Trust Company Oklahoma
INVESTMENT PERSPECTIVES

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FINDING A CURE FOR INFLATION

Tighter Monetary Policy Is Only Part of the Solution

After two extraordinarily odd years, through COVID in 2020 and the economic rebound and bull market in 2021, many of us were lulled into thinking that good times were here again. The economy had returned to relative normalcy, investment portfolios were reaching new heights, kids were doing everyday kid things again, and masks were no longer required in most places. But as Lee Corso likes to say on Saturday mornings in the fall, "Not so fast, my friend!" Underneath the façade of economic normalcy, things were not all well.

Inflation began percolating in mid to late 2021, reaching worrisome levels that had not been seen in several decades. Arguably, the most influential institution for the global financial markets – the Federal Reserve – made the biggest mistake of all by misdiagnosing the initial inflation as "transitory." However, things have become worse since then, with energy prices spiking and housing prices and rents continuing to rise at double-digit rates. You've probably noticed on the latest trip to the grocery store just how painful these price increases have become, with food inflation currently up 10% year-over-year.

Nick Gallus
CFA
Senior Vice President & Director of Investment Research

Short-Term Pain for Long-Term Gain

Given the historically low starting point for interest rates and their rapid increase, this year has been one of the worst on record for bond returns. This has resulted in a "short-term pain for long-term gain" situation. In other words, despite the recent decline in bond prices, investors should ultimately fare better over the long run, assuming they stay fully invested. Future interest earned on reinvestment of both interest and principal as bonds mature will result in better long-term returns than if interest rates were to stay low (and bond prices stay high). For example, a typical A-rated 10-year corporate bond currently yields about 4.5%, whereas that same bond yielded 2.0% just one year ago. Although bond prices are down, that's more than a doubling in yield earned for holding the same bond.

Inflation Is (Unfortunately) Back

Why have interest rates risen so sharply this year? In August, the Federal Reserve Bank of Chicago answered that question in a working research paper, stating, "Inflation is back. After two decades of low inflation, policymakers all over the world are newly confronted with a high bout of fast-growing prices." However, the more provocative idea advanced by the paper is that, "Low and stable inflation requires an appropriate fiscal framework aimed at stabilizing government debt. … The conquest of post-pandemic inflation requires mutually consistent monetary and fiscal policies to avoid fiscal stagflation."

My translation of their rhetoric goes something like this:

> *[Federal Reserve speaking]: "Hey, Congress! We're slinging haymakers left and right to fight this nasty inflation! But we can't take this guy down alone. We're doing our job, now you need to do yours. Get in here!"*

This year markets across the board (i.e., stocks, bonds, housing, cryptocurrencies, etc.) have all experienced a rapid and painful adjustment to higher interest rates. Those higher rates were necessary in response to the persistently high inflation environment, which in turn resulted from an overheated economy and the over-

Continued on page 2

MARKET RECAP

As the Fed continues to try to tame the worst inflation in decades, both stocks and bonds have struggled. The S&P 500 turned in the third-worst performance for the first nine months of the year since 1931.

	YTD	Past 3 Months	Past 12 Months
S&P 500	-23.9%	-4.9%	-15.5%
EAFE (International)	-27.1%	-9.3%	-25.1%

ANNOUNCEMENTS

Trust Company of Oklahoma is proud to announce the recent achievements of two employees.

Rebecca Mitchell has earned her Chartered Financial Analyst designation. The CFA® charter is the most prestigious mark in the investment industry. To obtain it, candidates must complete the CFA® program, which consists of a rigorous, three-part exam testing the fundamentals of investment tools, valuing assets, portfolio management, and wealth planning.

Darryl Reed has passed the Oklahoma real estate exam. He joins our two current real estate licensed officers.

Please join us in congratulating Rebecca and Darryl on their outstanding achievements.

abundant fiscal and monetary stimulus of 2020 and 2021.

Albeit far too slowly, the Federal Reserve is correcting course from its over-stimulus and now working to push inflation numbers back down into the low single digits. Monetary policy has tightened rapidly. Short-term interest rates have risen from near zero to approximately 3%. And through August 2022, the M2 money supply – the total U.S. dollars circulating in the economy – has risen only 1% from December 2021. This follows a 40% (you read that correctly) rise in the money supply from December 2019 through December 2021 due to both fiscal and monetary stimulus.

Finding a Way Back to Normal

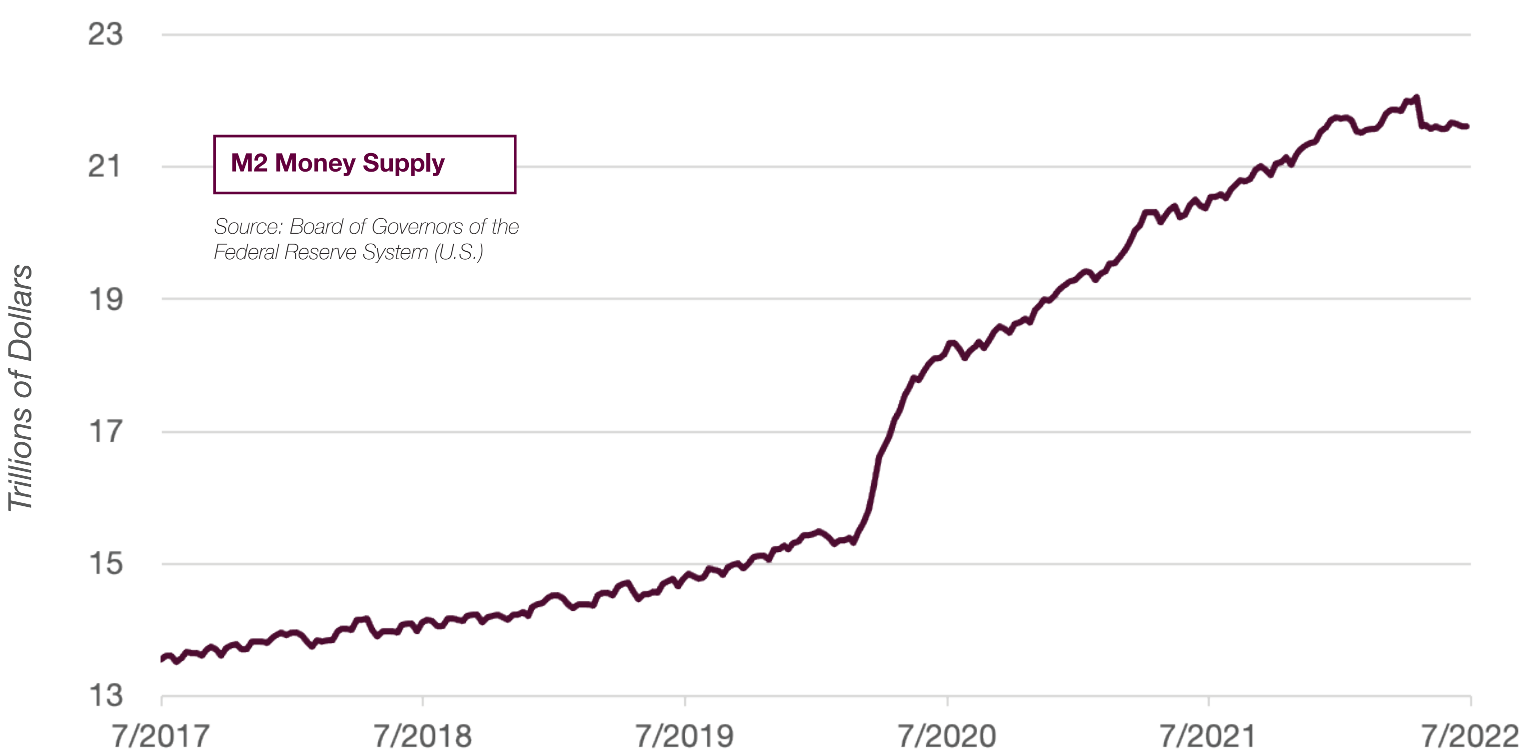
My interpretation of all of this data is that we're roughly halfway back to normal for inflation and the economy. There are encouraging signs that inflation is now slowly decelerating. But the additional medicine that America needs to take now is to get its budget back in order as well.

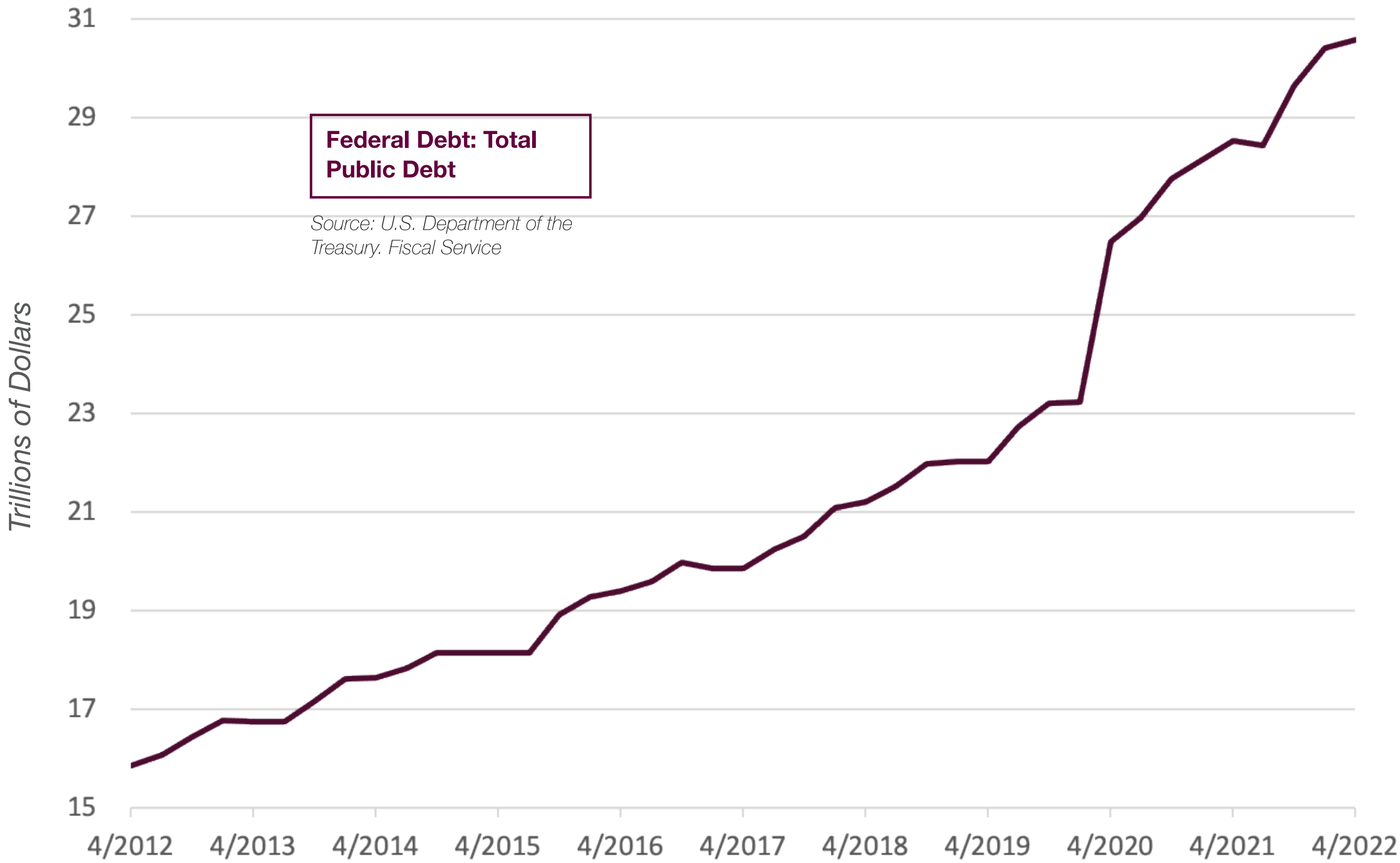
Before the pandemic, the annual federal deficit was already trending up, from around $400 billion in 2015 to $1 trillion in 2019. Then from 2019 to 2021, federal government spending increased by an astonishing 50%. The deficit reached over $3 trillion in 2020 – which was nearly 15% of GDP – before falling slightly to $2.8 trillion in 2021. The one piece of encouraging news here is that the deficit for 2022 is expected to fall meaningfully to around $1 trillion once again.

> **"There are encouraging signs that inflation is now slowly decelerating. But the additional medicine that America needs to take now is to get its budget back in order as well.**

Persistent annual borrowing is clearly not a healthy or responsible way to run an economy over the long term. Consider this: If the U.S. Treasury were to refinance all Federal debt at current interest rates (approximately 3.5% to 4.25%), the interest payments alone would equal nearly 5% of our country's total economic output. That interest burden would need to be paid either by future taxpayers or by all of us in the form of slower economic growth.

Continued on page 3





Will Congress Do Its Part?

Recently, Federal Reserve Chair Jerome Powell clearly stated that the Federal Reserve is committed to getting it right. In a September speech, Powell stated, "What we hope to achieve is a period of growth below trend, which will cause the labor market to get back into better balance and that will bring wages back down to levels that are more consistent with 2% inflation over time." Now it's time for Congress to get our country's budget in order. But the million-dollar question: Is there political will in Washington to make the necessary changes?

Counterintuitively, the good news is that according to a recent Gallup poll, the majority of American people see the light. Fifty-six percent of Americans say that price increases are causing financial hardship, up from 45% less than one year ago, in November 2021. Virtually no one is happy with the present situation of high inflation, and there is now political pressure to fix it.

The Road Ahead

In 1981, the last time inflation reached this high, it took a difficult recession with significant job losses and approximately two years of recovery before inflation returned to 3%. America likely faces a similarly challenging road to recovery, given the magnitude of the current inflation problem. It has now been approximately nine months since things started to turn for the worse, so there might be another year or more to go, unfortunately.

If high inflation is allowed to persist, slow economic growth, also known as stagflation, will continue as well. The medicine the economy needs now is higher interest rates and a sustainable federal budget. The best advice we can offer is that it will be much better if we take ALL that medicine sooner rather than later, so that both the economy and investment portfolios can be healthier and return to growth.

Although the downturn in the stock market has been painful so far this year, the good news is that the market is now much more reasonably priced than it was at the end of 2021. Once it bottoms, the market will be better positioned for higher and more sustainable returns in the future.

ROTH IRA CONVERSIONS

Considerations Before Turning Your Traditional IRA Into a Roth

Michael Hopper
CFP®, CTFA
Executive Vice President & Chief Operating Officer

This year marks the 25th anniversary of the Roth IRA. Since its introduction via the Taxpayer Relief Act of 1997, the Roth IRA has proven to be an indispensable tool for retirement savers. Much of its popularity can be attributed to how it upends the traditional rules of retirement account taxation.

What makes the Roth so unique is that contributions are made with dollars that have already been taxed, unlike traditional IRAs and 401(k)s, which are funded with pretax contributions. While paying tax upfront might not sound like a tremendous benefit, the tradeoff is that, as long as you meet certain requirements, all of your future withdrawals from the Roth are tax-free.

The Roth's special tax treatment can offer diversification to your income streams in retirement, providing you with a tax-free income option in years when your tax rate might be higher. Furthermore, there are no required minimum distributions (RMDs), which allows your money to remain in the account and compound tax-free for a longer period. This last point also makes the Roth IRA a phenomenal vehicle for passing on a tax-free inheritance to your heirs – especially now that children and most other nonspousal heirs must deplete inherited IRAs within 10 years of the original owner's death.

If you have already accumulated large balances in a traditional IRA, you can still convert some or all of your traditional IRA to a Roth. Upon conversion, the value of the assets converted will be included in your taxable income. Then, provided you are at least 59½ and wait at least five years from conversion, all your future withdrawals will be tax-free.

Before rushing to make a conversion tomorrow, here are a few important considerations:

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Lower Market Values

Although market volatility may have reduced the balance of your IRA and left you feeling glum, there is a small silver lining. Since income taxes are based on the value of the assets at the time of conversion, you get more mileage out of a conversion if you do it while market values are lower and allow its rebound to occur inside the Roth IRA.

Lower Tax Bracket Today Than in the Future

When you fund a Roth IRA, you are effectively wagering that your tax bracket will be lower at the time of your contribution than at the time of distributions. The same concept holds for Roth conversions. For the strategy to succeed, your income tax bracket should be lower at the time of conversion than it is at the time of withdrawals.

There are many scenarios where this might be the case. For example, if you have recently retired but have not yet begun taking distributions from your IRA or 401(k), you could be in a brief window where you find yourself in a lower tax bracket and have an opportunity to make a tax-efficient conversion. Rather than converting all at once and potentially pushing into a higher tax bracket, however, you can also convert smaller amounts spread over multiple tax years.

Outside Assets to Pay Tax

To make the math of a conversion work in your favor, you need to have cash outside of your IRA to pay the resulting income tax. If you pay your tax bill by taking a distribution from your IRA or by selling assets in a taxable account and paying capital gains, odds are the conversion will become too expensive to see a benefit from the Roth IRA.

Commitment to the Conversion

It was once possible to change your mind if you converted but didn't like the outcome. For example, if the conversion took place at the beginning of the year and the value of your Roth IRA subsequently plummeted, you could undo the conversion and avoid the resulting income taxes so long as you did so by the tax-extension deadline. However, since 2018 this "recharacterization" is no longer allowed. As a result, once you convert you must live with the consequences.

Please keep in mind that these are all general guidelines and that each circumstance is unique. Before initiating a Roth conversion, be sure to visit with your TCO advisors and your tax advisor.

iStock.com/BrianAJackson

THE PITFALLS OF SELF-MADE ESTATE PLANS

Dr. Jekyll Provides a Lesson in the Dangers of Creating One's Own Will

Emily Crain
Senior Vice President

For all of its obvious intrigue, estate planning rarely makes its way into literature. Characters are born. Characters die. Characters undergo all imaginable life events that make estate planners' fingers itch to craft the exact power of attorney or testamentary document to assuage whatever pitfall the character might encounter.

But then, the ability to address Hamlet's issues at the right time with the right health care power of attorney would leave us without Shakespeare's classic.

Lucky us, the estate nerds, for the greatness that is Robert Louis Stevenson's *The Strange Case of Dr. Jekyll and Mr. Hyde*. The driver of the plot is the holographic will of Dr. Jekyll, a respected doctor known for his decency and charitable works. Herein the lawyer narrator, Gabriel John Utterson, is so repelled by Dr. Jekyll's will that he at first refuses to draft or sanction it in any way. His subsequent investigation as to why Dr. Jekyll has devised the remainder of his estate, outside of a few specific gifts to household staff, to the contemptible Mr. Hyde is the substance of the novel.

Dr. Jekyll's will is a legal minefield. A testator needs to exhibit knowledge of his assets, his natural heirs, and perceive rational judgment as to how those elements pertain to each other. A holographic will is a handwritten will that requires no witnesses. In Oklahoma, a holographic will is one that is entirely written, dated, and signed by the hand of the testator himself. It may be made in or out of Oklahoma and need not be witnessed. (See 84 O.S. 54.) The lack of witnesses lends itself to a question about the capacity and duress on the part of the drafter, Jekyll, for the benefit of the beneficiary, Hyde. In fact, Utterson's first suspicion is that Mr. Hyde came to be a beneficiary of Dr. Jekyll's will due to blackmail.

A testator must be of sound mind to make a will. He must also create that will without coercion. As we know, Dr. Jekyll was dosing himself with a potion of his own making to indulge in his baser instincts. One could easily contest that Dr. Jekyll was not able to know his assets, nor have the ability to make a reasonable decision as to those assets at the time of drafting the will.

It is unlikely that you will be creating a testamentary document that leaves the bulk of estate to your drug-conceived, evil alter-ego, but even a seemingly simple set of facts can present its own unique set of legal pitfalls. Whenever you need estate planning, consult with an attorney to help you navigate the process.

SPOTLIGHT

To learn more about this organization and how to assist in its mission, visit **cceok.org**.

Eastern Oklahoma CATHOLIC CHARITIES Love Changing Lives.

Catholic Charities of Eastern Oklahoma has been serving those in need since 1951. Catholic Charities has 15 programs, including providing dental care, counseling, refugee resettlement, and adult education. They provide services to all in need, regardless of race, color, or creed. Approximately 80% of clients served by the organization are not of the Catholic faith.

The Market at Catholic Charities, the first of its kind in the Tulsa area, opened in spring 2022. The Market gives those in need the opportunity to "shop" for their families, choosing healthy foods they will enjoy, thereby reducing food waste. Catholic Charities' ultimate goal for the Market is to provide dignity for people, helping them feel good about putting food on their family's table.

Catholic Charities is not a United Way agency, nor does it receive funding from the Diocese of Tulsa and Eastern Oklahoma or its Faith and Works campaign. As such, most of the organization's operating funds are provided by donations from individuals and charitable organizations.

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FORWARDING SERVICE REQUESTED

Alone we can do so little; together, we can do so much.

Helen Keller

CREATING A PLAN FOR YOUR ASSETS STARTS WITH A CONVERSATION.

**PROTECTING YOUR ASSETS.
GROWING YOUR WEALTH.
ADVISING YOU FOR LIFE.**

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