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THE AEGIS

Quarterly insights from your friends at Armor Investment Advisors

THE SECRET SITS

by Adam J. Morgan, CFA, CMT

Every year around this time, the investment management community feels compelled to offer forecasts, predictions, and outlooks for the coming year. The problem is, collectively, we're terrible at it. Nobody makes meteorologists look better…

If you've read financial news or watched any of the business-related entertainment networks recently, you've probably heard several predictions of an upcoming recession in 2023. In fact, if our economy does go into a recession, it will surely be the most predicted one of all-time. Typically, when so many display this much confidence around a forecast, it's helpful to remain skeptical. I'm reminded of the poem "The Secret Sits" by Robert Frost, "We dance round in a ring and suppose, But the Secret sits in the middle and knows." I'd love to see someone on CNBC inject that kind of honest uncertainty into their investment outlook, but I won't hold my breath.

Developing a forecast of how economic conditions will evolve and how investment markets may behave is an important way to be best prepared for what might occur. I try very hard to estimate future market behavior using data and historical context, while avoiding subjective considerations and behavioral biases. And it's important to try to assign a

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confidence interval to every outlook as a way of acknowledging the appropriate degree of uncertainty.

The Federal Reserve offers their base-case economic forecast in a document called, "The Summary of Economic Projections." In the most recent release made public on December 14th, they paint a picture that is now being referred to as "a soft landing." According to the Fed's median forecast, they believe that we will be able to avoid a recession in 2023 entirely. They believe that they will successfully bring inflation back down to their 2% target by continuing to raise interest rates on into 2023 and do so while real GDP grows for the year. Furthermore, they believe that they will be positioned to then lower the Fed Funds rate in 2024 even as the rate of inflation continues to drop, all without the unemployment rate rising above 4.6%. I'm skeptical.

For months the Fed and many others were saying that inflation would be "transitory" and dissipate on its own. That view was clearly naive. They have now raised the Fed Funds rate 425 basis points (or 4.25%) in 2022 to modulate the rate of inflation. That is the most rate increases in any one year since 1980, and yet inflation remains an issue.

However, those rate increases have had an impact. The money supply, as measured by M2, has begun to come down, and price reductions can be seen at the gas pump, as well as the Case Shiller Home Price Index. But the notion that further monetary tightening measures can be taken whilst the economy continues to grow is a curious one, especially when you consider the Fed's less than stellar track record at fighting inflation without creating a recession. In fact,

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according to a recent study by Harvard economist Larry Summers and Harvard research fellow Alex Domash, since 1955 there has never been a quarter with average inflation above 4 percent and unemployment below 5 percent that was not followed by a recession within the next two years. Those conditions have been met.

Analysts who cover S&P 500 companies also appear to share the Fed's optimistic outlook. Industry analysts are relied upon to estimate future earnings growth for the companies in their coverage space. According to FactSet, analysts estimated that all S&P 500 companies would earn $222.38 per share in aggregate for 2022. Today, that same forward-looking estimate for 2023 has only lowered marginally to $218.47 per share. So analysts' 12-month estimate of corporate earnings for 2023 is only 1.7% lower than their expectation back when fed policy was extremely accommodative. To put that number in context, according to research firm Strategas, during recessions earnings decline on average about 30 percent with a median of down 22 percent.

Those same industry analysts provide a year-end target price for each of the companies that they cover. According to FactSet, when you aggregate those estimates based on the company-level target prices submitted by analysts for all companies in the index, the estimated closing price of the S&P 500 at the end of 2023 is 4,493.50, or 15% higher from where the S&P 500 trades at the time that I am writing this on December 28th. Again, I'm skeptical.

In my opinion, the labor market is the most important aspect of the entire equation. The Fed needs to bring down inflation and they'll need to increase the unemployment rate to accomplish that. The Fed has acknowledged that while recessions are bad, runaway inflation is worse. So in a sense, higher unemployment is bad news and good news. This is the corner into which the Fed has backed themselves. We have begun to see layoffs already and unfortunately, or fortunately, according to the St Louis Fed, delinquencies on credit card debt have already begun to creep higher. If you're a millennial who has convinced yourself that working-from-home is the new way of life, you may want to re-consider that. Companies will be trimming the fat in the coming months.

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In our view, after considering all the variables that we deem most important, the mosaic suggests that the best way forward is to "de-risk" portfolios where appropriate, while remaining invested with longer-term objectives in mind. So that's what we've done. Beginning in November of 2021 and continuing through December of 2022, we have taken several steps to shift portfolios to a more defensive posture. In some strategies, we've sold several stocks entirely with an emphasis on shifting investment away from companies with longer-duration growth prospects and into companies with strong balance sheets and more stable business models. In other strategies, we've reduced equity allocations altogether in favor of high-quality fixed income that is now yielding a nice income stream while we wait for a better investment landscape to develop.

During times like this, it is extremely important to remember that we are long-term investors. The stock market is already down roughly 20% from its peak as a way of pricing in a slowing economy, and recession is not a foregone conclusion. As we've discussed in previous editions of "THE AEGIS", if history is any indication, investors could realize above-average market returns after the worst of the economic woes subside. After all, despite whatever cockamamie click-bait predictions can be found on the internet, the world is not going to end in 2023. The single greatest free market economy in the history of the world will survive and continue to invent new and innovative technologies, develop medicines that improve health outcomes, create brand new industries, and make vast scientific discoveries that advance civilization and raise the standard of living for humanity. That, I can safely predict.
—*A. Morgan*

(Please see disclosures on page 4.)

SECURE ACT 2.0 AND YOU (OR, WHAT RHYMES WITH OMNIBUS?)

by Matthew Miller, CFP®

You may remember that the original Secure Act was passed in late 2019. If you don't, that's okay – that's what we're here for! Intended to make a secure retirement more attainable for everyone, it added some planning opportunities that many of our clients were able to enjoy taking advantage of. Secure Act 2.0 was passed just before Christmas and goes even further. While many of its 80+ sections will be subject to some refinement and interpretation when the rubber of the new law meets the road of reality, we see some key changes that could immediately impact our clients:

Required Minimum Distributions have been pushed back to age 73 in 2023, and that starting age will rise to 75 in 2033. This will open the door for more in-depth "paycheck replacement" discussions for early retirees and near-retirees, and allow additional time for Roth conversions in certain circumstances. Penalties for missing RMDs have been decreased as well. Qualified Charitable Distributions from IRAs are still allowed starting at age 70.5.

For college savers worried about over-contributing to 529 Plans, some relief has been granted in the form of 529-to-Roth IRA transfers. Beginning in 2024, savers can move 529 money directly into a Roth IRA. The 529 must have been maintained for at least 15 years and the Roth IRA must be in the name of that 529's beneficiary, and there is a lifetime limit of $35,000. There are additional conditions, but this represents an attempt to assuage at least one unpleasantness in the college planning world, and we welcome that. On a side note, if you or your student want to talk about college planning or saving, let us know. It's never too early to have that conversation.

Catch-up contributions for retirement plan participants and IRA owners have been improved as well! The $1,000 catch-up for IRA owners 50+ will be indexed for inflation starting in 2024, and (starting in 2025) 401(k) participants ages 60-63 will be able to catch up beyond the current $7,500 allowed for those 50+.

This list is by no means exhaustive, and there is likely to be some back-and-forth when the IRS begins to interpret and apply everything. There are numerous additional provisions that encourage employers to provide better retirement plans, and some that help simplify and standardize things like rollover paperwork. Notably, the ability to do backdoor Roth conversions (an oft discussed potential "loophole" to close) was not eliminated. Know that we are keeping our eyes and ears open, and are always seeking to stay ahead of the game for our clients. Watch this space for more information, and don't hesitate to call Armor with any questions. We are excited to see Secure Act 2.0 in action!—*M. Miller*

ARMOR GIVES BACK

Last quarter we volunteered with Family Promise of Wake County raking leaves on their campus. Family Promise works with families in Wake County experiencing homelessness. The program provides families with temporary housing and financial education while they get back on their feet.

Join us this quarter for our Armor Volunteer Day with the Food Bank of Central and Eastern North Carolina on Friday, March 3, 2023. The Food Bank has been an imperative program serving 34 counties in central and eastern North Carolina since 1980 by providing food to those in need and developing solutions to end hunger in our communities.

We extend an invitation for all to join us, as well as welcome any suggestions for volunteer initiatives you are passionate about. Reach out to Allison at amiller@armorinvestmentadvisors.com with suggestions for future events, requests to participate, or if you would like to donate towards this cause.

(Please see disclosures on page 4.)

FOUNDER'S CORNER: CRYPTOMANIA AND THE MADNESS OF GREED

by Jeffrey R. Miller, CFA

2022 ended with a whimper, not a bang. The first two months of the final quarter reversed some misery, though December failed to deliver a Santa rally. I would therefore like to provide some comic relief (if you can call it that) in these troubling times.

Headlines have been filled with the ongoing saga of the collapse of cryptocurrency derivatives exchange FTX, which "disappeared" billions of the crypto-wealth around the world. Shades of Bernie "Madeoff-with the money!"

Sam Bankman-Fried (SBF), the alleged perpetrator, is the son of Stanford University Law professors, and majored in physics and math at THE Massachusetts Institute of Technology. Incredible credentials, which helped him gather billions of capital from famous persons, only to collapse the scheme in less than a year. At least Bernie took several decades to fall. In a digital world things happen fast!

There are now many struggling companies in the cryptoverse—Voyager Digital, Celsius Networks, 3 Arrow Capital, BlockFi, Terraform Labs, and my personal favorite, Babel. Like the tower of biblical fame these business models are collapsing. With such intergalactic names, it's like a Star Wars crime wave, in a galaxy far, far away. SBF is the alleged genius crypto-crime lord, with that wild hair and blank dark eyes. How

could you deny his pitch? The peak of the current madness was the commercial featuring Matt Damon in space, shilling the future bravely, with crypto at the center. Interesting how fast that went off the air…

This story is not unlike financial scandals of the past—tulip bulbs, Ponzi, Enron, the internet crash, leveraged lending in 2008, and Bernie "Made-Off with the money". History repeats and greed usually drives the boat. And greed unbridled leads to bad decisions. That is a human thing.

Years ago when asked, "what is crypto and should we invest in it," I came up with a simple way to answer. I would hold out my hand, palm up and ask "what do you see in the palm of my hand?" Nothing. The origin of crypto was a nine page thesis authored by a yet to be identified digital cognoscenti. We have a copy of the paper and have read it. It is so smart we are too dumb to understand it. Always a red flag.

Cryptocurrencies represent unique numbers in which you have a proprietary ownership because of an exclusive algorithm. It also has value in that it can be traded anonymously on the internet, dark web, or even a portable flash drive, enabling tax evasion, money laundering, or other nefarious purposes. As recently as two years ago there were as many as 10,000 cryptocurrencies in existence or development. You can even find Bitcoin ATM machines at a convenience store near you.

The FTX collapse has taken down dozens of firms and billions in wealth as the value of Bitcoin plunged from $69,000 to below $16,000. I am reminded of the comment the CEO of JP Morgan Chase made in reference to crypto and NFT's (non-fungible tokens). "They are today's Pet Rock."

I hope this has provided with you with at least a chuckle. Rest assured Armor has resisted any exposure to cryptomania, to your benefit. We remain skeptical and are not ready to invest.

I would like to close with this observation: when things appear to be at their worst they usually are, or are close to the bottom. The path before us is rocky but there were great returns to be had after 2008, the last time markets were this challenging.

Happy New Year!—*J. Miller*

OUR PROFESSIONALS

John V. Purrington, CFP® - CEO
Graham F. Shepherd, CFP® - COO
Adam J. Morgan, CFA, CMT - CIO
Matthew C. Miller, CFP® - CFO
Allison R. Miller, CFP®, AIF®
Austen Hawkey, CFP®, CPA
Jeffrey R. Miller, CFA

4101 Lake Boone Trail, Suite 208 | Raleigh, NC 27607 | tel 919. 571.4382 | fax 919.571.4368 | armorinvestmentadvisors.com

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