SilverStar Insights

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SILVERSTAR
WEALTH MANAGEMENT
Plan • Invest • Guide

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2021 finished with continued strong economic growth across the board except for auto sales due to the chip shortage. Inflation continues to increase largely due to supply-chain bottlenecks in the global economy which leads some to suggest that inflation is largely transitory and may subside at some point. With the Feds projecting 3-4 interest rate hikes this year, it warrants a review of our portfolios and a discussion of the impact that rising interest rates and inflation can have on our portfolios.

Download our **new 2022 Key Financial Datasheet** from our website, www.SilverStarWealth.com under Resources. We expect the Biden Administration to take up tax reform sometime this year so stay tuned. Save the date for our 2022 **CajunFest** on Saturday, April 30th. Details soon.

Market View

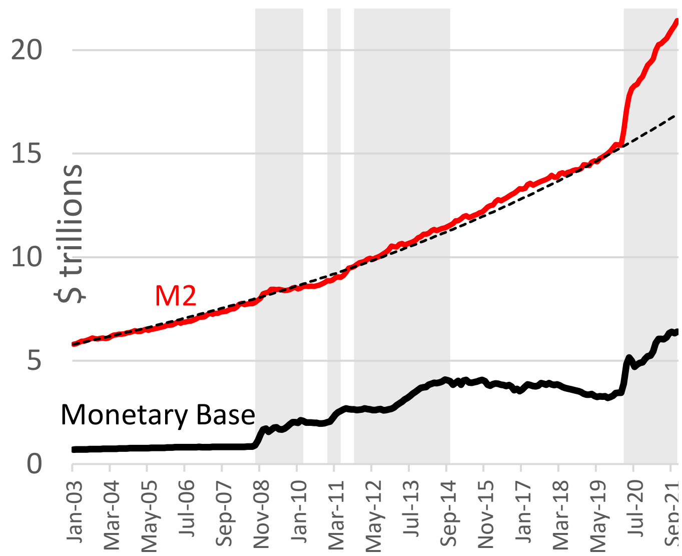
2021 Performance of Capital Markets	
S&P 500 - The S&P 500 (Standard & Poor's Index) is a stock market index containing the stocks 28 500 American corporations with large market capitalization that are considered to be widely held.	**28.71%**
MSCI EAFE – The MSCI EAFE serves as a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia, and Southeast Asia.	**11.26%**
Barclays U.S. Aggregate Bond – The Barclays U.S. Aggregate Bond Index is an index of U.S. dollar-denominated, investment-grade U.S. corporate, government and mortgage-backed securities.	**-1.54%**
10-Year Treasury Yield Rate (as of 12/31/21)	**1.52%**

Sources: Morningstar (Performance from 1/1/2021 to 12/31/2021)
Treasury.gov (As of 12/31/2021)

The economy, driven by continued consumer demand for goods, provided for strong corporate earnings which translated into higher stock prices for 2021. The main driver for this demand and growth is the astounding surge in M2 Money Supply from the massive federal Covid stimulus dollars as illustrated in Figure 1. The M2 Money Supply is currency held by the public plus checking, savings, and money market accounts. The economist, Fritz Meyer, states, "A quadrupling of the monetary base with Fed's Quantitative Easing (QE) did not affect M2 growth. The Cares Act and subsequent stimulus did by putting money directly into consumers' and businesses' accounts."[1] The Feds could never get inflation to their goal of 2% for many years with Quantitative Easing (QE), but the Covid stimulus dollars sure did—and much more than they wanted. The U.S. Labor Department reported, "inflation finished at its highest level since 1982 with the consumer-price index up 7% in December versus a year ago, compared with 6.8% in November."[2]

1 Fritz Meyer, "Economic Update," Webinar, (January 11, 2022).
2 Thomas Gryta, "Inflation Surge Is on Many Executives' List of 2022 Worries," WSJ.com, (January 13, 2022).

Figure 1. The Monetary Base and M2 Money Supply



Source: Federal Reserve, statistical release H.6. Data through November 2021. (Graph provided by Fritz Meyer, Webinar Powerpoint, January 11, 2022)

Stocks have done well in moderate rising interest rate environments in the past as is indicative of a strong economy, provided the Feds avoid inverting the Yield Curve. The Yield Curve is defined by the relationship between the short and long-term rates of U.S. Treasury securities typically represented by the 10-year Treasury bond (long-term) minus the Fed Funds Rate (short-term). When the Yield Curve inverts or goes negative, it means that short-term rates exceed the long-term rates and are often an indicator of an impending recession. The Feds are aware of this risk and will hopefully navigate the upcoming rate hikes cautiously.

Now, the Feds appear ready to wind down their bond-buying QE and start raising interest rates in 2022. "Federal Reserve Chairman Jerome Powell called high inflation a 'severe threat' to a full economic recovery and said the central bank was preparing to raise interest rates because the economy no longer needed emergency support" and was optimistic that supply-chain bottlenecks would ease this year.[3]

There are 3-4 interest rate hikes widely projected for 2022 to help tame inflation. The supply chain bottlenecks do suggest "transitory inflation," as suggested by the Feds, but the inflated M2 Money Supply may take much longer to fall to a normal level which could leave us with higher inflation for a while. A recent survey of 900 global CEOs reflects an expectation of higher prices until at least mid-2023.[4]

Inflationary Risk to Investment Portfolios

The rising cost of goods and services over time is inflation—also known as the silent thief because it steals your future purchasing power over time. If an investment portfolio does not have positive real returns, defined as net return less inflation, it is losing purchasing power to inflation. For example, a portfolio earning 2% and inflation at 4% creates a negative 2% real return (2%-4%= -2%). This issue was less critical in the past with low inflation, but with inflation last month at 7%, it demands our attention now for our more moderate and conservative portfolios holding large percentages in bonds for two reasons.

First, due to the current low-interest rates, investors are not getting much in terms of interest or bond coupon payments. Second, interest rates are at historically low rates and will likely move up causing downward pressures on bond values due to the inverse relationship bond values have with interest movements. Looking back over the last 30-plus years, bonds have appreciated while interest rates have dropped from the highs of the 1970s and 1980s. The *older, higher-interest rate bonds become more valuable in a dropping interest market*. But, when interest rates begin to rise, *the older, lower-interest bonds become less valuable in a rising interest market.* The longer the bond duration, the more pronounced the move in either direction.

This projected shift leads many to believe that a moderate portfolio consisting of 60% stocks and 40% bonds will not likely do as well going forward with rising interest rates as it did over the last 30 years with falling interest rates. As Jean Boivin, Head of BlackRock Investment Institute recently stated, "You cannot look at

3 Nick Timiraos, "Fed's Powell Says Economy No Longer Needs Aggressive Stimulus," WSJ.com, (January 11, 2022).
4 Thomas Gryta, "Inflation Surge Is on Many Executives' List f 2022 Worries," WSJ.com, (January 13, 2022).

something that has worked well for the last 30 years and expect it will continue."[5]

Bonds have, and still do, play a significant role in portfolio construction for two important reasons. First, they can help stabilize the portfolio when stocks are down since they are not perfectly correlated with stock market movements. Second, they can provide stable interest/coupon payments for income. But we must reset our expectations for a traditional 60/40 or explore other options.

Below are some considerations for those with portfolios that would typically require large bond percentages:

1. **Review your risk tolerance, time horizon, and purpose for investing.** Things can change over time; therefore, it is a good idea to review your objectives periodically and adjust as needed. Having your portfolio allocated for your unique objectives is important. Some may believe they have a particular risk tolerance but may not have all their assets such as 401(k)-plans allocated properly. This is quite common and could be costly over time or after a correction. The best time to know your true risk tolerance is before a market correction rather than after.
2. **Review your portfolio to make sure it is properly allocated and diversified to help meet your objectives.** Consider other asset classes including preferred stock, real estate, commodities, inflation-adjusted securities, etc. to include in your portfolio besides just traditional stock and bonds. Having more non-correlated assets included in a portfolio may help to reduce volatility.
3. **Review your retirement income plan.** We need our investments to do two key things for us in our retirement. First, provide liquidity for when we need access for a key purchase or an emergency. Second, we need to convert our investments into a retirement income stream to meet our monthly expenses. For those assets allocated for income, an annuity income rider might be a solution for a portion of your assets…but not all because you will still need liquidity. Some annuity income riders may offer a guaranteed step up on a future income base, such as 5% net after fees which could be an attractive alternative for some. Once the income is started, annuities can provide lifetime income for one, or both spouses.

When considering an annuity make sure it fits within your situation, and you fully understand how the income rider works along with the fees and cost.

Retirement income planning helps to ensure that sufficient income is sustainable during retirement years when the paychecks stop. "The elephant in the room is Inflation—which magnifies the dismal performance of bonds (and indeed cash). As Ben Carlson wrote in this 2018 piece on bond bear markets: 'The real risk in bonds isn't nominal draw-downs or losses in the principal value. It is the loss of purchasing power over the long-term due to the effects of inflation."[6]

As inflation demonstrates, there can be risk of being too conservative in addition to being too aggressive depending on your situation.

Words of Wisdom

"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for the five dollars when you had hair."
--Sam Ewing

Please call us if you would like to schedule a risk/portfolio review and discuss your options to address the higher inflation we are experiencing.

The SilverStar Team

5 Michael Mackenzie and Liz McCormick, "Inflation Is the Biggest Threat to the Bedrock 60/40 Portfolio," Bloomberg.com, (December, 7, 2021).
6 The Wealth Advisor, "Bond Bear Market May be Hard to define But This Sure Is Nasty," TheWealthAdvisor.com, (February 9, 2022).