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THE AEGIS

Quarterly insights from your friends at Armor Investment Advisors

INFLATION 22

by Adam J. Morgan, CFA, CMT

We've all been through a lot together these past several years, from contentious elections and a global pandemic to a war abroad, and now another virus - this one being economic in nature. While inflation certainly isn't as bad as the very real and tragic toll waged on humanity by Covid 19, it is a virus of sorts that affects everyone, and in the end will hurt the economically vulnerable the most.

How did this current inflation variant become such a problem? After all, it was only six or seven months ago when the economy was cooking with grease and investor-profits were so great and widespread that some in Congress were discussing the possibility of taxing unrealized capital gains. Now the congressional debate du jour involves a possible tax holiday on gasoline. You know things are bad when the Federal Government goes from "give us your money" to "well, maybe you should keep some for yourself." Maybe they have a guilty conscience…

While the dramatic spike in the rate of inflation has been a 2022 story, it was a problem in the making for quite some time. After the financial crisis of 2008, then Fed Chair Ben Bernanke earned the nickname "Helicopter Ben" when he implemented monetary policy so easy that it resembled, to some, a man throwing money out of a helicopter onto the US economy below. The Fed began an era defined by its zero percent interest rate policy as a solution to the problem that ailed us then: deflation. Mechanically, the Fed maintains low interest rates primarily by buying bonds with the help of the US Treasury. The bond purchases go on the Federal Reserve's balance sheet and the money paid for the bonds circulates into our economy. This process, while a tad more sophisticated than simply making it rain from a helicopter, serves to keep interest rates low and drive asset values higher.

> **"Inflation . . . is a virus of sorts that affects everyone, and in the end will hurt the economically vulnerable the most."**

Bernanke decided to target a 2% inflation rate. His successor, Janet Yellen, and her successor, Jerome Powell, adopted that mission. Where they came up with 2% as a target rate of inflation, I don't know, but they believe that is the rate of inflation that will best allow our economy to achieve price stability and a robust labor market. Furthermore, they determined that if the long run average rate of inflation is below the 2% target, then we need a significant amount of time where the rate of inflation exceeds 2%. So, to bring the long run average up, they pushed the money supply higher. Now to be fair, Mr. Powell couldn't have foreseen the numerous Covid variants and the war in Ukraine, but nevertheless he played with matches, and we got burned.

So, what can we expect going forward? Well, naturally as prices rise at the pump, grocery stores and virtually everywhere else, rational economic participants tighten their belts. They don't actually spend less because they can't, but the money they do have now buys less stuff. And

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that has a downstream effect. Remember when we mailed checks to people who couldn't work? Well, unfortunately, many of them are now directly in the line of fire. Just think of the things that Americans will do less of when budgets get tight. And then think about the chain reaction as contagion spreads. There is no vaccine for this virus. The only saving grace today is that we currently have a healthy labor market, but that is unlikely to continue. Growth will slow at best, and possibly regress.

As for investors, this is where the story gets tricky. Many people focus on whether our economy will sink into a recession. Whether we do or do not has a lot to do with Fed policy going forward, and even they admit to a high degree of uncertainty in their "wait and see" approach. But the economy and the stock market are not the same thing. The stock market is a forward-looking entity that will not wait for the economy to get better before rising again. The chart below shows how the stock market has behaved going into and out of every recession in the United States dating back to 1948.

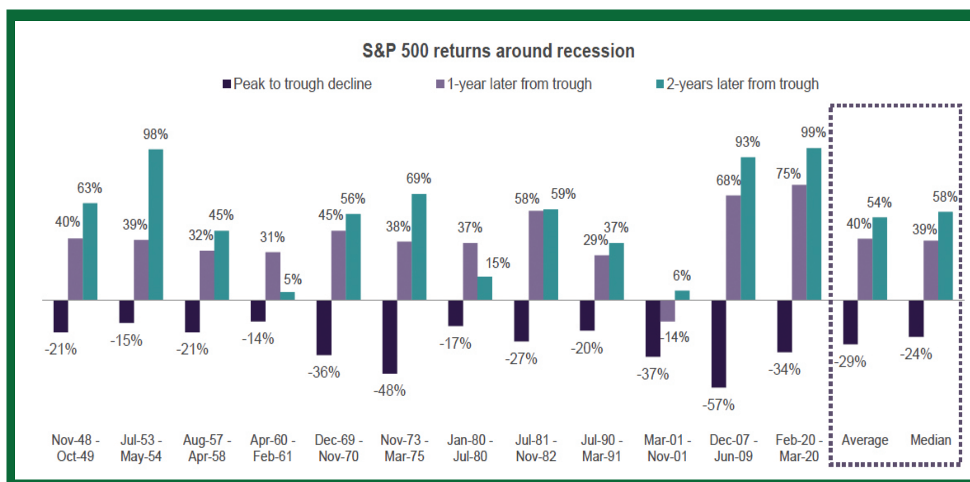
As you can see, the average decline in the stock market leading up to the last twelve recessions in the US is 29%. However, the average gains in the market from the trough looking 12 and 24 months out are 40% and 54%, respectively. Furthermore, the average time that it took for the stock market to recover back to its peak was roughly 2 years. At the market's lowest point so far this year, which occurred in mid-June, the S&P 500 was down almost 25% year-to-date, meaning the market has already begun pricing in a recession. What this data is describing is a favorable asymmetric risk return dynamic for investors who are willing and able to wait.

Unfortunately, digging deeper into the data may tell a less optimistic story. The longest period of time the stock market took to recover from a recession-induced bear market was 5.8 years, which occurred after the market decline in 1973-74, a time that also saw runaway inflation and two oil shocks, one from the oil embargo of '73 and another during the Iranian revolution in '79. That period was followed by a Fed that aggressively raised interest rates in what was eventually a successful effort to "Whip Inflation Now." So, by the time the market reached fresh new highs, prices of goods and services had risen for years and purchasing power had eroded.

It's important to remember why we invest money. We want to make money, of course, but it must be on a relative basis, relative to the prices of desired goods and services. We want to create purchasing power, which means that we want to grow our investment with an after-tax return greater than the rate of inflation. That obviously hasn't occurred for nearly anyone in 2022, and it didn't occur for a long period of time in the 1970's. The reality is that there are important economic similarities between now and the 1970's, and there are great differences, not the least of which is the massive advancement in the technology sector, which has produced a litany of innovations between then and now that are broadly thought to be a disinflationary force.

I cannot predict the future. My industry is full of charlatans who will try, but you and I both know better. At the same time, I am not one of those people afraid to take a position. I believe you deserve better. Good investment management involves using current and historical data along with experience and some intuition to make the best decisions possible at the time. At this time, I favor high quality stocks to those with the risk tolerance and time horizon to withstand a higher-than-average degree of volatility. I spend a lot of time reviewing our portfolio companies and where we're invested in individual stocks, I see strength. It may take more time than we would all like for stock prices to recover to where they once were, but I do believe that the economy will recover and the companies that we're invested in will prosper.

For anyone who would like to have a conversation about a few examples of where we see value, or would like to discuss anything aforementioned, please reach out to your advisor and let us know. My door is always open. Until then, be well.
—*A. Morgan*



Source: Truist IAG

(Please see disclosures on page 4.)

OPPORTUNITIES DURING A DOWN MARKET

by John V. Purrington CFP®

The market has been in what feels like a free fall since the beginning of the year. It has been gut wrenching and scary, but as Adam's article reminds us, the market has down cycles and it has recoveries.

With the equity markets down over 20% since the beginning of the year, there are planning opportunities which can take advantage of the current low valuations and the prospects of a recovery.

1. Tax Loss Harvesting

For all the advice to not sell when the market is down, there can sometimes be advantages to selling when the market is down. Intelligent rebalancing to harvest tax losses is a strategy focused on writing off capital losses from taxes to reduce current and future tax burdens while moving your account closer to its optimal long-term allocation.

This is part of our ongoing investment management process at Armor.

2. Roth Conversions

A 'Roth Conversion' is when assets are moved from a Traditional IRA into a Roth IRA. Assets in a Traditional IRA have not yet been taxed but will be in the future. Assets in a Roth IRA have already been taxed and will grow free of any taxes in the future.

Transferring funds from a Traditional IRA into a Roth IRA accelerates the tax burden into the current tax year. Depending on current income and projected future income, a Roth Conversion may make sense for you. Roth Conversions often makes sense in the early years of retirement when there is low taxable income, but before the IRS requires annual taxable distributions from the IRA (RMDs), increasing taxable income.

At times like now, when the value of IRA assets are deflated, a Roth Conversion can be even more beneficial because the 're-inflation' growth will occur in the tax free account.

At Armor, we work with clients to model an optimal conversion schedule based on their particular income projections. Effecting the conversion while the market is down, allows a greater percentage of an IRA to move to the more tax efficient Roth IRA where the assets are reinvested to grow tax free.

3. Gifting to heirs

The current Estate Tax exemption is $12.06 Million, meaning that an estate will not be subject to a tax unless net worth is over $12M, and for a couple over $24M. With that caveat, the exemption is scheduled to drop by half in 2026 and could always drop further, so future estate tax could have a broader impact.

Gifts given now which exceed an annual limit (a de minimis amount) are counted against the eventual estate exemption. If your estate may be subject to an estate tax, it is advisable to maximize your annual 'de minimis' gift. The 2022 de minimis amount is $16,000. Gifting the maximum before a rebound will allow for the rebound to happen outside of your taxable estate and avoid a 40% estate tax on the growth.

Complex trusts such as GRATs and CLATs can even further enhance the value of gifting deflated assets. As part of our estate reviews with clients, we identify opportunities to reduce estate taxes while achieving transfer goals and not relinquishing control.

The stock and bond markets have both been dismal in 2022 but remaining focused on long term goals and recognizing that in all likelihood we will exit this valley can reveal opportunities that can look brilliant in hindsight. We are reviewing accounts to identify openings for these strategies. Don't hesitate to reach out if you would like us to investigate a situation.

—*J. Purrington*

ARMOR HAPPENINGS

Please join us in welcoming Elizabeth Williams, who joined the Armor team in June as Client Service Associate. Elizabeth assists our clients with day-to-day service requests, addressing their ongoing account management needs. She also works with new clients throughout their initial onboarding, and helps ensure we are providing a superlative client service experience.

Elizabeth graduated from East Carolina University with a degree in Communication and Public Relations, and has previous experience in social media management.

(Please see disclosures on page 4.)

FOUNDER'S CORNER: THE LONG AND GRINDING BEAR

by Jeffrey R. Miller, CFA

The investment climate since Thanksgiving of last year has been a very difficult time for investors. The first five months of 2022 were the worst beginning of a year for markets in 90 years, and there was no safe haven from the Bear. Stocks, bonds, and all other asset classes fell down.

I have lived through 11 recessions since I was born, and I'm not dead yet! I received my MBA and was looking for a job in the middle of a severe downturn, 6 recessions back, knowing I just had to keep on grinding to find that next paycheck. I have never been unemployed since that time and have been in the position of managing money through 5 recessions. Crash of 1987—no big deal! The S&P 500 was UP 5% that year.

"Knowing the history of markets and maintaining a sense of humor helps."

That is not to say that as portfolio managers we are unaffected by emotions. I have spent many a 3am hour or two trying to work through what to do in these scenarios. I reminded myself of a famous old saying to "hurry up and do nothing." Knowing the history of markets and maintaining a sense of humor helps. No matter how daunting times like these may seem we always seem to grind through. It is especially important to not let fear overcome discipline in investment management. As my colleague's chart demonstrates we can, at some point, expect a strong recovery.

As a reminder. this is an excellent opportunity for clients to have their long-term planning stress-tested to ensure that they are still on target, and to sleep better through the storm.—*J. Miller*

ARMOR GIVES BACK

Join us this quarter for our Armor Volunteer Day with Note in the Pocket sorting clothes for homeless and impoverished children and families of Wake County on Friday, August 5, 2022.

We will be hosting a clothing drive in the weeks leading up to the volunteer day. Please stop by with any donations you would like to contribute. Contact Allison for guidelines on what can be donated.

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@armor-investmentadvisors.com with suggestions for future events, requests to participate, or if you would like to donate towards this cause.

FIRM PARTNERS

John V. Purrington, CFP®
Graham F. Shepherd, CFP®
Matthew C. Miller, CFP®

Jeffrey R. Miller, CFA
Adam J. Morgan, CFA, CMT
Allison R. Miller, CFP®

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

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