Quarterly Market Perspectives

WOODSTOCK

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

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Investment Strategies and Tactics for Tricky Times

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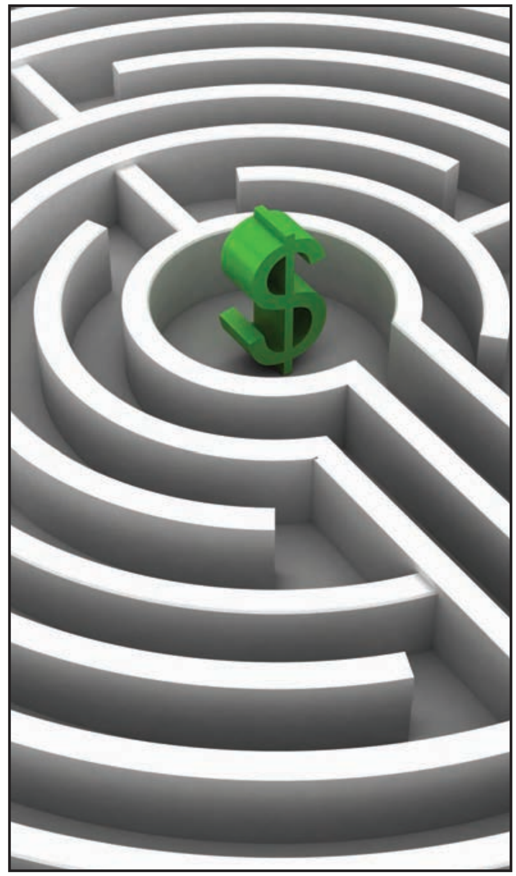
As we wait for the financial world to react to events while unsure of what theme or themes will predominate economic thought in the future, there are some strategies and tactics to keep in mind during tricky times. A popular endowment model strategy is rebalancing a portfolio. As different sections of a portfolio gain value quickly, or slowly, or even regress, the original, and hopefully optimal, asset allocation percentages change to something different. At various times, perhaps annually, the increased percentages are sold down to their original allocation and the funds raised are reinvested in the decreased percentage assets, thereby rebalancing. As a tactic to make some investors comfortable with the risk profile of their portfolios, this works. However, one author points out that he has "yet to see a study that shows it improves your returns," and in fact it sometimes can mean "missing out on big returns." [1]

Some investors and traders believe in a different strategy: "Cut your losers short and let your winners run." Letting your winners run may seem easy, but for portfolio managers with good alternative ideas, there is a desire to get going. One thought holding them back is that those new, good ideas are probably right, but they may be early.

A favored tactic at Woodstock, made possible by owning individual stocks in lots in a separately managed account, is tax-loss selling. How important is being able to manage taxes to a portfolio? A recent study showed that "systematically taking losses that reduced taxable gains boosted after-tax returns by an average of 0.82% a year from 1926 to 2018 for an investor in the 35% tax bracket," [2] This gain wouldn't be included in performance calculations, but the investor should notice the increase in portfolio value over time.



One emerging theme seems to be investing heavily in private equity. As we've mentioned before, there seem to be too many dollars chasing too few good deals. An accepted definition of a "good deal" is making two to three times your money in a reasonable time period, say five to seven years. The last economic downturn, in 2008, lengthened that time period to ten years or more. What's the latest trend? The latest trend is to move the goal posts and shoot for "a few percentage points more than corporate and government bonds pay"[3] as a return. The large private equity firms are diversifying into "lower-yielding but steadier businesses."[4]

[1] WSJ, 6/7/21

[2] WSJ, 4/17-18/21

[3] WSJ, 5/3/21

[4] WSJ, 5/10/21

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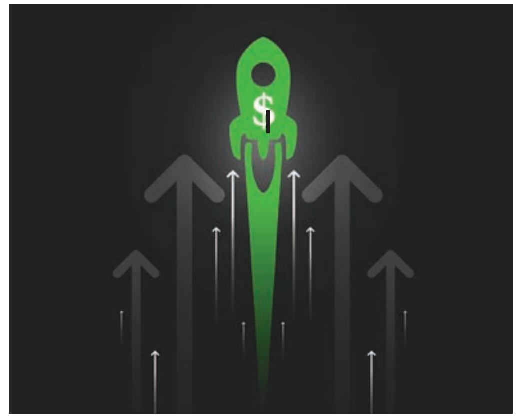
They are evolving from private equity firms to "broader alternative asset giants" "catering primarily to insurance companies looking to park reams of cash from selling retirement-savings products known as fixed annuities." [5]

Some of you may have noticed recent changes at Woodstock. We've welcomed back Ben Dawson as a portfolio manager, with Ben returning after 25 years of running his own investment management firm. All of our managers bring their unique perspectives on investment management to Woodstock and to their clients. Ben's will be on display on our website videos as we add his commentary over the next few months. Also, we have promoted from within. David Layden has become a part-time investment manager while still fulfilling responsibilities as head of our custody operation. David completed his MBA in finance and business analytics at Babson during his employment at Woodstock. Finally, on June 30, assets under management at Woodstock passed the $1 billion mark. While we have been here before, 20 plus years ago, the current team has built our clients' assets up the hard way: 10% inspiration, 90% perspiration. We thank them for their efforts and thank you for your business.

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.

[5] *WSJ, 5/3/21*



Remember Normal? Economy Reaccelerates at Full Tilt

Adrian G. Davies, President

"A Bloomberg survey of economists expects US real GDP to grow a robust 6.6% this year and 4.1% next."

With the pandemic subsiding and economic growth reaccelerating, a Bloomberg survey of economists expects US real GDP to grow a robust 6.6% this year and 4.1% next. The economy (as measured by real GDP) is expected to have surpassed its pre-pandemic peak in the second quarter of 2021. The S&P 500 Index returned a strong 14.4% through the first half of the year to close at a record high. Pent-up demand and federal stimulus funds have meant that demand for goods and services has recovered much faster than supply. Businesses can't hire workers fast enough and they're struggling with supply chain bottlenecks. Strong economic conditions drove the Consumer Price Index (CPI) up 5.4% year-over-year in June, following up 5.0% y/y in May. While many economists had been expecting some inflation, these inflation statistics were higher than most of them, including many Fed officials, anticipated.[1] The CPI excluding food and energy was up 4.5% y/y in June, reaching its highest level since 1991.

"Strong economic conditions drove the Consumer Price Index (CPI) up 5.4% year-over-year in June."

The capital markets already seem to have taken the brunt of recent high inflation statistics in stride. Reasoning that the burst of inflation is primarily caused by the sudden economic reopening compared to depressed year-ago prices, coupled with temporary stimulus measures, Federal Reserve

[1] *Nick Timiraos, "Fed's Powell Concedes Anxiety About Inflation but Resists Policy Shift," Wall Street Journal, 7/16/21*

“Chairman Jerome Powell has described the inflation as transitory.”

“Beyond 2022, we expect US real GDP growth to settle back to where it was before the pandemic.”

“Initial pandemic stimulus reflected rare Congressional bipartisanship in the face of certain calamity.”

Chairman Jerome Powell has described the inflation as transitory. At present, real bond yields, that is, bond yields after deducting inflation, are negative. If bond investors expected higher inflation to continue, bonds would most likely be priced to incorporate the expected loss of purchasing power, although negative real yields also likely reflect an abundance of money in the financial system. While inflation could still grind down investors' enthusiasm, it is most likely on a decelerating, manageable trend. According to one analysis, 55% of the increase in the June CPI came from products and services that have been lifted by short-term supply-demand imbalances.[2] These include used cars, lodging, airfare, and food away from home. That still leaves 45% of the increase stemming from other sources. A one-time change in price levels is probably manageable — inflation would become more problematic if it persisted. The pace at which inflation comes back down and where it settles remain open questions, however.

Beyond 2022, we expect US real GDP growth to settle back to where it was before the pandemic. The inflation rate over the next 10 years will probably be higher than it has been over the last ten, but not by much. Apart from the temporary factors driving inflation higher in the near term, many market observers look to changes in fiscal and monetary policy as reasons why inflation may be structurally higher in the years ahead. Attitudes towards fiscal and monetary policy have changed in recent years, but even so, we don't think government policy will keep inflation at levels that would be problematic for the economy or for markets.

Attitudes Towards Fiscal and Monetary Stimulus Have Changed

As can be seen in the chart on page 4, Federal deficits have increased either by increasing spending or by reducing taxes under almost every US president since Truman. The Obama administration ran annual deficits of up to $1.5 trillion a year to help the US recover from the Great Financial Crisis of 2008-2009. Operating deficits had been reduced to $500-$600 billion by the end of his tenure, only to be driven back towards $1 trillion under President Trump.

The COVID-19 pandemic saw fiscal spending bills totaling about $6 trillion beyond the country's operating budget, mostly to be spent over a two- to three-year window to backfill lost economic activity. According to the Congressional Budget Office (CBO), the federal deficit is expected to hit $3.0 trillion this year, but then drop significantly, averaging $1.2 trillion a year from 2022 to 2031.[3] The CBO projections take into account enacted legislation, but do not factor in any legislation under consideration.

The heightened level of deficit spending certainly reflects a new attitude, emboldened by the deficit spending over the prior ten years which, despite much anxiety, did little to raise inflation, threaten the federal government's credit worthiness, or undermine confidence in the value of the US dollar. US Treasury yields remain well below their average levels of the past ten years, and the US Dollar Index remains above its average rate over the past ten years.

Initial pandemic stimulus reflected rare Congressional bipartisanship in the face of certain calamity, conditions which are less likely to recur under more normal economic conditions. The latter part of the $6 trillion in economic stimulus, some $1.9 trillion, occurred under unified Democratic leadership of Congress and the presidency. Most political prognosticators see the Democrats losing at least one house of Congress in 2022, making increased deficit spending that much less likely at least in the near term. President Biden may get an infrastructure bill through Congress, but even so, the bill is likely to call for an increase in spending of $200 billion or so per year over 10-15 years -- significant, but not on the order of magnitude prescribed over a short period to address the pandemic. Despite a greater tolerance for deficit spending in Washington, political tensions are likely to act as a constraint on further spending, at least until the next economic crisis.

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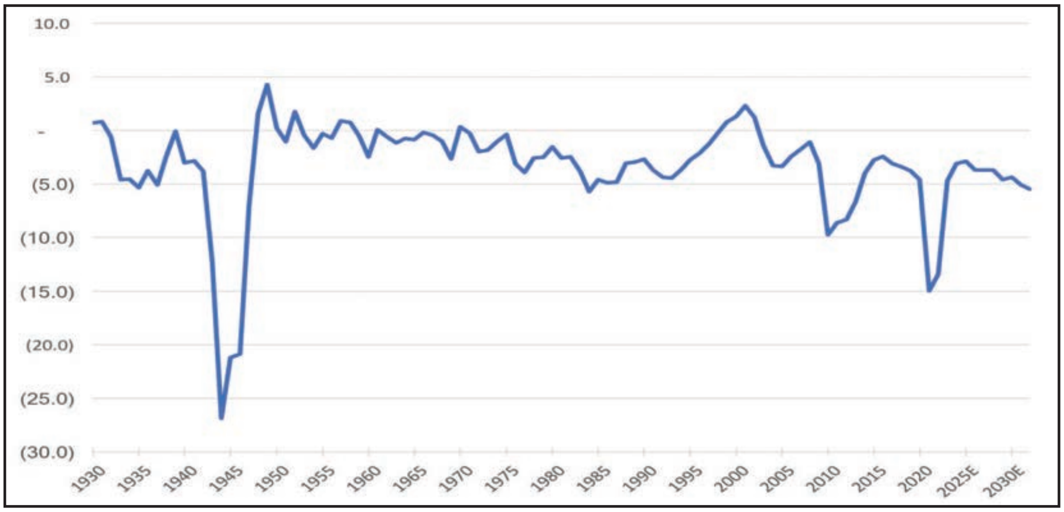
[2] *Andrew Husby and Eliza Winger, "US React: CPI Details Mean Fed Clings to 'Transitory' View," Bloomberg Intelligence, 7/13/21.*

[3] *Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2021 to 2031," July 2021.*

"US money supply (M2) grew much faster during the pandemic than during previous quantitative easing implementations."

"Notwithstanding the COVID-19-related market dive and recovery, the retraction of both fiscal and monetary stimulus over the next few years increases the likelihood that markets will become more volatile."

US Federal Deficit as a Percentage of GDP



Source: St. Louis Federal Reserve; Projections: Congressional Budget Office

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Attitudes towards monetary stimulus have shifted as well, and for the same reasons they have shifted regarding fiscal stimulus. During the Great Financial Crisis and its aftermath, many economists and market participants were concerned that the Fed's Quantitative Easing (QE) programs would spur runaway inflation. When QE didn't lead to significant inflation, and inflation even chronically undershot the Fed's own target of 2%, observers became much more comfortable with easy monetary policies.

US money supply (M2) grew much faster during the pandemic than during previous quantitative easing implementations. Higher M2 growth may forebode higher inflation but it is already receding. Money supply growth peaked at +27.6% y/y in February and came back down to +13.0% by the end of May.

The Monetary Road Ahead

Anticipating further improvement with economic growth reaccelerating, the Fed is looking to when it should begin reining in its ultra-loose monetary policy. The $120 billion worth of Treasury and mortgage-backed securities the Fed is buying every month has contributed to excess liquidity in the financial system. Tangible signs of excess liquidity at present include: high valuations of stocks, the aforementioned negative real bond yields, the lowest yield spreads on corporate bonds since 2007,[4] average home prices increasing 14.6% over the past year,[5] a heavy Initial Public Offering (IPO) calendar, the proliferation of Special Purpose Acquisition Corporations (SPACs), the return of day traders, meme stocks, cryptocurrency trading, and the rise of non-fungible tokens (NFTs).

Dallas Federal Reserve Bank President Robert Kaplan, one of the more hawkish Fed officials, recently had this to say on the matter: "One of the things that comes with these extraordinary monetary-policy actions is the positive effect on financial assets. It's also the reason why, as you emerge from the crisis, you want to wean off these extraordinary actions sooner than later."[6]

Notwithstanding the COVID-19-related market dive and recovery, the retraction of both fiscal and monetary stimulus over the next few years increases the likelihood that markets will become more volatile. In the past, tightening monetary policy, or even reversing loose policy, has been a high-wire act. While the Fed was eventually able to end its QE programs and raise the federal funds rate after the Great Financial Crisis, it wasn't able to do so without creating some market

[4] *"Karen Pierog, "US Corporate Junk-bond Spread Narrows, Lowest Since 2007," 6/18/21, Reuters.*

[5] *Nicole Friedman, "US Home-Price Growth Rose to Record in April," Wall Street Journal, 6/29/21*

[6] *Lisa Beilfuss, "Dallas Fed Chief Robert Kaplan on Why the Fed Should (Slowly) Back Off," Barron's, 7/9/21.*

"At least since 2000, inflation has not been as much of a problem for the stock market as the Fed's anticipatory tightening actions have been."

"After each of these attempts to tighten monetary policy, the stock market moved on to new highs — why we generally recommend investors stay invested."

"Confident that it can maintain stable price levels, the Fed had pivoted to focus more on its other mandate, maximizing long-term employment."

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turbulence. The Fed's second and third QE programs in 2010 and 2012 were initiated in part because the expiration of the prior QE programs led to stock market softness. In June 2013, then-Fed Chairman Ben Bernanke suggested that the Fed would taper its third round of QE in what has since been referred to as the market's "taper tantrum." The S&P 500 fell 4.8% and the 10-year US Treasury yield jumped from 2.18% to 2.54% over the ensuing days. Bond investors accepted the Fed's thesis that the economy was strengthening, warranting higher long-term rates.

The Fed began raising the federal funds rate under Chair Janet Yellen in December 2015. Although the first rate hike in nine years was well telegraphed, the Fed also provided guidance in December that it expected to raise rates four times during 2016.[7] The S&P 500 fell 9.2% over the ensuing two months. This time bond investors also took a skeptical view, interpreting the Fed's tightening as bearish for the economy, and driving the yield on the 10-year US Treasury down from 2.22% to 1.66 percent.

The Fed started Quantitative Tightening under Chair Yellen in October 2017 letting $10 billion dollars' worth of bonds on the Fed's balance sheet mature each month without replacing them. The plan, implemented as chairmanship transitioned to current Chairman Jerome Powell, gradually increased the maturing amount to $50 billion a month. By the fourth quarter of 2018, topped off with a quarter-point interest rate hike in December, the stock market had had enough of the tightening, tumbling 13.5 percent. The bond market concurred that the Fed's plan was overly aggressive, with the 10-year US Treasury yield falling from 3.05% to 2.68% in the fourth quarter and starting a much longer drop. The Fed relented, stopping its rate increases and its program of letting bonds roll off its balance sheet.

Through past interest rate cycles, fear of inflation has motivated the Fed to raise rates. At least since 2000, inflation has not been as much of a problem for the stock market as the Fed's anticipatory tightening actions have been. The Fed has continuously learned to

take a more measured approach to tightening, and is learning to communicate better their intended adjustments well in advance. They further seem to have learned that greater tolerance for inflation could lead to more stable monetary policy. After each of these not-well-coordinated attempts to tighten monetary policy, the stock market of course moved on to new highs, offering examples of why we generally recommend investors stay invested.

A Mid-Course Correction

Confident that it can maintain stable price levels, the Fed had pivoted to focus more on its other mandate, maximizing long-term employment. The Fed is still looking for the economy to recover a further 6.8 million jobs lost during the pandemic. Most economists believe that looser monetary policy – "letting the economy run hot" -- will help stimulate the economy and employment. Since the Fed had shifted the emphasis of its policy objectives however, it has been unclear how the current Fed would prioritize its potentially competing mandates.

[7] *Kate Davidson, "Economists React to the Fed's Interest-Rate Decision: 'When is the Next Hike?'" Wall Street Journal, 12/16/15.*

"With inflation statistics coming in higher than they expected for April and May, Fed officials wanted to communicate that they remain attentive to their inflation-fighting mandate."

"As economic growth slows, inflationary pressures are likely to come off the boil."

"Our expectations for a return to modest growth suggest longer-term interest rates will also stay fairly low."

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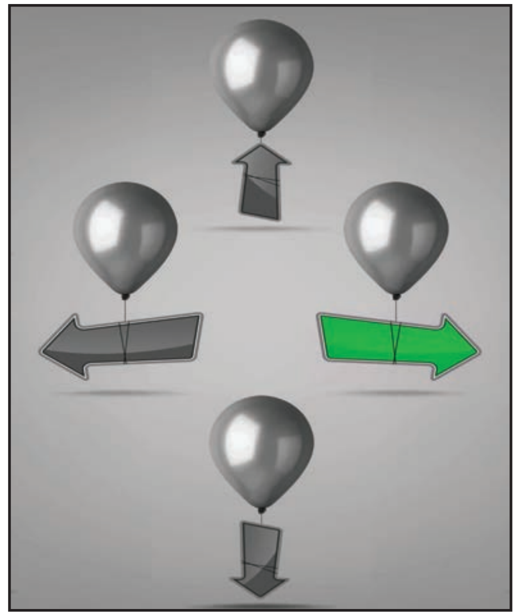
In June, the Fed made a course adjustment. With inflation statistics coming in higher than they expected for April and May, Fed officials wanted to communicate that they remain attentive to their inflation-fighting mandate. The Fed released guidance suggesting they might increase interest rates twice in 2023 – that's earlier than what Fed officials had previously communicated and earlier than most observers had been thinking. Bond yields fell on the realization that the Fed would be more willing to sacrifice economic growth in order to maintain price stability than previously believed. Starting the year at 0.92%, the 10-year US Treasury yield rose to 1.75% in the first quarter, before falling back to 1.44% through mid-year despite the high inflation statistics being reported. The course correction succeeded in reminding investors that at least some Fed governors intend to prioritize fighting inflation.

Staying Invested

Supply shortages will extend economic growth, while the reopening of other nations' economies will keep upward pressure on both global demand and prices. At the same time, the satiation of pent-up demand and the exhaustion of fiscal stimulus are reasons US economic growth will slow from its current high pace. As economic growth slows, inflationary pressures are likely to come off the boil. We expect US real economic growth and inflation are likely to be elevated for the next two years, gradually decelerating, with GDP growth settling back to around 2.0% and inflation settling into a range of 2.0%-2.5% beyond that. These expectations are generally in line with the Fed's own forecast for longer-run real GDP growth of 1.8%-2.0% and modestly higher than its forecast for Personal Consumption Expenditure (PCE) inflation of 2.0 percent.[8]

The reduction of both fiscal and monetary stimuli probably also means we are entering a period of greater volatility for markets. Two years is a long time for stock traders, typically an excitable bunch, to remain equanimous. The markets will undoubtedly present surprises along the way. In managing the withdrawal of monetary stimulus, the Fed



may cause some market turbulence, and will adjust its plans as circumstances evolve.

Our expectations for a return to modest growth suggest longer-term interest rates will also stay fairly low. Stock investors are familiar with this environment, and it has been favorable for stocks. Stock valuations may stay at elevated levels.

Larger disappointments along the path to stable growth would likely prompt further fiscal and monetary support. The general popularity of the fiscal measures taken during the pandemic assures that they will be used with comparable verve during the next crisis. While economic shortfalls may be inherently deflationary, we know how the Fed responds – they add reserves to the banking system. The government's more active role may induce somewhat greater long-term inflation. As we've just experienced recovering from the COVID-19 pandemic, these episodes can still offer particularly rewarding opportunities for investors. However the outcome unfolds, investors will likely be rewarded for their patience. We believe staying invested in high-quality stocks is the best way to grow wealth over the long term.

[8] "June 16, 2021: FOMC Projection materials, accessible version," www.federalreserve.gov/monetarypolicy/fomcprojtabl20210616.htm

Tax Update:
Tax Planning in an Unsettled Regulatory Environment

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

We've heard from our portfolio managers that some clients are asking about tax planning in an unsettled regulatory environment. News reports of changes to US tax laws cover a wide range of proposals -- too many and at too early a stage to meaningfully discuss planning and tactics. Congressional and Treasury staffs are fully aware that for corporate taxes and wealthy citizens, whatever is passed (the statutory rate) "is illusory because it is manipulated by a phalanx of tax lawyers and accountants," resulting in significantly lower "effective" tax rates[1] and thereby funds received by the US Treasury.

General taxation rules of thumb or guidelines are also difficult to use. Capital gains changes are in the news and rates appear to be headed up. The advice to sell appreciated assets now at lower rates is contrary to one of the most effective tax strategies: never pay a tax early, if you have a choice. The last successful effort to entice taxpayers to pay early is Roth conversions, which, after paying ordinary income tax rates on the conversion, can grow tax free with tax-free payouts at times far into the future. Current publicity around "super-sized" Roth IRAs and suggested changes by current Congressional committees[2] make the current Roth structure appear to be "too good to be true." The willingness of legislators to change the rules around distributions from traditional IRAs to prevent multigenerational IRAs beyond ten years ended a widely used estate planning tool and showed a government's willingness to eschew precedent to the detriment of taxpayers.

"Capital gains changes are in the news and rates appear to be headed up."

As we've mentioned in the past, anyone's basic tax and generational planning should include those items that require no paperwork to be filed. The annual gift tax exclusion of $15,000 to any number of recipients requires no paperwork. Gifts to the same person from both spouses require no paperwork, if made from each separately. An investment account grows relatively tax free if turnover is low and it is invested in growth stocks. If the account stays out of the "retirement assets" bucket, then it avoids the conversion of capital gains to ordinary income at withdrawal. A wealth tax is a tax levied on the net fair market value of a taxpayer's assets, perhaps annually. A wealth tax would be tied to "ownership of assets." Creating a trust for a portion of assets transfers ownership to trustees from the grantors, thereby potentially putting the grantors under the threshold for the wealth tax.

"As we've mentioned in the past, anyone's basic tax and generational planning should include those items that require no paperwork to be filed."

Because we don't know what will finally be proposed, we need a method to orient ourselves to a world where government makes a forced extraction of assets from citizens annually, quarterly and every paycheck.

Perhaps the best way to become oriented is to be informed by the newspaper editor's code. A newspaper story describing the who, what, when, where and how effectively describes a situation to a reader.

1. Who is the taxpayer? (Key: ownership)
2. What kind of income? (Ordinary vs. capital gain)
3. When to recognize? (If at any time)
4. Where? (The US taxes worldwide income; other countries don't.)
5. How? (The US Internal Revenue Code, as manipulated by Congress and the IRS)

Lowering tax rates, perversely, raises more revenue for the US Treasury and creates the compliant US tax base that politicians claim to want. Raising rates, changing the rules of the game arbitrarily, and creating the uncertainty of constant change are not the ways a sophisticated government should raise the funds it needs. Let the games begin!

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

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[1] *WSJ Letters, 7/13/21*

[2] *WSJ, 7/3-4/21*

We at Woodstock hope you
and your family are enjoying a happy and
healthy summer!

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.**