Financial Services Advisory
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Second Quarter 2022
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Where Is the Inflation Coming From?

By now you know that the U.S. is experiencing a fairly dramatic inflation rate. The Consumer Price Index rose 7.9% last year, and prices this year are surging as well. The question that is not being asked, however, is how much of these rising prices are a result of supply chain issues and higher worker wage demands and how much are reflecting higher profits?

If worker pay has gone up at roughly the inflation rate, then we can pinpoint the higher costs that companies are having to pass on at the register. By this measure, however, worker costs are running substantially behind price increases; the average hourly wages across the U.S. economy rose 4.7% last year, while inflation grew by 7.9%.

A more credible place to look for the drivers of inflation is the snafus in the supply chains running here, there, and everywhere, only to be held up idling outside of ports or ceasing altogether whenever another bout of COVID strikes. Ocean shippers made nearly $80 billion in the first three quarters of 2021, which is twice as much as in the entire ten-year period from 2010 to 2020. Freight rates have increased tenfold, and companies are effectively paying for ships that stand waiting their turn for weeks outside of major ports. Shipping and associated delays are clearly driving up manufacturing costs.

Even so, the fact that we are seeing high inflation at the same time as corporate profit margins are at their highest level in 70 years cannot be totally coincidental. When *Fortune* magazine looked at the profit margins on 28 food and consumer goods from manufacturers listed on the Fortune 500, it found that the net profit margins were higher than pre-pandemic levels on 14 of them and roughly the same on the others. Datasembly, which tracks food and consumer goods manufacturers, found that 11 of a sampling of 18 key consumer products had experienced inflation-beating price increases. JBS, Kellogg, Kimberly Clark, and Tyson all raised their prices higher than the current inflation rate with the JBS steaks and Tyson Buffalo-style chicken bites rising a whopping 34% and 26.7% respectively. Molson Coors and Procter & Gamble more than doubled their profit margins last year compared to pre-pandemic levels.

It's helpful to remember, when members of Congress throw around terms like "price gouging," that any company is legally entitled to set prices at whatever the market will bear. And some of those price increases are set at the store level, so if there is exploitation, it may not be at the manufacturing or producing level.

The bottom line is that if customers are willing to pay 25% more for something this year than they did last year, then that's simply evidence of capitalism at work. But at some point, consumers might stop simply accepting the conventional wisdom from news sources that our current inflation can be directly traced to higher production prices. If that realization ever happens, you can expect people to halt buying. Prices will drop, and corporate profits will fall back to more normal levels or below.

From Our FSA Family

FSA is proud to announce two new employees we've added in 2022. Jordan Daugherty, CFA, and Langston Washington are our newest additions to the Investment Management Team. They'll be working alongside Ron Rough, Chief Investment Officer, and Mary Ann Drucker, Assistant Portfolio Director, to conduct investment research and place trades.

Jordan will support the Investment Management Team by researching investments and market trends, as well as identifying risks and opportunities within our strategies. Some interesting things about Jordan are that he is married to a French ballerina, his favorite national park is Zion National Park in Utah, and he played the electric bass in an indie rock band in college. Rock on!

Langston will focus on placing trades for the Investment Management Team. His responsibilities include working with the team to ensure our clients' accounts are allocated to the models and managing the individual and group trades. Langston is currently living in Virginia with plans to move to Baltimore. He enjoys watching documentaries (ask him about the deadliness of cashews), going to music festivals, and grilling and smoking meats at bar-b-ques.

Our team is growing so we can better serve our current clients and build capacity to help more people like you. If you have any friends, family, or colleagues looking for financial planning or investment management, we are happy to help! As always, we stand ready to advise you through these troubling times and markets.

Riding the Bitcoin Rollercoaster

If you're looking for a lot of excitement in your investment portfolio and enjoy the panic-inducing roller coaster of rapid gains and vertiginous drops in value, you could consider Bitcoin. Over the last year, the coins had been valued at $30,000 last February and last July. They'd been valued at more than $60,000 for part of April and much of October and November before crashing back down in value to, currently, a little under $39,000, 43% below the all-time high set last year. Nobody knows what tomorrow will bring – a jump in value or a 50% decline, depending on the mood of the moment. What we DO know is that there are not many components of a traditional portfolio that can lose 15% of their value in a single day or go down 50% twice in the same 12-month period.

Are Bitcoins actually investments? One way to define an investment is putting money into something tangible, ideally a company whose workers come to the office to enhance its value incrementally each day of the workweek, or a tangible asset like an apartment building or warehouse that will (like many companies) distribute cash to its investors on a regular basis. By this definition, gold is not an investment; its value depends on whatever the next person will pay for it. Interestingly, Bitcoin and the other cryptocurrencies are most often compared with gold as an "investment."

The original idea behind cryptocurrencies was to create a medium of exchange like traditional currencies but with a twist: There are a limited number of Bitcoins in circulation, and that number can never exceed 21 million. The new electronic currency is outside the control of central banks and their printing presses which means that the currency cannot be debased. No government can print a bunch more Bitcoins so that they become essentially worthless the way German marks became during the Weimer administration in Germany after World War I and the way some worry the dollar will be if the Federal Reserve Bank and the Treasury Department don't stop stimulating the U.S. economy.

In addition, Bitcoin transactions are anonymous, a feature which is welcomed by freedom lovers and also by people who don't want the government to see their wealth for tax purposes, as well as by a colorful variety of international drug and weapons dealers whose banking arrangements might otherwise attract the suspicion of law enforcement officers.

There is no evidence that Bitcoin was created to be an investment, much less a get-rich-quick (or, for those caught in the numerous downdrafts, a get-poor-quick) asset class in a retirement portfolio. Buying Bitcoin and other cryptocoins can fairly be defined as speculation, speculating, in this case, that somebody else will come along and pay a higher price for the coins than you did. You could argue that any investment could be defined as speculation, but when people buy a stock, they're holding a piece of a tangible asset which has a (hopefully growing) intrinsic value. No person alive can define the intrinsic value of a cryptocoin, which means it's possible that Bitcoin prices could fall to zero at some point in the future. That would, of course, be very exciting, but not necessarily in a good way.

The Crisis at Hand

At a time when many investors have become antsy about the U.S. stock market, one thing we did not need was an aggressive military incursion in Europe. But that's what we got, and as the Russian annexation of parts of Ukraine dominated the headlines, it is drowning out any positive news about the actual companies being traded. You are probably not hearing that earnings for companies in the S&P 500, in aggregate, rose 22% the last quarter of 2021 or that overall economic growth in the U.S. continues to be unusually robust.

Veteran investors tend to scratch their heads when eye-grabbing world events trigger market downturns. Why? Because it's hard to see any clear way that troop movements in Ukraine materially impact (as in diminish) the actual underlying value of the companies they're invested in. History tells us pretty clearly that once these times of headline panic have passed, stock prices migrate back to whatever they have been worth all along. This has happened through some events that were much more dramatic than what we're facing today – World War II, the Cuban Missile crisis, the Kennedy assassination, and more recently, the sudden realization that the COVID pandemic was a real threat to our collective health and safety.

We can pray for the people who are suffering the impact of military aggression, and we can hope and expect that our world leaders will successfully navigate this crisis as they have so many others. What we can't do is predict how the markets will behave in the ensuing months, which is why we will continue to stick to our FSA Safety Net® investment strategy to follow the money and navigate these tricky times.

2022 First Quarter Investment Market Report

There's no sugar-coating the news. The U.S. and global markets took a hit in the first three months of 2022, offering investors an experience that they haven't been accustomed to during the long bull market: a bit of red ink on their Schwab statements. The only bright spot is commodities, but it's doubtful that anyone with recent experience at the pump is cheering the turmoil in global oil prices.

Just about every investment declined in value in the first quarter. The Wilshire 5000 Total Market Index, the broadest measure of U.S. stocks, lost 6% since January 1. The technology-heavy Nasdaq Composite Index is down 9% for the year, as tech stocks are, for the first time in a while, underperforming the market as a whole. At the trough of this downtrend, the Nasdaq Index was down closer to 20%.

International investors were full participants in the downturn. The broad-based EAFE Index of companies in developed foreign economies lost 6.6% in the first quarter. In aggregate, European stocks, whose companies are close to the action in Ukraine, are down more than European stocks farther away from the altercation.

In the bond markets, yields are going up, albeit somewhat incrementally, which has caused bond funds to decline this year. Depending on the day and fund, bonds are down just as much as the S&P 500, meaning there has been very few investments to hide in.

These market declines are always a bit nerve-rattling which is why we prefer to systematically react (via our FSA Safety Nets®) to the market rather than predict what will happen. We often equate the markets to staircases because stair-cases go up, down, and sometimes sideways just like the market. In 2021, the market was a clear case of an upwards staircase, followed by a downward staircase in the first couple of months of 2022. We wrapped up the first quarter on a landing where the stock market is bouncing up and down in a trading range trying to decide where the staircase should break out to next.

That said, there are enough clouds on the horizon to raise the possibility that we'll have to endure further declines before the markets again touch new highs. The most obvious one is the uncertainty that comes with a continuing, grinding war in Ukraine and the sanctions and oil/grain supply disruptions associated with it.

Another is the possibility that the U.S. economy is approaching a recession. Saying the word "recession" out loud today is a bit like shouting "fire!" in a crowded theater. A recession is defined as several months of economic decline, and there is no evidence that we are experiencing that at this time.

Meanwhile, there's another recession indicator that will probably get more press coverage than it deserves. The bond markets have recently shifted to what is known in the trade as an inverted yield curve, which is a fancy way of saying that short-term bonds are offering higher rates than longer-term ones. Right now, the yield on 2-year Treasury notes (2.337%) is very slightly more generous than the yield on 10-year issues (2.331%), which makes no sense to a rational investor. Why take more risk on longer-term bonds when you can get a higher return for taking less risk on shorter-term ones?

The problem, of course, is that this "signal" has not exactly been a perfect predictor of recessions in the past, and even when it has, the time frame could be one year or five.

More optimistically, it is not easy to ignore the fact that the U.S. economy added 431,000 new jobs in March after a gain of 678,000 in February. Oil prices are down to $109 a barrel despite all the dire predictions of global shortages, and U.S.-based corporations experienced their most profitable year since 1950 in calendar 2021. People who see the glass half-empty certainly have some data on their side, but so too do the optimists among us. And what's interesting is that this has always been true. In retrospect, we will see who was right, but in the moment, as we look at the future, there tend to be good, compelling clues that lead us to expect very different possible outlooks.

And so, we wait, perhaps impatiently, for the next time the markets start another upward staircase. Even if we don't know when that will happen, history offers encouraging evidence that it will, and all the anxiety and excitement that the markets produce in the meantime will have been, depending on your temperament, wasted energy or pure entertainment.

Mysterious Gas Price Hikes

With a war raging in Eastern Europe, the common wisdom is that we are all going to pay for sanctions against Russia in the form of higher energy costs. But it's still a bit confusing that gas prices at the pump have risen so dramatically. In mid-February, the typical consumer was paying $3.49 a gallon; a month later, the average cost is $4.33, an increase of roughly 30%. In some places, the increase has been more dramatic. Californians are paying $5.34 a gallon when they fill their tanks, and there have been reports of people paying $7 a gallon at certain gas stations around the country.

Why should this be confusing? First of all, only about 8% of the petroleum that the U.S. imports comes from Russia, and the U.S. actually *exported* about 12 times that amount to other countries around the world, notably Mexico, Canada, and China. In most years, our domestic oil production exceeds consumption, which means that the ban on Russian oil should, theoretically at least, have little impact on the American gas pump.

But perhaps a cutoff in Russian oil is causing a bidding war that is driving up prices everywhere, and we're feeling the ripple effects. That doesn't actually seem to be the case. The cost of a barrel of the benchmark "Brent Crude" (which basically means oil on the world markets) peaked at around $130 in early March and has been falling ever since, down to around $109 currently. That's a *decline* of over 15%. Domestically produced oil is actually a bit cheaper.

Of course, oil industry experts are saying there is no evidence that they're raising prices without any increase in their costs, and we will have to wait for their profit numbers before that evidence becomes available to the general public. In the meantime, all we know is that that the recent spike in American gas prices is hard to directly tie to the war in Ukraine.

Retire to Where?

You may have read that a record number of people decided to retire during the COVID pandemic, but in fact, only about half of all people age 55 and over are actually retired, just 2% more than before the pandemic began. According to statistics compiled by the U.S. Census Bureau, people who are moving as a result of retirement are three times as likely to leave their state as those moving for work-related reasons. Of all the people who retired and moved away from home, a remarkable 47% decided to leave their home state.

Where did they go? The rankings differ modestly from 2020 to 2021, but it seems clear that retirees generally prefer a warmer climate and tax-friendly jurisdictions, but not always both. In 2021, Tennessee was the most popular relocation state, followed by Florida, Pennsylvania, North Carolina, South Carolina, Kansas, Arkansas, Georgia, Maine, and Louisiana. The top states in 2020 were, in order, Florida, Arizona, North Carolina, Texas, Tennessee, Idaho, Oregon, Nevada, and Alabama.

Of those states, Florida, Nevada, Tennessee, and Texas do not impose a state income tax or tax on pension income, while Florida, Arizona, North Carolina, South Carolina, Kansas, Missouri, and Texas do not levy state taxes on a retiree's Social Security benefits.

Some of the most popular cities for retiree relocation included (again, in order) Mesa and Scottsdale, AZ; Henderson, NV; Savannah, GA; Paradise, NV; Charlotte, NC; Fort Myers, FL; Cary, NC; Eugene, OR; and Tucson, AZ. But it should be noted that these are net numbers, where the retirees moving out were subtracted from the number of retirees moving in. Charlotte, Mesa, Henderson, and Tucson were among the cities which also experienced the largest number of retirees moving away.

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