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June Newsletter

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A June Letter to Clients

We were treated to one of the greatest bull markets in modern history during the last decade. It's not that we didn't experience sell-offs. We did.

During 2011 and 2018, the S&P 500 Index came very close to entering a bear market (Yahoo Finance), which is typically defined as a 20% or greater pullback in the broad-based S&P 500 Index.

From its closing peak of 4,796.56 on January 3, the S&P 500's most recent closing bottom of 3,900.79 on May 19 translates into a peak-to-trough loss of 18.68% (MarketWatch).

As we moved into the final days of May, a sharp rally helped minimize losses for the month, as illustrated in Table 1. The peak-to-date loss for the S&P 500 Index through May 31 is 13.85%.

Table 1: Key Index Returns

	MTD %	YTD %
Dow Jones Industrial Average	0.0	-9.2
NASDAQ Composite	-2.1	-22.8
S&P 500 Index	0.0	-13.3
Russell 2000 Index	0.0	-17.0
MSCI World ex-USA*	0.3	-11.7
MSCI Emerging Markets*	0.1	-12.5
Bloomberg US Agg Bond TR USD	0.6	-8.9

Source: Wall Street Journal, MSCI.com, MarketWatch, Morningstar
MTD returns: Apr 29, 2022-May 31, 2022
YTD returns: Dec 31, 2021-May 31, 2022
*In US dollars

What fueled the rise in stocks over the last decade and what has changed today? We believe there has been a shift in the economic fundamentals.

During the 2010s, interest rates were extremely low; the Fed was buying Treasury bonds during the early part of the decade (popularly called quantitative easing or QE); inflation was low; and the economy was expanding at a modest, if unimpressive, pace. That economic expansion fueled a rise in corporate profits.

When the Fed began to raise rates, the shift in policy was gradual.

While stocks never rise in a straight line, the economic fundamentals created a strong tailwind for equities.

A brief review of the data from Yahoo Finance shows that on December 31, 2009, the S&P 500 Index closed at 1,115. Ten years later, the S&P 500 had nearly tripled to 3,231. On May 31, it closed at 4,132.

On December 31, 2009, the Dow Jones Industrial Average closed at 10,428. It ended the decade at 28,538. On May 31, the Dow closed at 32,990.

What's Going on Today

Today, the economy is expanding, and corporate profits are rising, according to Refinitiv. But an upbeat Q1 profit season failed to stem the latest slide in stocks. Why? We believe you can point to a shift in the once-favorable fundamentals.

First, let's start with the Federal Reserve. During prior rate-hike cycles, such as the early 2000s and the second half of the 2010s, the Fed took great pains to reassure investors that increases would be "measured" or "gradual."

The investor-friendly language has been jettisoned.

In hindsight, the Fed should have started tightening the monetary screws with rate hikes last year. It didn't. It insisted that last year's rise in inflation was "transitory." It wasn't.

In response to the sharp rise in inflation, the Fed is being forced to play catch-up.

In May, the Fed hiked its key lending rate, the fed funds rate, by 50 basis points (bp, 1 bp = 0.01%) to 0.75% – 1.00%. It was the first 50 bp rise in over 20 years.

While 75 bp is off the table, at least for now, the Fed is signaling that another 50 bp rate hike will be delivered in June and again in late July.

In an https://www.wsj.com/articles/transcript-fed-chairman-jerome-powell-at-the-wsj-future-of-everything-festival-11652821738 interview last month, Fed Chief Powell said, "What we need to see is inflation coming down in a clear and convincing way, and we're going to keep pushing until we see that." It's tough talk.

We want a return to price stability, and comments like that strongly suggest job #1 at the Fed is price stability. But over the shorter term, an aggressive policy to rein in inflation increases economic uncertainty and angst among investors.

In addition to rate hikes, the Fed will also let some of the maturing bonds it holds run off its balance sheet without replacing them. It's the opposite of QE, and it's called QT—quantitative tightening. As with rate hikes, it's a shift away from the Fed's easy money policy.

While the Fed should take some responsibility for today's high inflation, we won't blame it entirely on them. Excessive fiscal stimulus encouraged a consumer-led buying binge (and a fast return to full employment), and supply chain woes that limited the availability of some goods are part of the problem, too.

Further, severe labor shortages have lifted wages, and businesses are passing along the higher costs.

Market volatility is also being exacerbated by Russia's invasion of Ukraine, which has pushed up energy prices and appears poised to slow global growth. Recent lockdowns in China have aggravated supply chain issues.

Lastly, whether it is warranted or not, odds of a recession have risen, which is adding to uncertainty.

Taking the Stairs Up and the Elevator Down

Stocks have a long-term upward bias, but downturns can be swift and uncomfortable. We understand that. But a review of the long-term data is encouraging.

The https://www.schwab.com/learn/story/7-investing-strategies-to-prepare-bear-markets Schwab Center for Financial Research analyzed S&P 500 data going back to 1966.

While we know that past performance doesn't guarantee future results, Schwab found that the average bear market lasted 446 days (including weekends/holidays). The average bear market decline was 38.4%.

Here is the good news. Bull markets averaged 2,069 days and returned an average of 209.2%.

Yet, market timing is exceedingly difficult.

"I never have the faintest idea what the stock market is going to do in the next six months, or the next year, or the next two," legendary investor Warren Buffett once quipped. He's right.

A few get lucky from time to time, but no one can consistently call market tops and market bottoms. Nonetheless, we believe that clarity on inflation and rate hikes would inject a more positive tone into sentiment.

That said, Buffett has an investment plan. He follows it, and he has an enviable track record. Buffet knows markets don't rise without corrections.

His investment plan and your investment plan account for unexpected detours--you know, when markets take an unscheduled detour lower.

But your plan isn't set in stone. As life's circumstances change, the plan can and should be revisited. But let's be careful about making investment decisions that are based on emotion.

As the plan discourages one from taking on too much risk when stocks are soaring (and we may feel invincible), it also discourages one from selling when the waters turn choppy.

Successful investors are disciplined. They avoid letting excess optimism or pessimism guide their decisions.

We know times like these can be difficult. If you have questions or would like to talk, we are only an email or phone call away.

Estate Planning and Gift-giving Taxes and Strategies

An estate plan is an integral part of the financial planning process. It is conceived to carry out your wishes upon death.

Some folks choose DIY, or do-it-yourself wills or trusts. Ultimately, it is your choice, but given the complexity of estate planning, we strongly recommend that you seek guidance from an attorney.

An attorney that specializes in estate planning can lead you through the process and draw up plans that will establish the appropriate strategy for you.

As a part of the process, we will discuss gift taxes and gift giving. Estate planning and gift taxrules are complicated, and this will be a high-level overview. Please consider consulting your attorney or tax advisor for any questions.

Under the current law, the lifetime exemption for gift and estate taxes last year was $11.7 million for individuals and $23.4 million per married couple. For 2022, the thresholds rise to $12.06 million per person and $24.12 million per couple.

The annual gift-tax exemption in 2022 is $16,000 per donor, per recipient, up from $15,000 last year. The recipient may be your child, relative or a stranger.

This means that a giver can give someone a gift that is valued up to $16,000 in a calendar year, and the giver will pay no federal gift taxes. If the gift comes from a couple, the limit doubles to $32,000. Even then, if you exceed the thresholds, it's unlikely you will owe federal taxes on your gift, as we'll explain in a moment.

Please note that in 2019, the IRS clarified that individuals taking advantage of the increased gift tax exclusion in effect from 2018 to 2025 will not be adversely impacted after 2025, when the exclusion amount is scheduled to drop to pre-2018 levels.

Because it is a gift, the recipient owes no federal income tax. However, the giver will not receive a tax deduction for the gift. Gifts to a qualified charity may be tax-deductible and are not subject to gift tax limits.

What if your gift exceeds the prescribed limit? Do you, the giver, owe a gift tax? The short answer is probably not.

You see, the annual limit is also applied to the lifetime exemption of $12.06 million per person and $24.12 million for a couple (for 2022).

For example, if Mom gives a $20,000 gift in 2022 to her daughter, Mom exceeds the $16,000 annual limit by $4,000. Taxes can still be avoided. However, Mom would be required to file U.S. Gift Tax (and Generation-Skipping Transfer) Form 709 with the IRS.

You may avoid the gift tax unless you top the lifetime exemption.

If you exceed the lifetime exemption, the gift tax rate ranges from 18% to 40%. Beware of exceptions and rules for calculating the tax. If you are running up against the limit, please consider talking to your tax professional.

What gifts are excluded?

- Gifts that are not more than the annual exclusion for the calendar year.
- Tuition or medical expenses you pay for someone.
- Gifts to your spouse.
- Gifts to a political organization for its use.
- Gifts to qualifying charities.

7 Strategies You May Utilize

1. **Give extra.** If you are wealthy and won't need the assets, consider giving above the annual exclusion. While you will file a gift tax form with the IRS, you may rely on your large lifetime exemption.
2. **Give assets that are appreciating**, as these assets remove any future appreciation to the estate. But beware of taxes. When received as a gift, the recipient will usually receive the cost basis of the donor. If the recipient sells, the assets will be taxed on the appreciation as a capital gain. If the gift is inherited, the tax basis will increase to the current value, potentially reducing taxes if the asset is sold.
3. **Gift assets from joint owners**. This doubles the amount of the gift without running up against annual exclusion.
4. **Spread out the gifts over several years**. Recipients get all that you want to give them, just over a longer period of time.
5. **Paying for tuition or medical expenses avoids the annual limit**. But they must be paid directly to the institution, not the recipient.
6. **Be careful**. Speak with your attorney or tax advisor if your assets include real estate or business holdings that could generate unwanted tax liabilities without proper planning.
7. **Playing the lottery? Think ahead**. Finally, on the outside chance you win the lottery and you decide to share your winnings with siblings, your generosity is commendable. But it's probably best that you buy the ticket jointly with your siblings or have some type of partnership agreement in place before the winning ticket is purchased. If not, the gift tax could take a big bite of your windfall.

I trust you've found this review to be educational and insightful. If you have any questions or would like to discuss any matter, please feel free to give me or any of my team members a call.

As always, thank you for the trust, confidence and the opportunity to serve as your financial advisor.

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