

Market Insights & Planning Highlights

Q1-2024



ECONOMIC OUTLOOK

Money Supply, Recessions, and Sectors That Benefit



by Robert Koscik

The drumbeat began in 2022. It seems like every time you tuned to a business channel, another economist was predicting an imminent recession. Why? In part because they were witnessing one of the handful of times in history when there was a 2% or higher year-over-year drop in M2—or the amount of money in circulation. To understand what that means, I will take you through the history of M2 supply.

First off, money contractions are rare events. There have only been four such episodes since the Federal Reserve was established (and all were followed by recessions): 1920-22,

1929-33, 1937-38, and 1948-49. Historic trends reveal that before a recession, the M2 supply chart will show a fairly sharp decline before rising sharply through the recessionary period. In addition, record-high unemployment rates preceded those recessions.

The current M2 money supply has been contracting at the fastest rate since the 1930s. The M2 contraction peaked in July 2022, before falling 4.5%, which gets us to a 2.2% decline YOY. Analysts view this as an important threshold since a 2%+ decline has only occurred four times since 1870: the depression of 1921, the panic of 1893, and

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ECONOMIC OUTLOOK

Money Supply, Recessions, and Sectors That Benefit (cont.)

the 1870s depression. The M2 chart for FY2023 shows sharp drops during Q1, with leveling out and less volatile movements up and down on the back half.

There is something very different this time around, and that is the historic rise in M2 prior to the drop. M2 increased from pre-pandemic point to 2022 by 6 trillion or 39%. Historically it takes an average of 5 years for the level to grow that much, not a mere 2+.



Congressional Acts & Deficit Spending

Just as we haven't seen a recession, we also haven't seen a sharp drop in GDP (nor should we in the immediate term). This is partly because the Inflation Reduction Act and CHIPS Act allocated an unprecedented \$2 trillion. The word trillion gets thrown around a lot these days, but it still takes a very long time to get \$2 trillion into the economy. In fact, much of that \$2 trillion is allocated but not yet spent.

Watch Out for 2025 & 2026

Since the 1950s, it has taken an average of 23 months from the initial rate increase in the hiking cycle until an economic downturn. The first hike in this recent cycle was on St. Patrick's Day 2022. The reckoning may be upon us. You've heard me say before that deficits, or living off borrowed money, is not a problem...UNTIL IT IS. This applies to the consumer too. Since the covid checks stopped, savings rates have plummeted, credit delinquencies are up, and car loans have expanded—but spending has held strong. It's also a presidential election year. These are historically and unnaturally good, especially when an incumbent with power over the economy is running. The last time the market dropped in an incumbent election was 1940 under FDR. We've seen the can get kicked down the road, and in 2024 we'll likely see the same. In other words, very little belt tightening by the government. I expect to be writing a very different article in Q1 2025, as both the U.S. and consumers confront living within their means. No one wants a repeat of 2008 when consumers spent their money, then spent the equity in their homes, then lost their jobs, and couldn't make the mortgage payment. We're certainly not there yet, but it's a cliff to be watchful for.

ECONOMIC OUTLOOK

Money Supply, Recessions, and Sectors That Benefit (cont.)

Sectors that Benefit

Now that we have all that fun econo-speak behind us, let's focus on what has performed well in a similar historical environments. At times when the Fed is poised to start lowering rates, high dividend yielding sectors such as **utilities** and **real estate** are the biggest beneficiaries (given their sensitivity to interest rates). This is especially true as these offer higher returns due to their outsized yields. Sector return for the period following the early 1980's recession through 1989 saw staples, health care and utilities outperform. However, don't expect to see us committing too much to real estate any time soon. The commercial space, especially office buildings, will remain a headwind for at least the next 12 months.

<https://seekingalpha.com/article/4029866-investors-may-want-to-look-sectors-worked-in-1980s>.



Healthcare is favored currently because of recent innovations in the sector and its lack of exposure to the normal recession cycle. Breakthrough weight loss drugs, Alzheimer's treatments, and AI have all given the industry considerable momentum. A new clinical trial for an Alzheimer's drug has shown great promise. Meanwhile, AI can help the sector via greatly improved efficiencies, specifically for R&D sequencing and genomics. Healthcare is also reasonably priced, as very few sectors are.

In my most recent article, I mentioned that **small company stocks** are much better positioned, from a valuation standpoint, than their large cap counterparts (by a wide margin). Unfortunately, the trigger I look for in small cap exposure is coming out of a correction. It will not be unnatural to see us pull back in our Mega-Cap tech exposure, but that's mostly due to its massive recent (one-year) and long-term (15-year) out-performance. Small Caps will have their day, but we'll wait for a major commitment.

ECONOMIC OUTLOOK

Money Supply, Recessions, and Sectors That Benefit (cont.)

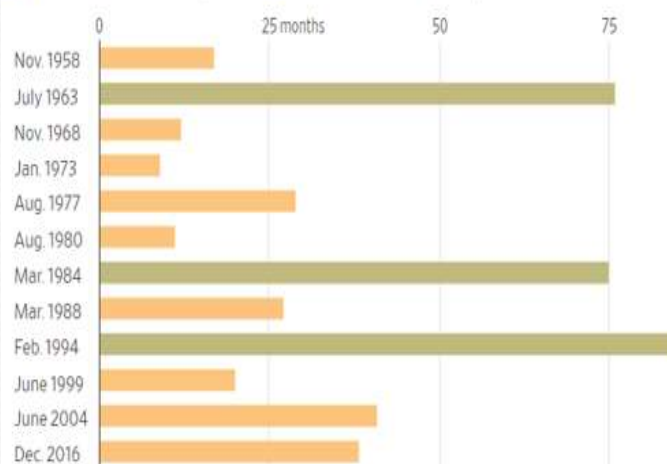
The Road Ahead

Overall, it is very likely things will slow more this year, and loosening will then become the new Fed policy. This will have a big impact on stocks, and more importantly sectors we favor. What you will not see DLAK do in 2024 is chase the winners. You'll instead see us begin to pare back on some of our biggest winners, as valuations again are stretched.

1958-2016			
Inflation	Average P/E	Highest P/E	Lowest P/E
0 – 1%	16.3	20.9	11.7
1 – 2 %	17.0	20.6	13.1
2 – 3%	17.6	26.7	10.8
3 – 4%	16.0	20.7	10.1
4 – 5%	14.0	21.0	9.5
5 – 6%	14.9	20.2	8.2
6 – 7%	11.6	17.9	7.2
>7%	8.4	11.5	6.6

Duration of rate-hiking cycle, in months

Recession within 3.5 years No recession within 3.5 years



Note: Months refer to the beginning of each cycle

Sources: FactSet and the Federal Reserve via ClearBridge Investments

The chart at left above (Bureau of Labor Statistics), although only through 2016, shows the highest P/E ratio for the S&P than at any other time when inflation was between 3 and 4%. Valuations are never the #1 indicator in changing short-term allocation, since they can stay stretched or muted for extended periods. **Momentum** is your trigger. My belief is that negative momentum is not a big concern in 2024, but we have to be very careful not to party like it's 1999. Never forget the phrase "irrational exuberance." If you have, be sure to ask me in our next meeting.

Sources:

<https://www.goldmansachs.com/intelligence/pages/why-the-us-money-supply-is-shrinking.html>

<https://www.fool.com/investing/2023/12/10/us-money-supply-shrinking-the-most-since-the-great/#:~:text=U.S.%20money%20supply%20has%20declined,the%20stock%20market%20in%202024>

IN THE NEWS

WSJ Reports on Intriguing “New” Investment Vehicles



by Jason Phipps

I recently came across an article in the Wall Street Journal titled “These Funds Offer a Way to Lock in High Bond Yield.” The headline obviously piqued my curiosity, as continuous learning is a key to being a successful money manager. What responsible financial advisor wouldn’t read up on this new and innovative way to help clients?

The article referenced products offered by two Wall Street titans. The funds profiled are defined-maturity exchange-traded funds or ETFs. These funds hold bonds that all mature and liquidate on a specific date.

They provide the same reduction of interest-rate risk as buying an individual bond while still allowing an investor to achieve diversification and the liquidity needed to provide the ability to trade and get market price. These ETFs allow you to build a bond ladder to lock in a specific yield over a set time frame. This requires more work than buying a bond mutual fund, where you don’t get a yield to maturity or even a defined maturity, making it impossible to control the rate risk that is being taken.

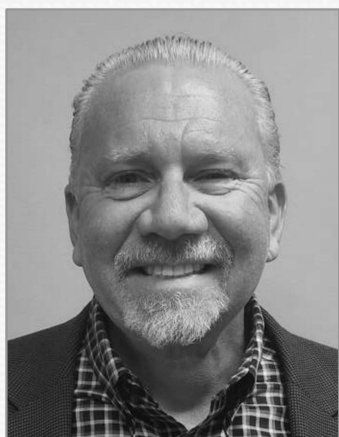
As I finished the article, I began to laugh. I couldn’t wait to share it with the rest of the team at our next meeting. You may be thinking I was laughing because I had just found a tool that would help us build better bond portfolios or you may be thinking I need a new hobby. I was in fact laughing because we have been using these investments in portfolios for 10 YEARS. Many of you have heard in meetings how we don’t use bond funds and the reasons sound eerily familiar to this article in the Journal. The good news is that it looks like some other advisors are catching on. Both of these companies saw record inflows into these funds in 2022 and 2023. Much of our success in limiting losses for clients in bonds in 2022 can be attributed to the use of these ETFs prior to 2022. When I shared this with the staff, they also got a chuckle out of it. This is yet another example of skating to where the puck is going.

https://www.wsj.com/finance/investing/these-funds-offer-a-way-to-lock-in-high-bond-yields-1f36fb29?mod=investing_news_article_pos5



INVESTMENT STRATEGIES

DLAK Was Ahead of the Curve on ETFs



by Brett Roth

If you read the preceding article by my colleague Jason, you were reminded that DLAK uses ETFs as a major component in our portfolio structures. But what you may not know is why and when we began using them.

At a high level, ETFs are funds that generally hold a basket of securities such as stocks and bonds. Unlike mutual funds, ETFs are traded on a stock exchange. Like stocks, they can be traded through the day and their price rises and falls during that time. Mutual fund trades, by contrast, are executed once a day and all investors get the same price.

We really started to see in the past 10 years an acceleration of both the demand of ETFs, and more recently with their supply. Over that time, ETFs market share rose from 10% to 19.6% in 2023; 20 years ago, ETFs made up just 1% of share. Rob was ahead of that acceleration, as he started using these vehicles when he launched DLAK in 2005. Why did he believe they would be a better investment than standard mutual funds? There are three big reasons: Source (Chart)

<https://www.ici.org/system/files/2023-03/per29-03.pdf>



- For one, ETFs are generally more tax efficient. It gives investment managers control of when they take capital gains and when they don't.
- ETFs also tend to have lower costs than mutual funds. For example, the average expense ratio across the entire fund industry (excluding Vanguard) was 0.47% in 2022, while the ETF average was 0.16% in 2022.
- Lastly, they do not deviate much from their intended investment strategy, so when we invest in these, we know how the underlying investments will behave.

Not only has DLAK saved a significant cost difference by using ETFs vs. classic mutual funds, we are more aware of how ETFs will perform based upon their investment objectives compared to mutual funds. Both can have a big effect on one's portfolio.

Sources: <https://www.cnbc.com/2023/11/06/3-big-reasons-exchange-traded-funds-went-mainstream-with-investors.html>



TAX MATTERS

Preparing for the Widow's Tax Penalty



by Anthony Scassellati & Jenny Cyrus

Losing a spouse is one of life's great heartaches. Making things even worse are the financial headaches that can follow, one of which is the "Widow's Tax Penalty." The penalty occurs when the surviving spouse must begin filing as 'Single'—which has smaller standard deductions and different tax brackets than 'Married Filing Jointly.' The survivor will usually pay the same or a higher rate than in the past.

Single Filers (S)	
2023 Taxable Income	Rate
\$0 - \$11,000	10.0%
\$11,001 - \$44,725	12.0%
\$44,726 - \$95,375	22.0%
\$95,376 - \$182,100	24.0%
\$182,101 - \$231,250	32.0%
\$231,251 - \$578,125	35.0%
\$578,126+	37.0%

Married Filing Jointly (MFJ)	
2023 Taxable Income	Rate
\$0 - \$22,000	10.0%
\$22,001 - \$89,450	12.0%
\$89,451 - \$190,750	22.0%
\$190,751 - \$364,200	24.0%
\$364,201 - \$462,500	32.0%
\$462,501 - \$693,750	35.0%
\$693,751+	37.0%

<https://www.kiplinger.com/taxes/widows-penalty-how-to-prepare>

The tables above show the drastic difference in brackets for each filing status. Someone who recently lost a spouse could have a significant loss in income but still have the same or even larger tax burden than before the change of status...

Standard Deduction	
Single	\$13,850
65 or older	+\$1,750
65 or older AND blind	+\$3,500
Head of Household	\$20,800
65 or older	+\$1,850
65 or older AND blind	+\$3,700
MFJ	\$27,700
65 or older	+\$1,400
65 or older AND blind	+\$2,800
MFS	\$13,850
65 or older	+\$1,500
65 or older AND blind	+\$3,000

TAX MATTERS

Preparing for the Widow's Tax Penalty (continued)

For example, if a couple who files MFJ has \$130,000 in taxable income, they will have a tax rate of 22%. When one spouse passes away, the income is halved to \$65,000 and the surviving spouse still pays the same tax rate on a significantly smaller income. While unpleasant to think about, it is important to prepare for this scenario, and the earlier the better helps. So, what exactly can be done to help the surviving spouses tax burden?

What can be done NOW

It is important to take advantage of your tax brackets in the present. We don't know what rates will be in the future, but they very likely will not go down. One action that could help are partial Roth conversions, wherein you can pay on taxes now in a more favorable Joint tax bracket and save on a potential larger future tax burden.

You might also consider a change of beneficiary. If you have planned well and can see the surviving spouse having enough savings and income for their life, the couple can consider designating non-spouse beneficiaries for their tax deferred accounts, such as children or grandchildren.

What can be done AFTER

Pay attention to your step-up basis. Assets you inherit receive a new original cost or 'basis' at the original owners time of death so the difference between this basis and the cost at withdrawal will create another taxable event. Be sure to review often with DLAK so you are aware of the values of your new accounts.

Paying taxes is never ideal but it's important to know that the government is going to get its money one way or another. We cannot control this but what we can control is how much we give to them.

Source: <https://www.kiplinger.com/retirement/retirement-planning/ways-retirement-planning-is-changing-new-year>

Current tax law is subject to interpretation and legislative change. Tax results and the appropriateness of any product for any specific taxpayer may vary depending on the particular set of facts and circumstances. Entities or persons distributing this information are not authorized to provide tax or legal advice. Individuals are encouraged to seek specific advice from their personal tax or legal counsel.

TAX MATTERS

Monitor Your Tax Bill...Even Before You File



by Matt Ringle

Inflation isn't the only thing that has been ticking higher of late. IRS interest penalties for under-payments on taxes have also taken a big jump. The penalty has risen from 3% to 8% in two years. The IRS assessed more than \$1.8 billion in penalties for underpaying estimated taxes on 12.2 million returns in 2022.

Small businesses, consultants, and gig workers who don't always have taxes withheld and figure they can just pay come April are especially susceptible to these penalties. What's more, taxpayers with bonuses and equity compensation (whereby automatic withholding is too low) could face underpayment penalties.

Finally, with interest rates rising and bank savings rates increasing, anyone with higher-than-usual interest from high-yield savings accounts could also be affected.

Pay As You Earn

The U.S. tax system is pay-as-you-earn, meaning as you gain income you are expected to pay the corresponding taxes. There are several ways to do that inclusive of withholding or by making quarterly (or more frequent) tax payments during the year.

To avoid under-payment penalties, most filers must pay 90% of their taxes through withholding during the calendar year, or through estimated payments due quarterly.

Here to Help

As we've said before, we're not accountants at DLAK, but we do take a very proactive approach to reviewing your estimated income. We strive to help identify any possible tax situations before you prepare and file your tax return.

https://www.wsj.com/personal-finance/taxes/federal-tax-withholding-estimates-penalty-2023-e6c3736f?mod=personal-finance_feat1_taxes_pos3

RETIREMENT PLANNING

Are You Ready to Retire? Kiplinger Has Some Advice



by Kelli Helvey

A common concern of those in their 60s is determining a prudent time to retire. After decades of regular paychecks (and hopefully some raises and bonuses), many people are understandably uncomfortable with the idea of relying solely upon retirement funds and Social Security.

While the top concerns are usually related to finances, there are also lifestyle adjustments that must be considered to ensure a fulfilling and secure retirement. So, before you hand in your resignation letter, it's critical to consider the core aspects of a rewarding golden era.

To help, here's a great "retirement readiness checklist" from the experts at *Kiplinger Personal Finance*...

1. Wipe out all your debt.
2. Consider your Social Security claiming strategy.
3. Assess your income sources and expenses.
4. Determine a safe withdrawal rate from your portfolio.
5. Consider Medicare and Medigap deadlines.
6. Plan for long-term care needs.
7. Simplify your financial life.
8. Plan to retire TO something, not FROM something.
9. Develop a daily routine for retirement.
10. Spend your money!



Taking the time to methodically plan for this new stage of life will lead to thoughtful decisions. You deserve to spend what you've earned. But as always, live within your means. It will ensure your golden years are how you always envisioned them.

Source: <https://www.kiplinger.com/retirement/retirement-checklist-are-you-ready-to-retire>

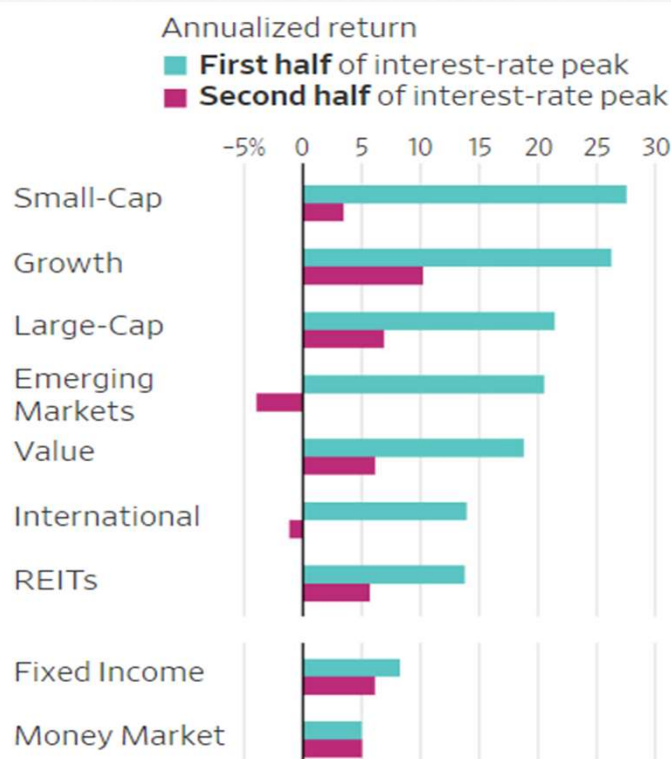
INVESTING INSIGHTS

How Investments React When Interest Rates Pause



by Jason Phipps

The Federal Reserve has been closely watching inflationary data and leading indicators. Over the past few months, the Fed has signaled that it could pause rate increases if the inflationary data continues to cool. This means we could be at peak rates for this cycle right now. That would be welcome news to interest-rate-sensitive borrowers and lenders after more than 18 months of consistent and aggressive rate increases. But what do peak rates mean for portfolios, and how can you take advantage?



Note: Shows the average annualized returns for various asset classes during the first and second halves of an interest-rate peak.

Source: Derek Horstmeyer, George Mason University

Five Decades of Data

The information I'll share in this article represents 50 years of market history and contains data from various asset classes.

Across that timeframe, we have witnessed six occurrences where the Federal Reserve stopped raising rates and then kept rates steady for three months or more...

INVESTING INSIGHTS

How Investments React When Interest Rates Pause (cont.)

The data suggest that stocks of all types do well when interest rates first reach their peak, but most of the returns come in the first six months after the rate plateau.

The average large cap stock in the S&P 500 returned 21.4% during the first half of rate plateaus compared to 6.9% during the second half. The average return of those same category of stocks during the entire 50 years was 12.5%. Small-cap stocks averaged 27.6% and Growth stocks averaged 26.3% in the first half of the rate pause; They average 3.5% and 10.2% in the back half of the pause.



REITs and international stocks had the weakest performance during the first half of the rate pause, averaging gains of 13.8% and 13.9%. They also performed worse during the second half of the pause. Historically, fixed-income assets haven't performed nearly as well as stocks during these interest rate plateaus. They have averaged 8.25% during the first half of the pause and 6.13% during the second half of the pause.

“Don't Fight the Fed”

We have all heard that expression. One factor that is likely causing excess returns when the Fed stops raising rates is the optimism from policy becoming more friendly to growth. A fundamental finding is that stocks do well, especially small cap and growth stocks, and usually early on after the Fed stops raising rates.

Source: https://www.wsj.com/finance/investing/investing-peak-interest-rates-89b9c8d5?mod=finance_feat3_investing_pos4

NEWS TO USE

Did You Know?

Investors Want Help

According to a poll of 6,000 investors by Cerville Associates, the percentage of investors willing to pay for financial advice surged from 36% in 2009 to 64% in 2023. Relationships have also become less transactional as 55% of advised assets are now in fiduciary accounts, compared to just 34% in 2011. (Source: RIA Intel)



The Mortgage is Too Darn High

As interest rates have surged, the pool of households that qualify for a mortgage has been more than cut in half. When the 30-year rate was at 3% two years ago, 50 million U.S. households could qualify for a \$400K mortgage. With the same rate now at 8%, just 22 million would qualify. (Source: John Burns Research & Consulting)

Nearly 9 in 10 Take Standard Deduction

Each filing season, millions of Americans take the standard deduction—a flat dollar amount that reduces taxable income—instead of itemizing deductions such as mortgage interest and charitable donations on their 1040. According to the most recent IRS tally, 87.3% of filers claimed the standard deduction for fiscal year 2020.

Seniors Get a Standard Deduction Boost

The extra standard deduction for seniors for 2023 is \$1,850 for single filers or who file as head of household, and \$3,000 for married couples—if each spouse is 65 or over—filing jointly. Those increases boost the total standard deduction for single filers and married couples filing jointly—to \$15,700 and \$30,700, respectively.

The Core Four Continue to Rise

In 2014, Apple, Microsoft, Alphabet and Amazon, the four largest publicly traded U.S. companies, had a combined market cap of \$1.3 trillion. It is now 9.75 trillion and their weighting in the S&P 500 has risen from 7.7% to 22.2%. – Rob Koscik

NEWS TO USE

Did You Know? (continued)

MEGA Loves AI

So-called Mega-cap tech stocks continue to rush headlong into AI (Artificial Intelligence), as evidenced by the number of times "AI" is mentioned on quarterly conference calls. In the Q3 earnings reported period "AI" was mentioned 418 times across the conference calls of APPLE, Alphabet, Amazon, Meta, Microsoft and NVIDIA compared to just 109 mentions a year ago. (Source: Seeking Alpha)

Investors With Advisors Stay the Course

In Fidelity's 2024 Financial Resolutions survey, 76% of Gen Z respondents said they'll be better off financially in the coming year versus just 52% of Boomers. When asked if they were able to stick to their financial resolutions in 2023, 80% of survey-takers who work with an advisor said versus just 51% without an advisor. (Source: Fidelity)

The Big 5 are Bigger Than Many Countries

The five largest stocks in the US (Apple, Microsoft, Alphabet, Amazon and NVIDIA) not only make up 24.2% of the S&P 500, but they're also now bigger than the total market caps of many countries. In the MSCI All World Index, the five US mega-cap tech stocks had the same weighting (15%) as the combined weighting of Japan, China, France and the UK. (Source: Bespoke)

Small-Caps are Surging

Through 12/27/23, the Small-cap Russell 2,000® had registered a two-month gain of 24.3% since November 1st. In the Russell's history, dating back to the late 1970s, that two-month gain was its third strongest on record behind a 28% gain from November to December 2020 and a 25.3% gain from March to April 2009. (Source: Bespoke)

It's a DLAK Nation ;)

DLAK is now registered in 28 states! In other words, we manage money for clients across more than half the 50 states.

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