JOHNSON
INVESTMENT COUNSEL

Quarterly Insight

MARKET UPDATE

FROM THE DESK OF CIO CHARLES RINEHART, CFA, CAIA

2023
THIRD
QUARTER

Have you ever been lost in a corn maze? I experienced this adventure a few weeks ago during a trip to the pumpkin patch with my kids. The task seemed straightforward – to win a prize, one must enter the maze, find the stamp in the middle, and safely navigate back out. Confident in my maize navigation abilities (pun intended), I dismissed the map at the entrance, thinking, "Who needs directions? It's just corn...". Thirty minutes and one irritated three-year-old later, I found myself desperately scouring my phone for satellite imagery of the farm to find the way out. It's amazing how easy it is to get lost in the details when what you really need is the big picture.

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This year's market has felt more like that maze with each passing quarter. The initial wide-eyed enthusiasm and AI-driven investing in the first half of the year has been replaced by a range of worries. Labor strikes, the resumption of student loan payments, and potential government shutdowns have dominated the financial news cycle. Inflation concerns, a growing deficit, and Fed policy loom large, pushing interest rates higher and bringing volatility back to the stock and bond markets. In the midst of all this, I thought the best use of this quarter's newsletter would be to zoom out and take a fresh look at the map.

At the heart of many of today's most pressing issues lie inflation and the Federal Reserve's actions to control it. The surge in prices for goods and services throughout 2021 and 2022 introduced several generations to inflation for the first time. While economists have dedicated considerable brainpower to explaining the phenomenon with sophisticated mathematical models, at its core, inflation emerges when the demand for goods and services outpaces their supply. When inflation needs to be tamed, it becomes the Federal Reserve's duty to step in and balance the scales.

Ideally, they would fix the problem by increasing the supply of goods and services for all to consume. However, boosting production across the economy is challenging. Therefore, they must combat inflation by reducing demand. Demand, in an economic sense, requires both the desire and the ability to make purchases. Fortunately, our desires remain beyond the reach of policymakers, but they can influence our ability to buy things by limiting the availability of credit.

The Fed's primary tool for this manipulation is its control of the Fed Funds rate, which is the interest rate at which banks lend and borrow excess reserves overnight. The Fed has been aggressive in using this tool, raising the rate from essentially zero at the beginning of 2022 to the current level of 5.5%. This has a

FEATURING

TOTAL RETURNS

	3Q 2023	2023
S&P 500	-3.3%	13.1%
Dow Jones Industrial Average	-2.1%	2.7%
NASDAQ	-3.9%	27.1%
Russell 2000	-5.1%	2.5%
MSCI EAFE (International)	4.0%	7.6%
Barclays Aggregate Bond Index	-3.2%	1.2%

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variety of impacts, some of which occur swiftly, while others take time.

For instance, let's look at the housing market to observe both immediate and longer-term impacts. Just two years ago, a 30-year mortgage could be obtained at less than 3% interest. That was good business for banks when their borrowing costs were near zero but not when they're at 5.5%. As expected, the average 30-year mortgage rate now stands at 7.5%, a 20-year high. Higher mortgage rates lead to reduced housing market activity, and indeed, we've seen existing home sales decline from 15-year highs to levels comparable to the lows of COVID and the Great Financial Crisis. This is an example of one of the quicker demand reactions to Fed policy.

The good news for the economy and consumers is that most of the mortgage debt in the United States is in the form of long-term fixed-rate loans. Anyone fortunate enough to have one of those 3% mortgages of yesteryear remains blissfully unaffected by their new neighbor's 7% rate. For most borrowers, increased interest rates don't affect cash flows until they need to refinance. Refinancing isn't necessarily an issue for a loan like a mortgage that pays down principal over time, but it is an issue in the bond market, where borrowers typically only pay interest from year to year and repay all their principal at the end.

Over time, governments and corporations must find capital to fund these balloon payments. The usual course of action is to pay off the maturing loans by taking out new ones. When interest rates have risen over the course of the loan, this replaces low-interest debt with higher-interest debt. The impact of this process starts slowly and builds over time, becoming more significant based on the magnitude of the increase in rates and the length of time rates remain high. Cash spent on higher interest payments is money that isn't spent on new factories, employees, or, in the case of consumers, pumpkin-spiced lattes. Consequently, demand is slowly lowered until there's enough supply for those who remain standing, and price stability returns.

Given how long it takes for changes in interest rates to work their way through the economy, it's very challenging for the Federal Reserve to know exactly when enough is enough. Keeping interest rates too high for too long can destroy too much demand. When this happens, we can enter recessions. Of course, when that happens, the Fed needs to encourage demand, which they do by lowering the Fed Funds rate. If they cut too much or for too long, demand can grow in excess, just as it did in 2021 and 2022. And this is why they call it a cycle…

Now, back to the map. Where are we today? The Fed has made a significant effort to curb demand and inflation is trending down. Core CPI has fallen from 6.6% to 4.4%, although we're still above the Fed's 2% goal. The Fed has indicated they're nearly done actively raising rates, but rates will remain "higher for longer." So far, the economy has remained resilient, but there are signs of slowing and the mounting pressures of strikes, possible shutdowns, and student loans are unlikely to help. That is the backdrop for this quarter's volatility and the reason interest rates are up and stocks and bonds are under pressure.

How much higher can interest rates move? It's difficult to say. We're in the maze now, and the only way to know when we're close to getting out is when we see the exit. This is the time when it feels like it can last forever, but it's important to remember that it's a cycle. The good news is that monetary policy works. Unfortunately, that's also the bad news. The key is to keep a level head and remember that trying to time the highs and lows is generally riskier than sticking to the original plan.

As always, we're continually evaluating portfolios to ensure they're well positioned for as many outcomes as possible and resilient to economic uncertainty. We are committed to keeping you informed about market changes and encourage you to reach out to your portfolio manager with any questions or concerns you may have. We'll get out of the maze together. For now, let's try to enjoy the walk.

Chief Investment Officer, Charles Rinehart, CFA, CAIA, leads our dedicated team of research analysts and portfolio managers as they manage our investment strategies to deliver financial peace of mind to our clients.

MARGIN BORROWING DONE WELL

THE VERY LIMITED (BUT USEFUL) CASE FOR MARGIN BORROWING

On the 25th anniversary of the failure of the famous hedge fund, Long Term Capital Management (LTCM), we can think of no better example of the dangers of using debt to finance speculative market bets.

For those who aren't familiar (or don't have much gray hair to remember it), LTCM was a famous hedge fund that collapsed in the fall of 1998 under the weight of an enormous amount of debt, which fueled their 40%+ annual returns. By the end of their run in September 1998, however, they held a leverage ratio of about 250-to-1, which means they had capital of about $400 million but assets of about $100 billion, according to a recent Bloomberg story. When everything is going up, it's not a problem, but when "bets" turn sour, that type of leverage can bring an investment house crashing down quickly.

MARGIN BORROWING DONE WELL

While the rise and fall of LTCM is the case study in large-scale leverage gone bad, many people on a smaller scale employ essentially the same tactics and suffer the same consequences, by borrowing against their assets "on margin" to speculate on what they are confident will be a positive investment outcome. The operative word is "speculate" because these folks aren't looking to purchase a security based on fundamentals, such as attractive relative valuation to peers or strong free cash flow. They are simply looking to buy with the intention of selling to the "next person" at a higher price in the next month, week, or day. Very often, they borrow money on margin to super-charge their potential returns, with the intention of paying back the loan after they've sold at a profit.

For prudent investors and most of our clients, this tactic is not one we employ when constructing an investment portfolio and wealth plan on which a family is expected to depend for decades and beyond. However, borrowing on margin can, in select cases, be a smart move financially when used correctly, cautiously, and in very limited circumstances.

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HOW MARGIN BORROWING WORKS

Borrowing on margin is simply borrowing cash to finance a purchase, and the collateral is the value of the investment account. Like any loan, the borrower pays an interest rate on the borrowed funds. The firm that supplies the cash is a custodian of these assets (e.g., Charles Schwab, Fidelity, etc.), and the amount available to borrow is based on some percentage of the assets held, usually stocks and bonds. Given the historic differences in the short-term volatility of stocks vs. bonds, firms usually allow a higher borrowing percentage of fixed income compared to equities. In addition, most firms limit the borrowing to taxable accounts only (not retirement accounts like IRAs) because they don't have the same tax and penalties associated with withdrawals. In general, borrowing is limited to 50% of marginable securities. If the underlying account value is stable or goes up, the custodian obviously doesn't require outside funding to maintain the required level. However, if the underlying account value goes down, then the dreaded "margin call" comes in, which requires outside funds to backstop the value of the depleted collateral. This dynamic has been the downfall of speculators dating back to the Dutch Tulip Bubble in the mid-1600's.

WHEN IT CAN MAKE SENSE

With all these warnings and caveats noted, we think borrowing against one's assets for short-term funds for a home purchase can make sense. The most common scenario is to provide "bridge financing" in that unsettling time between purchasing a new home and selling an existing home. Especially in today's still-competitive housing market, being able to buy a home with a cash offer is a distinct competitive advantage. Most people don't have hundreds of thousands of dollars of cash lying around, especially when they haven't sold their existing home yet. This is where margin borrowing can help: With the margin loan, a person can borrow the cash, buy the new home, pay interest on the margin loan for a month or two (hopefully), and the loan is repaid in full when their old house sells.

DOING THE MATH: INTEREST EXPENSE VS. CAPITAL GAINS

The key advantage to this strategy is to avoid having to liquidate stocks and bonds in a taxable account and incurring capital gains taxes, which can be as high as 23.8% federal on long-term capital gains and ordinary income rates (up to 37% federal) on short-term gains. Once you add in potential state tax, liability to the government can add up very quickly.

Here's the math: let's say a person wants short-term financing on a $400,000 home purchase, and they will sell their old home for $350,000. The market rate for margin loans (as crazy as it sounds now) is around 8%. (Note: this can fluctuate based on the custodian and the level of assets held at a firm). Interest expense in this case for two months would be about $5,333. ($400,000 x 8% / 12 x 2 months). Certainly not the cheap money we've grown accustomed to. Then, compare that to selling $400,000 securities with a conservative cost basis of $300,000 for a long-term capital gain of $100,000. The tax bill on that can be as high as $23,800 assuming it's all long-term gains! In addition, the higher capital gains income can result in collateral tax damage, such as more tax on Social Security and potentially higher Medicare premiums (due to IRMAA: income-related monthly adjustment).

(article continued)

So, borrowing on margin for a very short-term to purchase a home and then paying the loan back can save a family thousands or even tens of thousands of dollars if executed properly. Of course, a thorough analysis of potential capital gains and a tax projection is highly recommended.

BOTTOM LINE

For a family's long-term wealth plan, limiting or eliminating debt is certainly a prudent approach we fully endorse in general. Buying on margin is a dangerous game played by fast-money hedge fund types and meme-stock speculators, and it's a game we don't support or recommend. But in select cases, with a clear line-of-sight to a quick loan payback and limited time to endure underlying market fluctuations, a borrowing on margin tactic can make a lot of sense. In many cases, a few months of interest expense, even at today's higher rates, can be much lower than the potential capital gains taxes associated with liquidating low-basis investment holdings.

Disclaimer: Information contained herein is current as of 9/30/2023. It is subject to legislative changes and not intended to be legal or tax advice. Please consult your qualified tax advisor regarding your specific circumstances. The material is provided for informational purposes only on an "as is" basis. It's completeness and accuracy are not guaranteed.

UPCOMING WEBINAR

Are you, a family member, or friend a current or former Procter & Gamble employee? This webinar is designed to help owners of the P&G Profit Sharing Trust (PST) understand how the proceeds may be distributed and invested, and how taxes are impacted. Johnson Investment Counsel has helped hundreds of P&G employees navigate PST distribution options. We want to share what we know about transitioning from P&G so that you can make the best decisions for your family.

SCAN TO REGISTER

NATIONAL RANKING

We are thrilled to have been included once again on Barron's "Top 100 RIA Firms" list. We are at #36 and are the only Cincinnati-headquartered firm in the top 50. Barron's published its first advisor ranking in 2004 to shine a spotlight on the nation's best wealth managers and raise standards in the industry. This prestigious award considers assets managed by the firms, technology spending, staff diversity, succession planning, and other metrics. As an independent Registered Investment Advisor (RIA) we have a fiduciary duty to act in our clients' best interests, and we are honored to have been doing just that since 1965.

Disclaimer: Advisors who wish to be ranked fill out a 102-question survey about their firm. Data is collected as of 6/30/2023. Barron's verifies the data against regulatory databases then applies their own rankings formula to generate a ranking. The formula features three major categories of calculations: (1) Assets, (2) Revenue, and (3) Quality of Practice. Each category contains multiple subcalculations. Barron's ranking is based on a variety of quantitative and qualitative factors. Quantitative factors include, but are not limited to, amount of assets, type of assets, growth, and client retention. Qualitative factors include, but are not limited to, experience levels, advanced degrees, industry designations, the size, shape and diversity of teams, charitable and philanthropic work and the compliance records of the firm and its associated employees. The ranking may not be representative of any one client's experience as it reflects a sample of client experiences. The award is also not indicative of future performance and there is no guarantee of future investment success.

JOHNSON TRUST COMPANY CELEBRATES 25 YEARS

In October of 1998, with 33 years of business under its belt, and as one of the largest Registered Investment Advisors (RIAs) in Ohio, Johnson Investment Counsel responded to the needs of clients by establishing the Johnson Trust Company.

The addition of the Trust Company provided clients access to specialized services and deep knowledge from a team of attorneys and trust officers for developing and implementing our clients' estate plans, serving as trustee or executor, or assisting individual clients in these roles, providing philanthropic advising, and more.

Johnson Trust Company is not restricted by the impersonal limitations of big banks and has the specialized expertise and experience to hold unique assets that other trustees avoid. This expertise, combined with the exemplary personal service that is the hallmark of Johnson, provides clients assurance that their legacy will endure for future generations.

We thank you for your loyalty these past 25 years and look forward to many more years of partnership in the future!

1998 - 2023
CELEBRATING 25 YEARS

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PROMOTIONS

We are pleased to announce that the following individuals have been promoted to new positions.

> **Trinity Garrett, CTFA**
> Trust Officer

> **Max Klett, CFP®**
> Associate Portfolio Manager

> **Alex Wertz, CFP®**
> Associate Portfolio Manager

Garrett

Klett

Wertz

NEW DESIGNATIONS

We are committed to continuing education to provide personal development for our employees and better service to our clients. Congratulations to Portfolio Manager Assistant Lia Reece, CFP®, who has earned the CERTIFIED FINANCIAL PLANNER™ designation.

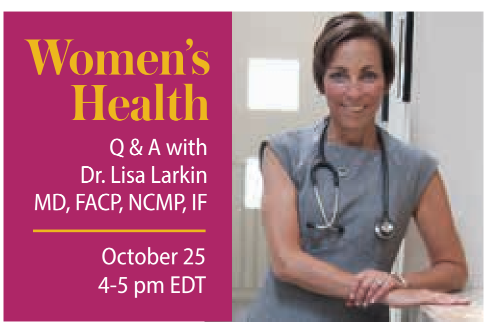
Reece

JIC WOMEN'S INITIATIVES HAVE A NEW LOOK

thrive NETWORK | wethrive

Johnson Investment Counsel's Women's Initiatives have a new look. Our external women's initiative, now Thrive Network, hosts events and educational webinars and participates in local and regional initiatives that support women. Our internal initiative, now WeThrive, is dedicated to supporting female employees with professional and personal development programs, as well as events and activities to strengthen connections with women across the firm.

UPCOMING WEBINAR



Johnson Investment Counsel's Thrive Network will host a webinar on Wednesday, October 25 from 4-5pm. This Q&A with Dr. Lisa Larkin, CEO and founder of Ms. Medicine will cover a range of topics regarding women's health. Named one of Cincinnati's "Top Docs" every year since 1991 (by Cincinnati Magazine), Dr. Larkin is recognized by her peers, patients, and members of the community, as an exceptional provider, educator, advocate, and innovator. Johnson's Vice President of Trust Services Tara Adams will talk with Dr. Larkin about how women can optimize their health at any age.

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ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing more than $17 billion in assets for clients in 49 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-only, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

- WEALTH MANAGEMENT
- FAMILY OFFICE SERVICES
- TRUST COMPANY
- ASSET MANAGEMENT

LOCATIONS

CINCINNATI - KENWOOD
CINCINNATI - WEST
CLEVELAND - AKRON
COLUMBUS
DAYTON
METRO DETROIT

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

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