PRAETORIAN GUARD℠

QUARTERLY NEWSLETTER
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IN THIS ISSUE

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FIRST QUARTER MARKET REVIEW

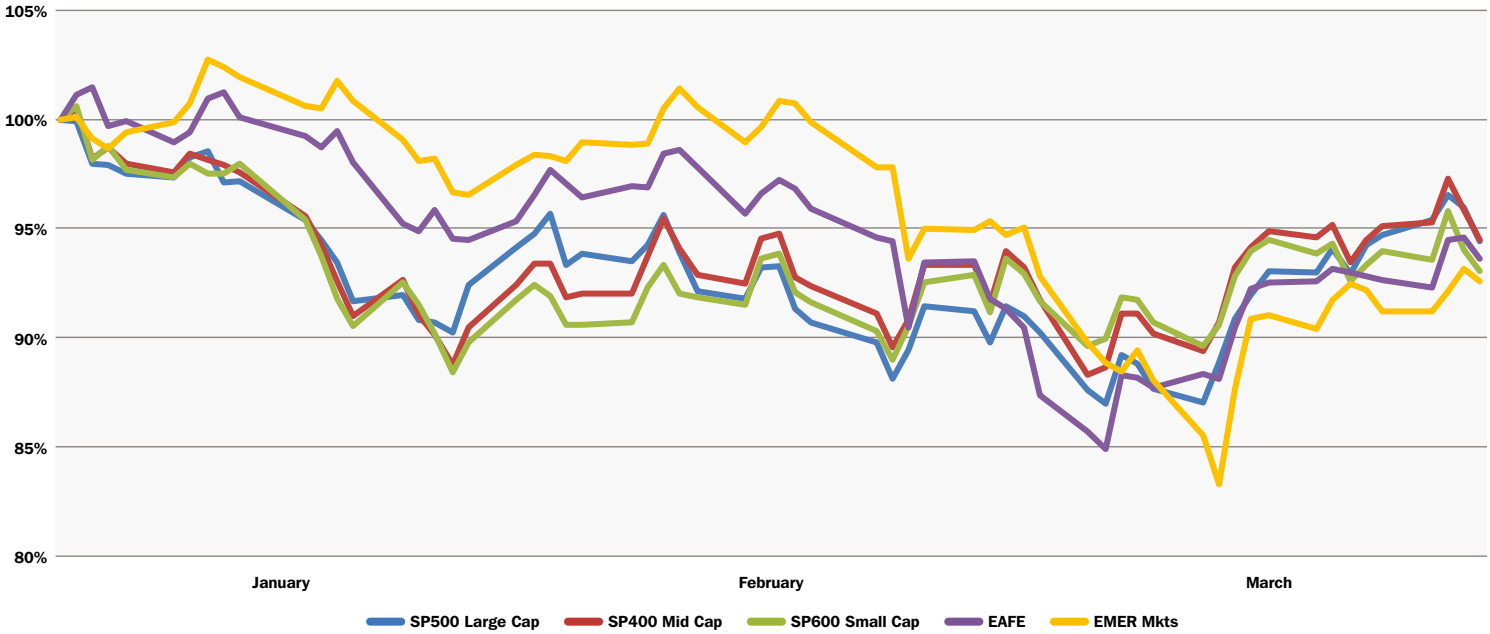
By **Richard A. Hewitt**

Markets stumbled at the beginning of the year, most significantly in the large cap growth stocks. We entered a market correction (defined as a decline of 10% from the recent market highs) for the first time since Q1 2020 at the onset of COVID shutdowns. There are some positive aspects of this — corrections are a recurring and "normal" part of market cycles. Secondly, it gives all of us the opportunity to check our risk tolerance during the drop. If you find yourself too focused on the decline, it may be your gut telling you to *consider* a slightly smaller allocation to stocks. Lastly, the change in the Federal Reserve's focus is now largely priced into the market, which should generate less of a reaction as the Fed raises interest rates at each of its next meetings.

Bond yields have been improving and it will continue. This indicates that for the first time in many years, bonds will begin to provide some income and no longer serve primarily as "ballast" for your portfolio. Purchasing power will be impacted until inflation declines but the Fed is finally on the correct course for the long-term needs of the economy.

The quarter ended with U.S. markets climbing out of the correction territory and we are monitoring if it is going to set the table for a period of slower but steady growth — the Fed and geopolitics will be the big drivers in answering that question.

2022 U.S. & International Equity Market Performance



Source: Yahoo! Finance and MSCI

INFLATION — CAUSES AND CORRECTIVE ACTIONS

By **Joseph P. Clark**

U.S. inflation reached 7.9% in February, the highest level in four decades. In general, the root cause is excess demand chasing too few goods or services. Many pundits have blamed this inflation on escalating government debt, but that is oversimplification. It is true that in February the U.S. national debt surpassed $30 trillion, however this national debt results from over 185 years of government borrowing overseen by 39 different presidents. The last time the federal government had zero debt was 1835. Over the past 35 years, increased deficit spending has resulted in our national debt growing even faster than the norm, and inflation has remained fairly low for most of that period. Therefore, rising national debt itself doesn't cause inflation. The link between debt and inflation is that government spending increases the money supply. The stimulus payments issued during the pandemic put money in the hands of consumers, which increased demand at a time when supply chains were strained. This has caused prices to climb quickly. The inflation we are experiencing has no direct correlation to the total national debt, but it does stem in part from recent deficit spending. Slowing the growth of the debt would not necessarily ease inflation; however, reducing the money supply should have that desired effect.The Fed will attempt to alter the money supply to combat rising prices as price stability is one of the two mandates given to the Federal Reserve. In slower economic times, the Fed seeks to increase the flow of money, a process known as quantitative easing (QE). When increased economic activity causes prices to rise, the Fed moves in the other direction with quantitative tightening (QT). Over the years, the controlling of interest rates has been the primary tool of monetary policy. Interest rate reductions encourage consumer and business borrowing, which leads to increased spending and economic activity. On the other hand, when the Fed raises interest rates, saving money becomes more attractive than borrowing so less dollars are being used to generate economic activity. As the Fed raises interest rates, they need to closely monitor all economic indicators because many businesses are still struggling from the pandemic slowdown. Making borrowing too difficult could slow the national recovery so rather than dramatically increasing the interest rate, the Fed is utilizing another tool in its arsenal.

During the pandemic, the Fed has been buying U.S. Treasury securities to increase the money supply since interest rates were already at historic lows. Currently the Fed's balance sheet includes over $2 trillion in Treasury bonds, T-notes, and T-bills, along with trillions more in mortgage-backed securities. The Fed is slowly selling those securities to decrease the money supply without having to dramatically increase interest rates. The hope is that this strategy can reduce inflation without slowing economic recovery. For this plan to work there must be willing buyers for the Fed's securities, which could mean more of the national debt being held by foreign entities. It is likely that no matter what steps are taken in monetary policy, inflation will persist until supply chain disruptions are resolved. Most economists believe inflation should ease later this year as supply chains normalize, but there is disagreement about the level where price increases will level out. Fed officials think inflation will return to 2.6% by the end of the year.

When asking whether the Fed can curb inflation, we only need to look at recent history. During the 2001 recession, under Alan Greenspan, the Fed lowered interest rates to ignite the economy and end that recession. By mid-2004, the Fed had to slowly raise rates to avoid inflation resulting from that economic turnaround. After the 2008 financial crisis, the Fed created programs to inject billions of dollars of liquidity and keep banks solvent. Many were worried this would create inflation once the global economy recovered, but the Fed successfully wound down those programs and ended quantitative easing. This time should be no different. During the 2020 pandemic, the Fed reduced interest rates to 0%-0.25% in order to prevent a recession. Now the Fed is taking actions that are necessary to combat inflation by raising interest rates for the first time since 2018. Every economic situation is different, but monetary policy has proven true time and time again to control inflation. The unknowns are how long it will take, and can it be done without harming an economy that was recovering strongly coming out of the pandemic.

TAX CONSIDERATIONS OF SELLING A HOME

By **Marc A. Wehmeyer**

Now is a good time to be a home seller in the United States. Demand is high, inventory is tight, and prices are up. It is likely if you are selling a home in today's market that you will be making a profit on the transaction — one that has been tax-free for most Americans since the tax law changed in 1997. Prior to 1997, home sellers could defer — but not eliminate — some (or all) of the gain on a home sale if they purchased another home within a specified time period. There was also a provision that enabled qualifying taxpayers at least 55 years old to make a one-time election to exclude up to $125,000 of gain.

The deferral rule and the age 55 rule were made obsolete when President Clinton signed the Taxpayer Relief Act of 1997. In addition to broadly reducing taxes in the United States, the legislation created the Roth IRA and the child tax credit. It also exempted most home sales from capital gains taxes. Under the 1997 law, eligible home sellers can exclude up to $250,000 of gain from the sale of their primary residence ($500,000 if married filing jointly). The exclusion amounts have not changed since 1997 and they are not indexed for inflation.

To qualify for the full exclusion, a homeowner generally must have owned the home and lived in it for at least two of the past five years at the time of sale. For a married couple filing jointly, only one spouse needs to have owned the home. Both spouses must meet the residence requirement, although the 24 months living there need not be continuous. If you acquired your home through a like-kind exchange during the past five years or are subject to expatriate tax, you are not eligible to exclude any gain. Finally, you can only take the full exclusion once in a two-year period.

There are several exceptions to the eligibility requirements. For example, service, intelligence, and peace corps personnel may suspend the five-year test period for ownership and residence for up to 10 years when they are on qualified extended duty. Also, surviving spouses who haven't remarried may sell up to two years after the deceased spouse's date of death and still qualify for an exclusion amount up to $500,000. Even if you don't qualify for the full exclusion, you may qualify for a partial exclusion if the primary reason for selling your home was the result of a work-related move, a health-related move, or an unforeseeable event.

Independent of your eligibility for a full or partial exclusion of gain, you still need to determine the total gain (or loss) from selling your home. To do this you take the amount realized (or the sales price net of selling expenses) and subtract the adjusted basis (or the purchase price plus improvements minus "basis adjustments" for certain payments, credits, or benefits you received). Keeping good records of your expenditures on improvements is essential to justify your adjusted basis when calculating gain.

Any portion of the gain from your home sale that exceeds the eligible exclusion amount will be taxed at the applicable capital gains rate. The gain on selling a home held at least one year will qualify for long-term capital gains treatment of 0%, 15% or 20% depending on your level of taxable income. Some (or all) of the taxable gain may also be subject to the 3.8% net investment income tax if your modified adjusted gross income is above $200,000 for single filers or above $250,000 for married couples filing jointly.

If you are a homeowner and considering a home sale in the future, we recommend you familiarize yourself with the contents of IRS Publication 523 (Selling Your Home). This document details the tax rules related to selling a home, including the eligibility requirements and exceptions for exclusion of gain, the steps for figuring a gain or loss, and the steps for determining how much of a gain is taxable.

As long as the exclusion amounts remain fixed at $250,000 and $500,000, it's likely more and more home sales are going to result in some amount of taxable capital gain for the sellers. You are more susceptible to this happening if you live in an expensive housing market or have owned your home for many years. If you are thinking about selling your home and would like to discuss the possible tax consequences of doing so, please reach out to us. We can review the unique circumstances of your situation and help you make an informed decision.

PRESIDENT'S COMMENTARY

By **Richard A. Hewitt**

We learned several critical lessons during the past 90 days: first, there are things worth fighting for as the brave Ukrainians are showing the world daily. Second, unanticipated events will impact markets directly by injecting uncertainty and indirectly by their impact on economic growth and the price of vital commodities. Finally, we (re)learned that the world still runs on oil and natural gas and that won't end anytime soon.

However, there is some positive impact from Russia's invasion of Ukraine — Europe (especially Germany) received a defense reality check and NATO is relevant (and functioning well). The beginning of the decoupling of Russia from the world economic system is underway and will be a multi-year (or longer) task.

POLITICAL AND ECONOMIC ENVIRONMENT

By **Richard A. Hewitt**

The impact of gas prices being at their highest level ever in many locations is going to be the defining domestic issue up to the November mid-term elections. It is not an easy problem to address nor is it one that is capable of a quick fix. There is a lot of political posturing going on from both parties but we predict that the Administration will not be able to hold the line on not encouraging domestic production — the pressure will be immense and nothing focuses a politician's mind so much as being shown the door.

The Build Back Better legislation is dead and any significant tax changes are unlikely to get signed into law so our recommendation is to plan as if the 2017 Tax Cut and Jobs Act (TCJA) will remain in force until some of those provisions sunset on December 31, 2025. The result is that long-term capital gains rates will remain at 0%, 15% or 20% (depending on your level of taxable income), ordinary income brackets will not be increased at the upper end and the corporate tax rate will remain at 21%. The estate tax exemption will remain at $12 million through the sunset date, so gifting opportunities remain available.

As Joe Clark's nearby piece covers in great detail, the Federal Reserve will have challenges in raising interest rates to combat inflation without causing a hard landing/recession. Of the Fed's two mandates, price stability will be at the forefront for the next 18-24 months. Jerome Powell is doing a good job of signaling to the market that rate hikes of 0.50% are likely to be necessary to get the Fed Funds target rate to a level where it starts to have some inflation fighting benefit. We now predict the next two rate increases to be at that level following the May and June meetings.

AN UPDATE ON THE SECURE ACT REGULATIONS

By **Richard A. Hewitt**

The IRS released new IRA and employer sponsored retirement plans (such as 401k and 403b) regulations to bring the rules into compliance with the SECURE Act which was signed into law December 27, 2019. There are a few changes to what was expected:

The ability of Eligible Designated Beneficiaries (EDB) to use their life expectancy to stretch tax deferral over long periods remains, as does the definition of who is an EDB. These include spouses, a minor child of the account owner, disabled and chronically ill individuals and a beneficiary not more than 10 years younger than the account owner. A twist is that the age of majority for a minor child is now set at age 21 regardless of school attendance or any state's individual age of majority rules. For disabled individuals, there is a "safe harbor" rule that states if one is disabled under the Social Security rules, you are automatically an EDB and can stretch the distributions of the inherited IRA over your own life expectancy.

The most significant change is regarding beneficiaries who inherit an IRA or workplace retirement account from an account owner who has already reached age 72 (called the Required Beginning Date). These beneficiaries still have 10 years to distribute the full account AND are required to take annual Required Minimum Distributions (RMD) in years 1 through 9. If you or someone you know inherited an IRA from an account owner who passed in 2020, they likely did not take an RMD for year 2021. The IRS says these people are not subject to the new regulations for 2021. It is possible the IRS will issue a ruling that there is no penalty for missing the 2021 RMD given the timing of the regulation issuance.

PARACHUTE TRAINING

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CLOSING THOUGHT

"If history teaches anything, it teaches self-delusion in the face of unpleasant facts is folly."

—President Ronald Reagan (1911-2004)

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