Talbot Asset Management Random Report

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Elections have Consequences

Historically, political elections are taken in stride by the markets. The markets usually like a divided government (like we have now) because radical legislation usually cannot be enacted one way or the other. We all know how politically polarized our nation is right now. As a portfolio manager, I can create a portfolio based on the outcome of the upcoming Presidential election. Unfortunately, those portfolios could be 180 degrees different based on who wins. I have to play the cards that are dealt to us.

Barack Obama infamously claimed after his inauguration in 2009 "Elections have consequences." "I won". He also stated in a campaign speech five days before his election, " We are five days away from fundamentally transforming the United States of America." Michelle Obama was quoted in May 2008, "We are going to change our traditions, our history; we're going to move into a different place as a nation." I have been perplexed by how you can change history but the recent removal of the statute of Thomas Jefferson from a New York City building (that had been there for 187 years) may explain how changing history might involve eliminating history.

So if the markets like divided government, what could go wrong? Government regulations by non-elected bureaucrats is a problem. Every single government agency is bringing out regulations that are a drag to the economy. The biggest example of this is in the Energy Department. So far they have introduced regulations to change light bulbs, air conditioners, dish washers, refrigerators and the one that gets my wife especially riled-regulating gas stoves. They are also working on mandating electric vehicles, limiting drilling of oil and gas on federal lands, and they just recently stopped permits on building liquified natural gas facilities using climate change as the catalyst to these regulations. If you want an economy to fire on all cylinders, you do not create regulations that cause the economy to slow down. If people want to buy an electric vehicle, let them buy an electric vehicle. Planned economies generally fail and capitalism usually succeeds by allocating resources to their best use. Recently, a cold spell in the north, especially Chicago, created a "Robot Graveyard" where no one could charge their electric vehicles due to extreme cold. That's just one problem with electric vehicles along with the state of our electric grid. We are years away from a fully functional market that would support this transformation. Yet, elections have consequences.

The biggest issue with voters right now is the situation on the Southern Border. Over 10 million people have come across the border in the last 3 years from nations all over the world. This is an economic risk and a security risk. FBI Director Christopher Wray even testified to Congress that his assessment of the current threat level was very high. America is a formidable superpower. You cannot take on the US Military and expect to win. In reality, Russia and China have aligned themselves with small militias that are problematic to America. If you remember in one of my earlier newsletters discussing the book written by two Chinese generals called "Unrestricted Warfare" where they destroy America without firing a shot. This border strategy could do it. By aligning with these non-state actors as they cross the border and move into the country freely, it runs the risk of organized crime gangs creating problems for Americans.

Over the last several years, Ecuador has become a global headquarters for organized crime (source: Dr. Pippa Malmgren). Ecuador has several ports on the ocean owned by China and China has been sponsoring a lot of the unrest against the Ecuador government. Organized crime gangs in Ecuador have currently created a civil war in Ecuador. A few weeks ago they infamously took over a TV station live and in color. How many people have crossed the southern border in the last 2 years from Ecuador according to the Department of Homeland Security: 31,000.

So why would the current administration not follow immigration law and allow 10 million people into the US? A lot of politicians are saying they are doing this to allow immigrants to vote. Most states do not allow non-citizens to vote although there is no national data base that states can use to prove US Citizenship. These immigrants do not even need to register to vote. They can be used for the purpose of redistricting. With the way our census works, we count the number of people, ***not the number of citizens***, for the purpose of allocating congressional districts and electoral votes. These immigrants will eventually be counted into the population of various states for the purpose of allocating congressional districts. It's a long term strategy that is appearing right in front of us.

This influx will create issues with school systems, healthcare systems, and dozens of other social services. A recent article in

Barron's Magazine described how 43% of rural hospitals in America are running deficits with a large number being in Texas. It could easily bankrupt various municipalities. It already takes me 3-4 months to get an appointment to see my doctor. Just wait until 10 million more people get into the system.

So you may think Ecuador is far away and not relevant to our political lives or our portfolios. Events occurring on our Southern Border are symptomatic of the new geopolitical conflict. China and Russia have a strategy to align with small militant groups around the world that will make life hard for America. The recent drone attack that killed three service members and wounded dozens more by the terrorist group Houthis is a perfect example. You can send in all the aircraft carriers you want but a small terrorist group with a $30,000 drone can be like a lion swatting at flies.

Now What?

Normally, stocks move according to earnings and interest rates. However, we now live in a world with lots of geopolitical risks. Some people already believe we are in World War 3.

I admit I was too conservative during 2023. With interest rates rising as rapidly as they did, it usually creates a head wind for stocks-especially growth stocks. With government backed money market funds yielding over 5% with no risk, I felt pretty comfortable having a decent allocation to money market funds and one-to-four-year bonds. For the first time since 2008, we could get paid for cash holdings. What surprised me was the almost one percent drop in interest rates at the end of October. After being in a trading range for most of 2023, the markets rallied strongly into the end of the year. The other problem I had was a lack of clarity and a lack of conviction on what stocks made sense. Large company stocks were dominated by what was referred to as the Magnificent 7. Almost 30% of last years gains came from seven stocks. Europe was already in a mild recession. China's economy is showing signs of deflation. Our manufacturing was in a pull back at the same time interest rates showed an "inverted yield curve." An inverted yield curve is where short term interest rates are higher than long term interest rates. When that occurs, it historically means a recession is on the horizon. In fact, most economists were predicting a recession, but it never came in 2023 like so many predicted.

How about 2024? Unless we get another drop in interest rates from here, I would expect a trading range environment for stocks. Large company stocks are historically priced expensively while small company stocks are historically priced very cheaply. You could easily have a market that has several rotations in and out of various sectors through most of the year. Interest rates are more "normalized." I got into the business when money market rates were 21% and mortgage rates were 16%. People complain that mortgage rates are high at 7% but in reality, this is more of a normalized rate based on economic factors and where the current rate of inflation is. The odds of seeing 3% mortgage rates again are pretty remote. It will take a while, but people will get used to higher rates over time. Usually in an election year, the Federal Reserve doesn't move interest rates much, so they don't get accused of affecting the election. Hopefully, they continue that policy.

Dark Shadows

One of my childhood memories was making it home from school in time to watch "Dark Shadows." It was one of the first popular daytime series that aired from June 27,1966 to April 2, 1971. It became popular when Barnabas Collins arrived where he became a vampire at night. The show had ghosts, werewolves, witches, zombies, etc. Everything a good nine year old would want to watch at the time. And of course, it was only available on black and white television. It eventually became ABC's highest rated daytime television show.

Vampire lore actually came to being in a novel by Bram Stoker in 1897. It was taken from Transylvania folklore. According to Vampire legend, vampires survive by "feeding on the vital essence of the living." Some of the qualities include blood drinking, immortality, avoiding sunlight, and heightened senses. Like a vampire, inflation can come quietly in the night. It creates pain and drinks the lifeblood out of the economy. Inflation avoids sunlight because central bankers (i.e. The Federal Reserve Bank) try to keep their methods and numbers in the dark as much as possible. Inflation makes you mad. It means you can't afford things you need or want. Energy inflation creates fertilizer inflation which creates food inflation. Once inflation is present, everyone realizes it is there. In other words, inflation is a vampire.

Inflation has been creeping back into our system for several years. The size of products began to shrink even when prices remained the same. A box of General Mills cereal decreased from 19.3 ounces to 18.1 ounces (a ten percent drop). In 2017, the publication "The Telegraph" put out a report saying over 2,500 products had undergone some version of "shrinkflation." In November 2021, The Dollar Store announced that prices would be going from $1.00 to $1.25.

The vampire of inflation went from 0% to 4% in a decade. This inflation shift can create several societal problems. As food costs rise due to inflation, people eat lower quality foods and this eventually creates heathcare issues.

Federal Reserve Chairman Powell incorrectly used the term "transitory" in describing the current state of inflation. The Inflation Vampire is probably not transitory, even with the rise of Artificial Intelligence making productivity increases in the economy. Unless the government can reign in government spending, which is currently unlikely, inflation could easily be here for awhile. By printing more money, the government is continuing to lessen the value of the dollar as that is the easiest way for them to pay back their debts. The other way: taxes. For a refresher on that, see the earlier section of "elections have consequences".

I got into the business right after the inflationary period of the late 1970's. The investment scenarios that work during inflationary times are different than when inflation is running at or below 2%. Granted technology helps in improving productivity in helping companies develop products faster and cheaper. Until the government can restrain their growth in spending, inflation will continue to be an issue for quite sometime. Hello again, Barnabas Collins.

College Today, Retirement Tomorrow...

I have mentioned 529 plans several times as an investment vehicle to use for children's education. It allows investments to grow tax free if used for educational expenses. They have other benefits as well. You can change beneficiaries if the beneficiary you initially established receives scholarships or decides not to go forward with school. You can change the beneficiary to yourself if you want to use it as an IRA alternative after 59 ½ years old. Or you can recapture the fund money and pay taxes on the investment earnings if you didn't want to change beneficiaries (penalties could apply).

Now, in an added benefit to the 529 plan, effective January 1, 2024, the Secure 2.0 Act included a provision allowing qualifying "leftover" funds to be moved to a Roth IRA penalty and tax free. There are a few requirements and limitations. The most pertinent is the 529 has to be in existence for a 15 year period. The 15 year period starts when the 529 is started. Therefore, it makes sense to start a 529 plan early even if you fund it with $100.

There are a few other limitations and several of them haven't totally been clarified by the IRS yet. One of the provisions limits the amount that can be rolled over to a Roth IRA is $35000 lifetime. There are other rules that will be subject to adjustments but in any case it now gives you the ability to fund college and also start the students retirement plan with one investment vehicle. Congress actually came up with a common sense policy (which they rarely do) that helps ease concerns about over funding an educational plan.

A Tragic Real Life Story

I had the unpleasant experience of being the pallbearer to a friend of mine recently who passed away from Alzheimer's at the young age of 67. Losing a friend to this disease is very disheartening as it is terrible to watch how the disease advances. His death though brought even more issues than you could fathom and I've seen it several times over my career. It is when only one of the spouses is handling all of the finances and the other spouse has no clue where they stand financially. This happens much more often than you think. The husband has historically been the financial contact in most situations although over the last decade it appears that duty is falling more onto the shoulders of the wife. I have had situations where the wife didn't know how or where to pay common bills like the electric bill.

In my friend's case, he was using their funds to take care of his parents and their assisted living scenarios and by the time he was unable to work, their finances were severely depleted. It's important that husbands and wives are aware of the financial situations so that it is much easier to move forward if something happens to one of you. I've had situations in the past having to do some investment forensics trying to track various investments down that weren't under my management. In one case, we were still finding assets two years later.

To help the cause, I would do the following things as a minimum:

1. Create a list of all your assets. In my case, I have a 3 ringed binder that has account statements for every account along with a list of passwords if the accounts have online access.

2. List your liabilities and debts with payment dates. You don't want to fall behind in payments.

3. Make sure you at least have a will and consider a living trust. A will transfers assets if you die but may have some assets subject to probate. A living trust names beneficiaries that could allow your beneficiaries to receive things faster and usually without probate. A will comes into play if you die, but a living trust can handle affairs if you are living but mentally or physically incapacitated.

4. Make sure the beneficiaries are up to date on your retirement accounts.

5. Please…….have a frank discussion with your estate attorney if they want you to name a trust as the primary beneficiary of a retirement account. The reason for having primary beneficiaries is to name who you want to receive your retirement assets. There are some tax options for beneficiaries if you name a person. Naming a trust **complicates** the situation. I would suggest using a trust if the beneficiary is under legal age or in a situation where you feel the beneficiary would run through the assets. A trust allows you to create when the distributions could occur and under what circumstances

6. Have a health care surrogate in case you are incapacitated like my friend and you are living but unable to make health care decisions.

7. Determine who your guardian of minor children would be if something happened to both of you.

8. Determine who would take care of your pets.

9. In 2025, the tax and estate tax cuts enacted under President Trump expire. If they don't keep or raise the estate tax exception, then you would want to have a discussion about inheritance tax issues if you have a large enough estate.

10. Make sure the executor of your estate knows what they are getting into and be aware of family dynamics when naming the executor. Money creates interesting personal dynamics so make sure that the person you name understands everything about your situation and can handle the issues that may pop up.

11. Make a list of who gets what sentimental personal property. I'm still unsure who will get my baseball cards, James Bond cards, Monkees and Green Hornet cards from the 1960's.

Future Freedoms at Risk

I realize most of you don't pay attention to cases coming to the Supreme Court unless it's a famous case that makes the nightly news. However, I feel one of the most important decisions the Supreme Court is looking at right now is a review of a decision they made 40 years ago which vastly expanded government and especially the regulations from government agencies.

In the Chevron Vs. Natural Resources Defense Council case, the court decided to allow decisions made by government agencies to be the guidelines unless the law specifically stated otherwise. This allowed massive increases in government bureaucracy especially in places like the Environmental Protection Agency. It also allowed the Education Department to dictate how schools should be run. It gave executive agencies vast and unaccountable powers. For years, Presidents who couldn't get laws passed through Congress would just turn their desires over to the federal agencies to enact their policies.

For example, who mandated electric vehicle mandates and the end of the internal combustion engine? It definitely wasn't an act of Congress.

The issue now appearing before the Supreme Court is where commercial fisherman sued the National Marine Fisheries Service (I bet you have never heard of them…but they do have 4200 employees) because the Fisheries Service was requiring government employees to ride on their boats to observe and make sure the boat owners weren't doing anything wrong. However, the government also made them pay the cost of having those observers on their boats. This would be similar to having someone in my office everyday from the SEC to observe my business practices and to make me pay a daily fee to the SEC for the privilege of this monitoring.

A few other recent examples of regulation overreach include a recent discovery of a massive lithium deposit in Nevada on government land that could power 50 million electric vehicles. The company that made this discovery also made another interesting discovery. On top of this lithium deposit is a six-inch-high desert flower called a Tiehm's buckwheat. This is a rare flower and the US Fish and Wildlife Service has declared the Tiehm's buckwheat as endangered. This has put the project on hold at considerable expense while they wait to see if the government will allow them to transplant this plant. They may be waiting for awhile since there has not been one mine approved on government land since the Biden Administration took office.

Another example is the rule just announced by the EPA and the Biden Administration on new air quality rules. It's called the National Ambient Air Quality Standards Rule. The rule enacts stricter air quality controls than what the Europeans even have. It lowers the amount of fine particle pollution omitted from manufacturing plants. According to Jim Timmons, President and CEO of the National Association of Manufacturers, this regulation could wipe out over 1 million manufacturing jobs in the US as manufacturing moves elsewhere.

If the Supreme Court fails to act on these pending cases, the odds of pulling back the power of government agencies will be more difficult without outright laws passed by Congress.

AI=Y2K

The question I am getting asked most often recently is "Are we investing in AI or Artificial Intelligence"? The answer to the question is yes but not in manner you think. Every company has been using forms of AI for quite sometime. SIRI or Alexa are driven by AI components. Walmart uses AI for inventory controls, distribution, customer identification and interests, etc. Every company is utilizing some form of AI in hardware or software. It is going to make everyone more productive if used properly in the workplace.

The interesting thing I am seeing from an investment scenario is the similarities going back to 1999 with the Y2K computer hype. Back in 1999, it was assumed that when computers rolled over to the year 2000, there would be computer failures, planes falling from the sky, power grids falling, etc. Every stock that someone said was affiliated with solving Y2K rocketed to the moon. When the planes didn't fall from the sky, most of those stocks did. The most popular stock of the Y2k hype didn't make anyone any money for 16 years after the bubble burst.

Artificial intelligence is real and occurring rapidly but it's an industry with multiple players from semiconductor chips, software, hardware, data centers, electric grids (because the data centers take immense amount of power), etc. This industry has been emerging for several years but the concerns I am seeing is when something is being hyped, the cautionary red flags go up. When everyone is talking about it, that's the time to be worried about it from an investment perspective.

IRA Deadlines & Contributions

Just a friendly reminder your IRA (Roth IRA) contribution deadline for 2023 is April 15th or before you file your 2023 taxes.

2023 max IRA (and Roth IRA) contributions:
- $6500
- $7500 (50 and older)

2024 max IRA (and Roth IRA) contributions:
- $7,000
- $8,000 (50 and older)

* Please check with your CPA, accountant or tax person regarding your income limits for Traditional or Roth IRA contributions.