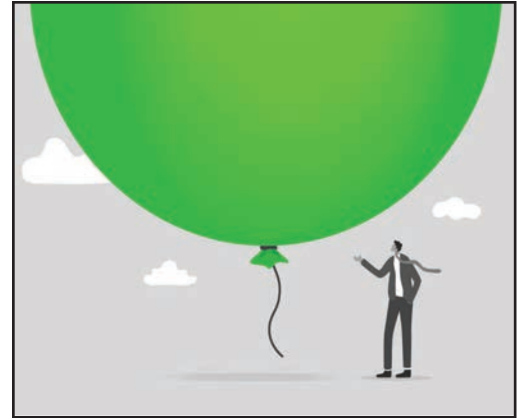
The managers of the high-quality company hire the people to put all the pieces together, make them work together profitably, and ultimately benefit because the company and its stock price do well. They – not you -- run the risk of understanding the nickel market.

The other way (not buying the actual company stock) puts all the pieces of the puzzle in front of you. In this situation your advisors, perhaps, benefit from academic acclaim or from a percentage of trading volume. Your success is not factored in directly but may be a side benefit.

However, "if you are interested in having your capital invested over decades in dominant successful companies whose financial results will command premium valuations and enviable stock market valuation then contacting Woodstock Corporation will reduce your anxiety about the future and your investment prospects."[3]

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow. We thank you for your support and want you to know that we are dedicated to serving your best interest.

[3] *"Thinking About Investment Success the Next 20-30 Years," T.C. Stakem, Woodstock Quarterly Newsletter, June 2019.*



As the Fed Fights Inflation, Can Recession Be Far Behind?

Robert B. Sanders, CFA, Senior Vice President

The S&P 500 Index dipped briefly into correction territory in mid-March (defined as at least a 10% fall from a recent stock market peak, which it hit January 3rd) before rebounding to close out the first quarter down only -4.95% as of March 31st. The tech-heavy Nasdaq Composite Index was off -9.1% on a price-only return basis for the quarter, but technically has been in correction territory since mid-January, down -11.4% from the highs it hit November 19th. Likewise, bonds had a tough quarter, finishing in the red with long-term Treasurys down -10.2%. Energy and utilities were the only equity sectors with positive price returns, +37.7% and +3.9%, respectively. All of these markets were digesting news of the Russian invasion of Ukraine, high energy prices, surging inflation, and a Federal Reserve turned hawkish with forecast aggressive federal funds rate hikes and open market bond sales to shrink its balance sheet. The question everyone is asking: Can the Fed orchestrate a soft landing with so many variables to combat? Not likely.

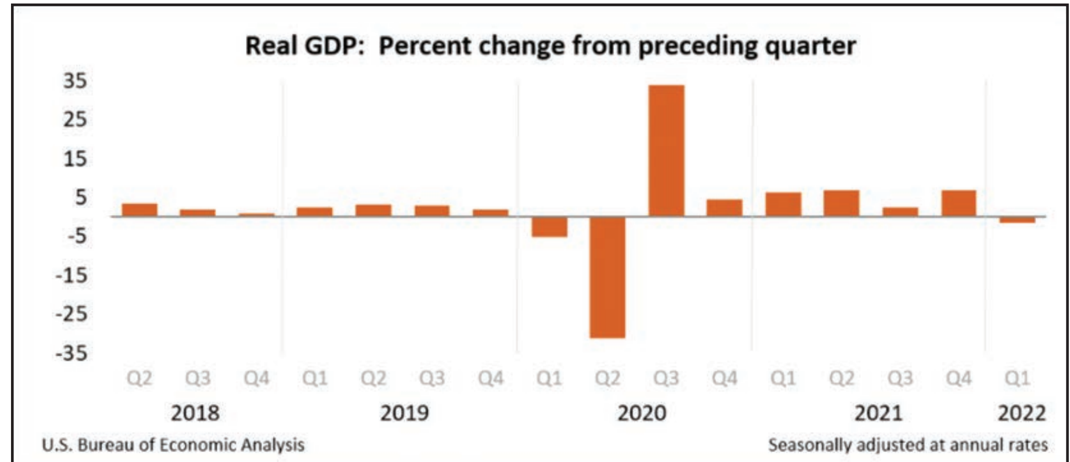
The Federal Reserve and Federal Open Market Committee will attempt to engineer a soft economic landing (rein in inflation without hurting employment) and avoid sparking a recession with the few tools at its disposal. Recession is marked by two consecutive quarters of negative real GDP growth. Advanced estimates by the Bureau of Economic Analysis indicate real GDP decreased at an annual rate of -1.4% in Q1,

WOODSTOCK

compared to an increase of 6.9% in Q4 (see Figure 1). The decline was driven in part by decreases in net exports (imports exceeded exports, which negatively impacted GDP), government spending, and inventory investment which more than offset the rise in personal consumption. The real GDP decline could be seen as a brief and modest GDP hiccup that will abate as supply chain bottlenecks ease. It could also be a canary in the coal mine, signaling danger ahead.

"The inflation rate was 8.5% in March 2022 as measured by the Consumer Price Index (CPI), the highest in 40 years (since December 1981)."

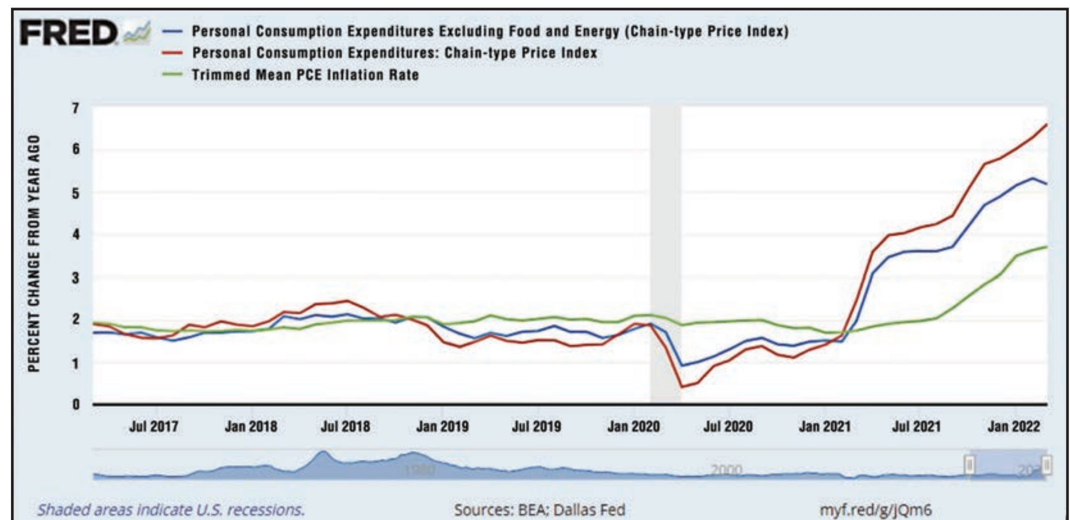
Figure 1. Real GDP



"The real GDP decline could be seen as a brief and modest GDP hiccup that will abate as supply chain bottlenecks ease. It could also be a canary in the coal mine, signaling danger ahead."

The inflation rate was 8.5% in March 2022 as measured by the Consumer Price Index (CPI), the highest in 40 years (since December 1981), up from 7.9% in February. Energy prices were up 32%, driven by fuel oil (+70.1%) and gasoline (+48%). Food prices were up 8.8%, used cars and trucks were up 35.3%, and new vehicles were up 12.5 percent. Core CPI, excluding energy and food, was up 6.5 percent. The Fed focuses on personal consumer expenditures (PCE) to measure inflation, considering it the most reliable statistic. PCE rose a more muted 6.4% in February, and core PCE, also excluding energy and food, rose 5.4% (see Figure 2). The expectation of higher future prices tends to increase demand in the short term, pulling forward purchases and sustaining the inflationary cycle.

Figure 2. Inflation as Measured by Personal Consumption Expenditures



“In the face of this spiking inflation, there are a number of supply-related factors the Fed cannot control. These include persistent supply chain bottlenecks, lingering pandemic-related supply and labor shortages, war in Ukraine, and energy, food and commodity inflation among them.”

“Economists are predicting 5–6 more rate increases this year and markets are predicting a 250-basis-point rise in 2022 in total.”

“A decline in the valuations of real estate and financial assets may have the greatest impact on consumer demand, and do so far more quickly than the Fed tightening cycle.”

(Continued from Page 3)

Supply Issues May Foil the Fed

In the face of this spiking inflation, there are a number of supply-related factors the Fed cannot control. These include persistent supply chain bottlenecks, lingering pandemic-related supply and labor shortages, war in Ukraine, and energy, food and commodity inflation among them. So, the Fed must focus on the demand side of the equation. It has changed its tune from repeated reassurances in the fall that inflation will be transitory to a very hawkish stance. The Fed executes their stated goals of promoting maximum employment, stable prices, and moderate long-term interest rates primarily by manipulating the federal funds rate and through open market purchases and sales of Treasurys, agency bonds, and mortgage-backed securities. They, and we, hope these tools will be used correctly to cool an overheating economy, slowing growth but not eliminating it. Ideally their tightening policy will reduce personal consumption, reduce investment, stimulate slower but still positive GDP growth, and thereby lower inflation back toward its long run goal of 2 percent.

The Fed may eventually be successful, but it will more than likely take longer than they expect, and also likely cause at least a mild recession. Historically, 11 of the 14 Fed tightening cycles since World War II have resulted in a US recession within two years.[1] This ominous track record aside, actions they take today and in the coming year will have a lagged impact on the economy, and many supply-side variables beyond their control will have unknown intervening consequences affecting the probability of a “soft landing.”

The Fed balance sheet has doubled in the pandemic crisis to $9 trillion (see Figure 3). The Fed announced it is beginning to unwind the run-up by letting $95B of Treasurys, agency debt and agency mortgage-backed securities mature without reinvestment per month. It is not yet known how long the Fed will let this balance sheet runoff continue; however, at that rate it would take nearly four years to bring the balance sheet back to pre-pandemic levels. The effect is to take liquidity out of the banking system, making lending

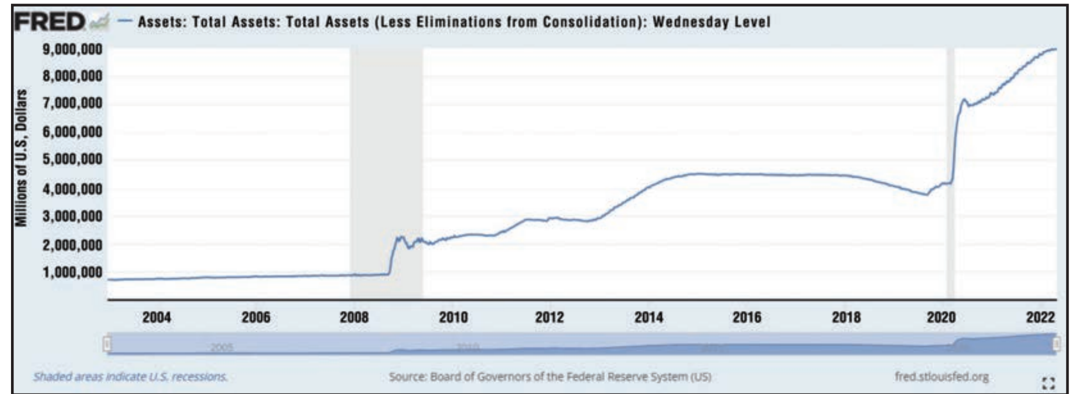
more expensive. In March they also raised their federal funds rate target from 0.0%–0.25% to 0.25%–0.5% (by 25 basis points). They raised rates an additional, and more aggressive, 50 basis points in May.

In the 1970s and early ‘80s, the Fed raised target rates to a level that exceeded the rate of inflation in order to bring high inflation back under control. The federal funds rate peaked at 20% in 1980. With inflation in March 2022 spiking up to 8.5%, a similar path of very high prescriptive interest rate hikes would cause chaos in the financial markets here and abroad. The Fed cannot raise rates that high or that quickly now without destabilizing the global economy. It should raise rates at a measured and steady pace. Economists are predicting 5–6 more rate increases this year and markets are predicting a 250-basis-point rise in 2022 in total. The most likely scenario is more aggressive federal funds rate moves in the coming months and less aggressive raises in the second half of 2022.

Similar to the open market bond transactions, raising rates will make it more expensive for companies and consumers to borrow. Combined, these two Fed levers should help crimp demand for goods and services by consumers and companies alike, slowing GDP growth, but also impacting employment, housing and market valuations. A decline in the valuations of real estate and financial assets may have the greatest impact on consumer demand, and do so far more quickly than the Fed tightening cycle.

[1] *Thomas Yeung, “Recession Fears Are a Golden Opportunity for Deep Value Moonshots,” Investorplace.com, April 22, 2022.*

Figure 3. Fed Balance Sheet December 2002 to April 2022



> *"The labor market is currently in good shape from the Fed's point of view, so while they will be mindful of unemployment spikes, their focus will be primarily on taming high inflation, which has become a much bigger challenge. "*

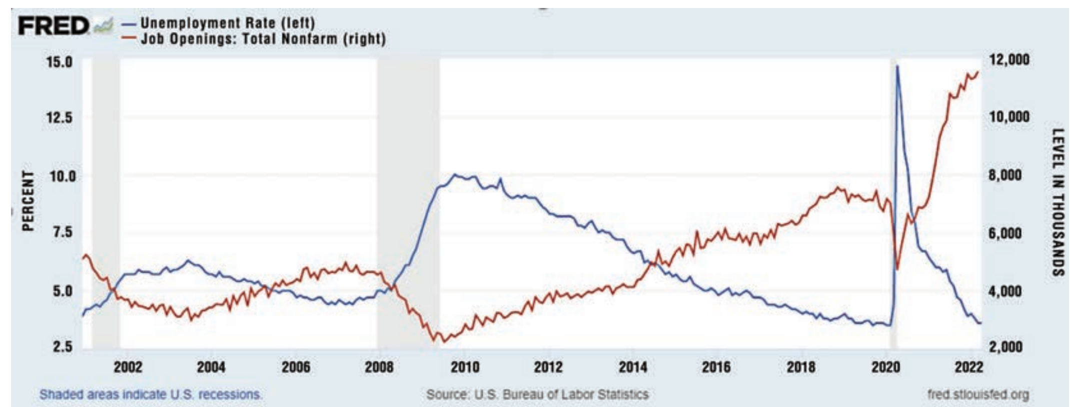
> *"Statistically, we are essentially at full employment, which creates its own inflationary pressures."*

Labor Market Impacts

The labor market is currently in good shape from the Fed's point of view, so while they will be mindful of unemployment spikes, their focus will be primarily on taming high inflation, which has become a much bigger challenge. The March unemployment rate hit historic lows of 3.6% (decreasing by 318,000 to 6 million people), though this may not fully count those who have left the workforce, cannot work due to the pandemic, are under-employed or working part time out of necessity. US wage growth was up 9.16% as of December 2021, steadily declining monthly from a peak of 15.3% in April 2021. There were roughly 56 unemployed workers for every 100 job openings at the end of February, with 11.3 million job openings and 6.3 million unemployed workers (see Fig. 4).

Statistically, we are essentially at full employment, which creates its own inflationary pressures. Labor shortages, higher minimum wages, and wage inflation to attract and retain workers all contribute to a perpetuating cycle necessitating higher pricing for goods and services that feed inflation. The Fed's policies designed to slow this economic growth would work counter to full employment goals and would have the effect of raising unemployment, cutting job openings, and limiting wage increases. Rising interest rates, combined with energy and food inflation, will reduce consumer demand. Forgoing discretionary spending, delaying large purchases, and trading down to lower-priced products would have a material impact on economic growth since consumer spending comprises 70% of GDP.

Figure 4. Unemployment Rate vs. Job Openings



(Continued from Page 5)

Real Estate Valuations

The rise in housing prices in the US has been fueled by historically low mortgage rates, pandemic isolation, and record low supply. With the Fed tightening cycle underway, mortgage rates have quickly jumped, hitting north of 5% for 30-year mortgages after quarter-end, up 64% year-to-date. Mortgage refinancing volume dropped 60% year-over-year in March. The current limited housing inventory will keep prices up in the short term as it will likely take some time for housing demand to come back in line with supply. However, if mortgage rates remain elevated, and continue to rise with the Fed hikes, housing demand will drop along with valuations. (See Figures 5 and 6.)

"The rise in housing prices in the US has been fueled by historically low mortgage rates, pandemic isolation, and record low supply."

"The current limited housing inventory will keep prices up in the short term as it will likely take some time for housing demand to come back in line with supply."

Figure 5. Mortgage Rates Skyrocket

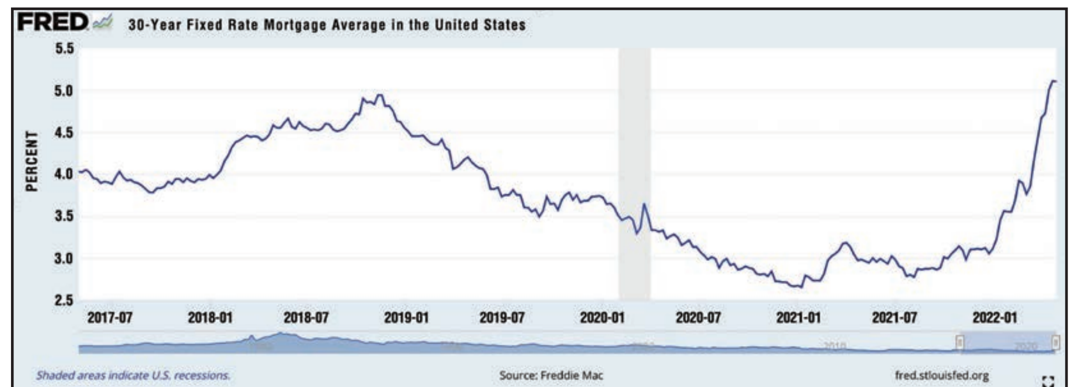
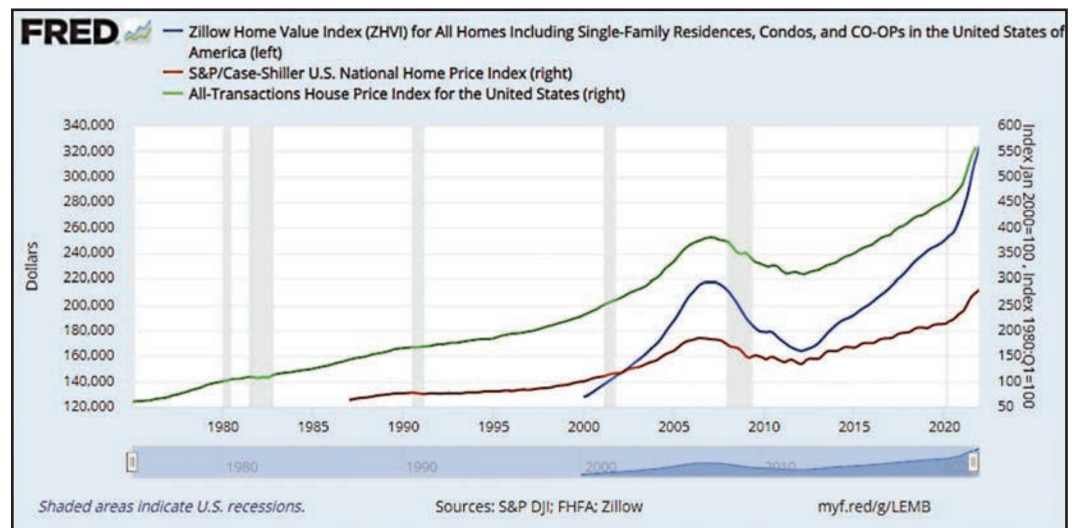


Figure 6. Home Prices Soar



> "The energy sector had a supply-and-demand imbalance even before Russia invaded Ukraine that was driving energy prices higher. Post invasion, embargoes of Russian oil and gas only add to the supply weakness."

> "Like oil and gas, food inflation is a problem the Fed can't solve locally."

> "As a result of price hikes, many emerging market nations are now rationing both food and energy, with their governments having to decide between feeding their people and paying their debts."

Energy and Food Inflation

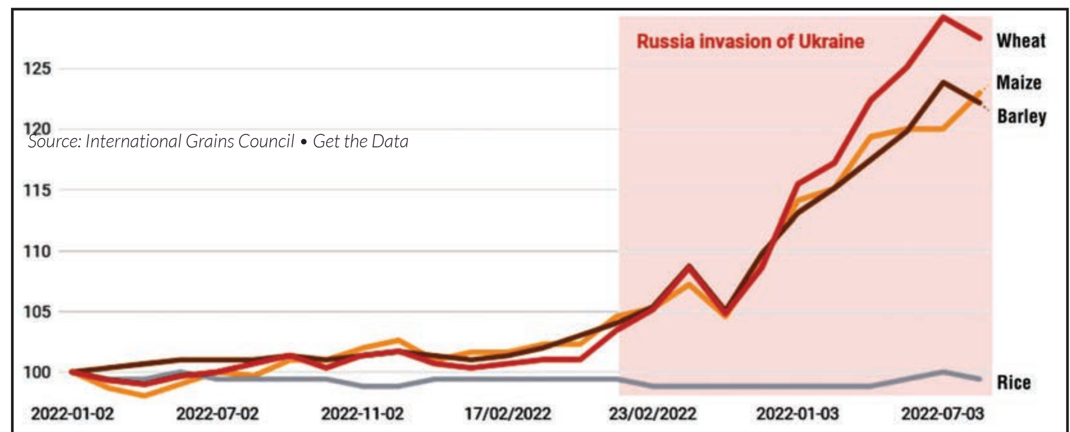
Energy prices are one of the main inflationary factors the Fed cannot contain with its actions. The energy sector had a supply-and-demand imbalance even before Russia invaded Ukraine that was driving energy prices higher. Post invasion, embargoes of Russian oil and gas only add to the supply weakness. Russia supplies 12% of the world's oil. The prices of oil and natural gas have risen 33% and 51% in the quarter, respectively. The remaining producers cannot replace this supply overnight, having underinvested in the preceding years of low energy prices. An elevated price of oil in the $100-per-barrel range is likely to remain for some time, despite President Biden's gradual release of 46% of the nation's strategic petroleum reserve. By extension, energy inflation in the form of higher prices for gasoline, jet fuel, and heating oil, higher costs for electricity, transportation, delivery of raw materials, and production of finished goods will continue to inflate prices across the spectrum of goods and services, despite the Fed's actions. The Russian-Ukrainian conflict is likely to go on for some time, prolonging the pain.

Like oil and gas, food inflation is a problem the Fed can't solve locally. Russia and the Ukraine are breadbaskets of sorts, supplying grain to many countries, accounting for 25% of the global wheat supply. The current war there has disrupted vital food security supply chains

in many developing nations, particularly Egypt, the largest wheat importer, at a cost of $4 billion annually. Wheat prices rose 30.5% in the first quarter. As a result of price hikes, many emerging market nations are now rationing both food and energy, with their governments having to decide between feeding their people and paying their debts.[2] History has shown us that food inflation in countries that have few alternatives has eventually led to geopolitical unrest, defaults, and regime changes. (See Figure 7)

Figure 7. Wheat, Maize, Barley & Rice Price Indexes

100 = Price on February 1, 2022



Source: International Grains Council • Get the Data

[2] *Donnan, Martin, Rosati and Laghmari, "Hunger and Blackouts Are Just the Start of an Emerging Economy Crisis," Bloomberg.com, April 20, 2022.*

WOODSTOCK

"The rise in short-term rates has caused the Treasury yield curve to flatten, beginning at two-year maturities, and briefly to invert with the 2-year Treasury yield temporarily exceeding the 10-year yield."

"Historically, an inverted yield curve is another leading indication of pending recession."

"With the Fed set on a path of slowing economic growth, and facing a high risk of overshooting that goal, it would appear that earnings expectations will need to come down."

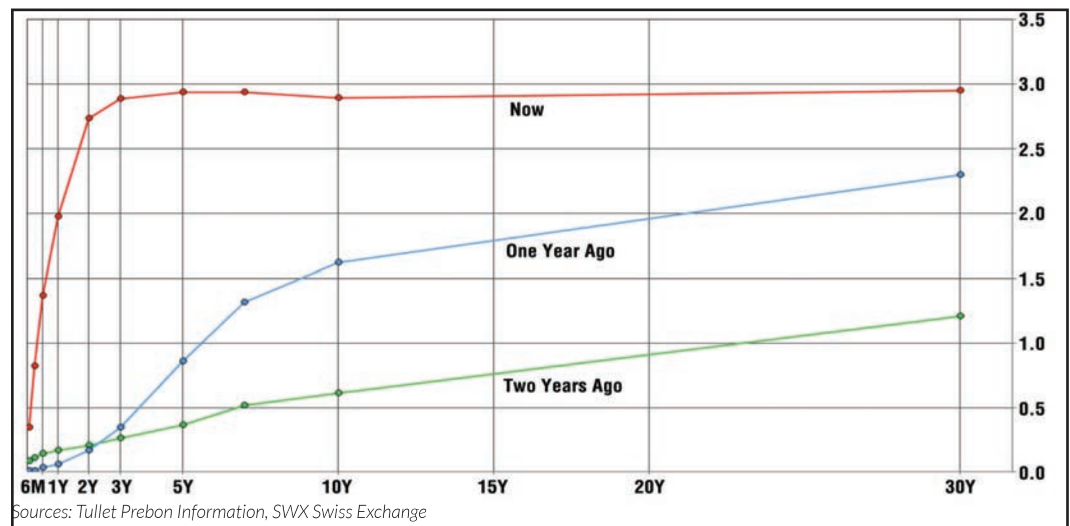
(Continued from Page 7)

The Yield Curve

The rise in short-term rates has caused the Treasury yield curve to flatten, beginning at two-year maturities, and briefly to invert with the 2-year Treasury yield temporarily exceeding the 10-year yield. That longer-term rates have yet to rise in lockstep with Fed hikes implies long-term inflation expectations are still moderate, in line with the Fed's stated long-run goals of 2%, while shorter-term rates appear to have Fed rate hikes baked in.

Longer-term rates are expecting the Fed tightening to be successful in cooling down the economy, reining in inflation, pricing in this future economic softening. If the Fed over-shoots its objectives and drives the economy into recession, the long end of the curve may be pricing in that outcome too. The current flattening of the Treasury yield curve could see moments of inversion at various maturities if the long-term outlook remains gloomy while the short end gets tightened to fight inflation. Historically, an inverted yield curve is another leading indication of pending recession.

Figure 8. Yield Curve *US Treasurys (4/29/2022)*



Sources: Tullet Prebon Information, SWX Swiss Exchange

Rising interest rates hurt bond investors, with prices moving inversely with the interest rates. Short-term bond yields have already moved up, and bond prices have fallen, in anticipation of future Fed rate hikes. To the extent that inflation endures, or the Fed hikes rates more than currently expected, bond yields could rise further. For an equivalent change in interest rates, longer-maturity bond prices are more volatile than shorter-maturity bond prices because they discount changes in rates over a longer period of time. In the current context of bond investors anticipating that inflation will moderate, longer-term rates have been more stable than short-term rates, resulting in a relatively flat yield curve. Flat as it currently is, long-term bonds do not offer a sufficient yield premium over short-term bonds to merit assuming the additional duration risk.

Equity Market Valuations

Rising rates should also have the effect of compressing equity market P/E ratios as the discount on future earnings gets greater. With the Fed set on a path of slowing economic growth, and facing a high risk of overshooting that goal, it would appear that earnings expectations will need to come down. The Fed will be actively undermining corporate earnings growth, which is being priced into the market. As a result, current valuations may still be too high. Long-term average market valuations for the S&P 500 Index are 15x-16x price-to-forward earnings, implying current valuations could have more room to come down, particularly for high-multiple growth stocks.

“We recommend investors focus on companies benefitting from long-term secular growth, staying invested through market cycles, and taking advantage of market dips to buy these good companies at better prices.”

“Finally, keeping enough liquidity for known cash needs in any economic environment is always a prudent strategy.”

“The Internal Revenue Service estimates that 15 million taxpayers requested an extension of time to file their 2021 tax return.”

Investor Considerations

Adding it all up, we can expect rising interest rates, more expensive borrowing, slowing corporate investment, slowing corporate earnings growth, contracting consumer spending, persistent energy and food inflation, rising unemployment, ongoing Covid-related supply disruptions, slowly easing supply chain bottlenecks, and repricing of the housing and equity markets. It is hard to envision a scenario where Fed actions coax all of these economic forces to ease into a perfect equilibrium where economic growth is modestly positive, unemployment remains low, and inflation glides back to long-run goals of 2 percent. An economic recession may be on the horizon.

This doesn’t mean it is time to head for the hills. Stock markets price in changing economic expectations quickly and often. Trying to correctly time getting out and back in again is a fool’s errand—nearly impossible to get right. We recommend investors focus on companies benefitting from long-term secular growth, staying invested through market cycles, and taking advantage of market dips to buy these good companies at better prices. The best companies take advantage of the opportunities presented to them, even finding ways to capitalize on stock market and economic weakness. Finally, keeping enough liquidity for known cash needs in any economic environment is always a prudent strategy.

Tax Update: Extensions, Capital Gains, and Social Security

William H. Darling, Chairman & CEO
Jeanne M. FitzGerald, CPA – Tax Manager

The first phase of the current tax season has ended. The flurry of activity to make sure that tax returns for 2021 are filed or, at least that the tax due is paid with the request for an extension, is done.

The Internal Revenue Service estimates that 15 million taxpayers requested an extension of time to file their 2021 tax return. An extension of time to file is not an extension of time to pay. Taxpayers must estimate their tax liability and pay any amount due by the April due date to avoid penalties and interest.

Filing a tax extension to file a tax return does not increase your risk of being audited, according to both the IRS and various tax professionals. Historically, it has been proven that individuals who earn $200,000 or more a year have a 3% greater chance of being audited. According to IRS data, the IRS audited 1% of people earning less than $200,000 and 4% of those earning more than $200,000.

Also, the chances of an audit appear to rise depending on parts of the tax return itself, such as if there is a Schedule C for self-employment income and whether it includes travel expenses, or whether large charitable deductions are adequately explained and presented in detail.

Individuals are subject to an underpayment penalty unless total withholding and estimated tax payments equal at least 90% of your tax liability for the current year or 100% of your prior year tax (110% of your tax liability if your adjusted gross income was over $150,000 married filing jointly or $75,000 for married filing separately).

You can avoid underpayment penalties by having additional tax withheld from your salary or year-end bonus by December 31. Taxpayers who have large variability in income from month to month can use the annualized income method. Annualizing computes the tax due based on income, gains, and losses through each estimated tax period.

We expect to hear that the IRS will continue to have problems with its IT systems. Americans

(Continued from Page 9)

for Tax Reform in 2022 reports that the Government Accountability Office (GAO) "reviewed five IRS IT investments and found that they met most performance goals in FY2019 and 2020."[1] However, the 60-year-old system called the Individual Master File would not be replaced until 2030. This system would be the key component for enabling "real time digital taxpayer interactions, rapid access to data and agile response to legislative changes," according to the GAO.

Within our taxpayer base, one interesting result of the current tax code is the tax-free nature of some capital gains. While federal tax rates start at 10% for anything above zero taxable income, the standard deduction of $12,000, or $24,000 if married, effectively applies the rate to incomes above that level. However, a zero capital gains rate on taxable income up to $41,675, or $83,350 if married, for 2022 is a startling benefit to those without other large sources of income other than capital gains. They pay no tax.

The long-term capital gains rate applies to investments held for more than a year. The applicable rate depends on your income and the type of asset. The long-term capital gains and qualified dividends tax rates are 0%, 15% and 20% depending on your taxable income and filing status. Married filing jointly taxpayers with taxable income under $80,800 in 2021 are taxed at 0% (MFS $40,400). Married filing jointly taxpayers with taxable income exceeding $501,600 are taxed at 20% (MFS $250,800).

When to Start Social Security?

This is the time of year when working Americans determine whether to begin taking their Social Security. The mathematics of delaying from age 62 to age 64, then from age 64 to full retirement age, and then from full retirement age to age 70 are increases of 5%, 6 2/3%, and 8% respectively. That these increases come in steps rather than gradually increasing means that the first year of each step is more important actuarially at ages 63, 65, and 68.[2] The incremental value of waiting is larger in these years than in others. The missed year or years are compared to the increase in benefits over an expected lifetime with an inflation adjustment.

Under the analysis by Investment Advisor, the largest benefits occur for recipients in the first year of a step up which minimizes lost years while maximizing the benefits. In the example where a woman is eligible to receive $20,000 per year at age 62, she can increase her total benefits received over her lifetime by $13,150 by waiting until age 63, or $17,330 by waiting until she's 65, or by $19,040 by waiting until age 68. In all other years, the benefit is less than the $13,150 for waiting until 63.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

---

[1] *Americans for Tax Reform, Washington, DC, 2022*

[2] *Michael Fink, "Why Claiming Social Security at 64 or 67 Could Be a Big Mistake," Investment Advisor, April/May 2022.*

Your ideas and questions are important to us. What would you like to see in our Quarterly Market Perspectives? Please contact your portfolio manager, or anyone from Woodstock's team of professionals, and let us know. **We want to hear from you!**

If you're new to Woodstock, you can reach us at **info@woodstockcorp.com.**