Market & Financial Planning Update

Insights from the Perissos Wealth Group

What Are You Afraid Of?

"I'm not afraid of storms, for I'm learning how to sail my ship." – Louisa May Alcott

Given the inflation and economic backdrop, it is completely natural to wonder if your Wealth Plan can hold up. Prices of goods and services have soared along with interest rates and the dollar, wreaking havoc on consumers and businesses. Asset prices have been heading down in 2022, however, most assets are still overvalued and inflation seems stubborn, putting the Federal Reserve in a tough situation. After more than a decade of easy monetary policy (stimulus) and low rates, the Fed is well into one of the most aggressive tightening campaigns in its history to combat an inflationary economy. Their desired effect is lower asset prices and demand destruction, and that is what is occurring.

Inflation is almost always a consequence of extreme fiscal and monetary stimulus, however, our current inflationary backdrop also includes a number of other factors, such as the conflict between Russia and Ukraine, China's lockdown policy, limited refining capacity in the oil and gas sector and a tight labor market. These are problems the Fed can't solve with monetary policy alone, it takes severe demand destruction (i.e. Recession) and new capacity to fix a tight resource market. Additionally, Globalization, which has helped improve economic productivity and lower costs for consumers the last 40 years is reversing, and we are now in an era of De-Globalization. This will likely lead to diminished productivity, tighter supply chains and higher prices.

Furthermore, after over a decade of the Fed suppressing interest rates with loose monetary policy, many companies have benefited that may have otherwise failed with more restrictive interest rates. These companies, dubbed "zombies", carry high debt loads and require an abundant amount of cheap debt to keep growing. They have accumulated much needed resources and have helped throw the economy out of equilibrium, causing a misallocation of resources. As interest rates rise and lending tightens up, these companies begin to see their growth decline dramatically or they go out of business.

Since 2020, the Federal Reserve and the US Government have created more monetary stimulus as a % of GDP than at any other time in history, even greater than the response during WWII. This leads us to believe that the Federal Reserve, knowing they went too far, too fast, will do whatever it takes to break inflation's back and get the economy back to equilibrium, even if the result is a deep recession. An aggressive Federal Reserve has many skeptical, because they have been very accommodative over the last 40 years and many expect them to remain so. However, we haven't seen inflation like this in 40 years, so we expect a sustained character change from them until disinflation or a severe market event and recession forces a reversal.

The Rundown

- *Market Action:* Markets attempt a rebound from the October lows on the hopes that inflation is cooling and the Fed is close to a "pivot" in policy. With the Inflation, Interest Rate and Currency shock likely behind us, Earnings and Employment will be **critical** going forward.

- *Technical Picture:* Downtrend still intact with Small Caps losing less since May, hinting at what might lead in the next bull market. Relentless defensive positioning in markets points to more volatility in the months ahead.

Given that context around asset prices, inflation and the Fed, it brings us to the title of our commentary, "What Are You Afraid Of?" Now, this title isn't meant to be sarcastic or belittle what is a very difficult environment, it is an exercise that we have been walking clients through in their Wealth Plans to alleviate concern around some common fears. At Perissos, we believe a well thought out Wealth Plan is critical for our client's long term success and it serves as the foundation of our relationships. Wealth Plan helps us model goals as they change and plan for events that may have an adverse impact on your retirement.

Perspective Quote

"Once an economy reaches a certain level of acceleration - the Fed is no longer with you. The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot."

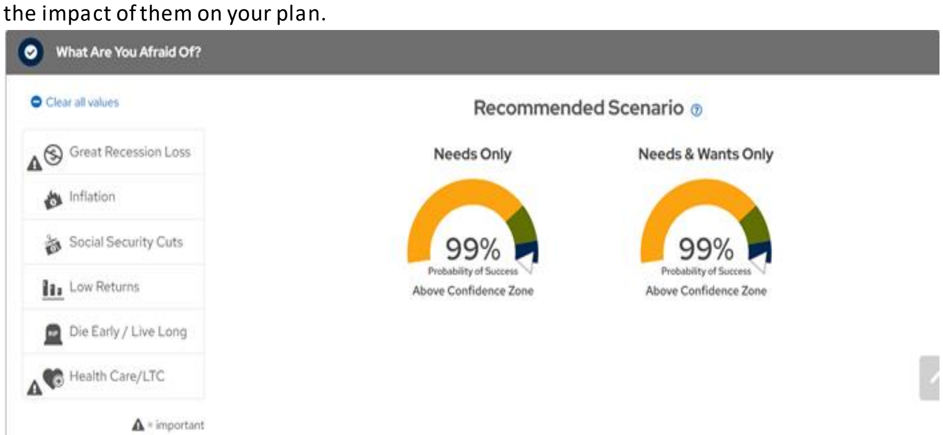
-Stanley Drunkenmiller

Many things are out of our control, such as government policy, inflation or deflation, market returns, life expectancy and etc. There are a few things that are in our control, such as spending or saving goals, when you retire, portfolio allocation and when and what goals to prioritize. For those of us that don't know what the future holds, the best approach is to set reasonable goals for the things we can control and have a plan for the things we can't control, or as one of our clients always says, "you have to plan for the tail risks". Our advice for managing the tail risks are as follows:

1. Spend within your limits in retirement and always leave a cushion – longevity risk or unforeseen health events can dent a plan.
2. If you are working towards retirement, save until it hurts.
3. Have a portfolio allocation that balances risk and reward and can hedge some of the tail risks – most clients do not need to take excessive risk and a balanced portfolio with a focus on protecting the downside serves most very well (in fact, the probability of success often goes up with a more conservative portfolio).
4. Cash flow is more important than assets in retirement – you don't live on your balance sheet, you live on your statement of cash flows. Own performing vs non-performing assets.
5. Plan for all stages of life and make sure your estate documents are updated every 5-7 years.
6. Review insurance coverages annually and think about using an umbrella policy to help protect your assets. Values change and you may find yourself under insured.
7. Understand what adverse events can derail your plan and respond appropriately if they happen.

We will focus on #7, understanding what adverse events can derail your plan and responding appropriately, for the rest of our commentary.

The snapshot below is from a sample Wealth Plan we have created that resembles our typical household. The yellow, green and blue rainbow represents the probability of success of meeting your goals and never running out of money. Ideally, we want clients to stay in the blue and green zones. The list on the left hand side are events that most fear and we can stress test the impact of them on your plan.



Given the current economic environment, we find it particularly useful to stress test Wealth Plans for the following financial events:

1. Portfolio and Market Losses
2. High Inflation
3. Social Security Cuts
4. Low Investment Returns
5. Die Early / Live Long
6. Health Care Event / Long Term Care Costs

Stress testing your wealth plan for these events can help provide much needed context so that you can be prepared if they occur and act accordingly based on math, not emotions. This is critical for a long term plan to be successful. Unforeseen events happen, it's how we handle those "tail risks" that are critical to long term financial success. When we stress test these different events in isolation, the results are quite surprising:

1. Portfolio and Market Losses

Most households can handle bear markets and portfolio losses between -25% to - 38% over 2 years without much impact to success rates. To put that in perspective, that would be as bad as or more extreme than the Great Recession for the average 60/40 portfolio. This tends to be the # 1 fear of most households and it tends to hardly impact probability of success rates. Our sample household saw their probability of success decline to 95%. Still in the blue zone, highly probable they will meet their goals after this event.

2. Social Security Cuts

Let's say SS gets cut by 25% to 50% in an extreme fiscal crisis. Indeed, this would be unlikely and unprecedented, however if it did occur, most can tolerate it. Our sample household saw their probability of success decline to only 93%.

3. Low Investment Returns

What if average annual returns dropped by 3% for the remainder of your plan in a low growth economic environment? Although frustrating, it does not impact most household's goals. Our sample household saw their probability of success decline to 85%, still in the green comfort zone.

4. Live too Long

Longevity risk is becoming a real concern and many fear outliving their money. Living to 100 or longer does not impact most households and our sample household saw their probability of success remain unchanged at 99%.

5. Long Term Care Costs

Certainly, long term care events are costly and need to be factored into plans carefully. This is why we always recommend leaving a large "buffer" in wealth plans to account for this possibility. As you might expect, LTC events typically have the largest impact to household success rates and our sample household saw a decline to 80%. Significant, yet still in the green comfort zone.

6. Inflation

You may have noticed that we saved Inflation for last, as it is relevant for today's economic environment and the most impactful to Wealth Plans. This is something we do have to worry about and will help provide context on why the Fed is on the war path and raising rates. RBC Capital Markets is estimating an annual average rate of 3% inflation for the next 10 years. At 3% most households are in terrific shape. At 4.5% inflation for the next 10 years, most households see a significant drop in success rates and the results are staggering. At 4.5% inflation our sample household saw the probability of success decline to **59%,** the largest drop of all the events we stress tested. In the yellow zone, we become less confident that goals can be met. Sustained, high inflation has a direct negative impact on a majority of our households and is the event we fear the most. So, what are you afraid of?

For most, recessions, bear markets and portoflio losses tend to be top of mind. They feel terrible and give you the impression that you will not meet your retirement goals. Although discomforting, they should not be feared, but accepted. These cycles always occur and will occur again. This reocurring financial event typically only reduces success rates modestly. Most of the other events we stress test also do not have detrimental impacts to most households, with the exception of inflation.

The Federal Reserve realized too late that society has a big problem. One that is worse than bear markets, SS cuts, low returns, LTC events and most things we worry about. Inflation is the hidden tax that compounds and its bite is being felt in the economy to a degree not felt since the 70's. The three main drivers of asset class returns are inflation, interest rates and earnings, and all three have been moving in the wrong direction.

What are we all to do?

- Be part of the demand destruction solution and tighten household budgets.
- Stick with a conservative allocation that has downside protection and keep your powder dry, better days will come.
- Keep an open mind to the possible outcomes by maintaining reasonable goals and adjusting accordingly.

The days of cheap and accesible goods and services may be behind us for the foreseable future. Making adjustments may be difficult but necessary to combat this inflationary enviroment that impacts us all. If you would like to go through this exercise in Wealth Plan to see how different financial events impact you, please reach out.

Perspective Quote

"When people begin anticipating inflation, it doesn't do any good anymore, because any benefit of inflation comes from the fact that you do better than you thought you were going to do." –Paul Volcker

Thanks for reading,

-Michael Matta | First Vice President | Financial Advisor |Senior Portfolio Manager – Portfolio Focus
-Garth Holbert | Senior Vice President | Financial Advisor |Consulting Group |Member of the President's Council |AWM
-Chris Jacobs | Senior Registered Client Associate
-Mary Hamby | Registered Client Associate | APP