Talbot Asset Management Random Report

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Don't Fight the Fed

"Don't Fight the Fed" is one of the most hallowed commandments in financial markets. Interest rates declined from 1982 until last year. For the last 40 years the markets, for the most part, have had a terrific tailwind. We have had a 40 year bull market in bonds and declining interest rates. Wall Street has always had a rule of "Don't Fight the Fed" which meant you should align your investment philosophy with the actions of the Federal Reserve. Aligning with the Fed means you invest aggressively when rates are low (and heading lower) and conservatively when rates are high (or moving higher). When rates are low, the economy usually expands and most asset classes go up in value. When rates rise, it prevents the economy from growing too quickly as it causes businesses to borrow at higher rates.
The Federal Reserve has five main responsibilities:

1. It enacts changes in the monetary policy in the US to promote price stability (keeps inflation reasonable and historically under 2% annually) and tries to keep unemployment low.

2. They regulate the banking system to maintain stability.

3. They try to contain risk in the financial markets.

4. They provide financial services to the US and foreign governments.

5. It monitors the impact of financial regulations, policies, and laws that politicians decide to enact.

As we are all aware, inflation has been rampant this past year and has caused the Federal Reserve to aggressively raise rates. The degree they have raised rates have been historic. They are a little late to the party to try and bring down inflation. They should have started this process much earlier and much more gradually. Unfortunately, they haven't had much help from Congress as Congress has passed several bills that actually helped create a lot of the inflation we are currently experiencing. This rapid increase in interest rates and inflationary issues caused 2022 to be one of the worst years on record for a wide range of assets from stocks to U.S. Treasuries to corporate bonds. It caused the housing market to cool off somewhat. The only sector that had a decent year last year was energy as the government continues to wage war against the US energy sector.

This means the <u>era of free money is probably over.</u> This also means the investment climate has changed. Investments and investment strategies that were in favor over the last decade may be different going forward. The things that I learned in business school about stock valuations may be coming back in vogue. Cash flow, book value, earnings per share, dividends, quality of management, etc. may be coming back instead of plowing money into ten large technology names and thinking things were going to the moon. Valuations will matter again.

Hello, it's me…. Part 2

As you know, we changed our newsletter from a quarterly newsletter to a whenever I have things to write about newsletter. Last year was one of the most difficult investment climates I have seen in years. I have written this newsletter multiple times over the last year only for market conditions to change so rapidly it was almost obsolete by the time I finished it. The other issue was that for most of 2022 my technical indicators were neutral to negative. I wasn't a fan of most equities except the energy space. It was more a market to try to not lose a lot of money as opposed to one where you try to make money. The odds were not necessarily in our favor. When inflation is high and rates are rising, it's a very difficult environment to make much money. It's better to have higher amounts of cash. For the first time since 2006, we are getting paid now to hold cash. Money market funds have gone from zero percent interest to over 4% currently. My asset allocation computer programs were suggesting to keep higher than normal allocations to cash and I tried to do that. The world is still a dangerous place with the war in Europe and the rise of the Chinese military (more on that later) and the political environment is a daily comedy hour. There are a few interesting opportunities developing and one of those is…

Bon Jour

I took two years of French in high school. About the only thing I remember is Parlez-vous Francais? I will admit that there are only a few places in the world where knowing French comes in handy. Learning Spanish or Chinese would have a been a much more useful language to learn.

When I went through training with E.F. Hutton in 1981, you were taught that you should have roughly 30% of your portfolio invested internationally. The reason for that allocation was that historically U.S stocks and international stocks were negatively correlated. This meant that if the US was doing poorly, the international stocks would perform better and vice versa.

For most of the 1980's and into the 1990's, this strategy generally worked. It works until it doesn't. For the last 15-20 years, international investing has significantly underperformed the US stock markets. The reasons for this are many. Currency translations, government interventions, lack of good international research, and a lack of transparent accounting all have been a factor for the international markets underperforming.

Things may be changing. I might have to dust off my old French textbooks. As an investment strategy, you want to buy international investments when the dollar is strong and then begins to weaken. Some market strategists I follow believe the 11 year bull market in the US dollar is over. Over the last 12 months, the dollar has been strong as the Federal Reserve raised interest rates. With higher rates, foreign investors had to buy dollars to buy our higher yielding interest rate vehicles. This drove the value of the US dollar significantly higher. In fact, a few months ago, the dollar was at parity with the Euro. That's the reason everyone and their cousin wanted to take a vacation to Europe (safety tip: avoid Ukraine).

Something is changing right now. I don't know if it is temporary or if it is a longer term trend. The dollar has weakened over the last few months. Investors have been shifting funds overseas. The US markets are starting to significantly underperform the international markets. My asset allocation computer models are now suggesting having almost 20 % allocated to the international markets. For the last decade, it has hovered around 10%. It has gone from 10% to 20% in just the last few months. This is highly unusual (everything seems highly unusual right now). Unfortunately, I have been underweighted in this area for quite sometime and we are looking at several alternatives to increase our allocations. Due to currency translations, I will generally use actively managed mutual funds to accomplish this.

Why is this occurring? One reason is the current drunken sailor spending occurring in Washington, DC. This will weaken the dollar when you create more of them. I mentioned in a prior newsletter about the explosive growth in the money supply. The dollar is the reserve currency in the world and the world is awash in dollars. This has cause inflation to spread worldwide. With most commodities priced in US dollars, it has created numerous problems in several countries, especially emerging markets. Central banks around the world have been buying massive amounts of gold as opposed to hoarding massive amounts of dollars as a reserve. Bottom line: foreign countries are losing faith in the US dollar.

Another factor is international investments are fundamentally cheaper than their US counterparts. International stocks yield almost twice what US stocks yield in dividends and they are valued at cheaper and more realistic valuations. With 2022 under our belts, value is starting to outperform growth, international is starting to outperform the US. I don't know yet if this is a long lasting trend but the move has been too pronounced to ignore it.

With that said, I am avoiding allocations to China. In our due diligence, I'm looking for international investments that exclude China. Even though everyone thinks China can be a good place to invest, I personally disagree. I believe, as I pointed out in an earlier newsletter that China is currently in a silent war with the US. I don't want to finance their expansion through investments.

One of my fraternity brothers is Casey Fleming, CEO of Black Ops Partners. He is an expert on China. In an interview with the Epoch Times, he stated "Social movements such as the promotion of Critical Race Theory, the "defund the police movement" and wokeness, as well as stealth tactics such as intellectual property theft and drug trafficking, are used in unrestricted hybrid warfare by the Chinese Communist Party (CCP) to weaken the United States." He believes the US is already at war with China and the CCP. He states, "There's only one China and it's completely controlled by the CCP, so you can't extract one or the other." China believes their destiny is to rule the world.

He believes that drug warfare is another area they are using to weaken the US. Everyone has seen the amount of fentanyl being brought into the US over our wide open southern border. Casey says "The fentanyl capital of the world is Wuhan, China and the CCP ships the chemicals to manufacture crystal meth pills and fentanyl pills to Mexican drug cartels."

Casey believes the defund the police movement and wokeism are also CCP methods in unrestricted hybrid warfare. He believes they are probably funding several of these NGOs (non governmental organizations). He states, "The ultimate goal is to weaken the United States and weakens our will to fight, and they can just walk on in. They don't have to fire a bullet. It's to take over the world and replace democracy and freedom worldwide with Chinese Communism." If you defund the police, it takes away a line of defense should the unlikely occur.

He believes "in order to prevent the CCP from winning this war, foreign influence through investments need to be stopped first, whether it's in business, academia, or government." "People should care a lot about it because their children and grand children are on the balance." He concludes the article by stating "We are in a battle. It's just a battle we're not familiar with."

Thus, China is not on my radar screen as an investment option.

Secure 2.0

Towards the end of last year, President Biden signed into law the Secure 2.0 Act. There are several interesting parts of this act that could affect some of us.

Let's start with the dreaded required retirement minimum distributions. For investors born between 1950 and 1959, the Secure 2.0 Act pushes the RMD to age 73. For those born in 1960 or after the new RMD age beginning in 2024 is 75.

It allows surviving spouses to be treated differently for RMD purposes, effectively delaying the distributions until the surviving spouse would have reached RMD age. So if one spouse dies before the RMD's begin, the surviving spouse can stretch out RMD's using the <u>uniform</u> lifetime table which will produce much lower RMD's.

In another win for investors and another reason I always suggest having a taxable account for tax diversification, the IRS created a higher income threshold for long term capital gains. For 2023, <u>zero</u> percent capital gains tax rates are $44,625 for single filers and $89,250 for married filers jointly. Single filers with taxable income of $44,625 to $492,000 and joint filers between $89,251 and $553,850 qualifies for a 15% long term capital gains rate. Single filers with a taxable income of $492,301 and joint filers of $553,851 will pay 20% on long term capital gains.

The Secure 2.0 Act also creates a new backdoor Roth IRA opportunity. The rules are still being defined but in it's current form it allows unused funds from a qualified college savings plan (i.e. 529 plans) to be transferred to a Roth IRA free of taxes or penalties. Bill Cass, a retirement expert from Putnam outlined the rules as he currently understands them. These rules include:

- The aggregate, lifetime amount eligible to be transferred from the 529 to the Roth IRA is $35000 per beneficiary.
- The Roth IRA must be established in the name of the 529 beneficiary.
- Annual contribution limits apply to transfers. For 2023, the contribution limit for IRA including Roth IRA's are $6500.
- The 529 beneficiary who is receiving the transferred funds in a Roth IRA is subject to the earned income requirement that applies to all IRA contributions (in other words, you need to have employment income).
- However, Income eligibility requirements for making Roth contributions do not apply.
- The 529 must be established for at least 15 years before a transfer to a Roth IRA can occur. This is an interesting provision should you want to use this as a back door option. You would want to start a 529 as soon as possible to begin the 15 year period. You could fund the 529 with a minimum amount to start the 15 year time period.
- The contributions (and the earnings earned) made into the 529 during the last 5 years are not eligible to be transferred to a Roth IRA (this is meant to prevent someone from making a large contribution into an existing 529 and trying to transfer those funds to a Roth IRA immediately to avoid income limits associated with Roth IRA contributions).

Now that we know that Congress never makes legislation easy to understand, I would expect additional guidance on how the details of this will work. This legislation does give parents a different option for 529 plans since the prior law taxed non-qualified withdrawals.

It also gives parents an option to fund their kids Roth IRA. You could jump start a retirement account for your child while saving for college at the same time. If they don't use all of the 529 plans for college, they would have a Roth IRA to start their retirement savings.
The parent could also allocate some funds to a 529 while naming themselves as the beneficiary. If those funds are needed for college in the future, you could change the beneficiary to the student. If the student doesn't need the funds, the parent could remain the beneficiary and begin transferring funds to a Roth IRA for themselves once the 529 has been established for 15 years.

These new rules could be changed in the future, but as of now, this new option adds another arrow in your quiver.

Why Interest Rates May Stay Higher For Longer...

During Joe Biden's State of the Union Speech he claimed that "my administration has cut the deficit by more than 1.7 Trillion -the largest deficit reduction in American history." He concluded by saying "They are the facts. Check it out. Check it out."

Challenge accepted. My job was made a little easier by the Congressional Budget Office (CBO) releasing their 10 year forecast for the Federal Budget shortly after Biden's speech. In this exciting, 101 page document, it shows that in January 2021, the CBO projected the federal deficit would be $2.3 Trillion. It actually came in at $2.8 Trillion. My math teachers at Urbana High School would have told me this was an INCREASE of $517 billion-not a decrease. According to the CBO, the deficit also increased by $320 billion in 2022, and will increase by $447 billion this year. If Biden's policies are left in place through 2031, the deficits will be $5.45 TRILLION higher than they would have been if Trump's policies remained in place.

According to the CBO, they are projecting a $6 Trillion dollar INCREASE in REVENUES over the next ten years. They also project economic growth with be HIGHER over the next ten years. The upcoming deficits have one cause and that is excessive SPENDING. This spending is projected to increase spending from 2022-2031 by $12 TRILLION.

This could easily be responsible for the decline in the value of the US dollar recently. Who is going to want to invest in our Treasury Bonds if they know we are going to be issuing more and more to finance this spending spree? The Chinese and Russians are already trying to get rid of the dollar as a reserve currency and these spending policies will continue to keep inflation elevated. The era of low interest rates is probably all over unless there is a change in Congressional fiscal policies and spending habits. (How many R's are there in FAT CHANCE).

This change in interest rate and inflation scenarios changes the investment climate. What worked over the last 10 years is probably not going to work well over the next 10 years.

Social Security, Medicare and Goal Planning...

As a reminder, we do have a software program available to us that calculates thousands of Social Security distribution options if you have not started collecting Social Security yet and want to know some of your options. Just send Sam one of your latest Social Security statements and we can input the data and go over your options.

Raymond James also has a firm that can work with you (for free) to help navigate through the mine field of Medicare options. We have used them for several clients and most have been very pleased with not having to go through the billions of options on their own. The company is called **Clear Match** and their dedicated Raymond James phone number is **844-269-2646.**

Several of you are also using our Goal Planning and Monitoring software which looks at your complete financial picture and creates a goal plan to meet your investment and retirement objectives. This involves completing a questionnaire with your data and the program constantly updates the results. Reach out to Sam at Sam.Giufre@raymondjames.com if you want to start this process.

Texting...

It has been the policy of the Securities and Exchange Commission to not allow texting of securities business between clients and their advisors because it does not comply with their Books and Records regulations. Based on this regulation, all emails and texts are documented electronically for record keeping purposes.

To make things more efficient and to keep us in compliance with the regulators, we have created an office phone number especially for texting purposes. This gives us the ability to message each other via texting for business related communications. This number will be on a business dedicated phone where one of us will have it with us daily during business hours. Please feel free to text us and we will respond as soon as possible. As always, please call the office when requesting a distribution of funds.

Our new texting number is: 407-714-3101. Please save to your phone contacts for easy recognition.

Things that don't make sense...

Speaking of government regulations, some of you might have received recently an email from Nancy asking if you were ok with receiving a form via email and to respond within 3 days. We had to send this email to all the clients that have been with us less than 5 years. If you didn't respond within 3 days, we will be sending you a 46 page document by mail.

Speaking of additional regulations, we now have to send you regulatory documents before making any recommendations or opening any accounts. Theoretically, if I ran into someone who is not a client and they asked me my opinion on something financial….I would have to say "what's your email so I can send you some documents before I give you my opinion."

I got into this business to find investments that make my clients money. The amount of regulatory stuff being pushed down from the Federal Regulators will not decrease anytime soon and that does take a little fun out of things.

Late Night Revelations and Other Useless Information...

Most golfers are familiar with the GHIN Handicap System. A golf handicap is a scoring system which measures a golfers potential and is used to enable golfers of all abilities to compete against each other. The maximum handicap anyone can have is **54.**

In the not sure it was a great idea category….we just got another dog. We already have a Great Dane (Apollo) and a Golden Doodle (Daphne) who are both eight years old. We just brought in a Golden Doodle puppy and named him after one of my favorite all time singers……Meat Loaf.

Since Twitter seems to be in the news daily after Billionaire Elon Musk took over the company, I thought I would enlighten you with some Twitter useless information. According to Facts.Net, Twitter was started in 2006. Seventy-one percent of Twitter users use the platform solely to read the news (myself included). Katy Perry has the most "followers" on Twitter. The oldest Twitter user ever was 104 years old. Twitter is more popular among males than females. Ten percent of Twitter users send out 80% of the "tweets" (and in my opinion, half of that 10 percent are psycho). Democrats make up a majority of Twitter users. The median age of the average Twitter user in the US is 40.

We all know about the Chinese spy balloon shot down over South Carolina recently. There were also at least 3 other balloons shot down and according to White House Homeland Security Advisor Liz Sherwood-Randall there are "hundreds, if not thousands of unknown objects in the skies-but they're likely just used car balloons or other benign crafts and not aliens visiting Earth." Next time I'm flying Southwest to Indianapolis, I'm definitely looking out the window for the balloons that say "Buy your F-150 here".