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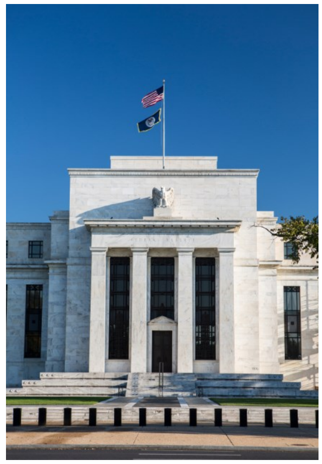
The End of the Buying Spree?

You might be reading about the internal debate at the Federal Reserve Board about when and how to "shrink its balance sheet" which will, articles tell us, have some mysteriously negative impact on the U.S. investment markets. But what are they actually talking about?



The Fed is, of course, the U.S. central bank which is granted unlimited purchasing power and which also can make unlimited funds available to banks in the form of (generally low-interest) loans. These powers were fully deployed during the market downturn in 2008-2009 when the reckless real estate bets by the major brokerage firms very nearly toppled the global economy. Then came COVID. The Fed acted as the major buyer of U.S. Treasury securities, which effectively held down their rates (bidding competitively on the low end), and also purchased massive amounts of mortgage-backed securities from Freddie Mac and Fannie Mae, who, in turn, buy loans from banks which makes housing credit more readily available and has had the effect of driving down mortgage rates.

The Fed has ramped up its buying spree in the past couple of years to the extent that it now owns an extraordinary $8.7 trillion worth of bonds overall, including more than 22% of all U.S. government bonds outstanding. But the interesting part is how this has disrupted the normal market forces of supply and demand.

Meaning? A normal bond buyer (that is, everyone except the Fed) wants to get the highest rate possible, so there is usually an equilibrium among greedy and less-greedy buyers where the auction ultimately delivers a fair price, usually some percentage over the current inflation rate. But with the Fed putting in bids way below what most investors would be willing to accept, the actual yield today is below 1.5% which, with today's inflation, results in a negative real return. This is why you will hear dark muttering from some economists that the Fed is interfering with the natural workings of the marketplace.

So, what does this have to do with the Fed "shrinking its balance sheet?" If the U.S. central bank were to stop buying Treasuries altogether, it's possible - even probable - that government bond rates would jump many multiples of where they are today to the point where investors are once again earning a fair return after inflation. If the Fed were to go further and actually start selling off its massive bond holdings, it would flood the market with bonds, potentially creating a massive buyer's market where the buyers could set the prices, which could drive rates even higher.

But how would that affect the equities markets? In two ways. First, if investors could buy safe, totally secure returns of, say, 8% a year, wouldn't they be motivated to shift at least some of their holdings from volatile stocks to risk-free bonds?

The other impact would be on the U.S. government debt, which currently stands at a record $28.43 trillion. What happens if the government is paying 7% on that debt instead of 1.5%? The debt would quickly spiral out of control, alarming taxpayers and potentially (certainly?) leading to higher tax rates.

Of course, Fed economists are highly aware of their potential impact on the government's debt and investment markets and are motivated to tread very lightly. The most recent announcement unveiled plans to scale back purchases by a minuscule $30 billion a month Reducing the balance sheet, it seems, actually means increasing it less rapidly than in the recent past, gradually buying fewer and fewer government securities while holding what the Fed already owns to maturity. It's probably going to take a very long time to unwind an $8 trillion balance sheet, but it's not out of the question that even a modest step in that direction will spook investors who are carefully watching to see how this drama plays out.

From Our FSA Family

Welcome to the first financial planning newsletter of 2022! As is tradition, the new year signifies a time to start fresh and create new goals for the year. Rather than share our many personal goals with you, we want to highlight a few of FSA's 2022 goals.

On the cybersecurity side of things, we are researching ways to increase the security measures for sharing documents with you. Finances are personal and private, so we want to keep it that way! Stay tuned for more information in the very near future.

As we do more and more financial and retirement plans for clients, we are researching easier ways for clients to submit the necessary information. If we can avoid

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Bear or No Bear? Does It Matter?

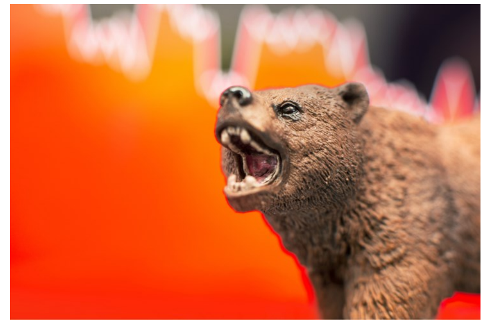
In U.S. stock market history, bear markets - defined as a drop of 20% or more for a broad market index - happen roughly every four years and eight months. With recent down days in the markets, we may be in the early stages of a new one.

Or we may not. And that, of course, is the problem. It is very easy to see these market downdrafts in retrospect but impossible to know when one is occurring - or to predict them in advance. Nor can we know how far down they'll take us or when the recovery will begin. That is why in our investment strategy we react to, not predict, the various market conditions.

Some of the longest declines were triggered by major geopolitical events, such as the attack on Pearl Harbor that pulled the U.S. military into World War II (a 308-day downturn, nearly a year) and Iraq's invasion of Kuwait in 1990 (108 days). The terrorist attacks of 2001 and the North Korean missile crisis of 2017 also triggered market declines. In 2008, the collapse of Wall Street speculation nearly brought down the entire global economy. More recently in 2020, the emergence of a major global pandemic caused a rapid decline which was, as most of us remember, followed by a precipitous rise in market values that has continued through the end of last year.

At the moment, it's not easy to see a major catastrophic trigger that would cause investors to race for the exits, but there have been other bear markets where a bull market simply ran out of steam. A recent example is the bursting of the dot-com bubble in 2000. The hardest-hit investors in that period were all crowded into the latest craze, tech stocks, and the tech-heavy Nasdaq index didn't recover its former value until 2015.

Which brings us back to the possibility that we're entering a bear market today. Taking another look at history, since 1929 the average duration of these 20%+ downturns is 21 months. And it is just as impossible to predict these durations as it is to predict the downturns to begin with. The COVID-related downturn in 2020 is a terrific example of how unpredictable the recovery can be. The pandemic news didn't change from February to April 2020, but the markets recovered anyway and were not discouraged through the ensuing political drama, the Delta and Omicron variants, and the highest inflation rate in decades.



The most important historical fact is that every bear market in U.S. history has been followed by new highs. Since 1950, we have experienced 53.8% up days in the market and 46.2% down days, and the magnitude of the positive days has exceeded the magnitude of the downdrafts. All that to say, we will continue to capture as much upside of the market as we can and enact our safety nets to protect the portfolios when the eventual bear markets occur.

Messy Retirement Spending

Retirement researchers typically assume that people in retirement will do one of two things. They will either pull a steady "income" from their retirement portfolios each year and adjust that amount for inflation to maintain the same spending power. Or they will spend a bit more in the early years of retirement (when they're more energetic), begin to cut back in the middle retirement years, and then spend more in their last years due to healthcare issues.

The real world apparently doesn't work that way. A recent study published by the JP Morgan Chase banking firm looked at 5 million defined contribution retirement account holders and found that the amount that households were spending rose dramatically from 2016 to 2019, which were good years for the market. Retirees spent 5% to 9% less in the COVID year of 2020. The research suggests that retirees vary their spending depending on how confident they are in their ability to spend, which, of course, would be a much messier (but more real) way for researchers to model consumer behavior.

Other findings? On average, the study calculated that most retirees were spending almost as much (92%) in retirement as they were when they were earning an income, and about 54% of that was contributed by Social Security benefits. In all, between 16% and 38% of their retirement income had to come from personal savings, depending on the age of the retiree. (As people get older, they tend to take less out of their personal savings.)

The point here is that retirees are more flexible in their spending than economists and our retirement analysis might assume. Life happens, and none of us are as predictable as the models would indicate. When we walk through those projections with you, our goal is to lean on the conservative side in hopes of giving you more flexibility.

7.12% Interest? What's the Catch?

The Treasury Department's Series I bonds are paying a nominal fixed rate of 0%, which is not really very exciting. But what IS kind of exciting is that an additional component of their interest payments is pegged to the inflation rate. Until April 2022, the Treasury Department has set that rate at 7.12%, about 5.6 percentage points more than you can currently receive from 10-year Treasury bonds.

There are, of course, some catches to this remarkable rate. One is that any individual can only buy a maximum of $10,000 of Series I bonds through the TreasuryDirect website. Theoretically, people could have each family member buy up to the limit, but it would still make up a limited part of a typical retirement portfolio.

Another "catch," if you can call it that, is that the rate only extends for six months at which point the government resets it. So, the Series I bond purchaser is not locking in 7.12% for the life of the bond; that rate is only valid through April. At the next reset in May, if inflation goes back down to where it has been over the past ten years, then these Treasury issues will become much less exciting. And if the investor redeems the bond at any time in the first five years of ownership, he or she would lose the last three months of interest. (The bonds have a 30-year maturity, but they can be redeemed or sold on the open market at any time.)

The Treasury Department created these 30-year instruments for investors who wanted a guaranteed hedge against inflation. The more normal rate in recent years has been between 1.5% and 2.5%. But the value of the bond will never decline, and even in a deflationary environment, the interest rate will never drop below zero. For the life of the bond, the owner will be protected from inflation, which in this day and age is not a trivial feature.

Crypto Enforcement

Anybody who bought a dollar's worth of Bitcoins on or before May 2010 would have been sitting on a gain of $6.7 million at various times this past fall before the crypto markets crashed once again. Total market cap for all cryptocurrencies stands at $2.5 trillion, which is apparently enough money to attract the attention of the Internal Revenue Service.

According to a recent article in the Wall Street Journal, the IRS wants to know how much money crypto investors have made and how to tax their gains. But at this point, it's hard to know exactly how it's going to proceed with enforcement; unlike traditional brokerage firms, crypto exchanges are not required to report their customers' transactions to any federal agency. Investors are on an honor system when it comes to reporting their transactions and capital gains on their tax forms.

In recent months, the IRS filed a lawsuit in an attempt to require several major crypto exchanges to hand over customer records. And there must be some mechanism for enforcement because Bloomberg recently reported that in 2021 the IRS seized $3.5 billion worth of crypto assets that it determined were obtained through a range of criminal activities this past year. Those crypto seizures made up an astounding 93% of the total assets seized by tax enforcement officials, reportedly in connection with wire fraud, money laundering, the distribution of illegal narcotics, and, yes, tax fraud. In one case, the IRS prosecuted a former Microsoft software developer who used cryptocurrency to hide $10 million that he embezzled from the company.

From our FSA Family *Continued from page 1*

the uploading and downloading of sensitive data, that's a win! We hope to have more information on this by the end of the first quarter.

In 2021, we continued to utilize Zoom to meet with clients. In 2022, we want to increase our use of Zoom with clients who are local and across the country. We feel there is no substitute for face-to-face meetings, but Zoom is a great alternative in this pandemic environment. Working with clients in over 40 states, we've seen some of their faces for the first time! Give Zoom a try for our next meeting!

We want to continue to promote the various tools we already have available for our clients. The FSA client portal is a succinct way to review your FSA-managed Schwab accounts and transactions. Some other notable features are the dynamic reports and the net worth tool where you can link your outside accounts to get a comprehensive view of all your assets—including your home! If you do not have a login for the client portal, please let us know.

For our employees, we have plans for multiple team-building events, education opportunities, and our annual retreat. We created a new committee focused on the firm's culture as we want to continue to foster a healthy culture even in this digital world. Locally, the FSA Cares committee has activities in the pipeline for us to give back to the community in the way of service and donations.

We are looking forward to another year of serving our clients, working with our team members, and giving back to the community!

Government-Approved Inter-Family Loan Rates

Logic might tell you that any loans you make to family members would be a personal matter without requiring the government to get involved. But whenever has the tax code followed logic?

The key issue to remember with the Internal Revenue Service involvement in family loans is that the IRS wants to be able to calculate gift taxes against the amount you would ultimately owe in estate taxes when you pass on assets to your heirs. If you were to make a no-interest loan to a son or daughter, the IRS would count the amount of interest you would be foregoing as a gift. If you DO charge interest, the amount of interest would need to be reasonable in the eyes of the government.

What's reasonable? The government monitors interest rate movements in the marketplace and calculates minimum applicable federal rates (AFR) for loans covering different time periods, posting them on its website. (You can find this month's rates at https://www.irs.gov/pub/irs-drop/rr-22-03.pdf.) If you charge family members or heirs less than this rate, then the government would calculate the difference, and that would be counted as a gift to the family member to whom you made the loan.

These rates are pretty low: A short-term AFR (up to three years) in September 2021 is 0.17%; the AFR on loans of three to nine years is 0.86%; and anything over nine years would have a rate of 1.71% to 1.73%, depending on whether the interest is being paid back yearly, quarterly, or monthly.

Note that these rules do not apply to loans of less than $10,000 that are not used to purchase income-producing property. And if you do not want to go through the hassle of charging interest, you could always calculate (or have a professional calculate) the implied interest payments and then offset that amount with your $15,000 annual gift exemption to the borrower. But even then, it's a good idea to document the terms and stated interest rate in case the IRS ever decides to come back and do an audit.

The Battle Between Wages and Inflation

The good news is that American workers saw their average hourly wage rise $1.46 an hour, a 5.8% increase that brought the average up to $26.61 an hour worked. The only one-year wage gain to compare with this was in 1981 when wages rose 7.2%. Meanwhile, the Conference Board's latest survey found that executives at large businesses are budgeting 3.9% salary increases for the current year, which would be the highest growth rate in budgeted raises since 2008.

Normal economic logic would tell us that when workers have more money in their pockets they will be inclined to spend more, which would raise the overall gross domestic product in the U.S. But the other side of the news is less upbeat; while workers were earning 5.8% more pay on average, the cost of a normal basket of the things they would be buying was rising even faster. The final tally on 2021 inflation was 7%, the largest 12-month gain since the 12 months ending in June 1982. In terms of purchasing power, American workers, in aggregate, lost ground last year.

Those references to the years 1981 and 1982 might ring alarm bells for anyone who happened to live through the "stagflation" era that lasted from the late 1960s to, yes, around 1982. Relative to the size of their paychecks, workers received bigger raises every year from 1971 to 1981 than they did in 2021, in large part because they needed to earn more to keep up with the inflation-driven erosion of the dollars they were receiving.

The dynamic at the time was eerily similar to what the U.S. economy experienced last year; companies had to pay more in wages to attract and keep workers, which created higher production costs for goods and services. Higher production costs showed up in the form of higher prices, driving up inflation, causing workers to demand higher wages in order to stay roughly even in purchasing power. Lather, rinse, and repeat over a period of years, and you have the perfect recipe for stagflation.

There is no guarantee that we will experience a repeat of that unfortunate time in economic history; 2021 could be a one-time anomaly that merely reminds us of the 1970s stagflation experience. But it is not out of the bounds of possibility that the U.S. economy has entered some kind of mutually reinforcing spiral, and that means that any joyful headlines you read about how much more money is flowing into the pockets of workers should be read, for now, at least, with a grain of caution.

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