Tax-loss harvesting could be rewarding this year

By Michael A. Tyler, CFA
Chief Investment Officer, Eastern Bank Wealth Management

Last January, following three spectacular years for stocks, we trimmed our clients’ equity holdings back down to their long-term targets. That meant selling about 10% of their stock positions and reinvesting in bonds, but it also meant realizing some significant taxable gains. On balance, this was a good trade: Depending on their individual cost bases, clients saved more than twice as much money by reducing their exposure to stocks as they will pay in capital gains taxes. Now, as this dismal year limps to a close, we have an opportunity to offset some of those January gains with realized losses in December, thereby keeping the early gains while still reducing tax bills.

The opportunity is not for everyone, even though we have all suffered losses this year. Long-term investors may still be sitting on hefty unrealized gains if today’s diminished market values remain well above their cost bases. We won’t attempt a broad-based strategy across all taxable clients, simply because the same security may be associated with a loss for some clients and a gain for others.

Instead, we ask our relationship managers to work individually with clients to identify possible opportunities for tax-loss selling. Many of these opportunities, surprisingly, are in fixed income portfolios; the Federal Reserve has raised overnight interest rates by nearly four percentage points just this year, which has crushed the value of longer-term bond funds.

For clients who want to pursue the idea of realizing losses in the last few weeks of 2022 to offset gains from January, we strongly recommend reinvesting the proceeds back into the markets; not just leaving the money in cash. The early winter months have historically been a strong seasonal period, and the risk of missing a rally is especially high now that prices are so much lower than they were a year ago. We can identify replacement securities that won’t trigger the IRS’s ire but will still keep clients properly invested.

As Wilson Pickett sang in his urgent cover of a well-known British pop song, “take a sad year and make it better.” Tax-loss selling isn’t for everyone — but if it’s right for you, we’re ready to help you act now while this fleeting opportunity is still here.

The housing market suffers as mortgage rates soar

By Ananya Pierce
Investment Associate, Eastern Bank Wealth Management

The Federal Reserve’s relentless campaign to curb inflation has been deleterious to the housing market, potentially driving the economy into recession. Homebuilder sentiment has tumbled to pandemic lows, and current and pending home sales have been deteriorating for months.

Higher interest rates and ongoing elevated construction costs have forced many first-time buyers out of the market. These buyers are facing the worst home affordability crisis in decades. Using recent data, for example, the median-priced home in the U.S. cost about $440,300. Assuming a 30-year mortgage and 20% down payment, a median-income homebuyer would need to spend approximately 55% of their gross income to cover the monthly payment today, compared with 35% a year ago when mortgage rates were less than half of current rates.

As affordability quickly dries up demand, home-price growth will continue to decelerate. Even though inventories remain tight in the resale market, that will do little to prevent a downward adjustment to home prices. In the rental market, the influx of would-be buyers pushed up prices earlier this year; but this peak in rent prices is already in the rearview mirror as apartment construction has reached 40-year highs. Apartment supplies are rising as completions are on track to peak in the second half of 2023, frustrated homeowners are renting rather than selling, and unaffordable prices have led to slower household formation.

This cooldown in home and rental prices is welcome news for the Fed. Fully one-third of the Consumer Price Index (CPI) is tied to the cost of shelter; if lower rents help trim CPI, we could potentially see the Fed pausing its rate hikes sooner than markets expect.

Homebuilder sentiment has tumbled as mortgage rates have climbed.

Source: Bloomberg
**Is growth investing dead?**

By Allen Laine, CFA  
**Equity Analyst, Eastern Bank Wealth Management**

The stock market overall has performed dreadfully in 2022, but the carnage has been most acute in growth stocks. Companies with faster revenue and profit growth have trailed more stable “value” stocks by more than ten percentage points through the first ten months of 2022 — so why the dramatic selloff in growth?

The underperformance can be explained, in part, by the rapidly rising interest rate environment. Inflation is running at a four-decade high and needs to be tamed; the Federal Reserve has aggressively hiked interest rates in hopes of restoring prices back to more palatable levels. Growth stocks derive a far larger percentage of their intrinsic value from cash flows they will generate in the distant future. To calculate the intrinsic value of a stock, those future cash flows need to be discounted back to present value terms; a dollar tomorrow is worth less than a dollar today. The discount rate is correlated with interest rates, and rising discount rates translate into lower present values and lower stock prices.

Meanwhile, the growth cohort of stocks in the S&P 500 continues to grow earnings at a solid pace. These companies are still growing faster than value stocks, and the differential in earnings is widening. Yet growth stocks’ share prices are falling faster than those of value stocks, while the earnings per share growth differential leans in growth stocks’ favor. On a P/E ratio basis, growth stocks are looking increasingly cheaper versus their value peers. Importantly, from a long-term perspective, the fundamental growth stories haven’t changed at all with higher inflation and potential recession. Today, growth stocks are about 40% cheaper than they were last January, yet they maintain the same long-term growth prospects. Growth companies have become more compelling value stocks.

We continue to own high-quality growth stocks in our clients’ portfolios, and we will add to those positions as opportunities present themselves. While many of these stocks are attractive, a balanced approach is still key. Value stocks have performed better this year, which may or may not continue in the near term. The best risk-adjusted performance throughout market cycles comes from being properly diversified and having both growth and value characteristics in your portfolio.

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**Credit markets show no panic**

By Timothy Garvey, CFA  
**Vice President – Fixed Income, Eastern Bank Wealth Management**

This has been a year to forget for bond investors. The Federal Reserve has raised interest rates at a blistering clip; the result has been a Treasury yield curve that is steep on the short end, inverted in the intermediate maturities, and flat on the long end. An inverted yield curve is typically a strong indicator that Treasury investors fear an economic slowdown, but we haven’t seen similar cracks in the corporate bond market.

Credit spreads, which measure the differences in yield between corporate and Treasury bonds of similar maturity, widen sharply in times of significant distress; when investors expect corporate balance sheets to deteriorate, they demand to be compensated with higher yields. Yet despite soaring inflation, an unwaveringly restrictive Fed, and forecasts of an impending recession, we are simply not seeing heightened risk priced into the credit markets.

Spreads have widened modestly this year in response to tighter financial conditions and the uncertain economic outlook. But we are not seeing the panic spikes of credit spreads that occurred in 2008 and 2020. Investors know that companies in recent years have refinanced and extended their debt obligations at extremely low interest rates. We still see opportunities in credit, due in large part to the prudent decisions made by corporations to shore up their balance sheets. We have recently upgraded the credit quality of our client portfolios by exiting shorter-dated high yield funds in favor of investment grade credit funds. Even though excessive risk is not currently being priced in, we recognize that the high yield space is more susceptible to the many risk factors that currently exist.

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**CREDIT SPREADS OVER TREASURY YIELDS**

Although credit spreads have widened modestly, they don’t show any signs of panic in the credit markets.

*Source: Bank of America Merrill Lynch*