EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

December 31, 2023

HIGHLIGHTS

- The market is confident that the Fed is done raising rates and expects cuts starting in the spring of 2024 and to finish the year with short term rates below 4%. The economy may also avoid a recession.
- 2024 will most likely not be a repeat of 2023 with the market up another 20%. The earnings growth will not be high enough and/or further multiple expansion will not occur even if the Fed cuts rates as expected.
- The current predicament of high levels of debt will not be solved easily. Spending on Social Security and Medicare is expected to grow faster than the economy for the foreseeable future. Interest rates are coming down, which should ease the impact of these follow-on effects of higher levels of debt.

2023 – Better Than Expected

The market started 2023 with expectations that the Federal Reserve (Fed) would be cutting its benchmark rate by year end and we'd finish the year below 5%. Instead, after four 25 basis points rate hikes, we exited 2023 with a benchmark rate of 5.25% to 5.50%. The Fed continued to hike rates as inflation remained stubbornly high, although it did fall from 6.4% in January on a year-over-year basis to 3.1% in November. The more informative core inflation, which removes volatile food and energy prices, started the year lower (up 5.6% in January) but only fell to 4% - about twice the Fed's 2.0% to 2.5% target. The largest component of inflation, shelter costs, also remained well above the Fed's target and overall inflation, falling from 7.9% to 6.5%.

In addition to high interest rates and high inflation, company earnings are estimated to be down in 2023 vs. 2022 by about 2%. As a result, the market was up about 26%. This dichotomy was driven by multiple expansion, as the S&P 500 started the year trading at about 18X trailing earnings (around the historical average) and closed the year at about 23X trailing earnings (above the top quartile). Why did the multiple expand from average to high with high interest rates and high inflation and no earnings growth? The market trades on expectations of what will happen in the future.

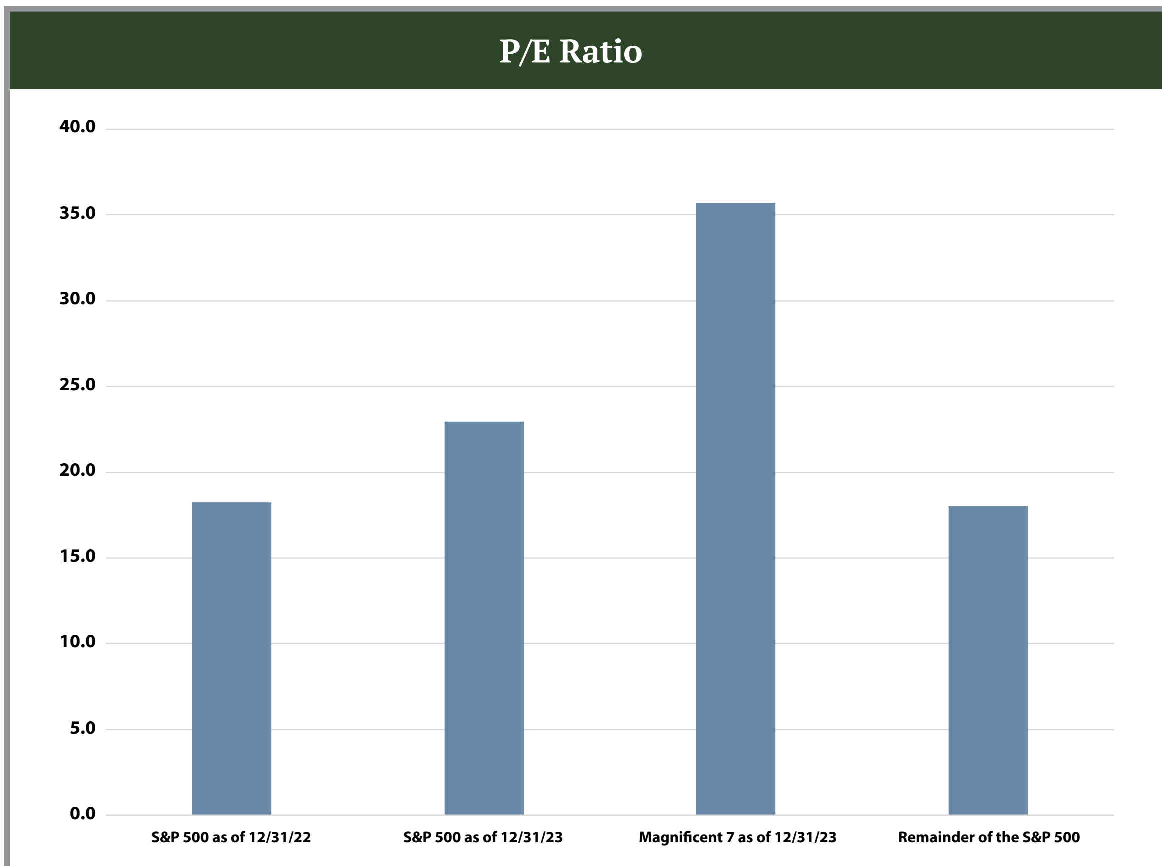
The market is confident that the Fed is done raising rates and expects cuts starting in the spring of 2024 and to finish the year with short term rates below 4%. The economy may also avoid a recession. The Fed's goal since the beginning of its rate hiking campaign has been to rein in inflation without causing a recession, engineering a "soft landing." This seemed unlikely at the start of 2023 but as growth has continued despite the Fed's actions, it has become more likely.

2023 – Better Than Expected continued

Inflation, while still above the Fed's target, has come down. The shelter component is still elevated but also lags other components given the time it takes for the calculation to properly reflect housing prices. Once the calculation catches up to reality, core inflation should fall closer to the Fed's target. Additionally, earnings are estimated to grow in 2024 by about 12%, driven by both revenue growth and margin expansion. Margins contracted in 2023 as companies dealt with rising input costs but as those costs stabilize, or come down as they have for energy, companies will be able to pass along the costs to consumers. This will drive margins up and flow through to higher earnings.

These expectations provide some context for the elevated multiple. A breakdown of the calculation adds additional color. The market was driven by the "magnificent seven" in 2023 - Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta and Tesla. These companies make up about 30% of the S&P 500 and have a weighted average multiple of about 36X trailing earnings. Excluding these seven companies, the weighted average multiple of the S&P 500 is about 18X trailing earnings, which is in line with historical averages.

2024 will most likely not be a repeat of 2023 with the market up another 20%. The earnings growth will not be high enough and/or further multiple expansion will not occur even if the Fed cuts rates as expected. However, there most likely will be opportunities for strong performance in certain unloved names from 2023 trading at more reasonable multiples while still delivering decent earnings growth. Even among the magnificent seven, there are disparities in the valuations. Investing continues to be about understanding your underlying companies and having confidence in their earnings power.



US Debt and its Repercussions

Over the last couple of decades, the Federal Government has consistently run large fiscal deficits by spending more money than it has received through tax revenues. For instance, last fiscal year, the United States ran a fiscal deficit of $1.7 Trillion when it spent $6.13 Trillion compared to only receiving $4.44 Trillion in revenue. This massive deficit decreased from a peak deficit of $3.13 Trillion in fiscal 2020 when the government stimulated the economy in response to the COVID shock. Many years of running deficits have caused the total debt to swell to almost $34 Trillion. The total US economy produces about $27 Trillion worth of goods and services so that the debt is 26% larger than the country's Gross Domestic Product (GDP). For historical context, this debt level is higher than at any time in the country's history including during World War II when the United States was fighting a global war in Europe and Asia and spending 40% of its GDP on defense.

Much of the debt has been due to the growth in mandatory entitlement programs including Social Security and Medicare. These programs represent about 65% of Federal Government spending. In fiscal 2022, interest payments on the country's debt consumed another 7.5% of the total budget. When interest rates were low, the government could increase its spending and its debt without a large concurrent increase in interest payments. From the financial crisis of 2008 until last year, short-term interest rates fluctuated between 0% and 2.5%. However, over the past six months, the Federal Funds rate has been over 5%. Therefore, every time the government issues bonds to finance its debt, it needs to pay much more than in the recent past. In fiscal 2023 which ended in October, it is estimated that interest payments increased to 10% of the Federal Budget.

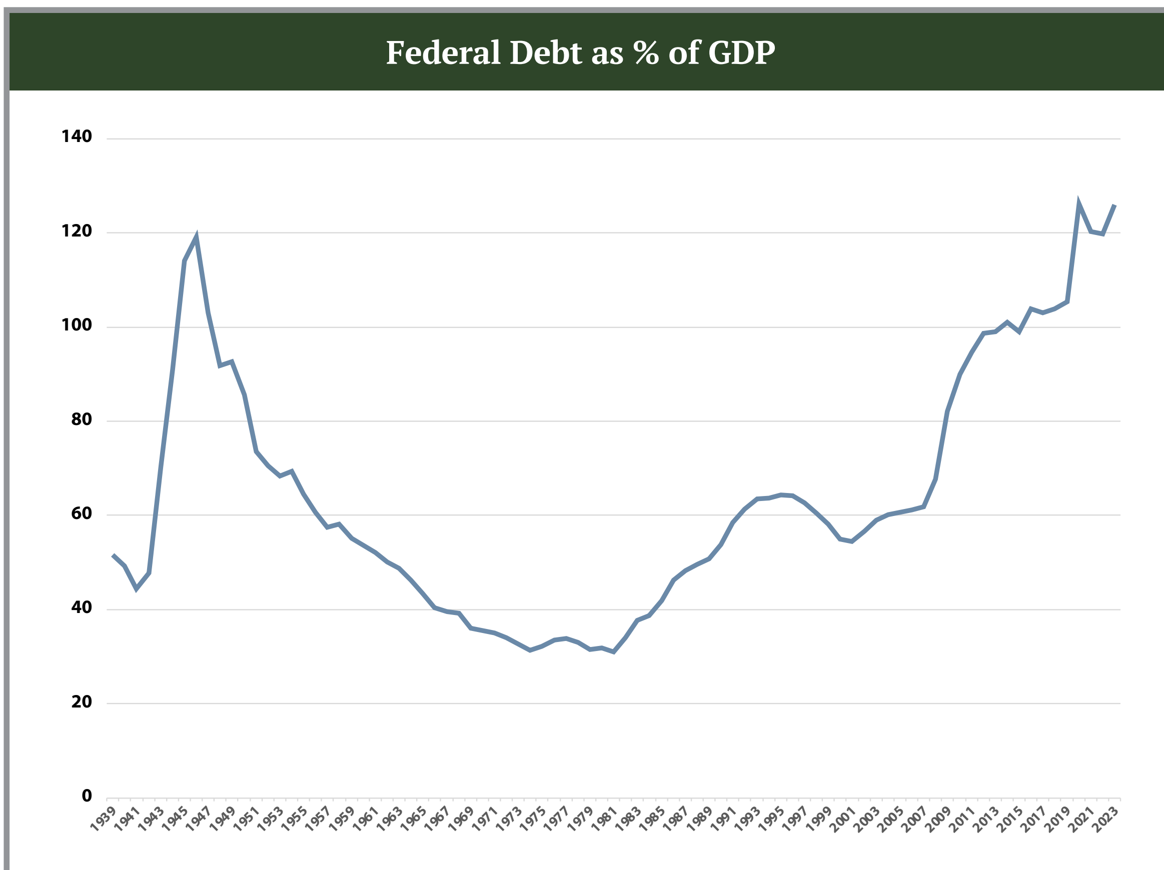
These higher interest payments on the debt together with mandatory programs, crowd out other spending that the government would like to do. As noted, just in the past year, interest payments on the debt increased by a full 2.5% of the total budget and now combine with mandatory programs to represent about 75% of Federal Government spending. Therefore, the government can only dedicate 25% of its budget toward defense, education, infrastructure, research, the environment, etc. While the public calls for the solutions to our myriad problems, the debt constrains the ability to respond to these problems.

To manage this debt, the government will need to increase its tax revenues. Cutting spending, especially that tied to the entitlement programs, is hard to envision. Ideally, policies could be enacted to grow the economy faster than in recent years such that revenues would naturally rise (this is 'the rising tide lifts all boats' analogy). Since enlightened economic policies are most likely out of reach, the other option for the Federal Government is to increase tax rates. We expect higher taxes on income in the future.

The other solution to government debt is inflation. Inflation cheapens the value of money so that past debt can be paid back with dollars that are worth much less than when the debt was issued. The economy appears to be coming out of a period of higher inflation and the Federal Reserve is intent on returning inflation to its target of 2%. However, future administrations could revert to these tactics since, while unpopular, they are effective.

US Debt and its Repercussions continued

The current predicament of high levels of debt will not be solved easily. Spending on Social Security and Medicare is expected to grow faster than the economy for the foreseeable future. Interest rates are coming down, which should ease the impact of these follow-on effects of higher levels of debt. Technology will most likely play a role in a future solution. For instance, Artificial Intelligence has the potential to dramatically increase productivity and thus economic growth that would allow us to grow ourselves out of the problem. Regardless, it is more prudent to be prepared for the repercussions of our current debt levels which could include some combination of a fiscally constrained government, higher taxes, and future bouts of inflation.

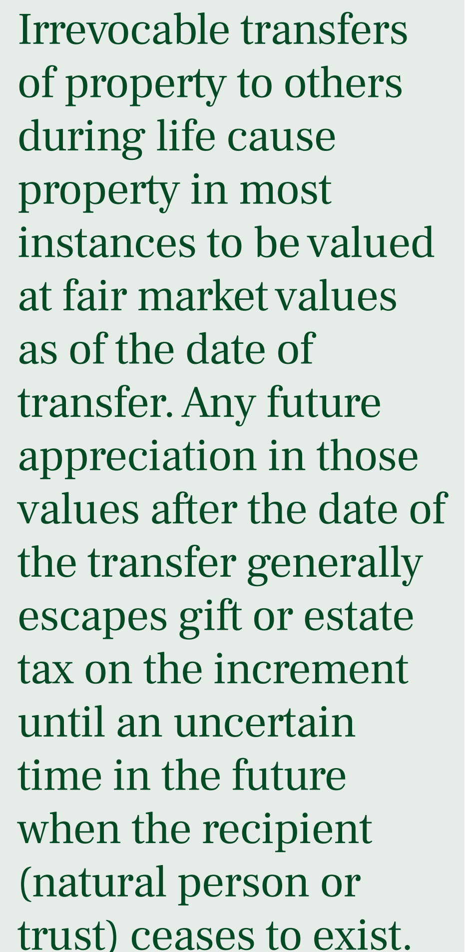


Source: Federal Reserve Economic Data

The Paradoxical Benefits of an Intentionally "Defective" Grantor Trust

Webster's Dictionary defines an *Optical Illusion* as "something that deceives the eye by appearing to be other than it is." Many individuals may not realize such an event can also exist in the complex world of estate planning and taxation! In fact, the illusion we are about to describe can transform an income tax liability into a tax-free gift of property to a trust for the benefit of future generations of one's family. Properly structured, all of this can occur without triggering any additional federal estate tax liability at death.

Sound too good to be true? Well, what makes this all possible is an "inconsistency" between Internal Revenue Federal transfer tax and income tax codes on what is deemed an irrevocable completed transfer of property. Irrevocable transfers of property to others during life cause property in most instances to be valued at fair market values as of the date of transfer. Any future appreciation in those values after the date of the transfer generally escapes gift or estate tax on the increment until an uncertain time in the future when the recipient (natural person or trust) ceases to exist. Irrevocable transfers of rapidly-appreciating assets to either descendants directly, or to a trust for the benefit of descendants, can make solid planning sense for this reason.



Since the irrevocably transferred property is removed from the donor's estate as of date of transfer, it would seem logical that any income generated by this irrevocably transferred property after date of transfer should now become *income taxable* to the new owner (natural person or trust). In most instances, this is the outcome. However, where *irrevocable trusts* are concerned, the income tax liability on income-producing property no longer owned by the grantor can remain the responsibility of the grantor, by having counsel incorporate a few esoteric provisions in the trust agreement.

You might ask: Why would we do this? The answer is that when a trust grantor becomes responsible for the payment of income taxes on both capital gains and ordinary income produced by property that has been irrevocably gifted in trust, the grantor is effectively making an addition to the trust by the amount of the income tax liability, without consuming any of the donor's applicable exemption amount, or, if fully consumed from prior gifts that have been made, without incurring any federal gift tax liability at the flat transfer tax rate of 40%.

This type of trust arrangement is known as an "Intentionally *Defective* Grantor Trust" (or IDGT – pronounced "I Dig It"). While not a universal estate planning technique applicable to every situation, the IDGT can provide significant tax savings for grantors and lower generation family members over time with a carefully crafted and orchestrated plan among clients, family members, legal professionals and the family's investment advisers.

The Paradoxical Benefits of an Intentionally “Defective” Grantor Trust continued

In the world of estate planning, nothing is certain except for continued uncertainty! As we begin 2024, and quickly approach the bewitching hour of midnight on December 31, 2025, questions remain surrounding Congressional disposition of expiring provisions of the **Tax Cuts and Jobs Act (2017)**. One of the provisions set to expire is the doubled Applicable Exemption Amount (“AEA”). The Applicable Exemption Amount is the cumulative, dollar value of property, owned by a taxpayer that can pass at death, or by gift during life, to anyone other than a surviving spouse, federal estate or gift tax free. Bequests and lifetime gifts to surviving spouses, assuming the spouse is a U.S. Citizen, are estate/gift tax free. Cumulative transfers of property during life or at death exceeding the AEA in effect at the time of transfer will incur a federal gift/estate tax at a flat tax rate of 40% of the amount transferred.

At present, the Applicable Exemption Amount per transferor on transfers to non-spousal beneficiaries in 2024 rests at $13,610,000. For married taxpayers, this amount is effectively doubled to $27.22 million. However, inaction or affirmative action by Congress prior to midnight on December 31, 2025, could see this amount effectively ***reduced by one-half*** on the morning of January 1, 2026! Nobody likes or wants half of a pie tomorrow, when, in fact, they could have had the entire pie yesterday. Leveraging this exemption, prior to December 31, 2025, has been the topic of several Eagle Ridge blogs and Investment Commentaries throughout 2023.

Admittedly, most taxpayers will fall beneath these thresholds for federal gift and estate taxation, and this alters the landscape somewhat from *estate/gift tax minimization or avoidance* to *income tax minimization or avoidance* within the realm of financial and estate planning.

Techniques such as the Intentionally Defective Grantor Trust can work effectively for clients regardless of whether or not their estates exceed the estate/gift transfer tax threshold.

December 31, 2025 is only 731 days away from today. Optical illusions such as the IDGT can disappear quickly with the stroke of a pen! Eagle Ridge Investment Management partners and professionals stand ready and would be happy to acquaint you with the IDGT and other popular planning vehicles, preliminarily to further discussion with legal and tax accounting professionals.

With our very best wishes for a Happy New Year!

About Eagle Ridge

Eagle Ridge Investment Management is an independently owned, SEC-registered investment advisory firm. Our goal is to provide superior investment performance and a high level of service to a select group of clients, unencumbered by the need to sell products or meet corporate goals. We strive to help our clients meet their needs and compound their wealth through a disciplined investment process.

For more information, please contact Mike Oliver at **m.oliver@eagleridgeinvestment.com** or **203-227-4515**.