WOODSTOCK

Quarterly Market Perspectives

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

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Trends to Watch in the Year Ahead

William H. Darling, Chairman & CEO

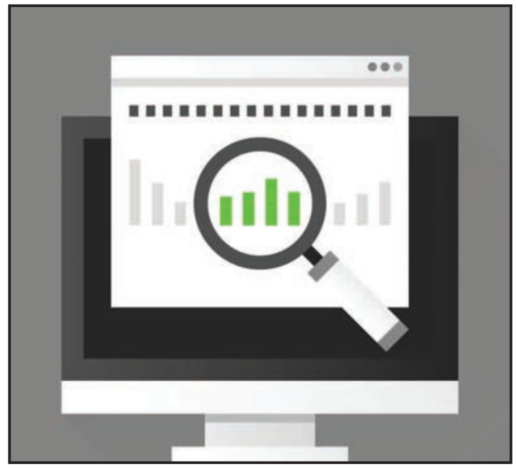
In thinking about what may happen financially and economically over the next several years, we realize that much depends on how countries and their citizens react to medical issues. For perspective, Marcel Proust wrote in 1913: "For, medicine being a compendium of the successive and contradictory mistakes of doctors, even when we call in the best of them the chances are that we may be staking our hopes on some medical theory that will be proved false in a few years. So that to believe in medicine would be utter madness, were it not still a greater madness not to believe in it, for from this accumulation of errors a few valid theories have emerged in the long run."[1]

More current (2020) is the news from Sweden that "two thirds of deaths [from Covid-19] have been among those over age 80 and 97% never received intensive care treatment."[2] The rationing of medical resources appears to be alive in socialized health care systems.[3]

And lastly, a note on the statistical analysis of operational data. An inflation rate of 4% or higher may make up for "inflation that has been running at 2% or less" according to the Fed; however, "managing on averages" is problematic because "one may become blind to what happens in the tails of the distribution."[4] "Applying the Fed's logic, if I show up an hour early for an airplane flight today, it's OK if I show up an hour late next time. On average, I'm on time."[5] If allowed to function, the give-and-take of the free market may allow these truths and perspectives to benefit us all. Or, if not, the result will likely be mismanagement.

Beware of Being on Autopilot

A business associate who now works mostly remotely for a large firm recently commented that his retirement and other savings are invested in low-cost exchange traded funds (ETFs). His plan is on autopilot. Of course, in



a larger sense, "autopilot" is what Boeing thought they had with the problematic Maneuvering Characteristics Augmentation System for their 737 Max aircraft.[6] "The mystery is why the organization (Boeing) let the change (made by Boeing engineers for, perhaps, a narrow reason) flow through without examining every likely or unlikely effect."[7] In a narrow sense, as ETFs grow in popularity and in "flavors," the risks become more evident. In the passive category, "many sober investors have a surprising degree of exposure (to meme stocks) through index funds."[8]

As ETFs evolve in the active management direction, they are picking up some of the same issues facing mutual funds. "About a third of all active ETFs are marked as having a medium to high risk of closure."[9] On performance, "two thirds of large-cap managers of mutual funds have fallen short of their benchmarks this year (2021). While roughly 10% of 371 US active EFTs with full year performance are beating the S&P 500."[10] Pooled vehicles also have the disadvantage of not being able to use tax-loss selling. A recent article tried to quantify the advantage that

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[1] WSJ Letters, 11/18/2021
[2] WSJ Letters, 8/07/2020
[3] WSJ Letters, 8/07/2020
[4] WSJ Letters, 12/10/2021
[5] WSJ Letters, 12/10/2021
[6] WSJ, 10/16-17/2021
[7] WSJ, 10/16-17/2021
[8] WSJ, 11/20-21/2021
[9] WSJ, 12/31/2021
[10] WSJ, 12/13/2021

"Woodstock ends 2021 with performance generally beating our benchmark and assets under management at $1 billion."

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tax-loss selling can bring to a separately managed account, not available to those invested in pooled investment vehicles, such as ETFs and mutual funds, whether active or passive. Using data from 1930 on and "extensive simulations," the authors calculated that tax-loss selling improves an equity portfolio return by 110 to 140 basis points annually.[11] The difference in the fee paid for a passive ETF and a separately managed account at Woodstock is a fraction of this difference, even before the benefits of knowing what you own and that you actually own it are included.

Highs and Lows

As in any year, there were some highs and some lows at Woodstock. Our highs this past year include the health of our staff and the performance they have wrought for our clients. Woodstock ends 2021 with performance generally beating our benchmark and assets under management at $1 billion. Our lows include the surprise retirement of a portfolio manager and our failure to complete the Massachusetts registration of a portfolio manager who recently joined us. We've paid a price for each of these low points but neither persuades us that we're approaching investment management in the wrong way. The old adage in the investment world is that the company goes down the elevator every night and, also, we believe in firm, although fair and reasonable, regulation. Your portfolio manager is aware of all these matters and either I or they will be available to answer any question that you may have about these issues.

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.

[11] *WSJ, 12/06/2021*

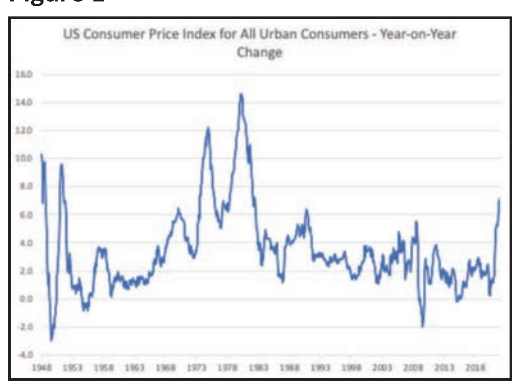
Inflation Presents a New Challenge

Adrian Davies, President

The S&P 500 Index returned 28.7% in 2021, following a 18.4% return in 2020, and a 31.5% return in 2019. Observers would be forgiven for not associating any of these returns with a two-year global pandemic. The index has in fact compounded at a 16.6% rate over the last 10 years. Equity investors have rarely had such excellent long-term returns. Last year, economic fundamentals were excellent too, with US GDP expanding 5.7% in real terms, surpassing its pre-pandemic size on a seasonally adjusted basis in the second quarter of 2021. S&P 500 Index earnings fell 13.9% in 2020 before rebounding an estimated 46% last year. The economic expansion and earnings rebound have been greatly helped by monetary and fiscal stimulus.

Perplexingly, financial markets don't seem to care that inflation has been rising, reaching 7.0% year-over-year in December (as measured by the Consumer Price Index or CPI), the fastest rate in almost 40 years (see Figure 1). The core CPI (excluding food and energy) was up 5.5 percent. Inflation has accelerated in other countries, but not to the extent it has in the US. The 10-year US Treasury yield finished 2021 at 1.51%, and most bond yields are well below the rate of inflation, suggesting that bond holders will receive negative returns after taking inflation into account. Low bond yields reflect how loose monetary policy has affected the

Figure 1



Source: Federal Reserve Bank of St. Louis (Federal Reserve Economic Data)

“Indeed, inflation seems likely to fall considering it has been triggered by three forces brought about by the pandemic: fiscal stimulus, supply-demand imbalances, and monetary policy.”

“The Fed increased the size of its balance sheet by $3.3 trillion since the beginning of the pandemic by buying bonds, and in so doing has helped expand the nation’s money supply (M2) by some $6.2 trillion, or 39.8 percent.”

financial markets, but these yields can be justified if inflation falls. Indeed, inflation seems likely to fall considering it has been triggered by three forces brought about by the pandemic: fiscal stimulus, supply-demand imbalances, and monetary policy. Despite the temporary nature of these drivers however, inflation could very well linger. The Federal Reserve is trying to make sure that does not happen.

Three Drivers of Inflation

During the pandemic and its aftermath, the federal government flooded our $22 trillion economy with nearly $6 trillion in stimulus spending. The Covid-19 recession was unique in that while US GDP dropped, personal income increased due to government programs including stimulus checks, supplemental unemployment insurance, and emergency rental assistance. These fillips succeeded in reviving the economy, and have arguably been too successful, contributing to inflation. They were always solutions to a temporary problem.

It’s hard to determine the extent to which the stimulus funds have worked their way through the US economic python. Most of the funds have been distributed through direct transfers; other funds remain in government accounts yet to be spent. Beyond government coffers, the spending has a multiplier effect as it ripples through the economy: Person A’s spending becomes Person B’s income, which is then spent generating income for Person C, and so on. Despite this multiplier effect, we cannot borrow and spend our way to prosperity. Such a proposal would require ever-increasing amounts of borrowing -- debt holders would eventually lose confidence in our government’s ability to repay. The stimulus ripples will fade, and the US government seems unlikely to pass additional large spending bills at this point.

With the help of federal largesse, demand for goods and services has recovered much faster than supply. Reluctant to spend on restaurants, travel, and live entertainment, consumers channeled their financial resources into their homes, cars, and consumer electronics. At the same time, business managers, expecting the Covid-19 recession to resemble the 2008-2009 recession, scaled back capacity and were caught off guard by the strong recovery in demand that ensued. Supply of many services has been further constrained because people have left the workforce, either because of Covid-19 or just because they have the financial means to do so. A number of choke points have appeared in supply chains, semi-conductor production being one.

A queue of over a hundred container ships outside the ports of Los Angeles and Long Beach is another often-cited example of supply chain constraints.[1] While the pandemic has limited supply chain throughput, the shipping queue also reflects the ports’ challenges dealing with record volumes of containers. Container shipments through the ports of Los Angeles and Long Beach, responsible for 40% of the nation’s total, grew 17.9% in 2021, accelerating from 1.9% growth in 2020.[2]

Monetary policy is a third factor driving inflation higher. The Fed increased the size of its balance sheet by $3.3 trillion since the beginning of the pandemic by buying bonds, and in so doing has helped expand the nation’s money supply (M2) by some $6.2 trillion, or 39.8 percent. With more dollars available, each dollar is worth less. Prices of goods and services have been bid up. Asset prices have also been bid up, helping Woodstock’s clients.

[1] Paul Berger, “Southern California Ports Struggle to Trim Cargo Backlog as Omicron Surges,” 1/11/22, Wall Street Journal.

[2] Jeff Berman, “Port Tracker Report Eyes a Return to Normal for U.S.-bound Import Volumes,” 1/12/2022, www.scmr.com.
Jeff Berman, “Port Tracker Has 2021 Import Volumes on Record Setting Pace,” 12/8/2021, www.logisticsmgmt.com

"...inflation could peak in the first half of 2022 when we anniversary the price increases of early 2021."

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Inflation May Be Persistent

Expecting inflation to peak in the summer of 2021, the Fed's Federal Open Market Committee (FOMC) members described inflation as "transitory" and were initially reluctant to change monetary policy. Frankly, we (I) thought inflation was peaking too. As the pandemic persisted longer than expected, extended by the Delta and Omicron variants, the Fed continued to buy bonds. The variant waves further prolonged supply-demand imbalances and compounded "transitory" inflation.

We expect that there will be additional Covid-19 variants, but we are hopeful that the US is learning to live with the disease. Each successive variant wave has been less detrimental to economic activity. Omicron is milder than prior variants, and with the help of vaccines we ought to be approaching herd immunity. We are hopeful that new variants won't develop in ways that cause further humanitarian disaster or greater economic disruption. We expect supply chain bottlenecks to get resolved, and that both fiscal and monetary support will recede. Given these expectations, inflation could peak in the first half of 2022 when we anniversary the price increases of early 2021.

How fast inflation retreats is another matter. Our major trading partners may take a little longer to normalize their economies. The forces that triggered inflation may not be symmetrical in pushing down inflation as fast as they drove it up. Inflation has its own inertia: if everyone expects inflation to rise, they will demand higher prices. Companies will keep raising prices as long as they can get away with it, particularly when costs are rising and everyone else is raising prices.

The tight labor market is a critical factor constraining the supply of goods and services, and pressuring wages. The unemployment rate fell to 3.9% in December, although this statistic does not include people who have stopped looking for work. There are still some 3.6 million fewer people in the workforce than before the pandemic. Some have permanently retired. Some 70 million baby boomers started turning 65 in 2011. Seeing how many people return to the workforce may be critical to keeping wages -- and therefore inflationary pressures -- down.

Looking at the components of the CPI, inflation has broadened out, with more than 80% of component prices above their 5-year average.[3] This does not bode well for inflation dissipating quickly. The "shelter" component of the CPI, which accounts for almost a third of the overall index, was up 4.1% in December 2021. Even at its highest rate since 2007, this component is helping to keep the broader CPI down. Because rents are repriced as they come up for renewal, realized rates lag spot market rates. One study suggested this component of CPI could be running at 6%-7% by next summer, contributing an additional 0.5 percentage points to the headline number.[4] Rent prices tend to follow home prices, which by some accounts have been rising at double-digit rates.[5]

How Much Will the Fed Tighten?

Even if the pressures that created inflation subside, the Fed needs to break inflation's self-perpetuating inertia by taking an assertive role. In November 2021, FOMC members agreed to taper their program of bond purchases, and in December, they accelerated their schedule. The FOMC further publicized expectations they will raise interest rates three times in 2022, albeit from near zero, and acknowledged they are considering shrinking their balance sheet by allowing the Fed's bond holdings to mature without replacing them.

We can be hopeful that inflation goes back down without causing a recession. Higher interest rates may have only a modest impact in the near term, enabling the economy to remain strong for another year or longer. Seven-percent inflation could itself start to crimp real economic activity. Increasingly

[3] *John Authers, "This Is Broad Inflation. Can It Be Controlled?" 1/13/2022, Bloomberg Opinion*

[4] *David Wilcox, "U.S. Insight: Stealth Threat to Fed Target – Modeling Rent Surge," 12/7/21, Bloomberg Economics*

[5] *S&P Corelogic, "S&P Corelogic Case-Shiller Index Reports 19.1% Annual Home Price Gain in October," 12/28/21, PR Newswire*

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tighter monetary policy will eventually slow economic growth. Both the extent to which monetary policy impacts the economy and the duration over which it plays out are difficult even for the Fed to gauge. Because it can take 12-24 months before the full effects of tightening are felt, the FOMC runs risks of both undershooting and overshooting its policy objectives. Undershooting would allow inflation to stay hot; overshooting would drive the economy into a recession. The Fed does not have a good track record of landing the economy softly. The monetary tightening cycles from 1999-2000 and from 2004-2006 both ended in recessions.

Some investors have the misguided impression that the Fed will use monetary policy to support the stock market. In the 1990s, this interpretation of policy was referred to as the "Greenspan Put." The Fed's two objectives are to control inflation and to try to maximize employment. Boosting asset prices is one of the mechanisms by which the Fed has been able to stimulate the economy. The Fed is not interested in stimulating the economy as long as it is primarily focused on fighting inflation.

We Are Benefitting from Strong GDP Growth

The US economy grew at its fastest rate in 37 years in 2021. Greater inflationary pressures are a consequence of stronger economic growth. The critical questions for the inflation outlook are: (1) how much longer will federal stimulus continue to spur consumption; (2) for how long will the pandemic continue to disrupt aggregate supply; (3) how many people will return to the workforce after the pandemic; and (4) how much will monetary tightening constrain demand?

For 2022, we are hopeful that we will put the Covid-19 pandemic behind us and solve our supply chain problems, unlocking further growth. Business capital spending to address capacity bottlenecks and to improve productivity will drive some economic growth. Even so, growth is likely to moderate from its torrid 5.7% pace, with substantial headwinds stemming from the withdrawal of fiscal and monetary support. Accelerating growth overseas could to some degree offset slowing growth here. While we are optimistic that inflation will moderate, we are concerned it will do so at an attenuated pace, coupled with risks that the Fed may undershoot or overshoot its monetary tightening. Given the uncertainties, 2022 could be a volatile year.

We may make slight changes to your portfolios based on your financial needs, your risk tolerance, and the outlook for individual stocks. From the standpoint of positioning investment portfolios, it would certainly be nice to know the timing and extent of the economic cycle, but we do not recommend making wholesale changes to portfolios based on economic forecasts. In a recent article, Bloomberg columnist Mohamed El-Erian pointed out that even if we had known a year ago that inflation would spike to 7%, and virtually no one did, we probably would not have guessed that the stock market would be up 28.7 percent. The juxtaposition of these outcomes provides an excellent example of why we should remain humble when trying to predict financial markets.[6]

Large portfolio changes would of course generate high tax bills in taxable accounts. In the absence of excellent foresight, we do our best to construct diversified, all-weather portfolios that are prepared for markets behaving like bad winter storms. High-quality companies have pricing power and will figure out how best to manage through these challenges. Stocks generally go up over time, even if the pathway is unpredictable. The only way to benefit from compounding returns is to stay invested in the market. If you have any questions about how the information discussed here pertains to your investments, please call either me or your portfolio manager.

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[6] *Mohamed El-Erian, "Inflation, China Cloud Outlook for 2022," 12/30/2021, Bloomberg Opinion.*

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.

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

Tax Update: Revenue Debates and the State of the IRS

William H. Darling, Chairman & CEO

Jeanne M. FitzGerald, CPA – Tax Manager

Sometimes changes to the US tax code seem like they are "floated" just to stir up money-making opportunities. Interest groups react to proposed changes by contacting, and throwing money at, lobbyists who counsel Congress against or for whatever was floated. There seems to be no recognition that managing the US tax code should be treated as a steering mechanism on a $20 trillion "truck." Care should be taken when operating it, as if even a slight wrong move can send it careening.

In a macro sense, we remind ourselves to review Hauser's Law. In 1993 Mr. Hauser, a San Francisco investment economist, said, "no matter what tax rates have been, in post-war America tax revenues have remained at about 19.5% of GDP."[1] From 1950 to 1993, marginal tax rates ranged from 90% to 28%, but the actual revenue collected by the government was inexplicably constant at 19.5% of GDP. Perhaps, taxpayers adapted. A review of Hauser's Law in 2019 had to adapt itself to a comprehensive revision of the calculation of GDP in 2013, which increased past estimates of GDP. From 1946 to 2018, total tax collections have averaged 16.8% of GDP with a standard deviation of 1.2% of GDP.[2] Still amazing and inexplicable.

In a micro sense, the effort to tax billionaires evidences frustration. An income tax needs to tax income. "An unrealized capital gain is exactly that: unrealized."[3] Instead of realizing income, "billionaires" borrow against appreciated assets to fund personal expenses.[4] This tactic is not without risk. It probably creates an unequal relationship with investment bankers if asset values fall. Elon Musk adopted a more straightforward approach of paying for personal expenses by selling appreciated assets and paying the taxes due. Congress should probably let the give-and-take of the free market convince "billionaires" to pay taxes, rather than try to legislate that behavior.

For the Winter 2020 QMP, we reviewed the state of the Internal Revenue Service (IRS) as reported in its own, but separate, National Taxpayer Advocate's 2018 Annual Report. The most current annual report is for 2021, which covers the fiscal year ending September 30, 2020 (FY2020), over 15 months ago. Some of the Advocate's suggestions for statutory remedies are the same as three years ago: fix the earned income tax credit (EITC) and reduce the complexity of certain provisions that confuse ordinary taxpayers. In advocating for more funds for the IRS itself, it presents a bleak picture, which will be familiar to those who practice before the IRS: "the IRS received over 100 million telephones calls in FY2020, yet employees were only able to answer about 24%. Antiquated information technology systems limit the ability of customer service representatives to effectively assist taxpayers and prevents the IRS from offering fully functional online taxpayer accounts."[5] The IRS operated in FY2020 on a budget of $11.51 billion.

Recently the IRS warned of delays anticipated for the upcoming tax filing season, which is scheduled to run from January 24, 2022 to April 18, 2022. Usually the IRS enters the filing season with about a million pieces of backlogged work from prior years. However, this year "the IRS had six million unprocessed 2020 returns as of December 23, plus 2.3 million unprocessed amended tax returns."[6]

As preparers, we've had a brief taste of having access to the IRS computer files for our clients who grant us permission. Online is wonderful. Investing in IT to bring the IRS online would be acceptable and overdue. It has probably already been appropriated for, but perhaps, misspent. Hiring of more government employees, as recently advocated, makes no sense.

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, 5/20/2008*

[2] *Political Calculations, 1/16/201*

[3] *WSJ Letters, 11/10/2021*

[4] *WSJ Letters, 11/10/2021*

[5] *National Taxpayer Advocate 2021 Purple Book, p. vi*

[6] *WSJ, 1/11/2022*