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First Quarter 2023
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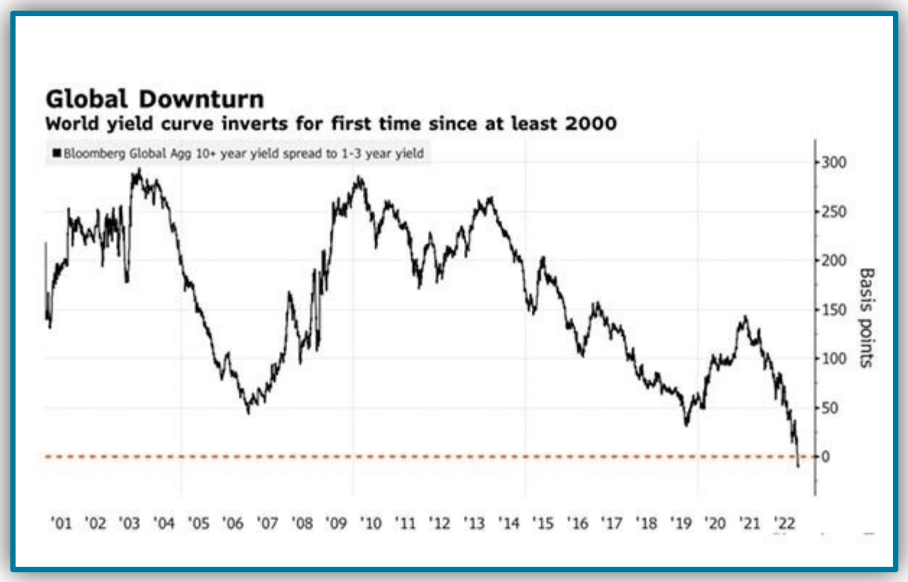
Inverted Yield Curve: Recession Coming?

A combined measure of 10-year government bond yields from a basket of major economies has fallen below a similar basket of one- to three-year government bonds; in other words, you can get a (slightly) higher coupon payment if you go short than if you make a longer-term bond investment. (See chart.) That, of course, is the definition of an 'inverted' yield curve, which is one possible signal that a recession is approaching.



As you can see from the chart, the inversion is pretty mild at this point, but the trend is clear over the past 12 months. Investors tend to switch their attention to longer-term bonds when they're pessimistic over the outlook for the economy, and today they might believe the central banks are choosing to fight inflation versus encouraging economic growth. Here in the U.S., the spread between two-year and ten-year Treasury yields recently hit its highest inversion level since 1981-82.

Of course, the collective wisdom of investors is not always right about these things. One analyst noted that the U.S. disparity between higher (4.37%) two-year Treasury rates and lower (3.7%) ten-year rates might simply mean that investors think the U.S. Fed is going to keep raising interest rates (high short-term rates) and successfully tame inflation (meaning that the ten-year rate would offer positive after-inflation returns over time). But it's worth noting that the last time we saw an inversion of this magnitude, during the Reagan Administration, the U.S. was in the midst of one of the worst economic downturns since the Great Depression. It's definitely something to keep an eye on.

From Our FSA Family

We hope everyone had a great holiday season and are ready to start 2023 with your best foot forward. To give your retirement savings a boost in 2023, we wrote some tips about IRAs. We hope you enjoy!

IRAs are a great way to save additional money for retirement outside of your employer-sponsored retirement plan. Here are a few tips to maximize the benefits:

- Start saving early. It will get you in the habit of saving and allow you to benefit from compounding growth over a long period of time.
- Try to max out your IRA, if eligible. In 2023, the new IRA maximum contribution increased to $6,500. In 2022, the maximum contribution was $6,000.
- Utilize the catch-up contributions. If you are **50 or older**, you can make an additional $1,000 contribution to your IRA.
- If you anticipate being in a higher tax bracket when you begin taking distributions (i.e., retirement), it may be beneficial to contribute to a Roth IRA.
- If you are interested in reducing your current taxable income or expect to be in the same or a lower tax bracket when you start taking distributions, consider contributing to a traditional IRA.
- If eligible, consider using both traditional and Roth accounts for savings to have more options when it's time to make withdrawals.
- Retirement accounts can be passed on to heirs. Be sure to have beneficiaries listed on the account.
- Work with a CPA, especially if your income is within or above the phaseout limits.

If you have any questions about IRAs or saving for your retirement, do not hesitate to reach out. Cheers to 2023!

2022 Investment Report

Many investors are no doubt glad to see 2022 in the rear-view mirror, and if they do look back, the picture is not pretty. Stocks were buffeted by the Federal Reserve Board's aggressive rate hikes (the fastest since the 1980s stagflation era) and the reverse of the QE policies which, for a decade or more, flooded the markets with liquidity. It didn't help that there were persistent fears of a recession all through the last 12 months and a certain level of alarm over the Russia-Ukraine war. The year 2022 saw the three main stock indexes post their first yearly drop since 2018, and market economists with long memories were comparing this perfect storm of headwinds to the declines triggered by the 2008 financial crisis.

A breakdown shows that just about every U.S. investment asset was showing double-digit declines. The Wilshire 5000 Total Market Index, the broadest measure of U.S. stocks, ended the year with a 19.04% loss. Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index posted a 19% loss for 2022.

The technology-heavy Nasdaq Composite Index was the biggest loser in 2022, dropping 28.27% of its value over the last 12 months.

The foreign markets were no better. The broad-based EAFE Index of companies in developed foreign economies gained 17% in the final quarter of 2022 but still lost 16.79% of its value in dollar terms for the year just ended.

Real estate securities produced even greater losses, albeit for small portions of most investment portfolios. The Wilshire U.S. REIT Index posted a truly awful 26.81% loss in 2022. But due to global increases in oil prices (and oil company profits), the S&P GSCI Index, which measures commodities returns, eked out a 0.38% gain in the 4th quarter, ending the year up 8.71%.

Perhaps the most dramatic market movements in 2022 occurred in the bond markets, where yields on 10-year Treasury bonds rose dramatically over the course of the year from 0.95% a year ago to 3.87% currently. Thirty-year government bonds rose from 1.88% yields at this time last year to 3.96%. Of course, for bond investors, these yield gains represented losses; when rates go up, the lower-yielding bonds that investors had purchased previously lose value proportionately.

As you can tell, there were little to no places to hide in markets last year. The broad market downturn, in stocks and bonds, marks the end of an extraordinary period of investment history, a three-year run. The interesting thing is that, despite the declines, we are not currently in bear market territory which is usually defined as a 20% decline.

What will the future bring? Of course, we don't know, but here is what we are seeing. It's certainly possible that the Fed will achieve that “soft landing” for the economy in the coming year. Inflation seems to have peaked and is falling faster than many expected; the CPI ended up being 6.5% year-over-year in December. The GDP, which measures growth in the economy, recovered in the third quarter; total economic activity in the U.S. expanded a healthy 2.9% for the

three months ending September 30. Unemployment is still low at 3.7%. Low unemployment, wage gains, and near 1% gains in personal income are fueling an increase in consumer spending. U.S retail sales posted their strongest gains in eight months this past October.

But investors may be cautious about feeling too optimistic quite yet, especially with that glimpse into the rear-view mirror. The year 2022 marks the first year in history when the S&P 500 and 20-year Treasury bonds both experienced double-digit losses; the previous “record” was 1969 when the S&P 500 lost 8.5% and long Treasuries declined by 5.1%. Global diversification also didn’t help as both the MSCI EAFE and emerging markets experienced double-digit losses.

So, what can we do in 2023? FSA will continue to react to the markets as the year plays out. Our portfolios started the year defensively positioned with most strategies 50% invested in cash and money markets. However, we remain flexible to either invest more into the markets if the uptrend starting in 2023 continues or follow our safety nets for an exit, if necessary.

Inflation Impact

The inflation rate soap opera currently playing out in the world economy matters for your investments in several ways. First, high inflation has a surprisingly large impact on the value of your assets. By one calculation, if you were to have put $10,000 under your mattress in 1980 (you know, to keep it safe) and pulled it back out in 2021, it would only be worth the equivalent of $2,679.

Of course, current inflation is much higher than in the recent past (6.5% as of the most recent report), so the value erosion is greater now than it has been over the last 40 years. Five years of inflation at that rate would reduce the value of a $10,000 cash to an equivalent value of $7,300.

Inflation also matters because the Federal Reserve is watching current rates and taking steps to bring the rate down to roughly 2%. The policy instrument, as you know, is raising short-term interest rates, which increases the chances of a recession and makes bonds more competitive with stocks. Every rate hike seems to bring with it another decline in the markets.

That introduces one other way that inflation impacts our lives: If the Fed does trigger an economic recession, companies will cut costs and lay off workers. More people will be out of work, the unemployment rate will go up, and wage increases will stall. Overall, the working public will not be better off.

It’s not easy to measure inflation in aggregate. Since all of us buy different things in our monthly budget, these price changes impact all of us differently. Some believe that “core inflation” is a better measure than the Consumer Price Index because it excludes volatile food and energy prices. Core inflation over the last twelve months has been running around 5.7% a year, having fallen a bit in part due to the re-normalization of formerly sky-high used car prices. That’s still higher than the Fed target and not much comfort for those of us who still insist on buying food and driving our cars.

Your Other Portfolio

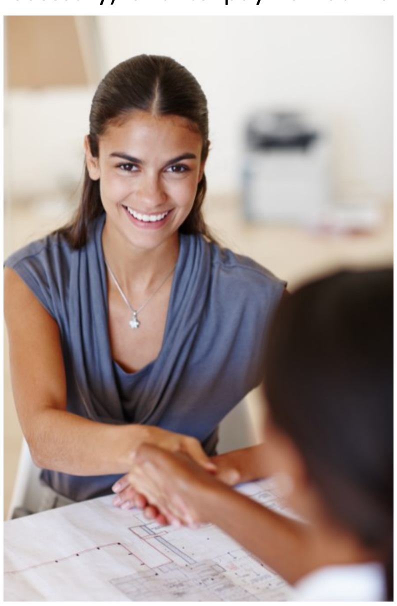
Your home is your most valuable asset, right? Or maybe it's your retirement portfolio. Chances are, if you're under the age of 55, there is another part of your personal balance sheet that trumps both of them.

Most of our investment conversations, professionally and informally, are about portfolio returns and asset allocation. But the truth is, every working person actually has two portfolios which generate returns. That second portfolio is what has been called your career asset.

Broadly speaking, people who enter the workforce start out with a very large career asset which can be defined as the (unknown but probably considerable) future value of all the earnings they'll receive over a 30–50-year work life. In general, college graduates have larger career assets (that is, their potential earnings are greater than people without a college degree), and any specialized training will increase the value of a person's career asset.

Over time, as people move through their careers, their career asset is incrementally monetized (that is, they're paid for the work they do). As they monetize their career asset, some of that is transformed into capital assets – their savings, which is invested in a retirement portfolio which will grow over the course of their career.

One of the fundamental jobs of a financial planner is to make sure that each of us keeps enough of the money generated by that career asset each year to eventually support us in retirement (to make work optional rather than necessary) and to pay for our other goals and objectives. Ideally, the returns on the monetary assets will eventually be enough to cover your monthly expenses, making work optional and retirement affordable.



We call this savings and investing, but it's really a process of gradually, with discipline, turning your career asset into capital assets so that when you decide to retire and your career asset has been consumed, it's replaced by the ever-growing capital assets in your investment portfolio. Tragically, millions of people never retain enough of the money generated by their career asset (never save enough) to make work optional later in life.

This career asset is usually far more stable than the stock market; when the markets go down, you still go to work; when the markets go up, you're still earning the same income. But as millions found out in the last economic downturn, your career, too, can be affected by upheavals in the economy. When somebody is laid off, it interrupts the cash flow from the career asset and raises a lot of "career asset management issues" that probably should have been considered all along:

Are you working in a stable, growing industry or profession?

Shouldn't you, every year, reevaluate your skills and value in the marketplace?

When does it make sense to change jobs or careers or get retraining?

How much of a return will you get on the cost of taking time out from work and paying for college courses or specialized training?

Are there free training opportunities that you should be taking advantage of?

Other seemingly complicated financial issues make much more sense once you understand the career asset concept. Life insurance, for instance, can be seen as a way to protect the future value of your career asset. The same is true for disability insurance. Theoretically (unless you have estate planning issues, which is another discussion), the amount of life and disability insurance coverage you need will be reduced as you "monetize" your career asset over time.

Financial planners are beginning to take a closer look at those clients who walk in their door and can't wait to retire early because they're miserable in their present job. What we're learning is that the solution may not be an early retirement but either a renegotiation of the current job (less responsibility, less stress, maybe less travel, and also less income) or a career change to something more satisfying. As more of your career asset is monetized, as work becomes more and more optional, some workers are looking for a more fun way to generate income and prolong their work life. One advisor recently talked about "helping people shift from a great-paying crappy job to a crappy-paying great job," something they would enjoy doing for many years.

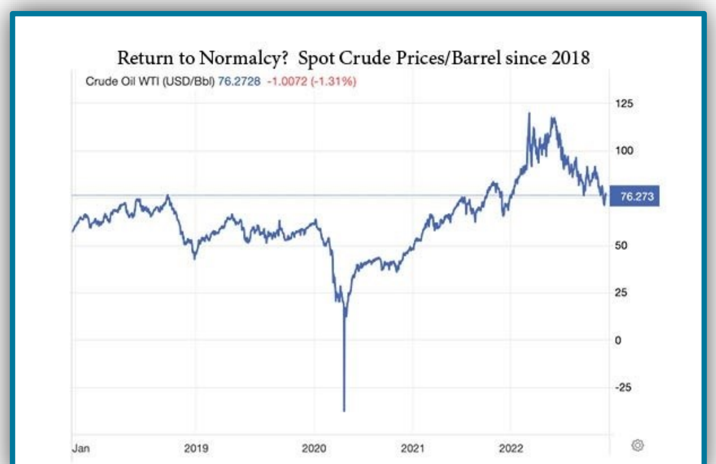
Suddenly, their work-life has been extended by a decade or more, putting less stress on the retirement portfolio, putting more fun in their lives, adding new value and life to their career asset. This is the holy grail of financial planning: a win-win-win.

Oil's Return to Normalcy

Just a couple of months ago, oil was selling on the international markets at upwards of $115 a barrel, and the gas prices at the pump (did you notice?) were ranging around $4-$5 a gallon. Now you can fill your tank at around $3 a gallon in most places, and barrels of oil are trading at around $76. If you look at the five-year price chart for oil, you can see the COVID pandemic and the Russian invasion of Ukraine having rather dramatic (and opposite) effects on oil prices, and the trend since mid-2022 has been a return to normalcy.

Over the years, there have been a number of alarmist predictions about how the world is running out of oil, how temporary price increases were going to continue forever, etc., etc., and each time the global economy corrected itself and reduced the alarming trend to a blip on the screen. If there is a trend, it is that demand for oil will continue to decline as alternative energy sources become more popular and as more automobiles are powered by electricity. According to the most basic economic theory, lower demand would mean lower prices.

In fact, you might be surprised to know that total oil production worldwide last year (89.88 million barrels a day) is actually lower than production levels in 2015. The peak came in 2019 (just under 95 million barrels) and has been incrementally declining ever since. We aren't running out of oil, but we are very slowly reducing our need or demand for it.



Unproductive Tech

Economists tell us that new innovative technologies enhance productivity in the workplace and make our lives better. That has certainly been true in the past. With the internal combustion engine, cars and tractors replaced horses. With the advent of electricity, we could work longer, later hours in the equivalent of daylight and stay warm or air conditioned while doing so. Trains and airplanes changed our travel plans. The Internet and computers launched a new era of white-collar productivity, and the worldwide web enhanced our communication abilities.

But the most recent round of large innovative tech companies may not have had nearly the same beneficial effect. Recently, Microsoft surveyed 20,000 people in 11 countries and analyzed trillions of productivity signals from its Microsoft 365 platform. The results: People are working longer but not faster or better, and their productivity is diminished by the constant distractions of incoming emails, non-meeting files, web activity, and a growing number of Zoom meetings. Also, 48% of employees and 53% of managers reported that they're burned out at work.

The Labor Department has also noticed a decline in worker productivity in the U.S., down by 6.0% annualized in the first half of 2022, the fastest pace on record.

At this point, it's fair to wonder whether social media giants (Facebook and Twitter), streaming movie services (Netflix), smartphone makers, or Amazon (which has put retail stores and malls out of business) are doing anything to boost productivity or improve anyone's lives in a meaningful way, especially compared with electricity and airline travel.

You might agree or disagree, but you should also know that the technology giants of today have hit a rough patch in their business lives, perhaps because they realize that they haven't been as relevant as anticipated. In November alone, Meta and Amazon laid off 11,000 and 10,000 workers respectively, Twitter added 3,700 to the unemployment rolls, and Microsoft recently announced plans to eliminate 10,000 jobs.

If there's good news in all this, it is that tech and the information sector overall make up just 2% of the total U.S. workforce and that the layoffs have not raised the unemployment rate drastically yet.

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