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Conversations with Commerce Trust podcast
November Episode: End-of-the-Year Investment Strategies
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David Hagee: Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're discussing recent economic and market activity and year-end portfolio strategies with Tara McConkey, Director of Portfolio Management for our Eastern region, and Tim Michel, Director of Portfolio Management for our Western region here at Commerce Trust. Welcome to the podcast.

Tara McConkey: Thank you, David.

Tim Michel: Good morning, David.

David: Great to have you on the podcast this morning. It's been a pretty eventful second half of the year. As I look at things, maybe before we get into portfolios, let's talk about what we've seen inside the markets. More volatility than I think we expected. At least looking at the economic data that we've seen, it's been a pretty positive trend. We've seen resilient economic growth. I was really surprised when we saw the (U.S.) GDP (gross domestic product) numbers up 4.9% for the third quarter. Of course, that's just the first print. I'm sure it could get revised around, but nonetheless, points to a very strong growth inside the U.S. economy. Tara, what are your thoughts on what we've seen so far inside the U.S. economy?

Tara: It's, as you said, been very resilient, and that's in face of many strong headwinds, including war, bank failures, China tensions, high interest rates, you name it. This stock market, especially, and economy have defied all the warnings of a recession. Higher wages have really led to a tight labor market, which has fueled spending. What we saw happen in the third quarter was inventories were really increased dramatically because businesses restocked due to all that strong demand. As we know, the U.S. economy is about two-thirds the consumer. As the consumer goes, so does the economy. The consumer continued to spend throughout that third quarter, and that really lifted those GDP numbers with the inventory rebuild.

David: Tara, you mentioned jobs, the base of our economy that's kept us going and provided so much upside here. All recession indicators have pointed to a recession in the very near future, but we haven't tripped into one. As I look at the jobs market, it certainly is moderating right now, but still very robust. We had 150,000 jobs added in October, and that was maybe a suppressed number given some of the strikes going on inside the auto industry. That's still adding 1.8 million jobs annually, so really strong. Tim, what are your thoughts around the jobs market?

Tim: It has been surprising, David. The one thing that I thought was interesting after the latest report, you mentioned the 150,000 jobs growth. We also saw that productivity grew 4% over the last six months. After '21 and '22 being a lackluster year from a productivity standpoint, we've started to see that aspect of the labor market improving as well, which is an encouraging sign.

David: Tim, let's talk about that productivity gain. You think that's all AI (artificial intelligence), or where is that coming from?

Tim: I think that's part of it. I think that as technology continues to change the way many of us do our jobs on a day-to-day basis, productivity that comes along with that is top of mind. Yes, I think that that's been something that's been driving much of what we've seen over the past six, seven months.

David: The story for 2022 and the first half of 2023 was inflation getting out of the box. It appears that it's subduing right now and that you're starting to see, again, moderating inflation numbers out there. Tara, as you're seeing it, what are the key determinants for continuing to see inflation cool down, and what path do we see moving forward?

Tara: Yes, so we've seen a huge decrease in the CPI (consumer price index) running from about 9.1% to about 3.2%, and that's probably happened much faster than most of us had anticipated. Majority of that has come over the last three, four months. Employment growth rate and wage pressure really has to reverse in order for, I think, really, CPI to get within the Fed's (Federal Reserve) numbers. You really want to see that growth come down so that what's been so strong as wage pressure, which has obviously led to this big consumption of demand for economic growth, that really needs to start to tail off to get probably CPI closer to where the Fed wants it at that 2% rate.

David: Certainly, all of this is happening with a geopolitical backdrop that has steadily deteriorated over the back half of 2023. Looking at the effects on markets here, I'm struck by how much volatility we've had in the second half of the year. First half of the year was this market that was led by the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) these tech stocks that have really driven the U.S. market. As we moved into the second half of the year, a market that I like to view through this lens of having a bear steepener on there, that we saw interest rates really move up. At the start of the year, 10-year Treasury was at about 3.88%, and by mid-October, it touched 5%. That's a seismic move in terms of how much the 10-year moved over that time period. Of course, that resets valuations. Tim, what are your thoughts on the market action for July through October?

Tim: The decline in the markets during that time period was quite striking. The S&P 500 (Index) moved from up 19% to being up 8% and value stocks actually turned negative. Small cap and international continued to struggle. The Russell 2000 (Index) during the time period you spoke to, David, was down almost 6% through the end of October. That Magnificent Seven was driving a large part of this market. The remaining 493 stocks in the S&P 500 struggled.

David: Then it all turns on a dime. We see that inflation number go down pretty dramatically in October. That spurs a larger rally. To your point earlier, people are starting to price in a cut. If you look at the futures market, you're seeing futures price in a rate cut somewhere around May here. Maybe let's get a little more granular on the markets. In terms of what we've seen inside the markets, you've seen large cap leadership, small caps lag over this whole time period. Then as this turns on a dime, you see this broad-based rally. Tara, what are your thoughts? Is this a year-end rally that we're going to see here?

Tara: It certainly has set us up for a nice rally. Once that inflation print came out, the market really jumped on the news. What had been declining over the third quarter, and those names were-- those heavy Magnificent Seven names had declined during that time period, as do small caps. This really stimulated the fact that the economy may reopen and started getting people to believe that we could have a soft landing versus a recession. You can see the market start to price that in. You could see this rally continue through year-end and then get a little bit more volatility as we start the new year.

David: Given that we've seen all this volatility, that we've seen markets moving up and down, and that you've seen a very narrow market over this time, what strategy should we be thinking about for year-end, more specifically to taxes? Tim, what are you thinking about for your client portfolios?

Tim: A strategy that's used every year at Commerce Trust, we go through, and we take a look at, is there any rebalancing that needs to be done in portfolios? If there is rebalancing that needs to be done, can we take losses on certain securities funds to offset gains in other parts of the portfolio to make sure that we are optimizing the tax hit from any changes that may occur here as we finish out the year?

I should also mention that that's something that portfolio managers do on a regular basis. Commerce Trust, we now have product offerings that literally every month, every quarter are looking to harvest losses throughout the year. This can be very beneficial for clients that are looking to minimize that tax drag on a portfolio throughout the course of the year.

David: Tara, you and I have had many discussions around this as well. I know you oftentimes reset cost basis as well. Maybe you could walk us through how that strategy works.

Tara: When assets are down in value and it's an asset that you believe has some long-term growth, sometimes you buy that asset first and then you wait out at least 30 days, if not prior to year-end, to actually sell the original position for that tax loss. Therefore, you've maintained exposure in the names that you want to maintain exposure in, and then you are able to utilize that tax loss a little bit further down the road. That was really popular in 2022, and it has occurred a little bit here in 2023 when we saw the sell-off here over the third quarter.

David: We've mostly spoken to equities today, but certainly on fixed income, given the markets we saw in 2022 when fixed income in general was down in the teens, and then this year, as you've seen, it bounce around with that interest rate movement, that too can represent an opportunity to do a little bit of tax loss harvesting there, especially as you maybe convert from mutual funds to individual bonds or individual bonds back to mutual funds to be able to generate some losses. That truly is one-for-one type trading that you can do there as well. In terms of other tools, thinking a little bit about philanthropy here, Tara, how have you used philanthropy in managing year-end portfolios and taxes?

Tara: As we come into the end of the year, people tend to be maybe more filled with gratitude and generosity and really wanting to help those less fortunate. There's also could be a tax benefit to year-end giving or giving throughout the year, quite frankly. If you've had nice returns in those Magnificent Seven and they've built up sizable positions in a portfolio, those are great assets to gift. You get a tax break on that by doing that. You can certainly use a DAF, a donor advised fund, again, to bring you back into more manageable tax brackets while still being charitably inclined. If you've done a Roth conversion this year, you could certainly use charitable giving to offset that taxable income. While philanthropy, want to do that for the good of it and you want to give to the charities, there can be some nice tax benefits in doing that.

David: Yes, I'm struck with those donor-advised funds, that it's not just a one-year plan that you can do in there as well, that you could front load that, and have three, four years' worth of planned giving that you expect to do and do that all at once and really drive a larger charitable contribution (deduction) inside one given year. I think all those strategies are great strategies to review with your portfolio manager and your private client advisor.

I know for me, it's always been some of the most robust conversations you have with clients are towards the end of the year, where you have an opportunity to wrap up the year from a review point of view, but then also to be able to do some planning and incorporate some of that tax management inside of the portfolio. With that, thank you for the interesting discussion today.

If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts. Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee, we'll talk again soon.

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