4Q23

The Financial Solutions Advisor

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Economic & Market Perspectives

Equities sold off in September in response to a surge in long maturity government bond yields. The rise in bond yields is symptomatic of a sharp reduction in market expectations for a soft landing economic outcome.

The S&P 500 achieved a year to date high of 4589 on July 31, but fell 7% to its quarterly low and down 3.7% for the quarter. The NASDAQ -4.1% and Russell 2000 -5.5% fell even more. Big tech was mixed with Apple down 11.7% despite new product launches. Among the culprits for the equity decline were higher interest rates and oil. 10 year treasury yield rose nearly a full percentage point achieving their highest yield in 16 years. The only positive sectors were energy +11.3% and communication services +2.8%. The worst sectors were utilities -10.1% and real estate -9.7%.

The Fed is still telegraphing rate cuts next year, but now by a trivial amount. This strongly suggests that investors will need to see a sustained period of core inflation below the Fed's end-2024 target for meaningful rate cuts to occur. Without imminent rate cuts, a soft landing outcome seems highly implausible.

The US consumer will likely determine whether or not the economy enjoys a soft landing. We see the wealth effect fading and the virtuous mini cycle of rising stock prices and upside economic surprises starting to unwind. Further, forward-looking employment indicators are rolling over, excess savings is ending, and student loan repayments have just restarted. While non-farm employment is slowing, the labor market is still holding up. On the surface, this dynamic is positive for the economy and risk assets as it suggests that inflationary pressures are continuing to ease without causing a significant deterioration in the economy.

The available evidence supports the notion that US monetary policy is tight, which argues against the no landing economic scenario. It also underscores that the recessionary clock is indeed ticking unless the monetary policy stance eases soon.

The soft landing narrative has recently been boosted by the June and July inflation data. However, these readings may have been depressed by odd seasonal adjustments.

Improving real wage growth in the prevalence of excess savings are the two factors that have supported US growth and labor demand this year. Both factors are likely to be fleeting, and recent labor market data points to increasing odds that incrementally weaker labor demand will show up in the form of higher unemployment.

Until we see concrete signs that the soft landing economic scenario is materializing, we will continue to recommend that investors maintain defensive portfolio positions and prioritize capital preservation over return maximization.

Equity selection should focus on earnings predictability, earnings persistence, good and growing cash flow, and reasonable valuations.

Source: Bob Doll, Crossmark Global Investments

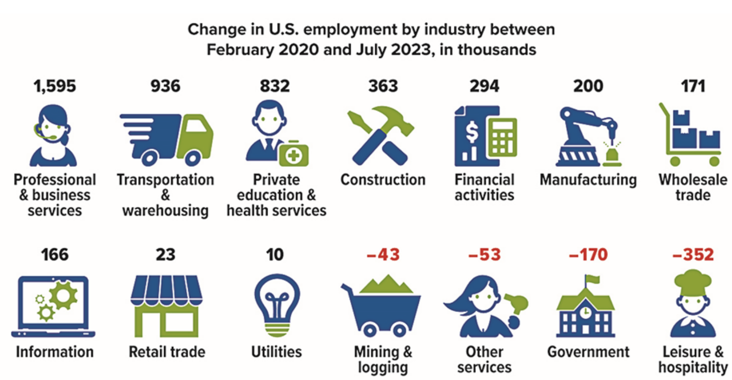
2023 Returns

S&P 500	*13.07%*
NASDAQ	*35.37%*
Russell Small Cap	*12.39%*
Russell Mid Cap	*3.91%*
MSCI EAFE	*7.08%*
MSCI World	*11.10%*
Barclay US Agg. Bond	*-1.21%*
Barclay Municipal Bond	*-1.38%*

Uneven Jobs Recovery

The U.S. economy lost nearly 22 million jobs during the two-month pandemic recession of March–April 2020. The total job count returned to pre-pandemic levels in June 2022, and by July 2023, there were almost 4 million more Americans working than before the pandemic. But jobs shifted among industries. The biggest gains have been in professional & business services (which includes many remote workers) and transportation & warehousing, while the biggest losses have been in leisure & hospitality and government, largely in public education.

Source: U.S. Bureau of Labor Statistics, 2023



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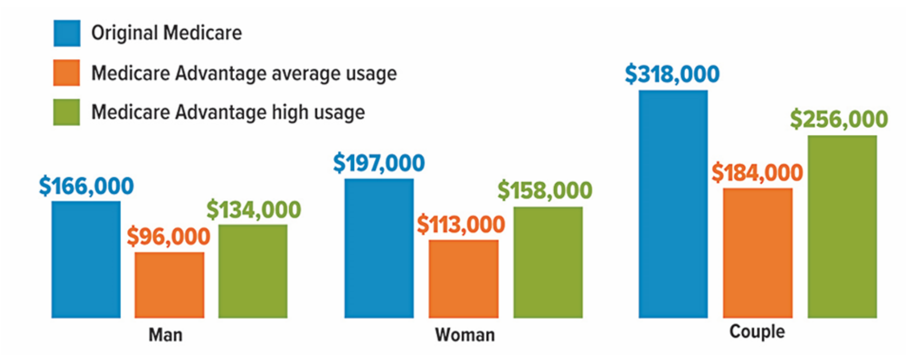
Saving for Retirement Health-Care Costs

The chart below shows the savings that a man, a woman, and a couple who retired at age 65 in 2022 might need to meet retirement health-care expenses, assuming median prescription drug expenses. The Original Medicare estimate includes premiums for Medicare Parts B and D, the Part B deductible, out-of-pocket prescription spending, and premiums for Medigap Plan G, which would pay most other out-of-pocket costs.



Medicare Advantage Plans — offered by private companies under Medicare oversight — require the Medicare Part B premium and typically combine hospital, medical, and prescription drug coverage. They often have limited networks and may require approval to cover certain medications and services.

Source: Employee Benefit Research Institute, 2023. Projections are based on a 90% chance of meeting expenses and assume savings earn a return of 7.32% from age 65 until expenditures are made. Does not include vision, hearing, dental, or long-term care expenses.

REITs, Rates, and Income

Real estate investment trusts (REITs) can offer a consistent income stream that is typically higher than Treasury yields and other stock dividends (see chart).

A qualified REIT must pay at least 90% of its taxable income each year as shareholder dividends, and unlike many companies, REITs generally do not retain earnings, which is why they provide higher dividend yields than most other stock investments. You can buy shares in individual REITs, just as you might buy shares in any publicly traded company, or you can invest through mutual funds and exchange-traded funds (ETFs).

Share Price Volatility

While REITs may offer solid dividends, share prices tend to be volatile and are especially sensitive to rising interest rates. The most common type of REIT is an equity REIT, which uses capital from a large number of investors to buy and manage residential, commercial, and industrial income properties. These REITs derive most of their income from rents and may be directly affected by rising rates, because companies often depend on debt to acquire rent-producing properties — and higher rates can push real estate values downward. Also, as interest rates rise, REIT dividends may appear less appealing to investors relative to the stability of bonds offering similar yields.

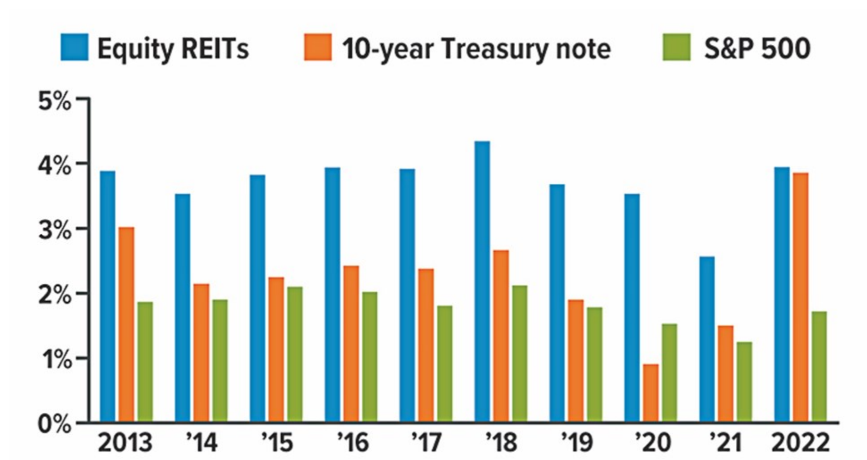
Considering these factors, it's not surprising that equity REIT shares struggled in 2022 — declining 25% in total returns — as the Federal Reserve raised rates to combat inflation. However, REITs soared in 2021, returning 41%, and may be poised for better performance in 2023 and beyond, as interest rates settle. In Q1 2023, REIT fundamentals such as funds from operation and net operating income were solid, and occupancy rates for industrial and retail properties surpassed pre-pandemic levels. (Apartment occupancy was down slightly, and office occupancy was still about 5% lower than before the pandemic.)[1]

Diversification and Asset Allocation

Along with providing income, REITs can be a helpful tool to increase diversification and broaden asset allocation, because they do not always follow the movements of stocks or bonds. Over the 10-year period ending in 2022, equity REITs had a correlation of 72% with the S&P 500 and 50% with the corporate and government bond market. The correlation was even lower over 30 years.[2] As this suggests, REITs are in some respects a unique asset class. Diversification and asset allocation are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.

Consistent Yields

Over the last decade, equity REITs maintained dividend yields that were higher than yields on the 10-year Treasury note and dividend yields on stocks in the S&P 500.



Sources: National Association of Real Estate Investment Trusts, 2023 (Equity REITs); Federal Reserve, 2023 (10-year Treasury note); S&P Dow Jones Indices (S&P 500). The S&P 500 Index is an unmanaged group of securities considered representative of the U.S. stock market in general. The performance of an unmanaged index is not indicative of the performance of any specific security. Individuals cannot invest directly in an index. Past performance is not a guarantee of future results. Actual results will vary. U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest. The principal value of Treasury securities fluctuates with market conditions. If not held to maturity, they could be worth more or less than the original amount paid.

College Forecast: Skepticism Toward Higher Education Rises

A notable shift in public opinion over the past decade about the value of a college degree may portend a reckoning for the higher education industry in the years ahead — and for the families who are trying to save for and manage the costs. A 2023 survey found disaffection spreading to all age groups, with 56% of Americans saying a four-year college degree isn't worth the cost due to students graduating with significant debt and a lack of specific job skills vs. 42% who think college is worth it.[1] Ten years ago, the survey numbers were almost reversed.

Lower College Enrollment

Public misgivings about college intensified during the pandemic, when academic instruction moved online and families began questioning sky-high tuition costs. This translated into lower enrollment, which continued post-pandemic. For the 2022–2023 school year, the college enrollment rate was 62%, down from 66.2% in 2019–2020. Over the past decade, college enrollment has declined by about 15%.[2]

There are other factors at play besides public skepticism. A robust job market for less-educated workers has made it easier for high school graduates to justify skipping college and head straight into the labor market. At the same time, alternative forms of job training, such as apprenticeships and certificate programs, have become more prevalent and are increasingly seen as viable educational paths toward landing a good job.

Cost: The Elephant in the Room

A big reason Americans are souring on college is the cost. For the 2022–2023 school year (most recent data available), the average one-year cost for tuition, fees, room, and board was $23,250 for in-state students at a four-year public college, $40,550 for out-of-state students, and $53,430 at a four-year private college.[3] But many schools, especially "elite" private colleges, cost substantially more, with some over the $80,000 mark.[4]

Even with a discount on the sticker price, the total cost over four years is too much for many families to absorb. One result of high sticker prices in recent years has been a surge of interest in public colleges, particularly state flagship universities, many of which offer robust academic and student life opportunities comparable to their private counterparts.

Another factor in the college value proposition is time. Four years (or longer if a student changes majors or doesn't have enough credits to graduate) is a significant investment of time when compared to a one- or two-year certificate or apprenticeship program. Some students are balking at the traditional time commitment of college and the lost opportunity cost of not entering the job market sooner.[5]

The Burden of Student Loans

Many students need to take out federal, and sometimes private, loans to cover college expenses. Interest rates on federal student loans are based on the rate for the 10-year U.S. Treasury note and reset each year. For the 2023–2024 school year, they have increased again and are now the highest in a decade.

The burden of student loan debt was bubbling in the public consciousness for years but boiled over during the pandemic. Nine payment pauses since March 2020 halted repayment, and widespread calls to cancel student debt led to an executive order in August 2022 cancelling up to $10,000 in federal student loans ($20,000 for Pell Grant recipients) for borrowers with incomes below certain limits, an order that was struck down in June 2023 by the U.S. Supreme Court.[6] Also in June, as part of the debt ceiling agreement, Congress ordered an end to the payment pause, and the Department of Education later clarified that payments would start back up in October — a sobering reality for millions of borrowers after three-and-a-half years of payment pauses.[7]

To help those who may be in financial distress, a new income-driven repayment plan — Saving on a Valuable Education (SAVE) — will allow borrowers to cap their monthly student loan payments at 5% of their discretionary income. It replaces the Revised Pay as You Earn (REPAYE) plan, which capped monthly payments at 10% of discretionary income.[8]

1) The Wall Street Journal, May 31, 2023 (numbers do not add up to 100% due to rounding)
2, 5) The Wall Street Journal, May 29, 2023
3) The College Board, 2022
4) Harvard University, 2023; Stanford University, 2023
6) The New York Times, June 30, 2023
7) Fiscal Responsibility Act of 2023; U.S. Department of Education, 2023
8) U.S. Department of Education, 2023

	2022–2023	2023–2024
Direct Loan: Undergraduate	4.99%	5.50%
Direct Loan: Graduate	6.54%	7.05%
PLUS Loan: Parent and Graduate	7.54%	8.05%

Four Key Objectives of a Sound Retirement Plan

A sound retirement plan should be based on your particular circumstances. No one strategy is suitable for everyone. Once you're retired, your income plan should strive to address four basic objectives: earn a reasonable rate of return, manage the risk of loss, maintain a source of sustainable and predictable income, and reduce the impact of taxes.

Earn a Reasonable Rate of Return

Your retirement savings portfolio will likely be used to provide at least a portion of your income throughout retirement. The overall goal is to maintain an amount that produces the necessary income each year. This requires accounting for the rising costs of goods and services (including health-care expenses); identifying your budgetary needs and wants; estimating how long you'll expect retirement to last; and factoring in Social Security and other income sources. It also requires estimating a rate of return you'll need to earn on your portfolio and then putting together an investment strategy to pursue that target rate. If you have enough savings to meet your retirement needs, you'll want to maintain that level of savings throughout your retirement years. That's why it's important to strive for a realistic rate of return on those savings. Of course, determining a reasonable rate of return depends on your individual circumstances and goals.

Manage Risk of Loss

If you have sufficient savings to meet your retirement needs and goals, you'll want to protect those savings and reduce the risk of loss due to sudden market corrections and volatility. The goal is to reduce investment risk and preserve savings. A reduction in savings due to a market downturn could require you to sacrifice important retirement goals and reduce retirement income.

Prior to retirement, you have more time to recover from market losses. However, once retired, your time frame for recovery is much shorter. For example, if you had retirement savings of $500,000 and lost 25% due to market volatility, your savings would be reduced to $375,000. You would have to earn a rate of return of more than 33% in order to get back to $500,000. That could take plenty of time to achieve.

Maintain a Sustainable and Predictable Income

During our working years, most of us are used to receiving a steady income. However, once we retire, the income we got from work is no longer there, even though that's what we've been accustomed to. So it's important to create a sustainable, dependable, income stream in retirement to replace the income we received during our working years. While you may receive Social Security retirement benefits, it's unlikely that you can maintain your desired lifestyle in retirement on just Social Security. In addition, defined-benefit pension plans are not as prevalent or available as they once may have been. Most employers don't offer pension plans, placing the burden on us to find our own sources of retirement income.

Maintaining a sustainable income in retirement is important for many reasons. You'll want sufficient income to meet your retirement expenses. It is also important that your income is not negatively impacted by downturns in the market. And you'll want your income to last as long as you do.

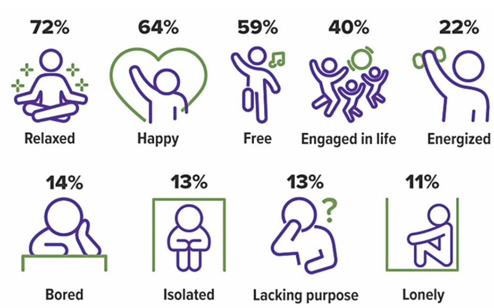
Reduce the Impact of Taxes on Retirement Income

Taxes can cut into your retirement income if you don't plan properly. Many of us think our tax rate will be lower in retirement compared to our working years, but that is often not the case. For instance, we may no longer have all of the tax deductions in retirement that we had while working. In addition, taxes may increase in the future, potentially taking a bigger chunk out of your retirement income. So it's important to create a tax-efficient retirement.

Your retirement plan should be suited to your particular situation. However, these four objectives are often part of a sound retirement plan. A financial professional may be able to help you to earn a reasonable rate of return, manage risk of loss, create and maintain predictable retirement income, and reduce the impact of taxes on that income. There is no guarantee that working with a financial professional will improve investment results.

A Few Words About Retirement

In a recent survey, retirees ages 40 to 74 were asked to choose from a list of words and short phrases to describe their feelings about retirement. The good news is that most had positive feelings.



Source: AARP, 2022 (multiple responses allowed)

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