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Quarterly
FINANCIAL FOCUS

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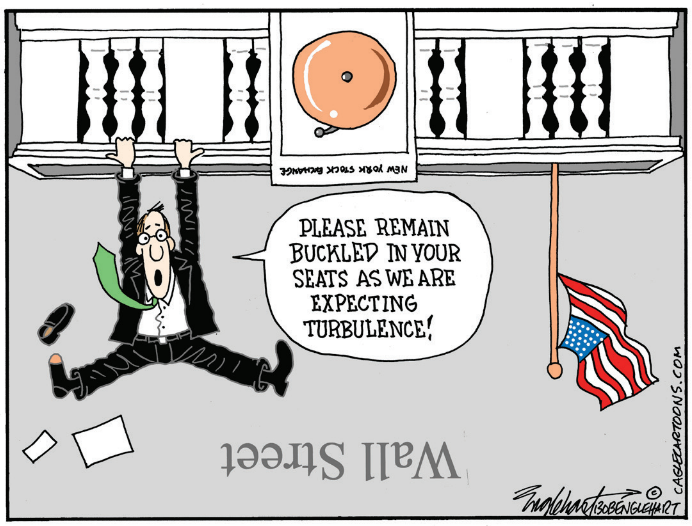
Tactical Moves can Weather the Recessionary Storm



In our last newsletter, we talked about the tall task that the Federal Reserve ("The Fed") faced in trying to engineer a soft landing for the economy. At the time, it seemed possible that the Fed could manage the balancing act of slowing down the economy just enough to tame inflation but avoid a recession. However, just three months (and three bank failures) later, the writing appears to be on the wall for an economic recession ahead.

In this letter, we explore why we are facing recessionary headwinds, what it means for your portfolio positioning, and opportunities to play offense in a defensive market environment.

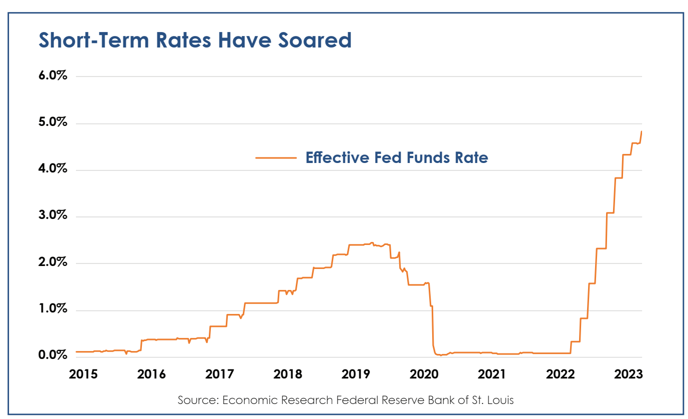
What Goes Down, Must Come Up
– The Story Behind the Recent Rate Rise

Before we can assess where the economy is going, we first need to understand how we got here. The story starts with the dueling nature of the Fed's main objectives of maintaining stable prices and maximizing employment. These mandates often conflict with each other, and thus the Fed's job is to alternate between pushing on the gas pedal and then applying the brakes to keep the economy humming at a steady speed.

A difficult job in normal times, the pandemic introduced a completely new challenge when government lockdowns effectively shut down large swaths of the economy. In response, the Fed took extraordinary measures to stimulate economic demand by lowering borrowing costs and flooding the economy with liquidity. While these stimulus measures were successful in staving off an economic depression (saving jobs = success), they also contributed to massive inflation (stable prices = failure).

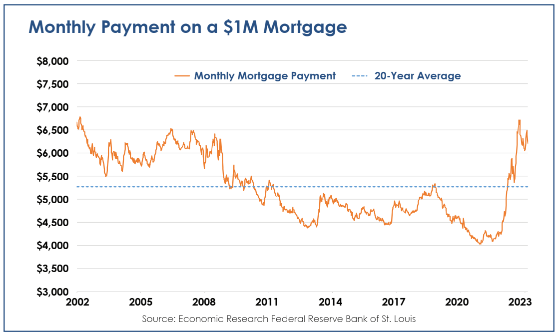
Over the last twelve months, the Fed has been on a mission to lower inflation by raising borrowing costs. While this is not a new technique, the pace at which the Fed is raising rates is unprecedented (short-term rates have risen from 0.50% to 5.00% in just one year[1]).

The good news is that the pace of inflation does seem to be slowing, meaning that the rate hikes are working. However, the impact of higher borrowing costs is still making its way through the economic system, as we just recently witnessed with the collapse of Silicon Valley Bank (SVB). While there were other contributing factors to the bank's demise, the overarching driver was the negative impact of interest rates on the bank's balance sheet. While SVB was an extreme example, it is likely not the last domino to drop due to a higher interest rate regime.



The Impact of Higher Rates on the U.S. Consumer

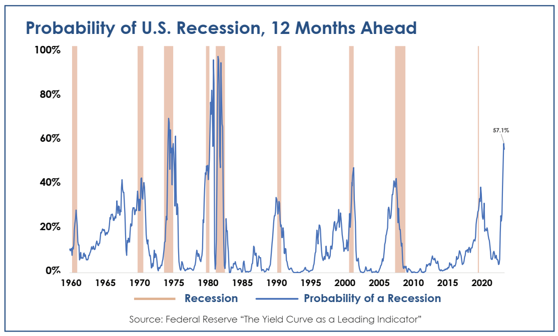
While bank failures and tech layoffs capture most of the headlines, the reality is that the Fed's hiking cycle is also impacting the everyday U.S. consumer. Take, for example, purchasing a home, which is the cornerstone of the American balance sheet. 30-year mortgage rates have risen sharply in the last 18 months, going from 2.65% to 6.32%[2]. This means that the monthly interest payment on a $1M mortgage has risen from $4,000 to over $6,000. This drastic increase removes potential buyers from the market, which puts downward pressure on housing prices and leads to less demand for appliances and consumer goods, as remodels are put on hold.



In addition to the housing market, the impact of higher rates is rearing its head in the auto market as well. The COVID stimulus programs made credit more accessible for consumers, and one area where that credit was spent was on new cars. Fast-forward to today, and you have a growing population of Americans who are finding it challenging to service the interest payments on their auto loans, leading to a spike in delinquency rates.

The Markets are Not Buying What the Fed is Saying

While the Fed is still standing behind the notion that a recession can be avoided, the economic indicators are saying otherwise. The shape of the yield curve, which historically has been a relatively accurate recession indicator, is currently showing a 54% probability of a recession in the next 12 months[3]. While this is just one indicator, a reading at this level has correctly predicted a recession 100% of the time.



The shape of the yield curve... is currently showing a 54% probability of a recession in the next 12 months

Preparing for a Bumpy Road Ahead

While recessions can be painful, especially for areas of the economy where excesses have built up (e.g., tech sector), they are also a necessary cleansing mechanism that paves the way for new leadership. While a more defensive portfolio posture is warranted, recessions are not always accompanied by negative returns. In fact, the S&P 500 has been positive in three of the last six recessions[4] (albeit this is a small sample size). Given the expectation for a lower growth economy ahead, we have highlighted some areas that we believe will outperform in this environment:

- **Equities** – We currently believe that investors should be cautious about high-valued areas of the market, such as technology stocks. Companies may struggle to justify these prices if interest rates remain high. Instead, we favor foreign equities, particularly international developed markets, which offer better valuations and stronger earnings growth potential. Emerging markets are also an attractive option, with a weakening U.S. dollar and the reopening of the Chinese economy providing tailwinds. In Q1, International Developed (MSCI EAFE Index) and Emerging Markets (MSCI EM Index) were up 8.6% and 3.6% respectively[5].

Recent Recessions	Duration (Months)	S&P 500 Return
1980	6	15%
1981-1982	16	6.8%
Early 1990s	8	4.4%
Tech Bubble	8	(8.2%)
COVID-19	2	(10.0%)
The Great Recession	18	(37.6%)

Source: Motley Fool "Stock Performance in Every Recession Since 1980"

- **Fixed Income** – With inflation showing signs of slowing and financial conditions tightening, we think that the Fed is approaching the end of its hiking cycle. This is a positive development for fixed income asset classes, which are generating meaningful yields (4%+) for the first time in almost two decades. We are favoring high-quality investment-grade municipal and corporate bonds with intermediate maturities (6-10 years).

- **Diversification** – We expect volatility to remain heightened and thus we have increased our exposure to asset classes that tend to be less correlated to the equity and fixed income markets. For example, we increased our allocation to gold at the end of Q4, which was one of the top performers in Q1 (+8%)[6]. In addition to gold, we also see opportunities in actively managed strategies ranging from infrastructure, farm, and timberland to managed futures.

Summary:

While the era of COVID lockdowns may feel well behind us, the economy is now paying the price for the massive amounts of stimulus that were unleashed during 2020 and 2021. The Fed has not wavered in its commitment to beating inflation and thus we are bracing for the impact of an economic slowdown ahead.

While a recession will not be favorable to certain areas of the market, it does not spell bad news across the entire investment landscape. Attractive yields in fixed income and cheap commodity prices are just two of several areas that can help mitigate volatility in a choppy market environment.

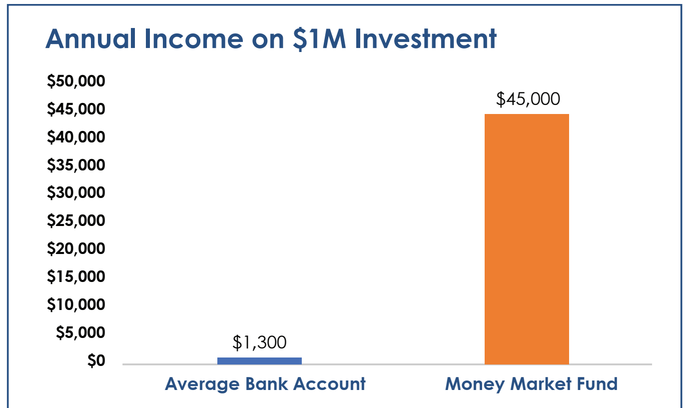
Cash is King Once Again

One of the more positive developments of the Fed's hiking cycle is that for the first time in two decades, investors can earn meaningful interest on their cash. However, investors must be aware of what their hard-earned cash is earning as it can vary widely depending on where the cash is invested. Most banks are still offering next to nothing on savings accounts. According to Bankrate, Bank of America, Chase, U.S. Bank and Wells Fargo each offer an annual rate of 0.01%, with the national average on savings accounts being just 0.13%[7].

One solution to these lower rate accounts is a money market fund held in your brokerage account. Money market funds invest in cash and cash equivalents like bankers' acceptances, certificates of deposit (CDs), commercial paper, repurchase agreements, and U.S. Treasuries. These funds are paying on average 4.5% with daily liquidity[7]. As you can see from the graph below, the difference in income between 0% and 4.5% is significant!

It is important to note that while money market funds are generally considered to be one of the safest and lowest-risk investments, they are not completely risk-free. Although the underlying investments in money market funds are generally short-term and high quality, there is still a risk of default by the issuer of the underlying securities. This risk is referred to as credit risk.

Therefore, it is important to carefully evaluate the credit quality of a money market fund before investing in it.



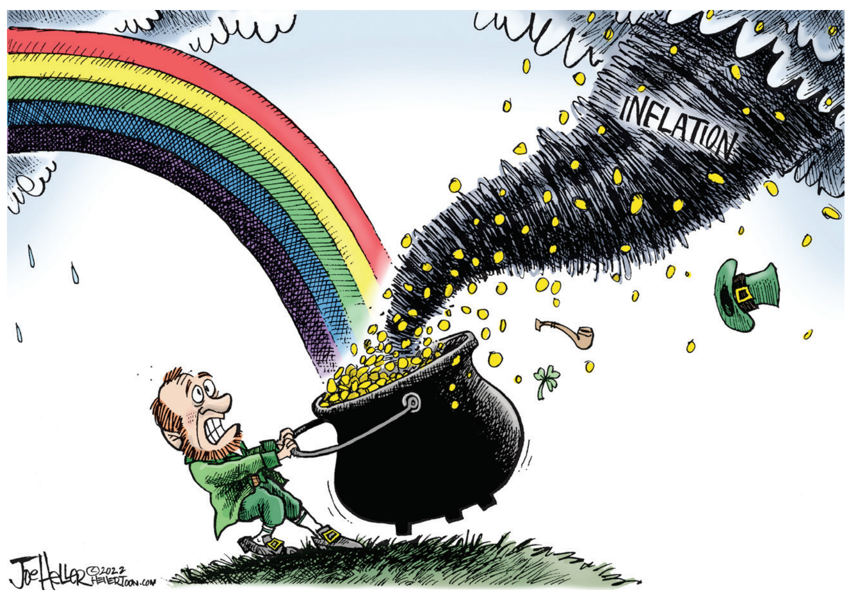
Source: Bankrate

Investing in treasuries through a public ETF or through individual treasury securities could also be a suitable option for some investors. These investments are generally considered to be safer than money market funds, as they are backed by the full faith and credit of the U.S. government. However, they may not offer the same level of liquidity as money market funds.

Please contact us if you have idle cash that can be put to work to discuss the best strategy for your situation.

Playing Offense in a Defensive Market

Volatile markets can be tough to stomach, and we stress that it is important to stay committed to long-term asset allocations during these periods. However, staying the course does not mean sitting on your hands, especially when it comes to optimizing your financial plan. Here are a few tactics that we are using to take advantage of choppy market conditions:



- **Tax-loss harvesting** – Tax-loss harvesting is a technique used to reduce an investor's tax liability by selling securities that have experienced a loss and replacing them with similar investments. The sale of the losing investment generates a capital loss, which can be used to offset capital gains or up to $3,000 of ordinary income per year. By reducing the amount of taxes paid, the investor can keep more of their investment returns. While this strategy requires more active portfolio turnover, it can be well worth the tax savings.
- **Optimizing Taxes for Retirement** – Another strategy to consider for certain individuals is a Roth conversion. A Roth conversion is the process of repositioning your assets in a Traditional IRA or qualified employer-sponsored retirement plan, such as a 401(k), 403(b), or governmental 457(b) to a Roth IRA. While you incur taxes in the year that you make the conversion, the assets are now in a tax-free vehicle and thus your future tax liability is reduced. If you enact this strategy when asset values are depressed, you will generate increased capital appreciation on a tax-free asset. It's important to note that the tax implications of a Roth conversion can be complex and may vary depending on an individual's financial situation.
- **Grantor Retained Annuity Trust (GRAT)** – A GRAT is an estate planning technique that allows an individual to transfer assets to their heirs while minimizing estate and gift taxes. The grantor (person creating the trust) transfers assets to the trust, and retains the right to receive an annuity payment for a specified period of time. At the end of the trust term, any remaining assets are transferred to the beneficiaries free of estate and gift taxes. By transferring assets when their values are depressed, the potential future appreciation can pass to the beneficiaries free of estate tax. The effectiveness of this strategy depends on various factors, including the length of the trust term and the performance of the assets. It is important to consult with your financial advisor to determine if a GRAT is suitable for your specific situation.

Staying Proactive in a Turbulent Market

No matter the highs and lows that happen throughout a given year, we will continue doing what we do best – servicing our clients with their best interests at heart. Throughout Q1, our Investment Strategy Group stayed proactive during times of volatility by making timely moves with regard to our client's investment portfolios. We will continue to do as such throughout the year, while also continuing to focus on opportunistic tax-loss harvesting and ensuring necessary distributions and conversions are made while asset values are depressed.

As always, we encourage clients to revisit their financial plans with their advisor to help achieve peace of mind during turbulent market conditions and make any necessary adjustments. While the economy faces a tough road ahead, we are confident that there will be opportunities abound for those who stay disciplined and make informed decisions regarding their portfolio and financial plans.

If you have any questions or concerns, please feel free to reach out.

Best Regards, Your Miracle Mile Team

SOURCES:
1 Economic Research Federal Reserve Bank of St. Louis data as of 3/31/2023 https://fred.stlouisfed.org/
2 Economic Research Federal Reserve Bank of St. Louis data as of 3/31/2023 https://fred.stlouisfed.org/
3 The Yield Curve as a Leading Indicator data as of 3/31/2023 https://www.newyorkfed.org/research/capital_markets/ycfaq#/
4 Motley Fool data as of 3/31/2023 https://www.fool.com/research/stock-performance-recessions/
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6 SPDR Gold Shares +8% as of 3/31/2023 - Yahoo Finance
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