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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

Global equities posted solid gains for April, thanks in large part to marked improvements across many key economic indicators. More recently, stocks with even a hint of future problems, earnings or otherwise, are being punished with rapid sell-offs.

U.S. stock earnings reports have been spectacular, but largely expected and have drawn an overall yawn from the stock market. Over 60% of S&P 500 companies have reported results to date, with a whopping 86% reporting positive EPS surprises, and 78% reporting positive revenue surprises. The blended earnings growth rate for the index has hit 45.8% for the quarter. Such positive news begs the 64-million-dollar question – **can such earnings growth continue into 2022 and, if so, will it be enough to offset the negative impact of higher corporate capital gains taxes?** This obviously remains a key SFG wildcard.

The research on this question is mildly positive. According to Strategas, among S&P 500 companies, 62.5% of all forward guidance by CEOs and CFOs is being classified as positive. This is above the five-year average of 37%, but again, this is coming off significant pandemic lows. We expect the second quarter to be another strong one given the increasingly positive chatter from corporate CEOs, however, Q3 and Q4 2021 earnings growth comparisons may be more challenging.

U.S. Federal Reserve Chair Powell announced **no changes to the fed funds target rate at the April meeting, and reiterated the central bank's commitment to supporting the U.S. economy.** He also confirmed that asset purchases will remain at $120 billion per month indefinitely. Despite the ongoing U.S. recovery and higher growth expectations, the Fed believes more progress needs to be seen before beginning to unwind its accommodative monetary policy.

Another aspect to keep in mind when attempting to predict stock market performance – **stocks generally react more up or down to material changes in the trend.** Ironically, in the case of the Fed, stocks would likely view a tightening of the Fed's monetary policy as a negative, rather than a positive (which it is) when, in fact, such a move would indicate the Fed no longer needs to prop up the economy. Go figure!

An increase in consumer spending, due in large part to pent-up demand, bodes well for the economy, even though many businesses here and abroad are not yet fully open.

Meanwhile, the debate over President Biden's new multi-trillion-dollar spending plan continues. Whether the plan as proposed ($4 trillion), or a modified version (at $2-3 trillion), is ultimately passed, the resulting impact to the U.S. economy will take the remainder of the decade to ripple through, creating some tailwind for economic growth as well as an addition to the pandemic spending that has taken our nation's debt to over $27 trillion dollars. The parts of the proposed spending bill that are focused on true infrastructure (roads and bridges, 5G and cybersecurity) will likely create some economic growth of their own to help offset future budget deficits.

Treasury Secretary Janet Yellen's take last week: "…these are investments our economy needs to be competitive and to be productive. I think our economy will grow faster because of them."

SFG's Take: This is not a time for FOMO-driven (Fear of Missing Out) investment decision making. Our three focus areas for a successful economy – pandemic progress, corporate earnings growth and continued health recovery – are still moving in the right direction in the U.S. As we've seen in several emerging markets, including India, these pillars of success are far less certain globally, which is why high-quality companies are still generally selling at a discount to their U.S. counterparts.

There is, unfortunately, a fourth focus area we continue to monitor – the downside scenarios. These include shifting market sentiment, interest rate/inflation trends, proposed tax changes, vaccinate hesitancy and reluctance, COVID-19 variant growth and our new addition – a potential shift in Fed tone or even policy in the next 6-12 months. These areas remain concerning and mandate a disciplined investment approach. SFG remains positive on certain investment areas and cautious in others.

Key Points to Consider

- **Inflation watch** – Supply chain capacity utilization, supplier delivery times and surveyed prices are useful measurements of current and future inflation. Ned Davis research reports these proxies have experienced a meaningful uptick in the U.S. Coupled with vaccine deployment, supply-chain bottlenecks (including factories and housing), substantial fiscal stimulus from the U.S. government and a strong near-term GDP growth outlook, **accelerating modest inflation remains the SFG base case in 2021.**

The Power of Good Planning

Nationally known speaker on change and SFG client Dr. Gary Bradt discusses on TheStreet.com how the pandemic almost upset his retirement plans in ***How to Cope When the Pandemic Fast Forwards Your Retirement Plan****.* Gary provides ideas on how to integrate financial plan updates and planning advice into the process of making key life decisions. https://www.thestreet.com/retirement-daily/lifestyle/how-to-cope-when-the-pandemic-fast-forwards-your-retirement-plans

Frequently Asked Questions

Q: Higher taxes are coming. What can we do to be more tax efficient?

A: The unveiling of President Biden's American Families Plan makes it clear that he is serious about pursuing some of the individual tax increases he called for during the 2020 campaign. One major proposal within the plan calls for taxing capital gains and dividend income at ordinary income tax rates for those with earnings over $1 million.

The details as to how this tax would be implemented are not yet clear and the slim margins in Congress guarantee a robust debate. With that said, tax efficiency will become even more important for wealthier households.

Fortunately, there are many strategies we can consider to help reduce the negative tax impact from the proposed tax law change. While a wait and see approach is required given uncertainty surrounding the final tax legislation, many of the following strategies are already in use and may be accelerated (and new approaches added) depending on the tax change outcome.

Ten possible tax mitigating strategies:

1. **Tax gain harvesting:** Investors often focus on selling losing investments and letting the winners ride. However, from a tax-planning prospective it sometimes can be better to sell a winner to lock in a lower tax rate today – a strategy known as tax-gain harvesting. High income investors may want to consider recognizing a portion of their capital gains before any new tax laws go into effect. Doing so could result in a lower tax bill and the opportunity to rebalance a portfolio into more tax-efficient investments. Before going hog wild on this strategy, remember that paying tax now reduces your investible assets and creates a higher target rate needed on the new investment. https://www.schwab.com/resource-center/insights/content/how-to-save-money-with-tax-gain-harvesting

   This strategy has less appeal for older clients who will get all their capital gains erased at death, but the new law may change this "stepped-up cost basis," which would shift our thinking on tax gain harvesting.

2. **Tax loss harvesting:** This has been a mainstay tax strategy for SFG for many years. The proposed higher tax rate on income over $400,000, and even higher over $1 million, likely would be levied only on the "net" gain realized. This means we could sell a losing asset to offset the taxable gain from profitable asset, a strategy known as tax-loss harvesting. The recognized losses could be used to bring the net gain to just below the new limits. https://www.schwab.com/resource-center/insights/content/reap-benefits-tax-loss-harvesting-to-lower-your-tax-bill

   This approach has been less accessible when losing assets are few and far between – as in recent years. However, SFG has several stock-fund managers that regularly employ tax loss harvesting strategies by taking advantage of short-term volatility. Remember, any given day that the "stock market" is up, a sizeable number of stocks are down.

   In addition, we now have the ability to customize these tax-loss harvesting funds further to fit our client's need for growth versus dividends, ESG factors and a host of other modifications to enhance overall fit with our client's longer-term goals. Note, however, these strategies are only effective for taxable portfolios, not retirement plan assets.

3. **Timing of asset sales:** If the tax rate on capital gains increases, we can strategically plan asset sales to ensure that gains are recognized only up to the limits in the new tax law. This strategy can be done every year, and also combined with items #1 and #2 above, to help minimize taxes over multiple years.

As with other strategies, **the tax tail shouldn't wag the economic dog.** If it's a good idea to capture gains in real estate (like a rental property that has maxed out its value or is in a declining neighborhood) or stocks that are well above fair market value with modest future potential, tax planning should take a backseat.

4. **Use more index-like portfolio strategies:** This approach was helpful for SFG clients as we came off the lows of the 2008/09 recession. Indices in various areas, including U.S. or overseas stocks, tend to be more tax efficient than more active managers since they trade less frequently. One danger to consider – we don't have the bargains today that we had coming out of the 2008/09 recession, and many indices may struggle more in the post-COVID-19 "grinding higher" environment.

5. **Consider higher retirement plan contributions:** This could include increasing the percentage going into your 401(k) or 403(b) plan or setting up a retirement plan for income earned in self-employment activities, including serving on a board of directors.

6. A **Roth conversion** in 2021 before the tax law change in 2022 could also make sense with converted monies growing tax free into the future. However, if you start out with 65 cents of a dollar in a Roth IRA from an IRA rollover (as a result of pre-paying the tax on a Roth conversion), making up the lost 35 cents can take a long, long time.

   SFG can run simulations to see if it is beneficial for your specific circumstances depending on the nuances of the new law.

7. **Consider Opportunity Zone investments:** These funds can defer (and potentially reduce depending on new tax rates and your income levels) taxes on previously earned capital gains until due in 2026. Most importantly, you will earn tax-*free* (better than deferred) gains on your new investment if held for 10 years.

   Worried about shifting gains to 2026 when tax rates are unknown? If you pay your gains and invest after-tax proceeds in any growth asset, you will be subject to the new higher rates anyway when that asset is sold. Our scenario models have demonstrated some good pre-tax return equivilents due to the tax free growth mentioned above, compared with the "do nothing, pay the tax" approach.

   SFG has considerable experience in this area and can help determine if the strategy fits with your other planning priorities.

8. **Charitable planning:** Another tried and true technique we've used for decades. Appreciated securities can be gifted to a charitable remainder trust, sold without triggering big gains for the donor, and a stream of income can be created for the future. Variations include the charitable lead trust (we are seeing this used more in sophisticated estate planning) and charitable gift annuities.

   And don't forget that contributing appreciated securities to a charitable entity is almost always preferable to cash.

   A desire to benefit one or more charitable causes is necessary for these tax planning ideas to work. There are many nuances to these startegeis – SFG can help develop a customized approach in conjunction with your other professional advisors.

9. **Hold assets longer:** For long-term investors, a possible strategy to avoid higher capital gains tax rates is to kick the can down the road. Don't sell investments with large built-in gains while tax rates are high. Again, **this approach has dangers if an asset appears to be peaking or if portfolio re-allocation or rebalancing is needed for economic or personal planning reasons.**

   As we have seen in the past few years, the tax code is constantly changing. It's possible that even if the current administration changes the capital gains tax rate, some future President and Congress could change the tax rates back again. Unfortunately, there's no way to know what the future holds, but change does seem to be the new norm.

10. **Increased tax planning with your tax professional:** Depending on provisions in the new law and how it impacts you, having more frequent tax planning meetings with your tax professional (accountant and/or tax lawyer), in conjunction with your SFG planners, can help you explore other ways to be tax smart in the future.

This discussion has focused more on income tax planning. While the preliminary tax changes discussed have **omitted major changes in estate tax laws** (other than the elimination of the stepped-up cost basis rules) due to pushback from some key Democrat senators, we could still see some changes in this area.

SFG's Take: We will be closely monitoring developments in this area with our network of tax specialists and research resources. While we believe tax planning is highly important, we want to reiterate that the tax tail should never wag the economic dog. Stay tuned for more planning ideas!

Summary

SFG's three focus areas for an economic recovery remain in positive trend territory, with COVID-19 news being more nuanced. Wildcard risks in our fourth focus area remain elevated. SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances.

In **growth** portfolios, we are leaning into a variety of short- and intermediate-term asset classes and trends that we believe will have favorable forward-looking risk/reward metrics.

In our more conservative **growth and income** portfolios, we are taking steps to be more defensive while still striving for positive real returns over inflation.

Our COVID-19 endgame investing approach can be summed up by six themes:

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,

- A more defensive stance using different portfolio tools for more conservative growth and income portfolios, and,
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
(the SFG Investment Committee)

REMINDER THAT COVID-19 OFFICE HOURS ARE STILL IN EFFECT

SFG is developing plans for expanded office hours, while keeping the safety of our clients and teammates in mind.

For now, we maintain limited in-person service hours at our offices in Chapel Hill and Greensboro, NC until we can all return to the office safely.

If you have a need to meet with us in person or to pick up or drop off documents, we are glad to accommodate you. We also have a number of traditional and virtual tools to facilitate document transfers. Please contact us in advance if an in-person meeting is needed.

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