WOODSTOCK

Quarterly Market Perspectives

SUMMER 2022

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

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Wall Street Catches Up

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Technology is allowing an investment strategy that was previously available mostly to high-net-worth clients to now be mass marketed: a customized portfolio can be offered to every client. Compared to a passive portfolio invested in pooled investments products, "direct indexing" seeks to mimic an index by owning all, or a representative portion, of the stocks in the index, individually. The next step to "custom indexing" allows the broker and the client to pick and choose those stocks from the index to invest in and hold.[1] The new products introduce the concept of tax-loss selling and its benefits to a wider audience. Not too long ago, Wall Street had suggested tax law changes to Congress which would have curtailed tax loss selling generally. Hopefully, the new push to mass market custom indexing will prevent that from recurring.

One of the criticisms of the new trend is that retirement plans don't benefit from tax-loss selling because they are tax free or tax agnostic until withdrawal. However, most retirement plans convert capital gains not taxed while accounts are growing into withdrawals 100% taxed as ordinary income. Clients and planners may decide that something less than 100% of savings going into retirement plans is actually a sound financial decision if their taxable accounts can use tax-loss selling. A taxable account invested for growth minimizes current taxable income at ordinary rates and pays capital gains tax rates all the way up to and through retirement, a benefit that planners and their clients may appreciate.

Although it has taken awhile to develop, a custom indexed portfolio is a Woodstock account. Drop the number of stocks from several hundred to 35–45, use tax-loss selling to offset much of the fee, add some very sharp-minded portfolio managers to position the portfolio, and you are on the cutting edge—and actually, you have been. The customization of direct indexing is expected to "be the key driver across wealth and asset management over the next decade, even more so than alternative investments and digital securities."[2]

A Shrinking Public Market Pool

Where do we see concerns? The size of the public market is shrinking. According to one source, "there are only 2,600 public companies with annual revenues greater than $100 million. That's a small slice of corporate America, where there are 17,000 private businesses of that size."[3] According to another source, "4,000 companies issue public stock that trade actively." Five hundred companies make up 80% of that market value. Another 10,000 companies trade over the counter.[4] Government may overregulate the markets, the markets themselves generate intense pressure on managements of public companies, and competition within industries is fierce. Investors interested in participating in the American dream should be advocating for government to support our public markets, rather than handicap them.

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[1] *Ryan W. Neal, "The Customization Revolution," Financial Planning, March 2022, p. 28.*

[2] *Ibid., p. 31.*

[3] *Josh Vail, "What 'Private for Longer' Means for Investors," Investment Advisor, March 2022, p. 39*

[4] *Jeffrey C. Hooke, The Myth of Private Equity, 2021, p. 41.*

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"The private markets present some issues for investors wanting to participate in them. According to one source, 'wealthy individuals are a new, and mostly untapped source of capital' for the private equity industry."

"The problem with mass marketed private equity is that there are just not enough good deals to go around."

The private markets present some issues for investors wanting to participate in them. According to one source, "wealthy individuals are a new, and mostly untapped source of capital" for the private equity industry.[5] Previously, the industry has mostly been selling to US public pension plans,[6] but this source of funding may be facing "over-exposure" to this asset class, hence the need to find other sources of funds. A critic of the private equity industry suggests some solutions or guardrails for the industry. Because the debt piled on purchased companies in a private equity investment vehicle sometimes carries provisions for payments out of earnings, he suggests a more aggressive classification of that debt as preferred stock by the IRS, thereby decreasing the interest expense deduction. Reducing tax deductibility would effectively limit the use of debt, overuse of which can be harmful to portfolio companies.

Too Much Money Chasing Private Equity

The critic also suggests improving performance reporting: "year-to-year returns are heavily reliant on managers' estimation of the value of portfolio companies, most of which are unsold even after holding periods exceeding five years."[7] This brings us to the shorthand version of performance reporting that he likes, TVPI or total value to paid in. He describes a goal of 2.0, to which we'd add a time limit of "over a reasonable time period" and expand to "two or three times your money." Some of our readers will recognize this standard, as we've used it in the past in QMP articles. The problem with mass marketed private equity is that there are just not enough good deals to go around. There is too much money being raised and an historic industry TVPI of less than 1.5 over an extended time period illustrates that fact.[8]

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] *Wall Street Journal*, 7/6/22.
[6] *IWall Street Journal*, 5/27/22, B9.
[7] *Jeffrey C. Hooke, ibid., p. 89.*
[8] *Ibid., p. 89.*

"The first half of 2022 was the worst first half for stocks since 1970 and the worst six months for bonds since 1980."

"Because the Fed was reluctant to raise interest rates when inflation was rising through 2021, it now finds itself behind the curve."

"Fed officials are prioritizing controlling inflation over economic growth—they are willing to risk a recession in order to get inflation back under control."

A Difficult Period for Stocks

Adrian G. Davies, President

The first half of 2022 was the worst first half for stocks since 1970 and the worst six months for bonds since 1980.[1] The S&P 500 Index returned -20.0% while the iShares US Core Aggregate Bond ETF returned -10.2 percent. The 10-year US Treasury finished June yielding 3.02%, double the 1.51% at which it began the year. Reversing much of the stock market's strong performance in 2021 (+28.7%), stock price levels returned roughly back to where they were in March 2021. Stocks are trading at cheaper valuations now. Markets have been rocked not only by runaway inflation, but also by the Fed's prescription to rein it in.

The Consumer Price Index (CPI) continued its march higher, up 9.1% year-over-year in June, and up 5.9% excluding food and energy, their highest rates in 40 years. The Federal Reserve is seeking to rein in inflation by tightening monetary policy, which will slow economic growth probably to the extent that it causes a recession, as our colleague Bob Sanders discussed in our last Quarterly Market Perspectives (see QMP Spring 2022). Even as the Fed tightens and economic growth slows, we expect inflation to stay relatively high through the end of the year. Unfortunately, this is not a good backdrop for equity appreciation. Investors will need to gain confidence that inflation is subsiding and that the Fed will end its tightening program. Also, importantly, the expected recession is likely to bring down earnings estimates. It's hard to see stocks making meaningful headway until investors see that earnings revisions are stabilizing.

Inflationary Pressures Will Diminish

The rate of inflation depends significantly on the strength of the economy. With US gross domestic product (GDP) growing 5.7% last year, its fastest real growth rate in 37 years, inflation perked up. While we did not expect inflation to rise as much as it has, we now expect it to decline gradually from its current high level. The Federal stimulus programs enacted in 2020 and 2021 to counteract the pandemic have mostly been exhausted, suggesting consumer spending will moderate. Many companies laid off employees and scaled back capacity during Covid-19, leaving them ill prepared for the snapback in demand. Given time, they will hire back and expand capacity as needed.

Multiple waves of Covid-19 outbreaks have extended manufacturing supply chain snarls, but these bottlenecks are gradually easing. The war in Ukraine has been a further shock to the global economy, driving shortages of key commodities, particularly oil, steel, and wheat. Inflation has become an issue beyond our borders as well—it's running at 8.6% in the Eurozone, driven by a 42% increase in energy prices.[2] The European Union was grappling with an energy crisis even before Russia invaded Ukraine.

The Fed Is Willing to Risk a Recession

Because the Fed was reluctant to raise interest rates when inflation was rising through 2021, it now finds itself behind the curve. Inflation has gotten out of control, and the Fed is rightfully committed to bringing it down. The Fed has been tightening policy aggressively, raising the fed funds rate at the fastest pace since the 1980s, from a range of 0.0%-0.25% as recently as March up to 2.25%-2.50% at present. In addition to hiking rates, the Fed started quantitative tightening in June, shrinking its balance sheet by $47.5 billion worth of bonds per month, on its way to $95 billion per month starting in September.

Fed officials are prioritizing controlling inflation over economic growth—they are willing to risk a recession in order to get inflation back under control. That Fed officials are so focused on bringing inflation down makes it likely that they will tighten monetary policy too much. When asked at a June press conference about the risk of tightening too much, Fed Chairman Jerome Powell replied, "Is there a risk we go too far? Certainly there's a risk. The bigger mistake to make ... would be to fail to restore price stability."[3]

[1] James Mackintosh, *"Markets Had a Terrible First Half of 2022. It Can Get Worse." Wall Street Journal, 7/2/22.*

[2] *Paul Hannon and David Harrison, "Cooling Demand for Goods Threatens to Turn Pandemic Boom Into Bust – 2nd Update," Dow Jones, 7/1/22.*

[3] *Nick Timiraos and Tom Fairless, "Powell Says Fed Must Accept Higher Recession Risk to Combat Inflation," Wall Street Journal, 7/29/22.*

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Previously, Powell had elaborated, "What we need to see is clear and convincing evidence that inflation pressures are abating and inflation is coming down. ...If we do see that, then we can consider moving to a slower pace [of rate hikes]."[4]

The Fed's official line is that it can achieve a "soft landing"—reducing inflation without causing a recession. We and many others are skeptical this can be accomplished. According to CNBC reporter Nathan Lee, "Every recession but one since World War II has seen an inflation hike right before the downturn. And nearly every recession since World War II has seen the unemployment rate fall to 5% or lower [before the recession]."[5]

Unemployment is hovering just above a 68-year low, at 3.6%.

History Lessons

There have been at least nine times in recent history where raising rates led to recessions. In his attempt to justify the strategy, Chairman Powell cited three instances when the Fed embarked on rate-hiking cycles which did not cause recessions: 1965, 1984, and 1994. But in none of these cycles did the CPI exceed 5%, making the possibility of pulling off a soft landing under the current conditions all the less likely. In the first two instances cited, the federal funds rates started and remained well above the CPI. There was a brief period in 1993 when the CPI exceeded the federal funds rate, but throughout 1994 the federal funds rose to exceed the CPI by 2.8 percentage points. That compares to a gap of 6.7 percentage points, inflation exceeding the funds rate, at present (see Figure 1).

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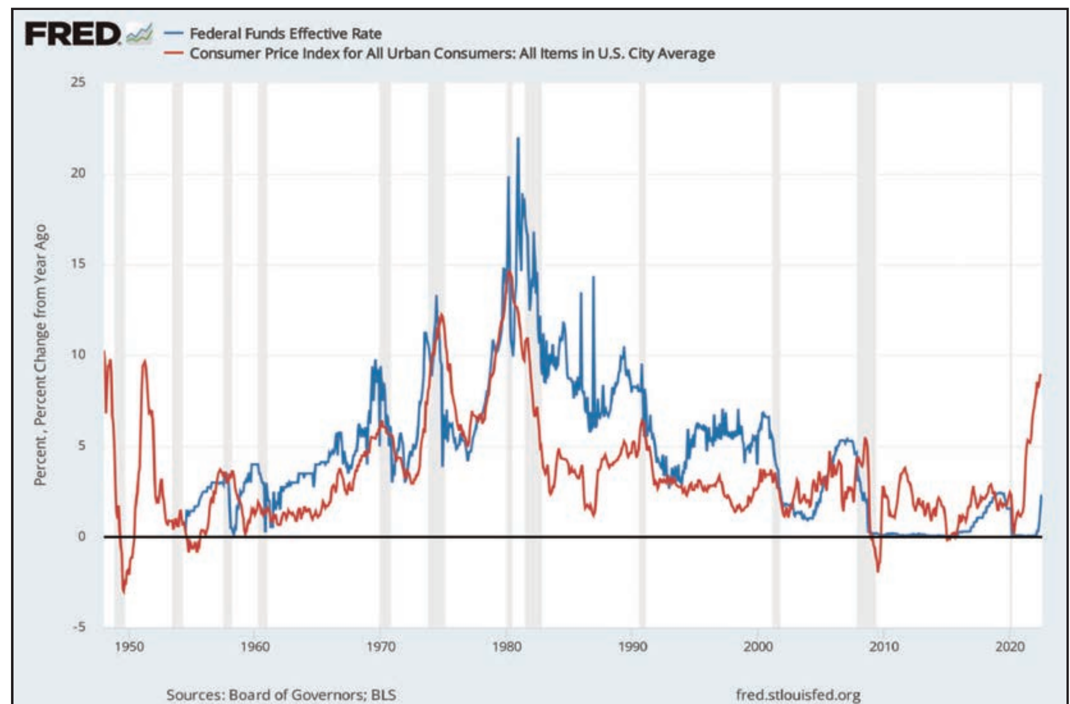
"Historically, short-term bond yields exceeding long-term bond yields has been a fairly good indicator that a recession is coming, with the condition having occurred before each of the last six recessions."

Figure 1. Fed Funds Rate and Consumer Price Index



Historically, short-term bond yields exceeding long-term bond yields has been a fairly good indicator that a recession is coming, with the condition having occurred before each of the last six recessions.[6] Short-term bond yields are currently higher than long-term bond yields.

While interest rate hikes have an immediate

[4] *"Transcript: Fed Chairman Jerome Powell at the WSJ Future of Everything Festival," Wall Street Journal, 5/17/22*

[3] *Nathan Lee, Video: "Economists Say Recessions May Be Inevitable. Here's Why, cnbc.com, 6/15/22.*

[3] *Michael S. Derby, "Derby's Take: Fed's Bullard Says Yield-Curve Signal Might Not Be So Ominous," Wall Street Journal, 7/19/22.*

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> *"Higher rates will further dampen demand for renovation and new building construction as existing projects are finished."*

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> *"The US and the global economies are already slowing. Concerns of a recession are rising in Europe as well."*

effect on financial markets, they will continue to slow both the economy and inflation for one to two years after they are announced. For instance, the average 30-year fixed mortgage rate went from 3.1% at the beginning of the year to 5.7% by mid-year, impacting home affordability. It will easily take a year or two for the diminished purchasing power of home buyers using mortgages to play out in both home selling prices and sales volumes. Higher rates will further dampen demand for renovation and new building construction as existing projects are finished. The results are only observable after the economic statistics have been compiled. As Fed officials look for confirmation that inflation is conclusively trending lower, the effects of their ongoing tightening efforts will continue to work through the economy. The cumulative effects will continue to play out well after they stop tightening, and will almost certainly be enough to push the economy into a recession.

What could make the coming recession unusual is its predictability. Most recessions are not foreseen. To the extent that individuals and businesses expect a recession, they can prepare for it by reining in spending and fortifying their balance sheets today. Thus, we may be better prepared for the coming recession, making it less harmful.

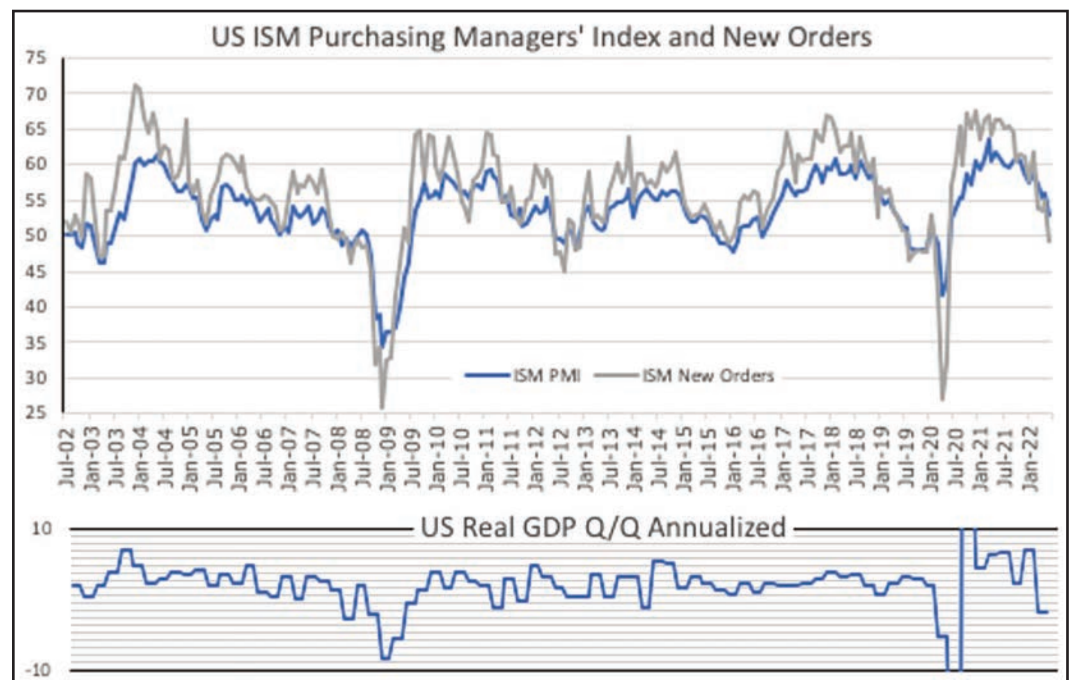
Economic Statistics Start to Turn Down

The US and the global economies are already slowing. Concerns of a recession are rising in Europe as well. High prices are eroding purchasing power and crimping consumer spending, as are interest rate hikes. Higher interest rates and slowing economic growth have both been pressuring stock prices, and will eventually dampen inflation.

US Real Personal Consumption Expenditures (PCE) growth, adjusted for inflation, turned negative in May. Nominal PCE is rising at a brisk pace, but that is only because consumers are paying more for the same quantity of goods and services. Real Personal Income has been declining for five months.[7]

The Institute of Supply Management's (ISM's) Purchasing Managers' Index fell to 53.0 in June, its lowest rate in two years, from 56.1 in May. Any number above 50 indicates expansion, so manufacturing activity in the US is still growing, but from the ISM chart it's evident that growth has rolled over (see Figure 2). The new orders component of the PMI hit 49.2 in June, entering contraction

Figure 2. Purchasing Managers' Index on the Edge of Contraction



Source: Bloomberg, St. Louis Federal Reserve FRED

[7] *Paul Hannon and David Harrison, op. cit.*

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territory, and manufacturing employment also contracted. Orders probably aren't slowing so much because of rising rates but because businesses may have over-ordered in response to supply-chain challenges, and because higher prices themselves may be crimping demand.

Over the year to June 30, the US dollar appreciated 13.1% against the euro, 22.2% against the Japanese yen, and has continued to appreciate against both since then. The strong US dollar is a further drag on the economy, encouraging imports and discouraging exports. Export orders from Asia are declining even though a strong US dollar should stimulate them.

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Inflation May Stay Stubbornly High

On a combined basis, home ownership and rent account for 32% of the CPI and 41% of the CPI excluding food and energy. The S&P/Case-Shiller National Home Price Index was up 20.4% over the year through April, and was up 41.7% since before the pandemic. Home prices are also an important driver of rent. Mortgage and rental agreements set prices for a fixed period of time such that changes in housing costs work their way into consumer spending gradually. The CPI formula is designed to reflect this dynamic. Because the shelter component of CPI, which was up 5.6% in June, is below the headline CPI number, it has actually served to keep the headline number lower than it otherwise would be. But shelter is likely to contribute to the broader index at an elevated rate for at least the next two to three years as current prices are worked into the calculation.

Workers' average hourly earnings are currently rising at a 5.2% clip, supported by strong demand. This strong demand for workers is reflected in the ratio of job openings to job seekers nationwide, which has skyrocketed to 1.9 at present. While workers deserve wages that keep up with the cost of living, many economists believe that if wage growth expectations were to become entrenched, they would contribute to more enduring inflation. The upward pressure on wages is unlikely to let up until the job-openings-to-seekers ratio falls back more in line with the cyclical range depicted in Figure 3. To the extent that the labor shortage has been caused by baby boomers retiring and others permanently leaving the workforce, the labor shortage could even persist through an economic downturn.

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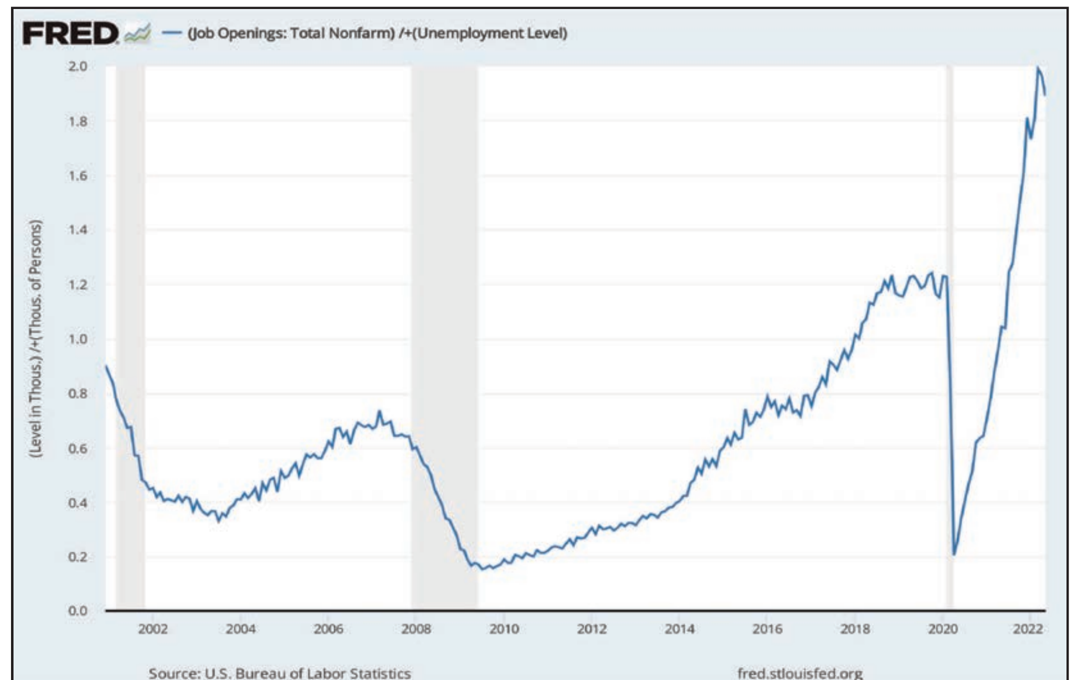
Figure 3. US Job Openings



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Commodity prices have generally come down since May, reflecting traders' concerns of an impending recession, but the war in Ukraine has brought new challenges, specifically heating Europe this winter and coming up with enough agricultural products to feed countries dependent on imports. Commodity prices continue to pose a threat to price stability. With continuing pressures from housing, wages, and possibly commodities, the CPI could linger in the 7%-9% range for several months. We do not believe this range is low enough to dissuade the Fed from continuing its tightening campaign.

A recession would likely have a fairly powerful dampening effect on inflation—the Fed has felt comfortable enough with diminishing inflationary risks to cut interest rates the last twelve times we've been in recessions. However, with inflation unusually high, getting itback under control is likely to be a multiyearprocess. Even in a recession, inflation can stay relatively high. It is unrealistic to expect inflation to get back to the Fed's target rate of 2% by 2023 without a wrenching downturn. How bad the forecast recession gets depends on how zealous the Fed remains. The Fed might stop raising rates as inflation eases, but officials will be reluctant to cut rates until inflation is sustainably lower than the federal funds rate.

Expect the Unexpected

The average peak-to-trough stock market decline during the past eleven recessions has been 26 percent.[8] The market was down 21.1% from its January 3 market peak to mid-year, excluding dividends, a stone's throw from fully discounting an average recession. By this reasoning, we may have reached a market bottom.

However, further consequences of inflation and the tightening cycle may continue to play out. Easy money has accumulated, not just since the Covid-19 pandemic, but at least since the Great Financial Crisis, allowing inefficient businesses to operate and inflated asset prices to persist. To quote Warren Buffett, "You don't find out who's been swimming naked until the tide goes out." The monetary tide is going out. During tightening cycles, idiosyncratic problems often come to light: many companies dependent on outside funding are likely to go bankrupt. We may still be realizing business closures, revaluing assets, and witnessing transaction liquidity drying up for the next several years. Higher interest rates could create problems on a larger scale, presenting challenges to whole industries, markets, and even currencies. We believe high-quality companies should be well protected from these surprises, and may even capitalize on the opportunities they present.

At the same time, macroeconomic news could certainly break to the upside from here. Supply chain problems will eventually be alleviated. China could stop locking down whole cities in their efforts to eradicate Covid-19. Scientists could find a more decisive solution for Covid-19. The war in Ukraine could come to some resolution. Any or all of these developments should be welcome news to investors.

The most positive development for the stock market would be for inflation to subside. The Fed can't rescue the economy until inflation comes under control. Stocks are most sensitive to the uncertainty. It's hard to see them advancing without having greater clarity on the path for inflation and interest rates. When the Fed stops tightening, we may have a better sense of how deep the expected recession will be.

Downturns are an inevitable part of stock investing. Whether the stock market goes up or down over the next several months misses the point. No one knows what path inflation will take, or what will spark the market's turnaround. Well-diversified portfolios tend go up over time, so investors are well served by staying fully invested. We put our faith in high-quality companies to manage through the market turbulence. In addition to making sure your portfolios weather difficult conditions, we are looking to take advantage of attractive valuations afforded by market weakness to position client portfolios for the next bull market.

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[8] *James Mackintosh, op cit.*

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> "Qualified charitable distributions from traditional IRAs have some great advantages to those charitably inclined. When combined with required minimum distributions, depending on the individual situation, they can be used to lower income recognition in any year..."

Tax Update

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

The purpose of our government-directed tax system and the intended and unintended consequences of tax law changes, along with the mechanics of the tax system itself and a particular tax-saving strategy are the focus of this issue's Tax Update.

While large corporate or individual tax increases seem to be off the table at this time, it is worth reviewing the idea that tax rate decreases can actually increase government revenue and increase benefits to individuals even if the changes are made to other than their individual rates. A review of 2017's tax reform effort, the 2017 Tax Cuts and Jobs Act which reduced the federal corporate tax rate to 21% from 35% and liberalized expensing of new equipment investing, shows that it actually delivered both average household real income gains and higher corporate tax revenue, both absolute and as a higher percentage of gross domestic product over the two-year period after passage.[1] The focus on domestic corporate business expansion enhanced worker bargaining power to provide a bigger increase in household real income in 2018 and 2019 than in the previous eight years of a weak recovery (from 2010 to 2017).

Correspondence Audits and Charitable Distributions

Collection of the federal individual income tax starts with the filing of an income tax return with payment and sometimes involves the IRS checking on the accuracy of that filing. This process may start with "computer-generated notices and letters that flag a discrepancy" on the return.[2] This process is called a "correspondence audit" and covers issues such as providing additional backup for certain deductions to taxable interest from a forgotten bank account.[3] More than 70% of what might be called "audits" are correspondence audits. Officially, audit statistics cover "office" audits, where you go to the IRS, or "field" audits, where they come to you. By including correspondence audits in statistics, "the audit rate for taxpayers making $1 million to $5 million in 2016 moved from an official 4.2% to 21.1%," according to the National Taxpayer Advocate.[4]

Qualified charitable distributions from traditional IRAs have some great advantages to those charitably inclined. When combined with required minimum distributions, depending on the individual situation, they can be used to lower income recognition in any year, even when using the standard deduction, as well as "mitigating stealth taxes" based on adjusted gross income, such as Medicare surcharges.[5] Use of this benefit requires the gift to go directly to the charity (not, for example, to a donor-advised fund), be free of any quid pro quo (even a coffee mug), and because the required minimum distribution recognized is reduced by the gift, not taking an additional charitable gift deduction on the return.

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] *Tyler Goodspeed and Kevin Hassett, "The 2017 Tax Reform Delivered as Promised," Wall Street Journal, 5/9/22*

[2] *Lynnley Browning, "Client Under Audit? Here's What Advisors Can Do," Financial Planning, June 2022, p. 37.*

[3] *Ibid.*

[4] *Ibid.*

[5] *Leonard Sloane, "Tax Issues When Giving to Charity from an IRA," Wall Street Journal, 7/5/22.*

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.**