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FINANCIAL STRATEGIES

Quarterly Playbook

4th Quarter 2021

Current Financial Planning and Investment Themes

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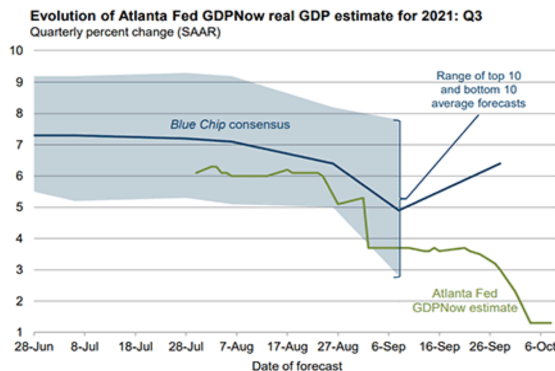
"Better than a punch in the nose…"

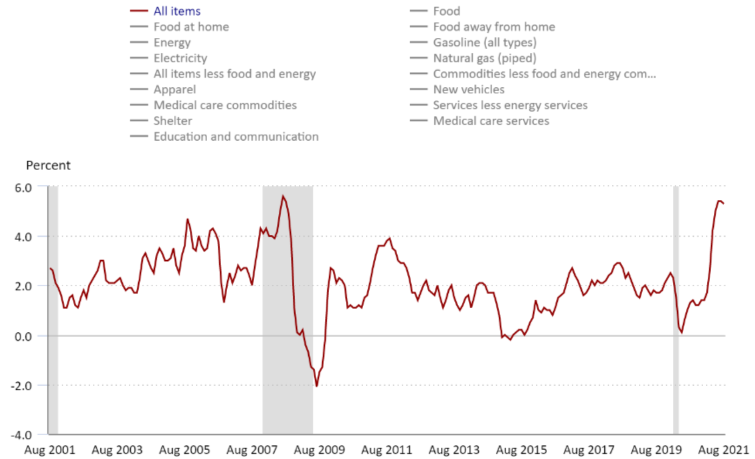
To be quite honest, the scattered current environment caused a bit of a hard time coming up with a theme for this quarter's playbook. Things aren't great, but they're also not that bad. We are optimistic through the end of the year but see clouds forming for 2022. Then the popular saying of one of our clients came to mind. He uses this phrase no matter if things are better than expected or not trending in the right direction. And you know what – he's right! It is better than a punch in the nose….. !

US Economics

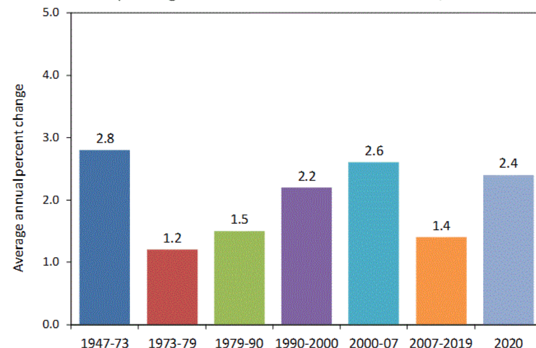
After an incredibly strong start to the year of 6.4% GDP growth in the first quarter and 6.7% GDP growth in the second quarter, we are now experiencing heavy deceleration with the latest (October 5th) estimate of 3rd quarter GDP growth at a dismal 1.3%. That said, the methodology used to estimate in real time the current economic growth rate is extremely difficult at best. The consensus (including ours) is that the actual reading will be higher, but significantly less than the first half of the year. The piece of economic data that has accelerated is *inflation*. The Consumer Price Index (CPI) hit 5.0% in May of 2021 and has remained above 5% each month through the latest reading in August of 5.3%. The Federal Reserve believes that this recent surge in inflation is



"transitory". However we believe inflation readings will remain elevated between 3-5% through the end of 2022 before settling back toward 2% . This is only the second time in the last 20 years that inflation has topped 5%, with the other being 2008. Lastly, the employment outlook is a mixed bag, starting with improvement in the September U-3 (official) unemployment rate coming in at 4.8%, falling from 5.9% back in June. . Additionally, the U-6 (broader definition including part-time) unemployment rate also fell to 8.5% from the June read of 9.8%. However, the labor participation rate remains persistently low at only 61.6% compared to 63.4% in January of 2020. That represents almost 2% of the working age population (those that are employed or unemployed looking for work ages 16 and older) that has left the workforce (not looking) and has shown little sign of coming back. Again, the significance of this is that in order to have sustained GDP growth we need to increase <u>both</u> the number of people in the workforce and productivity. We saw productivity pick up significantly in 2020, substantially subsidized by capital, but that substitution can't endure for the long-run.



So, to sum it up, we have extremely high GDP growth, but it's slowing down. We have 5%+ inflation for the second time in the last 20 years and it's expected to stay elevated. Our labor force participation rate remains very low, but unemployment is coming down. Productivity was very high in 2020 but is expected to decline. What can we say? Well, it's better than a punch in the nose….



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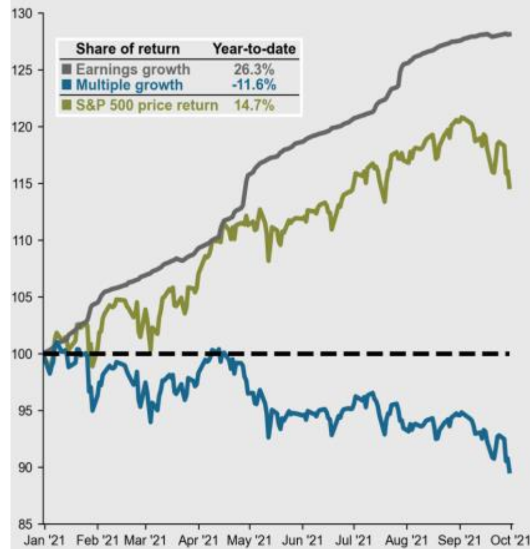
US Equity Markets

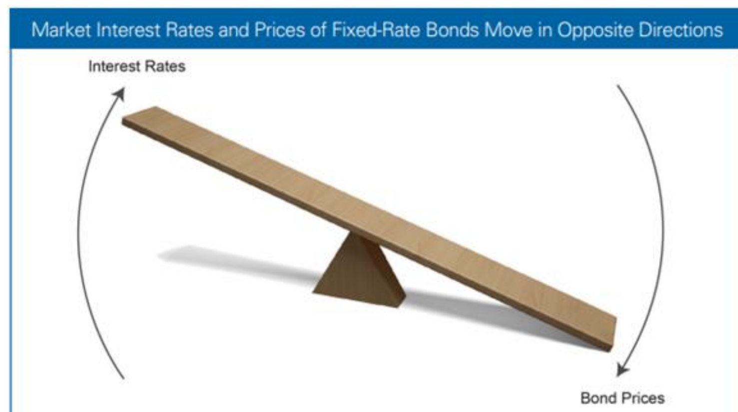


Source: JPMorgan Guide to the Markets

The 3rd quarter is usually the most volatile quarter of the year, and it delivered again this year with the first 5% pullback for the S&P 500 in 227 days occurring on September 30th, the very last day of the quarter. This was the seventh-longest such streak on record, with the S&P 500 gaining 29.4% during that period. Even with the decline, the S&P 500 managed to gain 0.6% during the 3rd quarter. Not so for the Dow, which lost -1.9%, the Nasdaq which lost -0.4% or the Russell 2000 (SmallCaps) which lost the most at -4.4%. However, stocks have had another stellar year with the S&P 500 up 14.7% through the end of the 3rd quarter driven by 26.3% earnings growth! Even better is that to start the 4th quarter, the S&P 500 is actually cheaper than it was in January by 11.6% on a P/E basis. Albeit at a slower scale, we do expect that trend to continue through the 4th quarter with Earnings growth outpacing Price growth. This means we finish the year with a grind higher in price and lower valuations. Again, better than a punch in the nose!

US Fixed Income

Bonds, bonds, bonds – you can't live with 'em, can't live without 'em. With increased inflation pressure, the fixed income environment has been tough this year and we expect that to continue for quite some time. While higher quality bonds such as Government and Investment grade corporate bonds have provided losses for the year due to lower coupon rates, more credit sensitive areas with higher risk such as High Yield bonds, Convertible Bonds and Preferred Stocks have posted gains. As the Fed starts to reduce bond purchases (at high prices) and raise short term interest rates, there will likely be further pressure on yields to move higher and thus prices lower.



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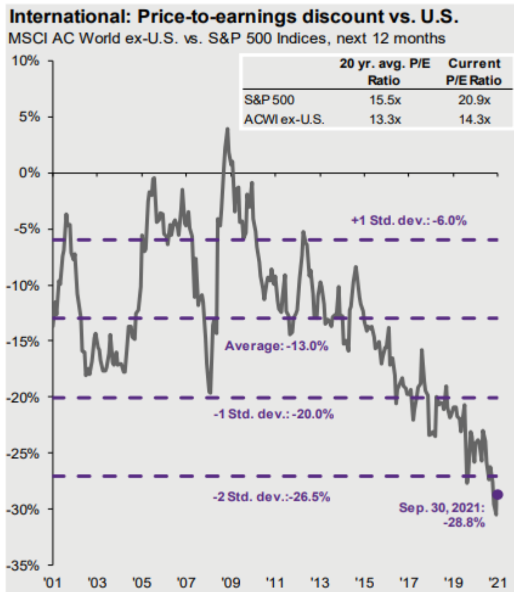
International Markets

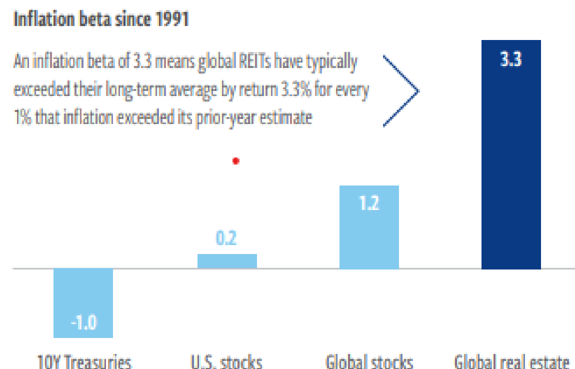


Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of September 30, 2021.

International markets are still lagging behind the US with the MSCI ACWI ex US up only 10.5% vs 15.9% for the S&P 500 through the third quarter. Although the return gap remained consistent, the valuation gap has widened even further to a 28.8% discount vs the 27.3% of last quarter. As you can see in the chart to the left the standard discount of Foreign stocks to the US is only 13% and the current levels represent extreme discounts over 2 standard deviations lower. We believe this is due to the continued restrictions caused by the Delta variant that should ease globally here in the 4th quarter and thus allow the foreign valuation gap to come back in. This in turn should allow pricing to catch up with the US. While we believe this is an opportunity gap that is ripe to take advantage of, not all Foreign markets are created equal though. The Eurozone and Emerging Markets are showing much greater earnings growth compared to Japan and China for example.

Real Estate

Listed Real Estate through Real Estate Investment Trusts continue to shine. As we have noted, REITS have been one of the top performing asset classes this year by far, with the FTSE NAREIT Composite Index up 21.4% YTD through the end of the 3rd quarter. Even so, we think the cycle is just getting started, with persistent elevated inflation adding fuel to the fire. We noted last quarter how REITS have performed better than the S&P500 in both moderate and high inflationary environments. But the expected continued increase in demand and attractive valuations make REITS particularly well positioned in this environment. Certainly better than a punch in the nose….



Source: Cohen & Steers

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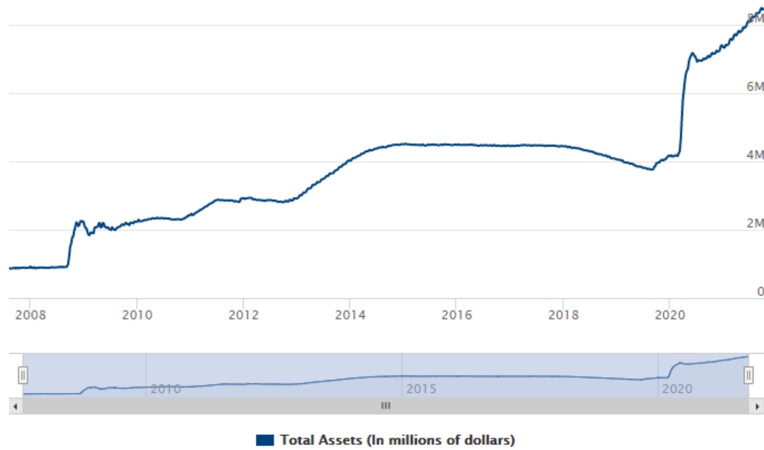
Interest Rates & the Fed

The Fed has been talking a big game about preparing to slow down the pace (taper) of the bond purchasing program that has added over 4 TRILLION dollars to their balance sheet just since March of 2020. But they likely will be more like a lamb than a lion. Reason being, the Fed is in a tricky spot; markets have become "hooked" on low interest rates and they risk disrupting the recovery if they move too fast. On the other hand, all the extra liquidity (money pumped into the system) is fueling the fire of inflation. Moreover, the Fed has the most control over short term interest rates and if they push them up to slow down inflation, they also risk inverting the yield curve which is typically seen as a precursor to recessions. All this with a backdrop of the Fed lowering 2021 GDP from 6.3-7.8% to 5.5-6.3% and PCE inflation up to 4.0-4.3% up from 3.0-3.9% in June. As you can see, they are in a tough position and once they decide to "lift off" of zero again for short term interest rates the Markets will keep the Fed in the spotlight. The good news is that we don't expect this to occur until the latter half of next year. So, I guess it's better than a punch in the nose…



Legislative Affairs

The faces to the left are the two Democrat U.S. Senators staving off passage of the $3.5 TRILLION dollar spending package. The $1.2 TRILLION dollar infrastructure bill was passed in August on a bipartisan vote in the Senate, but the House has wrestled between progressives and moderates on where to include an expansion of health-care, education and climate change programs. After going back and forth, Speaker Pelosi has now set a deadline of October 31st for the House to vote on the $1.2 TRILLION dollar infrastructure bill already passed by the Senate. It looks like the other Social Programs will likely have to wait to try again after the mid-term elections next year. While $1.2 TRILLION is still quite a large sum of money, true infrastructure is economically beneficial and importantly, there are no tax increases in the existing bill. Then there is the debt ceiling, which has recently been extended to December 3rd. While no one, Including market participants, expects there to be any kind of national default, the politics here are quite intense. We believe that the Republicans scored a small victory in soaking up the agenda for the rest of the year with the debt ceiling debate versus giving way to Democrats reconciliation plans. This leads us to lower the odds if tax increases occurring in 2021 to only a 40% chance of passing. Still certainly possible, but we feel unlikely.

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Financial Planning Corner

New Tax Proposals: What Does It Mean for You?

One of the most common questions we hear from clients today is: how will the proposed tax changes affect both me personally and the markets?

It's a great question, and an extremely relevant one considering the potential landscape of numerous tax changes if a version of the Build Back Better Plan ultimately gets passed. But it's also a difficult question to answer because each branch of the government has their own version of what they want to include in this bill.

In the end, it's hard to predict if the bill will pass, and if so, which of all the proposed tax changes they'll come to agreement on to be included. Here are the some of the most notable tax changes that have been proposed, along with how they may affect you and/or the markets:

1. **Backdoor Roth IRA: The prohibition of rollovers and conversions of after-tax dollars into a Roth IRA**. While not technically a "tax change", this piece of the legislation would ultimately end the strategies known as "backdoor Roth contributions" and "mega backdoor Roth contributions". If you've been able to contribute to a Roth IRA using the backdoor method, you would no longer be able to do that going forward. Also, you would not be able to roll after-tax dollars from an account such as a 401k or IRA into a Roth IRA, and employer retirement plans could no longer allow after-tax contributions.

   What Washington is ultimately saying here is, we're ok with you contributing after-tax dollars into your IRA, but we're no longer going to let you move those dollars into a Roth IRA. They want the gains to remain taxable and for Required Minimum Distributions to apply.

   Action Step: If this piece passes and you would like to get in one final backdoor Roth IRA contribution, the deadline would be 12/31/21 to have the dollars converted to your Roth. To make sure you don't miss out, we'd want to make your nondeductible IRA contribution before 12/1/21.

2. **Income Tax Rates: Raise the top federal income tax rate to 39.6% for single filers making over $400,000 and joint filers making over $450,000.** For context, it's currently 37% for single filers making over $523,600 and joint filers making over $628,300. This change is essentially reverting the federal tax brackets back to what they were before the Tax Cuts and Jobs Act passed in 2017, except the brackets for paying 39.6% would start even earlier in the proposed change.

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This one is pretty clear as far as what Washington is after – they want a higher tax on higher earners who are building their wealth through earned and realized income. Meaning, anyone who must report income from wages, salary, 1099 income, business earnings or distributions, ordinary dividends, interest, short-term capital gains, etc.

Action Step: **If you typically have taxable income above these thresholds, it might make sense to accelerate more income into 2021 if possible, and/or take advantage of as many deductions as possible for 2022 and beyond. This includes pretax contributions to retirement plans, HSAs, FSAs, and bunching charitable contributions to be able to itemize deductions.**

3. **Capital Gains Tax: Raise the top long-term capital gains rate from 20% to 25% for single filers making over $400,000 and joint filers making over $450,000.** For context, it's currently 20% for single filers making over $441,450 and joint filers over $496,600. So, the income bracket would come down along with the rate going up, similar to the federal income tax increase. The kicker with this one is it's the only proposed tax change that would likely be retroactive, and currently the increased rate would be set to apply to gains realized after September 13, 2021. The Net Investment Income Tax of 3.8% would stack on top of this, making it effectively a 28.8% long-term gains rate.

   Another clear one from Washington – they want to charge a higher tax for long-term capital gains to higher earners.

   Action Step: **Harvest capital losses even more tactfully (such as only up to the amount needed to stay out of the 25% bracket, and defer the remainder to the next year), as well as take advantage of deductions mentioned above to keep under the long-term gain 25% threshold.**

4. **Estate Tax: Reduce the estate tax exemption to somewhere between $3,500,000 and $6,500,000.** It's currently $11,700,000 per individual, and the new proposal wants to end the temporary increase that the Tax Cuts and Jobs Act provided, which was originally set to expire on 12/31/25. This change is essentially reverting back to the old estate exemption levels on 12/31/21 instead, and a ~$6,000,000 figure is being discussed more so than anything lower.

   Washington is trying to capture roughly $65 billion more in tax revenue by accelerating the sunset of the increased estate exemption. According to CNBC, in 2019 there were only 2,570 estate tax returns filed. That equates to around 0.2% of adults who pass away (compared to historical 1-2%), meaning very few people pay estate taxes. Because of that, this one could likely be an easy target for them to pass.

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Action Step: If your estate is already above the $6,000,000 (or $12,000,000 for a couple), it might be prudent to consider funding trusts with the excess that would remain under the current estate exemption levels. Going forward, strategies to avoid estate taxes such as maximizing lifetime gifting and using bypass or irrevocable trusts will be even more important.

5. **Net Investment Income Tax: Expand it to apply to active net income from a passthrough businesses.** Currently it's a 3.8% tax that applies to interest, dividends, capital gains, and passive business income when an individual is above certain levels of Modified Adjusted Gross Income. This change would allow it to apply to active business income from an S-Corp, partnership, or sole proprietorship when MAGI is over $400,000 for single filer and $500,000 for joint filers.

   With this one, Washington is applying an extra tax to business owners (and particularly small business owners) when their income is higher.

   Action Step: This one is tough. If you have a small business, it's not an easy change to switch to a regular C Corporation. It may make sense in some cases, but most of the time it'll be difficult to change your "passthrough business" status. Taking advantage of as many deductions as you can to stay under the MAGI levels and accelerating income into this year are the two most doable actions you can take.

6. **Corporate Tax Rates: Return to a progressive rate structure where corporate income above $5 million is taxed at 26.5%.** Currently the rate is 21%, so many corporations would see a rise in taxes.

   It's also clear what the target is here -- Washington is trying to tax medium-large corporations more.

   Action Step: Don't think that if this passes it automatically means a bear market. Tax policy alone doesn't usually cause a major sell-off. But it could slow the trajectory of equity price appreciation while investors wait for earnings to grow to compensate for the higher taxes.

There's plenty more that we could dive into – surcharges on very high incomes, limits on IRA balances, Roth conversions eliminated for higher earners in 10 years, elimination of step-up in basis, and many more. But to keep things short and sweet, we've highlighted some of the more notable ones.

The overall theme with these proposals is crystal clear: to assess more taxes on higher earners, small business owners, and medium-large corporations.

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