FINANCIAL DESIGN STUDIO

DESIGNED FOR LIFE

- Page 1: Don't Fight the Fed
- Page 6: Taxes: Underpayment Penalties Aren't Worth Paying.
- Page 7: Identity Theft: What You Need to Know.
- Page 7: Consolidate Accounts When it Makes Sense

Left to Right: Michelle Smalenberger, Steve Smalenberger, Rob Stoll, Trevore Meyer

Don't Fight the Fed

Written By: ROB STOLL, CFP®, CFA

In the face of one of the most devastating episodes of job loss and economic disruptions we've seen in 90 years, the Dow Jones Industrial Average is only down 14% so far in 2020. The NASDAQ 100 index of tech stocks and other growth companies is actually UP 8%. And before the COVID crisis erupted, the yield on 10 year government debt from Greece – which is nearly insolvent – was lower than the 10 year yield of U.S. government bonds.

How can we explain these strange occurrences in global markets? Have investors simply learned to look through a crisis and "buy the dip" whenever asset prices decline? Or is there something else going on here? Our view is the latter. It's the invisible hand of the Federal Reserve ("the Fed") and other global central banks constantly rushing in to prop up markets whenever they fall.

While this might sound like a noble cause, we can't dismiss the long-term consequences of these policies. And like it or not, the cost of these interventions is having a profound impact on society. Before we look at what those costs are, we have to understand how we got here in the first place.

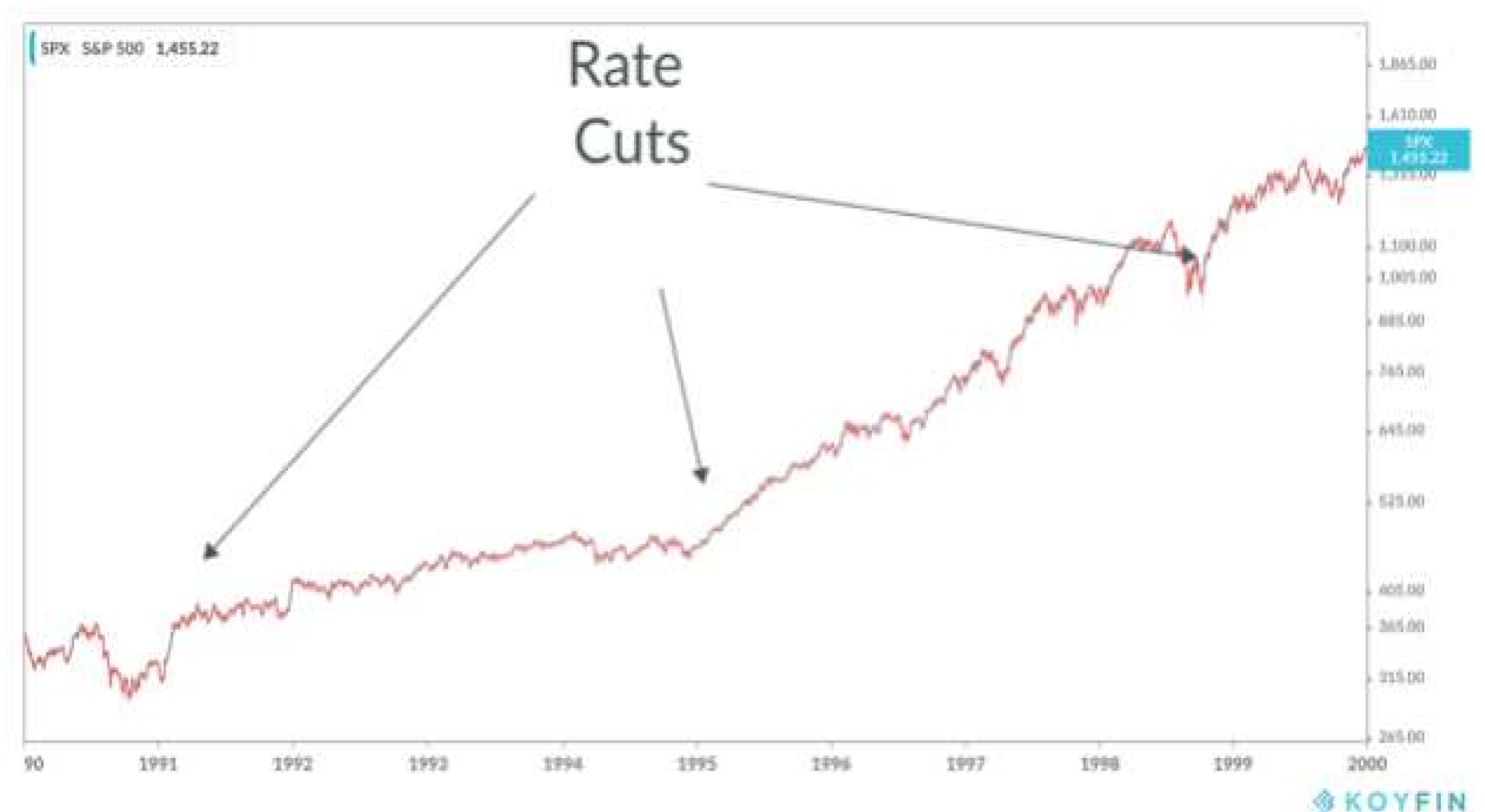
The Greenspan Put

In October 1987, the stock market crashed, falling more than 20% in one day. As you might imagine, this was a shocking event that immediately brought to mind what followed the last stock market crash in 1929: The Great Depression.

Determined to prevent the crash from spreading to the overall economy, Federal Reserve Chairman Alan Greenspan convened an emergency meeting at the Fed. The next day they cut interest rates by 0.50% with a message that they stood ready to make sure markets continue to function. By week's end, the stock market had recovered more than half its losses from the Crash.

This would not be the last time he cut rates in the face of trouble. Greenspan cut rates in 1995 in response to the Tequila Crisis of 1994 in Mexico. When Russia devalued its currency in 1998 and markets started to fall, Greenspan rushed in once again to cut rates. He continued to cut rates that year as a hedge fund – Long Term Capital Management – blew up and threatened markets. All of these rate cuts occurred in the midst of one of the greatest stock market runs in history. The 1990's Dot-Com Bubble was in full swing.

And it was frenzied enough that Greenspan himself wondered aloud whether there was "irrational exuberance" in the markets. Each time the Fed cut rates, stocks recovered and reached new highs. Investors named this phenomenon the "Greenspan Put" which jokingly refers to put options, whose value goes up as stock prices go down. Or if you like, it's Pavlov's Theory in action.



"Unconventional Measures"

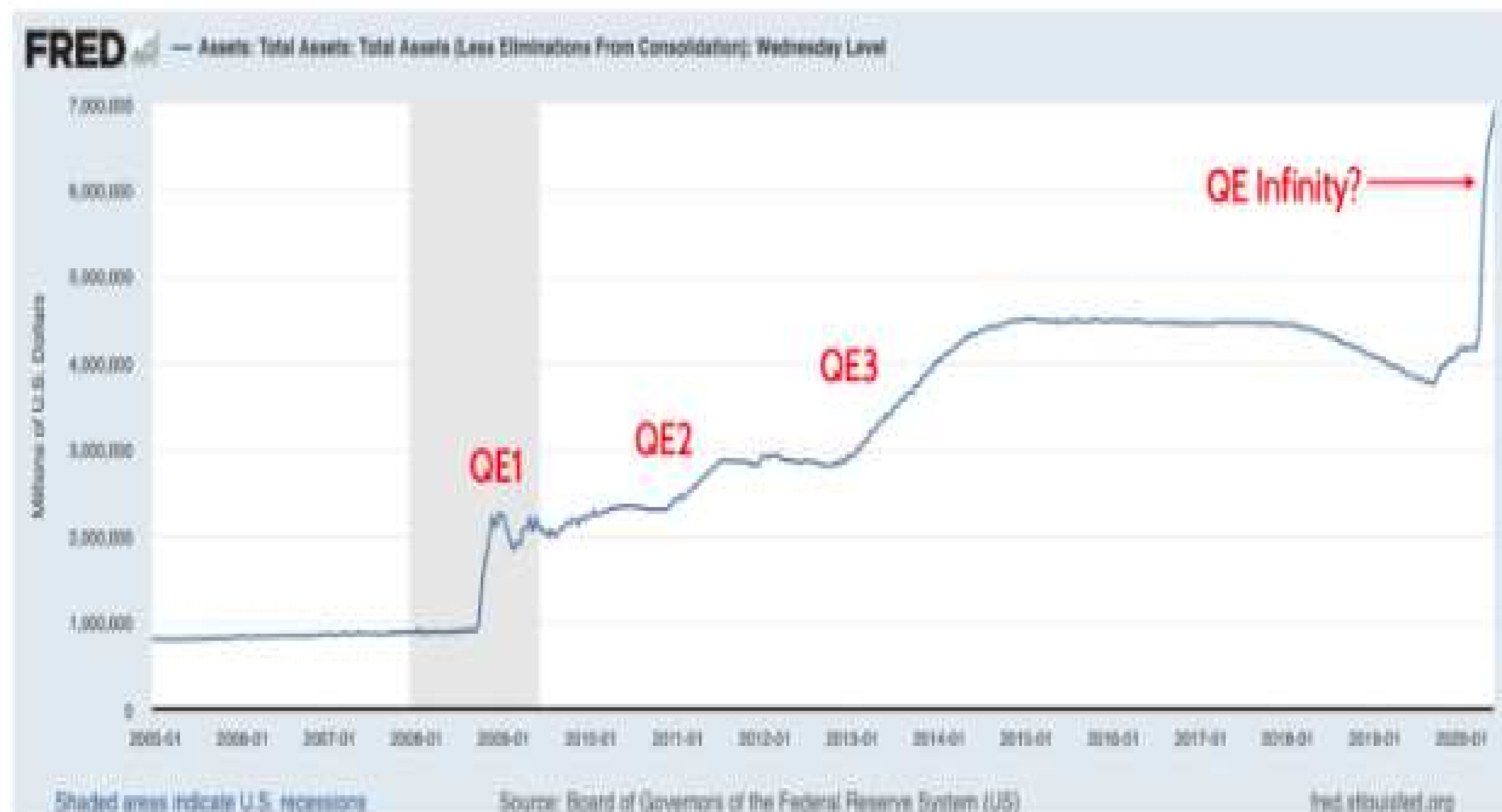
The bursting of the tech bubble was severe, and in response the Fed cut rates all the way down to 1%, which was an unheard of level at the time. That didn't prevent the stock market from falling by nearly 50% from its early 2000 peak. But it did sow the seeds for the next crisis: the mid-2000's Housing Bubble.

Mortgage rates in early 2000 were over 8% and had rarely been below 7% over the previous 30 years. But thanks to Fed rate cuts, they plunged to nearly 5% by 2005. As I'm sure many of us know from personal experience, this drove home prices to obscene levels. The "cash-out refi" was born and Americans were now using their home equity as an ATM.

The Fed tried to prevent a bubble by raising short-term rates back to 5% from 2004 to 2006 but it was too late. The housing market crashed and unleashed America's most severe recession since the 1930's.

Dusting off the old playbook, the Fed slashed rates back down to 1% but that wasn't enough. The economic fallout was too severe for "free" money to save. So they turned to more "unconventional measures" which included directly buying longer-term US Government bonds in a process known as Quantitative Easing ("QE").

This drove long-term interest rates lower which eventually helped over-leveraged borrowers (mainly banks, real estate companies, and mortgage borrowers) refinance at much lower rates. And yes, this saved the day as the economy started to recover in mid-2009. But just like last time, the Fed was unwittingly sowing the seeds for the next crisis.



Leveraging Up into COVID

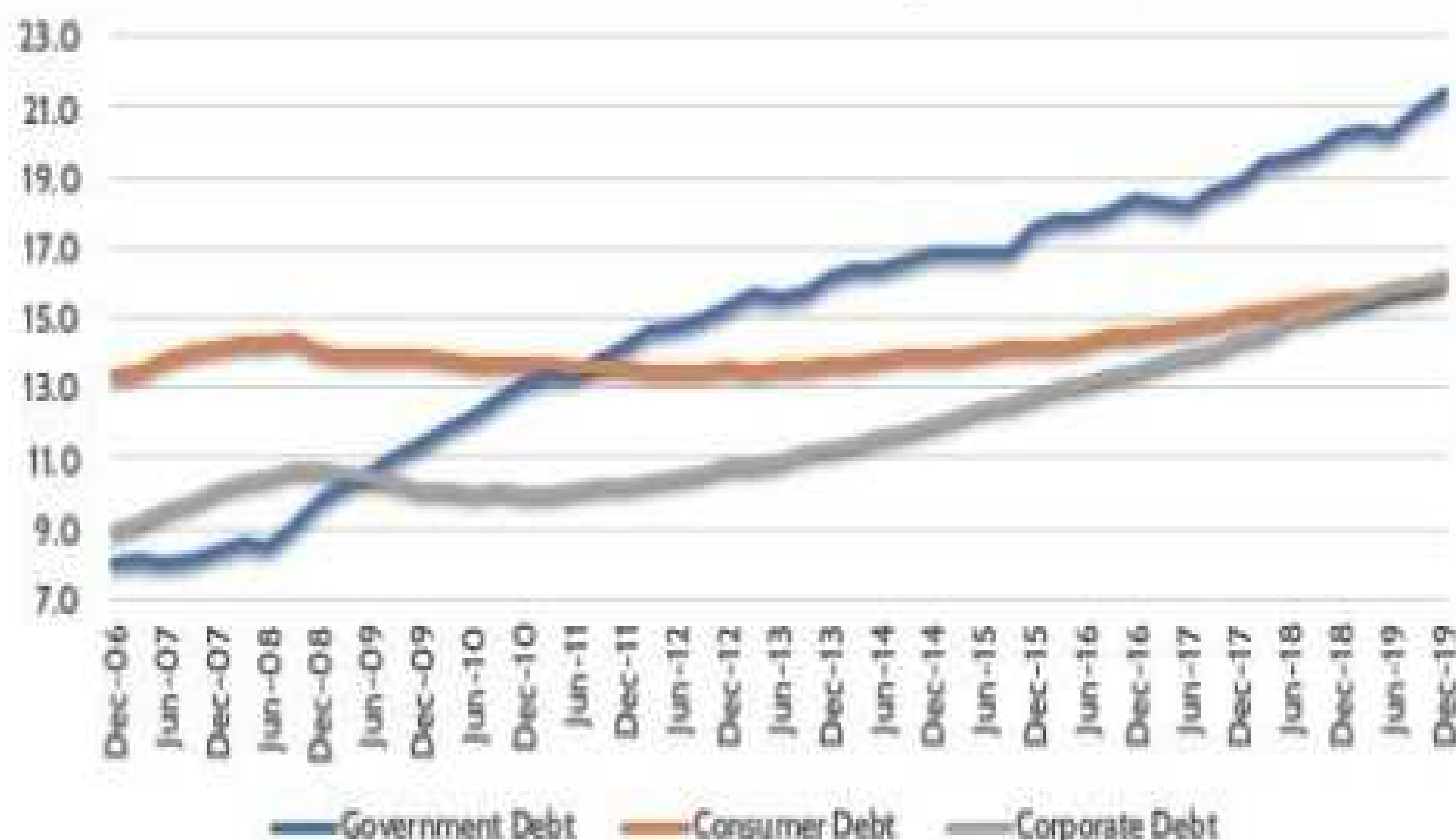
When the price of anything is driven lower, demand goes up. This dynamic is seen clearly with retailers who constantly run "20% off" sales. Cheap money works the same way.

The Federal Reserve intended to unwind its 'unconventional measures' after the economy recovered from the Great Recession. But they never did. Each time the Fed made noise about ending its QE policy, the markets revolted and sold off. And each time, the Fed came back with its tail tucked between its legs and restarted QE (2011, 2013) or cut interest rates (2019).

These repeated efforts to keep interest rates low had their predictable effect: increased borrowing. But instead of homeowners leveraging up, it's been governments and corporations. The numbers are amazing. While consumers have prudently kept borrowing in check since the Crisis, US governments have nearly tripled its borrowings to $21 trillion with big corporations adding another $7 trillion to their debt pile.

Fed Response to COVID Crisis

I admit this has been a long history lesson but it's vitally important to understand so we can view the Fed's current actions from the correct lens. For the sake of keeping this (somewhat) short I haven't even talked about the European Central Bank or Bank of Japan. But they've been following the Fed's lead on these unconventional measures. Which brings us to today. Since the start of the COVID pandemic in late February, the Fed has unleashed a laundry list of market support:



- Cut interest rates to 0%
- Has purchased $2.6 trillion of government bonds and mortgages ("QE Infinity") in order to keep these markets from seizing up (more on this below)
- Buying municipal debt issued by state and local governments
- Buying investment-grade corporate debt
- Buying junk-rated corporate debt if that debt was investment-grade before COVID
- Buying small business loans
- Lending dollars to Europe, Japan and Asia
- Lending dollars to a wide range of emerging markets

One thing you notice immediately is that the Fed is lending support to over-stretched borrowers: large corporations, both investment grade and "junk." What caused this mountain of debt? Answer: the Fed's easy monetary policy in response to the Great Recession.And why, exactly, does the Fed have to buy over $2 trillion of government bonds (and counting) in order to prevent these markets from seizing up? The answer: to bail out hedge funds and other asset managers who were allowed to take out huge amounts of leverage so they could earn better returns on their investments. It's the 1998 version of Long Term Capital Management 1000 times over!

Let's summarize how the Fed has engineered one financial crisis after another:

The "Greenspan Put" convinced stock investors in the 80's and 90's that there's less risk of them losing money in the market....
...So they bid up stock prices in the 1990's to such heights that stocks eventually collapsed in 2000...
...And in response to the Tech Bubble collapsing the Fed cut rates to an unheard of 1% and kept the rates there for far too long...
...Which encouraged consumers to use historically low mortgage rates to buy and flip homes...
...Until the housing market collapsed and wiped consumers out of their jobs and their homes...
...To which the Fed responded by cutting rates to 0% and engaging in unconventional policies such as QE...
...Which encouraged hedge funds, private equity funds, and large corporations alike to binge on cheap credit...
...Until the house of cards (almost) came crashing down when COVID arrived on our shores.

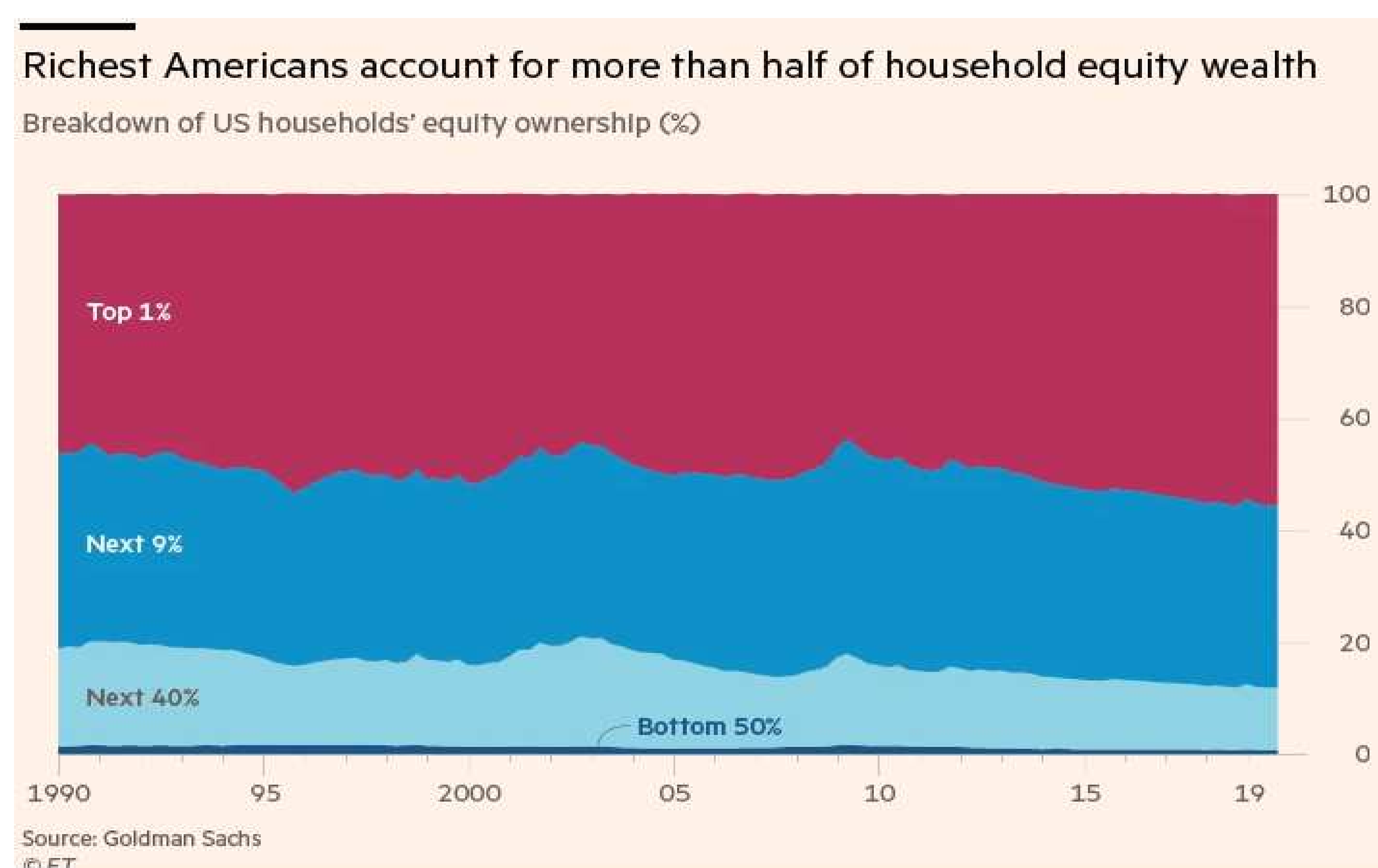
You see, the Fed's own policies to "save" markets has been the root cause of every major economic downturn we've had in the last 25 years. Tech Bubble. Housing Bubble. COVID/Debt Bubble. All caused by our very own Federal Reserve.

Financial Repression: Kicking the Consumer While They're Down

Why does any of this matter to you, the Investor and Client? If the Fed is "saving" the market and sending stocks higher, isn't that a good thing? On the surface, it would seem so. But there's a large shadow that's been cast over society as a result of these policies: Financial Repression.

Financial repression happens when policies are set up in such a way that one part of society "wins" at the expense of another part of society. Sometimes they're intentional, other times they're incidental. But the impact is the same. The easiest example of how the Fed has financially repressed society is with its interest rate policy. The winners and losers are clear.

- Borrowers win as they can borrow more cheaply
- Savers lose as they can't earn a good return on their savings and bonds



There's more. Who are the "savers" in society? Our elderly who depend on a fixed income to get them through retirement. In essence, the Fed's zero-rate policy punishes savers for the benefit of borrowers of all types – hedge funds, businesses, and yes, the Federal Government.

Well what about stocks? Higher stock prices are good for everyone, aren't they? For anyone saving for retirement the answer is YES. We count on higher stock prices to help meet retirement goals. But increasingly, the spoils of higher stock prices are accruing to a smaller and smaller portion of society.

By definition the wealthiest in society will always own the most assets. That's math. But look at the trend in the last 15 years since the Fed has gone "unconventional."

The amount of stock market wealth garnered by the Top 1% has increased from 45% of total stock market wealth 15 years ago to over 55% today. The loser? The "bottom" 90%, which has seen its share drop from 20% to around 12%. And we haven't even talked about income inequality, which has reached levels not seen since the 1920's.

The point is this: Federal Reserve policies over the last 30 years have inflicted Financial Repression on American society. For every winner from these policies there's been a loser. From the Poor and Middle Class to the Rich. From Savers to Borrowers. From Old to Young. Add it all up and there's been a lot more people ending up in the "loser" column than the winner's side as a result of Financial Repression.

Parting Shot

Now if you've made it this far you're probably wondering whether you're reading a Bernie Sanders campaign ad. Let me be clear: none of this is written with a political axe to grind. There's enough of that on social media and I don't do politics.

The reason I bring this up is because we are suffering our third major economic crisis in less than 20 years. Economic cycles are a fact of life in an open society, but the severity of these things keeps getting worse. And that's no accident.

The Fed wants Americans to believe they're here to save the day. Hardly. Their policies cause financial repression. Their policies cause income inequality. Their policies cause wealth inequality. Their policies create imbalances in the economy that send unemployment over 10% twice in 12 years (2020, 2008) after only happening ONCE in the 60 years prior to 2008. They crush the elderly on a fixed income.

With the Fed's latest moves to save the world from COVID, almost every major investable market is now being manipulated. When I look at stock and bond prices, I don't see fundamental investors duking it out over whether a company is worth $25 or $35 a share. The Fed is setting the prices. A market that's increasingly divorced from its fundamentals is a fundamentally riskier market. And that makes investing more challenging.

One of the reasons why you, the Client, pay us to manage your money is to think about these things, which is why I'm bringing them up in this month's newsletter. Rest assured we take all these things into consideration when constructing your portfolio.

Ebb & Flow of the Market

	April 2020	October 2019	April 2019
S&P 500 Index	2912.43	3037.56	2945.83
MSCI EAFE Index	1567.61	1955.48	1921.49
MSCI Emerging Markets	924.94	1041.98	1079.24
Gold ($/oz)	$1,686.63	$1,512.84	$1,283.42
Bloomberg Commodities	60.90	79.24	79.84
U.S. 10yr Gov't Bond Yield	0.63%	1.69%	2.51%
Fed Funds Rate	0.25%	2.00%	2.50%

Disclosure footnote:
Financial Design Studio, Inc. ("FDS") is a registered investment advisor offering advisory services in the State(s) of Illinois and in other jurisdictions where exempted. Registration does not imply a certain level of skill or training. Follow-up or individualized responses to consumers in a particular state by FDS in the rendering of personalized investment advice for compensation shall not be made without our first complying with jurisdiction requirements or pursuant an applicable state exemption.
All written content is for information purposes only. Opinions expressed herein are solely those of FDS, unless otherwise specifically cited. Material presented is believed to be from reliable sources and no representations are made by our firm as to other parties' informational accuracy or completeness. All information or ideas provided should be discussed in detail with an advisor, accountant or legal counsel prior to implementation.

Taxes: Underpayment Penalties Aren't Worth Paying

Written By: STEPHEN SMALENBERGER, EA

No one enjoys paying money to the state or the IRS, while they've already withheld money from their paychecks and then find out they owe a balance still. On top of that, adding insult to injury, there is also underpayment penalties and interest. Let's talk through some examples so you know now to make an estimated tax payment or adjust your withholding before the end of the year to target the amount you want. How can you avoid all of these penalties and interest? It's called **safe harboring**. We're going to look at a couple examples of how we get to those numbers. It sounds really involved, but it is actually pretty simple.

Example 1:

Looking at last year's return, let's assume you made $100,000. You had $10,000 in taxes owed and out of your paycheck you had $9,000 taken out. So at the end of the year you were $1,000 short, and have a balance due. Normally, you think if you have a balance due, you have until April to pay the balance due. In some cases, you do. There are a couple rules we need to think about here:

1. Is the balance due or the amount outstanding over $1,000? In this case, it is not. They meet rule number one. There's no underpayment and no interest because the amount due is ***not*** greater than $1,000.

2. This amount here that they had withheld, was 90% of what their tax balance was.

Example 2:

Fast forward to this year. You received a raise; a higher salary or a bonus at year-end. Since your income went up, the 90% of income can be a moving target. What you can do is safe harboring. This means estimating taxes to withhold by looking at last year's amount of taxes due. You can pay 100% of last year's income tax which is $10,000 to be within a safe harbor. There may still be a balance due, and you would have until you file your taxes to pay it, but there won't be any additional underpayment penalties or interest.

3. Pay last year's full taxes to be covered by safe harbor.

4. If your income is over $150,000 you need to withhold 110% of last year's tax due or 90% of this year's tax due.

So rather than looking at the past two years and paying 100%, you would have to pay in $11,000, 110% of last year's tax in order to avoid underpayment and interest.

If you don't like to pay taxes, throwing in additional interest and penalties won't help either. So, how do you keep more? Ultimately it's not about how much you make it is about how much you keep. And our goal is to help you keep as much as possible.

As a Reminder, the current Federal Tax Filing Deadline for your 2019 return is July 15th, 2020. Until this time no interest or penalties are being incurred on any balance due.

Identity Theft: What You Need To Know

Written by: ROBERT STOLL, CFP®, CFA & TREVORE MEYER, CFP®, CKA®

Talking about identity theft It is near and dear to our hearts because we have both recently gone through something similar to this. At the end of 2019 as I was wrapping up our family budget getting ready for 2020. I noticed around Christmas we had around $6500 in fraudulent charges on our credit card to Nordstrom. Needless to say that was a big surprise.

Very similar to Rob, only it wasn't nearly as much money. There were a couple of Amazon purchases that came through. That were just under $3500. In both of our examples we were fortunate enough because we were using our credit card and our credit card company let us know exactly what the charges were and shipped us out new cards.

As we were reflecting on that, we were trying to think through – how could this have gone better, how could this have gone worse? We were very fortunate because we were using our credit cards, because we weren't liable for any of those charges. We weren't fighting with the bank, trying to get our money back, because when you are using credit cards, you aren't actually using your money. It never becomes your money until it leaves your checking account and goes to the credit card company to pay back that account. So that's just a little tidbit of why we like using credit cards over debit cards to the extent that you can.

And the other thing we like to remind people is to regularly review your financials. It's a really good thing to do. I realize budgeting is boring, and nobody likes to look through bank and credit card statements, but it is really important to be able to catch things like this before it becomes a really big problem.

Consolidate Accounts When It Makes Sense

Written by: ROBERT STOLL, CFP®, CFA

In today's economy it is very common for people to change jobs often as they look to advance their career. While there is a lot of benefit from a jobs growth standpoint, what can happen is that you leave your old 401(k) savings plans at your old employers. This is when we recommend you consolidate old accounts. After a number of years, you might have 5-6 plans and wonder if you are really on track for retirement or not, given you have all these different plans out there. So we are going to talk about two things you can do to simplify your retirement life as it relates to old 401(k)'s and consolidating.

Current Employer 401(k) Consolidate

So your first option is to look at your current employer. If your current employer has a 401(k) plan and they allow you to bring in your old 401(k)s, you can just take all these old 401(k)s and move them right into that plan. Then all your retirement money is in one spot. You don't have to worry about keeping track of all these other accounts.

Rollover IRA

The second option for what to do with all your old 401(k)s is to do what is called a Rollover IRA. And what you do there is you open up an IRA with a custodian like Schwab and you instruct your old 401(k) providers to rollover that money over to the new IRA. Now one thing you want to be careful with is you want to make sure that they don't send you check from the 401(k). If they do, it could become a taxable event for you. You want to make sure if you do move your old 401(k)s into a rollover IRA, that they move directly and you never touch the money.

These are two ways you can simplify your financial life. By consolidating accounts like this you won't have to manage several different accounts or investment options.

Frequently Asked Questions (FAQs)

Are you a Fiduciary?

Yes, we are! This means we have a **duty** to act in **your** best interest. A person acting in a **fiduciary** capacity is held to a high standard of honesty and full disclosure in regard to the client and must not obtain a personal benefit at the expense of the client.

You're Fee-Only: What does that mean?

We have chosen to be a fee-only advisory firm. This means we do not accept any fees or compensation based on product sales. While we know our clients need products like insurance we do not receive any benefit from any source when you buy a product.

How does Financial Planning Work Virtually?

It's amazing how many of our clients move away as we work together. After all, that was part of your goal! For our services we are able to share everything we do in person! We simply use screen sharing and video software so we can see you and look at the same documents, together. We look forward to *seeing* you!

Weekly Q&A Sessions

The weekly Q&A sessions have been recorded so you can watch them. Please look in our weekly email for details each week as we continue these.

Want to share this with someone?

- Know someone who wants to receive this newsletter? Send us the mailing address at team@financialdesignstudio.com
- If you prefer to no longer receive this newsletter please email us at team@financialdesignstudio.com

21660 W. Field Parkway
Suite 118
Deer Park, IL 60010