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Hurricane Ian Edition of the Client Letter/4Q2022

Due to the disruption Hurricane Ian caused, this edition of our Client Letter lacks the formatting and proofreading normally completed. The damage from Hurricane Ian will most likely exceed $100 billion in losses and the deaths will exceed one hundred persons. Should you wish to support families who have been impacted, please consider donating to the Collier Community Foundation's Hurricane Ian fund. Funds will be distributed to worthwhile organizations in the affected areas.

*While the hardship on any individual extends well beyond finances, the rebuilding efforts will provide investment opportunities. Companies such as **Carrier Global**, **Xylem**, **Garmin** and **Generac** are positioned for the rebuilding process. Also, **Nucor** could benefit from the supply of scrap steel and reconstruction efforts.*

The hurricane will also have an inflationary impact. Given the Federal Reserve's myopic view on inflation, they may choose to raise interest rates even higher, even though the cause of inflation is from a hurricane.

Investment Strategy Overview of Year-to-Date Performance

Most financial assets including stocks, bonds, commodities and even Bitcoin declined sharply during the third quarter and year-to-date. The primary cause of the broad-based decline is the Federal Reserve's aggressive interest rate increases to combat inflation. Specific to portfolios, so far this year, most portfolios are holding up better than their benchmark, or in other words, "*we are doing less bad.*" We have reduced exposure to stocks significantly and have also positioned portfolios in companies that generally have fared better than the S&P500. In addition, most client portfolios have a short position in the S&P500 that further reduces net stock exposure.

In bond holdings, client portfolios have generally held up better than the Bloomberg Bond Index by keeping maturities short-term and of high quality. Also, we have purchased most bonds with a minimum credit rating of A-, which is a high credit grade. By keeping credit ratings high, the risk of a bond defaulting is low.

Bond Market Strategy- How high do yields need to go?

The selloff in the bond market is the epicenter of the bear market. Bond yields have risen to levels not seen since 2007. Bonds purchased today that will be held to maturity will generate decent returns that have not been experienced in decades. High quality corporate bonds are yielding 5% and AA Muni bonds are yielding 3.3%. While the bear market has hurt values, looking forward, the bond market is now offering attractive returns and a high degree of principal security.

How high will bond yields rise? The U.S. Treasury bond yields are the benchmark that most bond prices are based upon. The 2-year Treasury bond is yielding 4.14% while the 10-year is yielding 3.72%. Bond yields may continue to trend higher until the first major economic report indicates a slowdown has begun. Perhaps a retail sales report, or a weak employment report could put a halt to bond yields trending higher.

Once we are confident that the bond market has stabilized, we will shift funds from the short-term bonds into long-term bonds with higher long-term yields. For taxable accounts, the municipal bond market is looking tempting. The underlying credit fundamentals of most, but not all, states and cities are in solid financial conditions. For investors with a long-term horizon, 20-year state general obligations are yielding 4% about the same as treasuries of the same duration.

High yield bonds have spiked this year, but now is not the time for bond speculation. Once the economy bottoms, the purchase of preferred stocks and other higher yielding securities might be something to consider, but not now.

Equity Strategy besides "Hiding under the Table"

The equity market is the asset class reserved for long-term, in other words, the next five years, not next Tuesday. Equity performance is influenced by the U.S. Dollar, commodity prices, and heavily dependent on interest rates. The SP500 tends to correlate to the 2-year Treasury yield, while growth stocks are influenced by long-term bonds.

While the Federal Reserve has made aggressive interest rate hikes, stocks are in a bear market and searching for a bottom. Investor sentiment and the option traders' positions are in the area where a bottom could occur. Stock markets tend to bottom when fear is the highest and there is no hope soon.

While sentiment often provides clues to a "short-term bottom" in a stock market decline, a peak in long-term interest rates often triggers "longer-term bottoms" so growth stocks, such as **Microsoft** and **Apple** could possibly stabilize. In addition, corporate insiders, who are required to disclose trades are reducing their selling while increasing their purchases, which is a long-term positive sign for the equity market.

Searching For A Bottom In Stocks

With stocks already significantly down, many, but not all, of the economic concerns may have already been priced in. Sentiment has been extremely bearish; thus, the economy is showing many signs of weakness. For example, the increase in interest rates and corporate earnings are expected to be trending lower beginning in the 4th quarter. Therefore, much of these negative issues have already been considered by investors given the 20%-30% decline in the major indices during 2022. The final phase of a bear market is typically "emotional selling" when investors give up hope for the future. This often results in a climatic final sell-off which marks the low point.

Corporate earnings expectations are still holding up with the SP500 composite earnings projected to grow 7% in 2023. However, the expectations for next year still appear to be high.

Actually, we would like to see earnings estimates fall significantly, which would be sort of an economic capitulation. The third factor we are watching is the bond market. Once bond yields stop rising, stocks have a better chance of bottoming. Initially, long-term bonds may stabilize, then the bond market rally could spread to shorter-term issues. Beyond a short-term stock market bounce for a day or two, bond yields need to peak.

From a longer-term perspective, many stocks are beginning to look attractive. The hurricane will also create opportunities for rebuilding homes, infrastructure, and restocking.

Secular Trends Providing Opportunities

1. Energy Transition
2. High Tech Medical
3. High Tech Industrial
4. Capital Intermediation

Most of the core equity holdings are positively influenced by these long-term trends. In addition to our detailed quarterly analysis of core equity holdings, we believe that riding these trends will help client portfolios performance long term.

The **energy transition** from fossil fuels is based on three factors. First, fossil fuels impact the environment. As we personally experienced last week, the Gulf of Mexico was 88 degrees prior to the hurricane. While greenhouse gas emissions are well covered, other health problems such as the high incidence of lung cancer inflicted on non-smokers is one of the many signs that change is needed. The other factors motivating change include autocrats and the dictators that control a significant portion of the fossil fuel market, mainly Saudi Arabia and Russia. Make no mistake, they are not your friends. After a recent production cut OPEC appears to be targeting $100 per barrel of oil (Brent). Financially, renewables are becoming economically viable alternatives. While the U.S is behind China and Europe in the energy transition, the new IRA bill provides a “nudge”. Client portfolios have benefitted from the outperformance of **NextEra Energy**, **Enphase**, **National Fuel**, **Oneok**, and **Tesla**. **Tesla** has the most potential, being the leader in electronic vehicles by a country mile and having solar and storage businesses that are often overlooked. Unfortunately, Elon Musk is dealing with the “celebrity curse” which poses a material risk to investors as evidenced by the Twitter saga. Does he buy the Dallas Cowboys next?

30 years ago, **NextEra Energy** was getting started in deploying renewables. Now the world leader is energy produced by renewables, they are developing hydrogen applications and hope to replace their natural gas needs with hydrogen someday.

Checklist For a Longer-Term Bottom In Stocks

1. Bearish sentiment – Completed
2. Corporate earnings estimate decline – Not yet
3. Bond Yields – stabilize – getting closer, but not yet.

Analyzing the stock market is more of an emotional event as opposed to an economic outlook. Using the SP500 chart, stocks are currently trading at a major support area around 3600. A break of 3600, the next logical support levels would be 3400 and 3200. The analysis supporting these price levels is based Fibonacci retracements and Elliot Wave analysis. While there is still potential for further declines, most likely, the majority of the declines have occurred.

Economy Slowing to Stall Speed, Hoping We Don't Crash

The domestic economy has slowed from the Covid bust to boom cycles. Higher interest rates, Covid lock downs in China, and the war in Ukraine are factors impending economic opportunity. Industrial companies have been more exposed to the negative economic implications than consumer focused businesses. Recently, several global manufactures have warned of lower profits including GE, Huntsman (chemicals), Fed Ex, and **Nucor** to name just a few. Consumers are still spending although where and how much is in flux. Individuals who have jobs are confident and have been receiving 5% pay raises on average, much to the chagrin of the Federal Reserve. We are watching travel and entertainment related companies for clues as to the strength of consumer spending after the summer travel surge.

Looking ahead, the odds favor a recession that may have already begun. Excluding another major event, the economic downturn should not be too deep or too long in duration. The recovery from Hurricane Ian may help prevent recession, but inflation implications may prompt the Federal Reserve to continue raising interest rates.

Overall, the U.S. economy is slowing. Excluding the net export factors, GDP was significantly reduced for the 2nd quarter in 2022. However, investors are more focused on where the economy is going, not where it is now. Generally, the consumer is who is holding up the economy. Despite higher prices, consumers are still spending on goods and services. Given the cost increases, we will see how long spending holds up. For example, the cost of a Disney vacation is up about 40% from 2019.

With the Federal Reserve aggressively raising interest rates, the housing sector has begun to feel the pain. Mortgage interest rates are now over 7% and home sales are slowing. The impact on related industries is being watched. Will homeowners start to spend money on home projects since they will be there longer? If so, this will offset residential real estate sales.

The downturn in real estate could be offset by the investment in energy production. With energy prices increasing, the energy sector is benefiting from new investments. Several of our core portfolio holdings are benefiting from the investment in energy.

Globally, most economies are not doing as well as the U.S. economy. Most central banks are following the Federal Reserve's aggressive rate hikes. The Bank of England raised interest rates by ½ % and The European Central Bank matched the Federal Reserve with a ¾% interest rate increase. In addition, Europe is dealing with the economic damage from the Ukraine War. Countries dependent upon Russian commodities, such as Germany are paying a high price for not diversifying their supply chain. Longer-term diversity away from Russian oil and gas will be a positive move, but a challenge to make the transition.

Shifting to Asia, China continues to be fighting Covid-19 outbreaks which led to local lockdowns. Too bad they did not purchase Moderna's, mRNA vaccines. Also, China's real estate sector is dealing with over building. The geopolitical strain with the U.S. is also an issue. Companies that sell products and services to China are at risk. GE, Huntsman, and Fed Ex announced earnings short falls due slowdowns internationally. It is possible that the strong U.S. Dollar may have contributed to the earnings shortfall. The U.S. Dollar has soared due to the Federal Reserve rate hikes.

To sum up the economic back drop, the U.S. economy is barely growing and is in a very delicate situation. The chances of a recession are over 50%. Further, given the Federal Reserve's aggressive rate hikes after the Covid-19 challenges, the disruptions from the Ukraine War, and growing tensions with China, any new negative event may push the U.S. into a deep recession.

<u>New Tax Bill Actually Pretty Good; Contractors and Homeowners Take Notice</u>

President Biden signed the new Inflation Reduction Act (IRA) on August 16, 2022, although Senator Joe Manchin was responsible for the writing of the bill and negotiating with fellow Democrats. Details of the bill suggest it has a narrow focus, and even includes incentives for nuclear power and a token number of benefits for the coal industry.

While the final "regs" of the IRA bill have not been published in the Federal Registry, the general benefits of the bill are known and able to incentivize the investment in products that reduce energy consumption or produce clean energy. Specifically, the purchase of heat pumps "advanced air conditioning" could provide a 30% tax credit for homeowners. Electric vehicles provide as much as $7,500, but there are limits on vehicle prices and the income levels of the purchaser, which may limit the adoption of electric vehicles, but part of the political process. Also, in the years to come there will be a requirement that electric vehicles must be manufactured in the U.S. which is creating interest in the capacity of domestic manufacturing.

The IRA bill also provided incentives and long-term predictability for clean energy producers and investors. The long-term predictability was very important to **NextEra,** a company that builds solar wind projects with a 30-to-35-year use life. In the past, clean energy tax credits usually had a short-term window which made it difficult for businesses to invest long-term.

Over 70% of the cost of the bill is in the form of tax credits, not "free money" that led to the widespread fraud experienced with the Covid pandemic relief support. The funding of the bill will largely come from a minimum corporate tax of 15%. Many large corporations pay effective taxes under 10% of net income. **Nvidia** and **Garmin** both pay taxes of less than 10% of net income by using legal tax strategies compared to **Ulta Beauty** that pays 24.5% of net income. All these businesses benefit from operating in the U.S., which has the best military, regulated and stable financial markets and the largest economy in the world. The funding does make a stab at making all large businesses pay their fair share.

While our tax advice is only general in nature and the specifics are best left to your tax preparer, there are many opportunities to reduce your taxes, such as:

-Tax credits up to $7,500 for electric vehicle

-30% tax credit for home improvements of energy efficient improvements (insolation, heat pumps, dryer, electric stove, and windows)

-Energy audits up to $1,700

-Solar energy and back up batteries

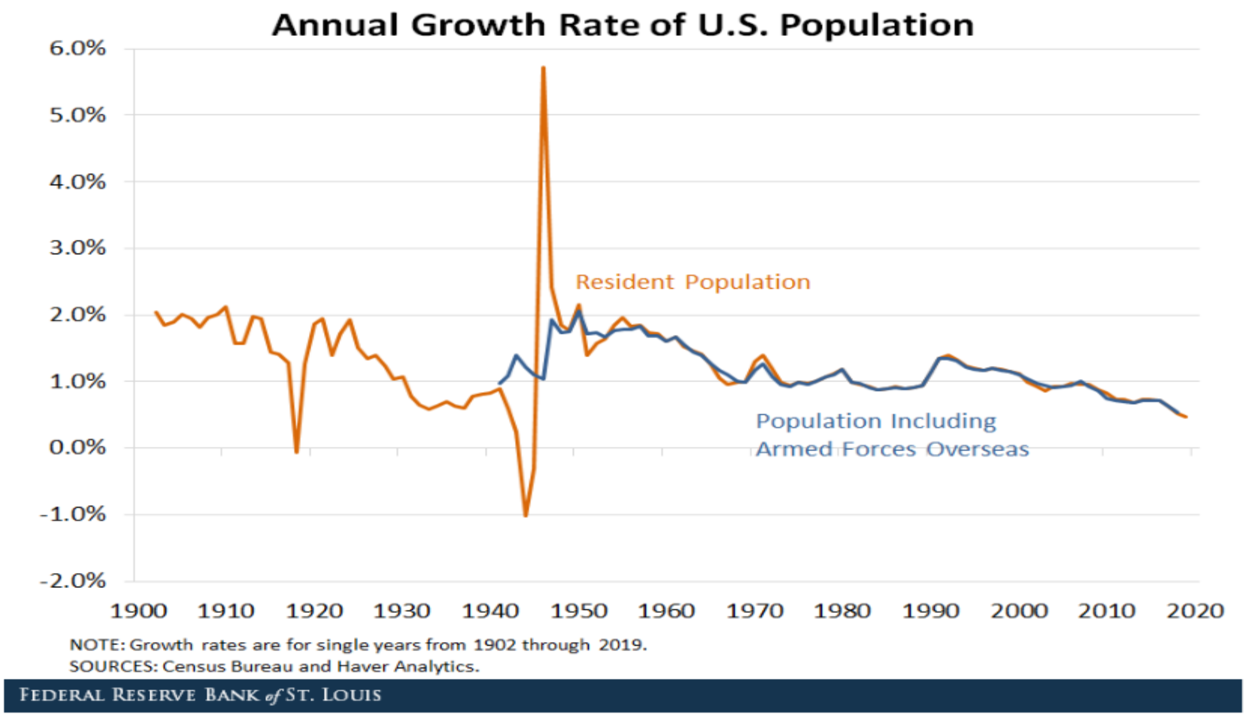
It’s All About the Myopic Federal Reserve

Interest rates are the foundation to investment prices and economic growth. The Federal Reserve is tasked to maintain stable prices and full employment, their proxy for the economy. After being slow to raise interest rates of 0.0% last year, the Fed Reserve has rapidly hiked short-term “Federal Funds” to over 3% and has mentioned additional increases to over 4.5% possibly.

Unfortunately, the underlying causes of high inflation and the employment market have nuances that the Federal Reserve is not equipped to manage, yet the Federal Reserve is adamant about making the sharpest increases in interest rates since the 1980’s. Yes, real estate related housing inflation is a huge problem, and an appropriate reason would be to raise interest rates. However, with the interest rate on a 30-year mortgage soaring from 3% to 7% since January, should the Federal Reserve take a “time out” to allow the economy to adjust to the higher rates?

Other factors that add to inflation are “supply shocks”, an economist term, that the Federal Reserve is incapable of addressing. The Covid-19 related supply chain issues are a good example, although these problems are improving. Weather problems, largely drought, have reduced agricultural production this year. Higher food costs, fires, floods, and other climate related damages are trending over $1 trillion dollars in damages this year that will be reflective in your next homeowner’s insurance renewal. Raising interest rates to combat climate related inflation will only be counterproductive. Similarly, the Russian invasion has caused oil, natural gas, fertilizer, and palladium to escalate in price. Europe is feeling this pain much worse than we are, although relying upon Russia as your primary source of anything is a bad strategy as Germany has learned.

Shifting to the Federal Reserve “fumble” on full employment, employment is the Federal Reserve’s proxy for economic activity. The unemployment rate appears to be very low at 3.7% of the work force. Wages are rapidly increasing across most areas of the economy. However, the real cause of unemployment is the loss of about 2 million workers, not excessive demand from a growing economy. To make matters worse, there are no short-term solutions. Natural population growth (births vs. deaths) added 148,000 persons and net immigration added 244,000 as the chart below shows. We have a demographic problem. Substituting robotics for humans is a growing trend, but the Federal Reserve's last interest rate hike increased the cost of financing new high equipment. Further, there is no political interest in increasing immigration materially and increasing the population via natural means has an 18-to-25-year lag.



Since the Federal Reserve has stated its position is to fight inflation until the 2% target is achieved and it is willing to sacrifice the economy to maintain their reputation (and egos), a cautious investment approach is needed. What the Federal Reserve should do is to taper the interest rate increases and allow the economy to adjust to the hikes already taken this year. If the Federal Reserve continues to raise rates at ¾% each meeting, they risk a sharp and deep recession which will force sharp cuts in the rates, once more. Further, the last jump in inflation can be attributed to Russian's invasion of Ukraine. President Putin must be laughing at the Federal Reserve's policies. He starts a war that raises oil prices to his advantage and the Federal Reserve's policies drain trillions of wealth from the economy. The best tool to blanket inflation would be a national sales tax, but this will never happen. Funds raised could be used to reduce the structural deficit and taper spending.

How To Cut Home and Business Energy Cost

The usage rates for FPL up over 20% in the past 2 years, which is largely due to higher natural gas prices. However, there are several ways you can lower your utility expenses. In order of ease, the following strategies should be considered:

1. **Reduce consumption**
    a. Monitoring your usage is very helpful. Turning up thermostat when not needed. Turning off lights in offices when you leave for an appointment or lunch.
2. **Insulation**
    a. The new form of rolled insulation makes it easy for anyone to install. This summer, Jennifer's son, Dante, installed R21 rolled insulation to our office ceiling tiles. It made a huge improvement in comfort and lower FPL bills. Andy insulated the underside of his condo and reduced usage by 43% last month compared to August 2021.
    b. The new Inflation Reduction Act (IRA) bill also provides tax credits.
3. **Investing in efficient appliances**
    a. From LED lights to heat pumps, home appliances can make a significant difference in consumption. When purchasing new household appliances, consider energy consumption. Purchasing energy efficient appliances may also qualify for a tax credit.
4. **Solar with battery storage**
    a. This is the big investment. With utility expenses rising, solar is now more economical. While the cost-benefit financial equation is usually considered, protection from outages and environmental benefits are other motivations to go solar. Since most systems will last 30 years, with nearly no maintenance expense, it's like pre-paying your FPL bill at a large discount.

<u>Year-End Tax Planning</u>

As the end of 2022 approaches, it is advisable to estimate your potential tax liability to avoid surprises and take advantage of planning opportunities.

We will be looking to sell holdings with material capital losses to offset gains. Usually, we do this in late December.

<u>2022 IRA Required Minimum Distributions</u>

Our goal is to have all IRA accounts subject to required minimum distributions to be paid out by December 1, 2022. We will notify you if your IRA(s) fall into this category.

<u>2022 Annual Exclusion Gifts:</u> The amount you can gift to any one person without filing an annual gift tax return is $16,000.

<u>Charitable Giving Opportunities:</u>

Outside your portfolio, charitable giving offers many tax savings opportunities. The easy one is using a "donor advised charitable fund." By donating appreciated securities your capital gains can be avoided. Also, clients often over fund annual charity gifts in one year to gain an itemized deduction. This is a smart strategy for clients who are already making annual gifts to charities.

The Fidelity Charitable Gift Fund is a donor advised fund that is a flexible and tax advantageous way to give to your favorite charities. Donate cash, long-term appreciated stock and qualify for tax benefits. The balance in the fund is invested tax-free to potentially grow your charitable dollars. When it's time to support your favorite charitable causes, you can do so online or through Fidelity's app. For more information, please call our office or visit www.fidelitycharitable.org.

Moving up to the "varsity" level, more sophisticated strategies offer income for life, tax avoidance of capital gains, and supporting your favorite charity. The charitable gift annuity (CGA) is an ideal strategy. Payouts of 6% to 8% of gift amount are possible depending on age and if one or two persons are included in the contract. Since CGA" s are liabilities of the charity, it is best to stick with financially strong and well managed organizations.