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Quarterly insights from your friends at Armor Investment Advisors

DUDE, WHERE'S MY MONEY?

by Adam J. Morgan, CFA, CMT

The very same place that set our economy ablaze with innovative technologies that would change our lives forever and inspire the longest bull market in our nation's history also sparked a financial wildfire this past month that sent embers around the world in seconds before finally being smothered, right here in Raleigh, NC. The recent bank failures of Silicon Valley Bank, and others, sent shockwaves through the global financial system as bank customers and the rest of us wondered if this was 2008 all over again. It is not. But it's not 2017, either.

The failure of Silicon Valley Bank was due to poor management, plain and simple. The bank's clients had the ability to withdraw large sums of money at any time using an app on their phones and yet the bank invested much of that money in long-term bonds marked as Held-To-Maturity (HTM) securities. HTM is an accounting classification designated for assets that are not intended to meet short-term cash needs and therefore don't need to be priced daily. Recent interest rate increases have reduced the value of those assets such that when the customers attempted to withdraw their deposits, the bank couldn't meet the demand without realizing big losses. It's akin to having to sell your house today to buy groceries tonight. Depending on the day, your effective grocery bill could be astronomic. You can rest assured that the Holding family will fix this problem now that First Citizens has established a foothold in Silicon Valley. They may also convince a few bankers to trade in their Allbirds for a necktie and a pair of wing-tips! #There'sANewSheriffInTown

> **"The problem that faced these banks was not the same problem that we grappled with in 2008."**

The problem that faced these banks was not the same problem that we grappled with in 2008. In 2008, the banks' leverage ratios made every problem exponentially worse. That problem does not exist today. However, it is worth noting how this fire caught. It wasn't hard for a community of otherwise intelligent entrepreneurs and businesspeople to believe that the bank might be failing. Why? Because these are people who are seeing firsthand how the business landscape is becoming increasingly more challenging. Everyone is well aware that lending standards have tightened, the cost of borrowing has soared, and the cost of labor has skyrocketed. So, when word spread that the banks might be in trouble, it was believable.

This speaks to the fact that our economy has lost confidence. Prior to the pandemic, economic conditions were about as good as they get. The unemployment rate was the lowest since 1969, inflation was nearly non-existent, companies were increasing capital expenditures in masse, and real wages for many Americans in every income bracket were rising. Equity and real estate markets followed suit. Fast forward a few years and our economy is slowly petering out like a late-night campfire. Optimists point to a resilient labor market as a sign of strength, but in my view that's the dog that hasn't yet barked. In order to keep runaway inflation at bay, the Federal Reserve must reduce aggregate demand which in turn is certain to put people out of work. We are already seeing the early signs of weakness as layoffs are spreading. In my view, we are very likely to experience an

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recession this year or next. And the recent bank fire didn't help. After all, would you be as willing to lend money after nearly watching "It's a Wonderful Life" play out in Silicon Valley? This fire surely slowed an economy already slowing.

It's important to keep in mind, however, that the stock market and the economy are not the same thing. The stock market is a forward-looking, price-seeking entity that is willing to look beyond the Valley to the next peak, as long as that peak is visible. Despite the bank failures, the market has rallied because there is now a consensus belief that the Fed will announce a "pause" from raising interest rates at their next meeting on May 2nd. If true, that brings the next peak a bit more into focus for many investors.

Personally, I don't believe that we're out of the woods just yet, but I am somewhat comforted by the strength of recent market-price action. We're now 15 months and 15% away from all-time highs on the S&P 500. That doesn't happen often. In fact, since the 1980s, it's only happened twice, both times during recessions ('01 and '08). So, the recession is not sneaking up on anyone and the S&P 500 just completed the first quarter of the year by posting a gain.

I'm worried that inflation will erode corporate earnings slowly over time and the bulls of late will reverse course when that reality is realized. I'm worried that years of ultra-low interest rates has trained too many to believe that all markets recover in a "V-shaped" pattern, instead of grinding sideways for years as those who aren't invested properly lose purchasing power by failing to generate returns that outpace inflation.

The weight of the evidence, as we see it, leaves us neither bullish nor bearish. We believe that we're in a market where companies that can produce consistent earnings will do well and those who cannot produce will be punished. In 2008 as in 2017, one could more easily evaluate the health of the market by following the obvious trend of the broader index. The ability to navigate through a recession as well as all the challenges facing businesses today should help separate the winners from the losers. For that reason, we continue to favor higher quality stocks that have displayed an ability to grow free cash flow as well as companies that are comfortably paying a consistent dividend. Furthermore, we have significantly reduced our exposure to lower credit quality fixed income in favor of investment grade fixed income now paying an attractive yield. For us, this means that we're likely to trail the broader index if we're dead wrong and heading into a strong bull market. For the time being, that is a risk we are willing to accept.

But we'll be keeping our eye out for opportunities. After all, recessions are like wildfires in that they cause destruction in their path while also creating a fertile landscape for new life to grow. —*A. Morgan*

BALANCE SHEET DIVERSIFICATION

by Austen Hawkey, CPA, CFP®

Asset Allocation is a vital aspect of the wealth management industry and for good reason. An often overlooked component of a sound financial plan is balance sheet diversification, also known as asset location. Balance sheet diversification means having various assets that are treated differently for legal and/or tax purposes based on the ownership or titling. There are three types of investment accounts I will focus on to help achieve balance sheet diversification.

Taxable accounts are funded with after-tax money and are taxed each year on the dividends, interest and realized capital gains. Qualified dividends and realized long-term capital gains within these accounts receive preferential tax treatment which are less than the federal ordinary income tax rates. For example, in 2023 a married filing jointly filer with total taxable income between $89,251 and $553,850 will have a 15% long-term capital gains rate. The ordinary income tax rates within that income range are between 22 - 35%.

(Please see disclosures on page 4.)

Tax-Deferred accounts, such as 401(k) and IRA's, are funded with pre-tax money meaning you have either received a deduction, tax credit, or did not paid taxes on the money funding the account(s). Furthermore, the dividends, interest, and capital gains are not taxed annually allowing the account(s) to defer the tax until a later date. The initial investment, as well as, any dividends, interest, and capital gains will be taxed at ordinary income tax rates when the funds are taken out of the account. In addition, the IRS says these funds cannot stay in the account forever and the account owner will be required to take a percentage out once they reach a certain age known as Required Minimum Distributions (RMDs).

Tax-Free accounts, such as Roth 401(k) and Roth IRA, are funded with after-tax money like the taxable accounts but their dividends, interest, and realized capital gains are not taxed annually. If certain requirements are met, dividends, interest, and capital gains are not taxed upon withdrawal like the tax-deferred accounts. Keep in mind there are limitations on who can contribute to a Roth IRA, and the Roth 401(k) option wasn't available until 2006 and isn't available in all employer sponsored plans.

So, why is asset location a critical consideration in financial planning? We've explored how the tax treatment of three types of accounts varies. Diversification among the asset types allows for flexibility to meet income needs and, with proper tax planning, can keep more money in your accounts and less going out for taxes in retirement. To illustrate this, let's compare two hypothetical scenarios.

Scenario 1: We'll assume an individual who saved for retirement through their company's 401(k) plan. This individual decided to save solely in the company sponsored 401(k) and by the time they reached age 73 had accumulated $2,000,000 for retirement.

Scenario 2: We have the same individual, however, instead of solely saving within the 401(k) plan this individual took a more balanced approach to saving and was able to accumulate $1,000,000 in the 401(k) plan, $500,000 in a taxable investment account, and $500,000 in a Roth IRA. So, this individual has the same amount, $2,000,000, saved for retirement but has diversified the funds among 3 different types of accounts that are treated differently for tax purposes.

My assumptions are as follows: age 73, filing status of single, no dependents, claims the standard deduction, receives $35,000 in social security, and is not subject to Alternative Minimum Tax. Table 1 demonstrates the differences for a side-by-side comparison.

Table 1

Scenario 1		Scenario 2	
RMD	$75,472	RMD	$37,736
Social Security	$35,000	Social Security	$35,000
Total Income	$110,472	Interest	$7,500
Ordinary Income	$105,222	Ordinary Income	$80,236
Standard Deduction	-$12,950	Standard Deduction	-$12,950
65+ additional	-$1,750	65+ additional	-$1,750
Taxable Ordinary Income	$90,522	Taxable Ordinary Income	$60,286
Qualified Dividends	$0	Qualified Dividends	$7,500
Estimated AGI	$90,522	Estimated AGI	$67,786
Estimated Tax at OI Rate	$15,562	Estimated Tax at OI Rate	$8,880
Qualified Dividends Tax	$0	Qualified Dividends Tax	$1,125
Estimated Tax Liability	$15,562	Estimated Tax Liability	$10,005

**Note 2022 tax rates, tables, and thresholds are used in this example.*

To compare the scenarios in Table 1, Scenario 2 has an estimated tax liability that is $5,557 less than Scenario 1. While Scenario 1 has $22,736 in additional income, Scenario 2 has the advantage of tax efficiency to narrow the income gap. Scenario 2 has the option of taking a tax-free withdrawal from the Roth IRA and/or realizing long-term capital gains in the taxable investment account. In this scenario, the long-term capital gains rate is 15% and only applies to the gain portion of a sale (sale proceeds less cost basis). For example, stock that was purchased for $15,000 is sold for $24,000. The gain of $9,000 is taxed at 15% resulting in a tax liability of $1,350. This is still well below the estimated tax liability in Scenario 1. Another consideration is how income impacts Medicare premiums. Roth IRA distributions are not included in income-related monthly adjustment amount (IRMAA) which can potentially decrease Medicare premiums depending on where an individual's income is in relation to the thresholds.

The outcomes of my example are not intended to discourage people from saving for retirement within tax-deferred accounts, and it does not take into consideration the tax savings that were realized when making contributions. Tax-deferred accounts are a great option for most people, especially when an employer provides matching contributions. However, tax-deferred accounts should not be the only investment asset on your balance sheet. Having balance sheet diversification allows for greater flexibility and tax diversification when you need those assets to support your lifestyle. Whether you are in the accumulation or distribution phase, having a comprehensive financial plan can help you gain tax efficiencies and benefit you in the long run.—*A. Hawkey*

(Please see disclosures on page 4.)

FOUNDER'S CORNER: WHEN THE TIDES ROLLS OUT

by Jeffrey R. Miller, CFA

Warren Buffet once famously stated, "when the tide goes out, we find out who is swimming naked." This is an appropriate metaphor for the Silicon Valley Bank fiasco, led by the rapid series of US Federal Reserve rate increases over the past 12 months. One may refer to this as "The Fed Tide" (with all due respect to the toxic algal blooms which plague warm climate coastlines during summer months).

If ever there was a pointed confluence of misbehaviors by a set of hapless characters, this was another one for the books. Seriously folks, everything that could go wrong did go wrong. The damage to the financial sector has been significant, with three banks (and counting) having gone or going down. We do not yet know how far this goes. Fortunately, early predictions of a 2008 apocalypse appear premature.

I find much of the fault with the Fed and the abrupt rise in interest rates driven by their actions. They are proving relentless in the effort to correct a couple of decades of loose monetary policy in a compressed time frame. It's like slamming the brakes on a 200 mph Ferrari and expecting a smooth stop. Not going to happen, all hell will break loose.

The effect of rapidly rising interest rates on bank balance sheets challenges them to correct the imbalance, in a very short time period. At its core, this is what happened to Silicon Valley Bank, aided by massive withdrawals by depositors via smart phone apps. There were also multiple examples of bad management and lack of responsibility to depositors and shareholders. In the weeks and months prior to bankruptcy, insiders were 1) selling their own shares in the bank while planning to issue more shares in a capital raise, 2) personally increasing borrowing from the bank, tripling their outstanding loans to $219 million, and 3) the president of Silicon Valley Bank was a director on the board of the Federal Reserve Bank of San Francisco, their chief regulator. This is the fox managing the hen house.

We think the banking sector will manage through this, but much blame can be placed at the feet of the Federal Reserve. A slower, more thoughtful rise in rates would have let markets, especially the banking sector, adjust more prudently. Instead, everyone is swimming on the beach. We have yet to see what damage will be wreaked upon the broader economy.

Yesterday, OPEC announced a substantial cut in oil production. Prices will rise, and the Fed has no control over this decision. Nor do they control the massive deficit spending being engaged in by the Federal government. It is with increasing concern that the probability of a harder than necessary recession may be ahead of us. The rate actions by the Federal Reserve are pushing risk into the economy. Is this prudent? OPEC's cut in oil production will drive oil and other energy prices up, stoking inflation—this has nothing to do with monetary policy.

So as the tide rolls out, let's hope you have your suit on.—*J. Miller*

ARMOR ON THE ROAD

We will be hosting a gathering at the Surf Club in Wrightsville Beach on Thursday, July 13 from 5:00-7:00 p.m. Invitations will be going out in June.

Reach out to **contact_us@armorinvestmentadvisors.com** and let us know if we can add you to the invitation list!

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