# Perspectives

**Newsletter** I Quarter Ending June 30, 2021

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## Inside This Issue



## Market Recap

It has been a great first half in 2021. Who would have thought that U.S. equities would be up 14% in the first half of this year after having been up 29% in 2019 and 16% in 2020?[1] The stock market has risen nearly 70% since its March 2020 COVID lows and continues to trend up. This will be a tough act to follow the last half of the year, though we expect the stock market to be higher at year-end than it is now.

So, what is driving these terrific U.S. stock market returns? As always, it is earnings - both actual and expected. The S&P 500 year-to-date earnings growth in the first half of this year was 19.7%. That was offset by a 5.3% reduction in the S&P 500's price to earnings ratio (a healthy thing for the market) to give us a net return of 14.4% year-to date. This earnings growth was driven by 11.9% growth in revenue and a huge 44.6% jump in profit margins.[2] One thing business learned to do during the pandemic was how to cut expenses and operate more efficiently! S&P 500 earnings are expected to continue to increase quite nicely over the next two years, which bodes well for the stock market.

Fixed income markets had a much tougher first half. The U.S. Aggregate Bond Index fell -1.6%.[3] As usual, when interest rates are rising (as they did in the first quarter) bonds with the longest time to maturity are hurt the most, and shorter term bonds are hurt the least. Interest rates fell a bit during the 2nd quarter (good for bond values) or the year-to-date decline would have been worse.

We would be remiss if we did not acknowledge that most of the growth in earnings is due to a re-opening of economies around the world, and particularly in the U.S. We have benefited greatly from a huge amount of pent-up demand. People want to get out and about and are celebrating a tentative end to the pandemic by changing jobs, buying houses, planning trips, and spending money on things that it did not make sense to do until now (like businesses expanding capacity). The miraculous success of newly developed vaccines has allowed us to re-open and we are getting closer and closer to herd immunity in the U.S., as a result. Let's hope we keep moving forward and avoid any backsliding this fall!

- **Patrick Powers, CFA®, CPA, CFP®**
  **Partner/Managing Principal**

## Forecast

A couple of weeks ago, the U.S. Federal Reserve (the "Fed") pushed forward the date when they will begin to raise interest rates. Federal Reserve Chairman Jay Powell stated that the "Fed would not even think about thinking about raising interest rates."[4] Now the Fed is talking about raising interest rates two notches by 2023 instead of 2024. Why the sudden change of heart? It is quite possible that the Fed thinks that the economy may be overheating. This could be a plausible explanation when you think about how much stimulus the federal government is pushing out on the fiscal side and how much money printing the Fed is doing on the monetary side.

Yet the bond market is acting as if the opposite will happen. Could the market be sensing another lockdown caused by the COVID-19 Delta or Lambda variant or is there excess savings over investment? We suspect that interest rates are declining due to a savings glut.

There is approximately $2.1 trillion dollars in excess savings ready to be unleashed[5], more fiscal thrust coming from President Biden, and even more Federal Reserve high powered money on the way. Once the global economy opens up, we believe the excess savings will be spent and interest rates will rise once again. Investors should not be fooled into thinking that interest rates will stay at zero forever.

What are the implications for investors? An overheating economy and rising inflation will force the Fed to raise interest rates at some point. This won't happen tomorrow, but most likely by 2023-2024. Although stock market valuations are a bit stretched, residential real estate prices grossly overpriced, and cryptocurrencies in a casino atmosphere, the next 12 months look very favorable to stocks.

- **Steven Yamshon, Ph.D.**
  **Partner/Managing Principal**

## Portfolio Management

The past two months saw some eye-popping inflation readings after subdued inflation prints last year due to COVID. The Core Consumer Price Index ("CPI"), which excludes the volatile energy and food categories, rose 0.7% in May after increasing 0.9% in April, bringing the year-over-year reading to 3.8%. Headline CPI, which includes energy and food, rose to 5.0% year-over-year for the largest 12-month increase since August 2008.[6]

A confluence of events drove these inflation outbursts: 1) the year-over-year inflation readings were expected to jump during the summer due to the low readings a year ago, 2) the speedy rollout of widespread COVID-19 vaccinations in the U.S. and fiscal stimulus unleashed pent-up demand faster than expected, catching many businesses off-guard, 3) the flow of goods ordered from overseas was slowed by shipping bottlenecks including the six-day blockage of the Suez Canal, 4) staffing issues are a contributing factor in the shortages, and 5) other one-off supply constraints (i.e., ransomware attack on a U.S. fuel pipeline, a brutal winter storm knocked out the power grid in Texas, and a global shortage of semiconductors).

Many economists (including those at the Federal Reserve) expect many of these price hikes to be short-lived ("transitory") as output increases to reduce the bottlenecks. In fact, roughly 90% of the CPI increase was accounted for by reopening price rebounds and supply disruptions. By far the largest contributor to the price rise in that category (accounting for over a third of the increase in the headline CPI) was used car purchases as new car sales were disrupted chip shortages. The other large contributor was transportation services, chiefly airline ticket sales. All the other categories (core services) barely budged. Despite two monthly increases, the 12-month increase in the shelter component, which constitutes nearly a third of the overall index, is still just 2.2%.

And add to this that as the supply constraints ease, year-over-year comparisons to the abnormal pandemic era are subsiding (May 2020 marked the pandemic low in the price index), the $300 federal enhanced unemployment benefit is expiring (many states have already ended it), many employers are re-opening offices, and schools will soon be back in session.

However, while inflation might prove to be transitory, the longer-term path of inflation is still unclear and could depend on economic policy decisions yet to be made. Consider this, inflation has been rising since last June, and yet the Fed has not changed policy one iota. It has been running monetary policy full steam ahead during rising inflationary pressures. Adjusting for inflation, monetary policy has become easier as the real Fed Funds rate (adjusted for inflation) has fallen from -1.1% to -3.8%. This is the result of their new policy framework not to raise interest rates preemptively but to seek maximum employment and deal with inflation later.

Given that "inflation is always and everywhere a monetary phenomenon" as famously said by Nobel laureate Milton Friedman, our goal as your advisers is to construct a risk-appropriate portfolio that will withstand any one of numerous economic scenarios that may unfold, including a scenario of high inflation.

One of my favorite quotes is attributed to Roman philosopher Seneca: "Luck is what happens when preparation meets opportunity." We had already prepared the portfolios for an inflation scenario before coming into this year by reducing our exposure to long-term bonds, holding Treasury Inflation-Protected Securities (TIPS), initiating and adding to our gold position, holding international stocks denominated in foreign currencies, and having discussions with you to reduce exorbitantly large cash reserves in low yielding savings accounts. We believe we will have an opportunity as inflation subsides over the next year to build these positions further and possibly add other real assets (i.e., real estate, natural resources, etc.). Your portfolios are prepared to meet the opportunity to enable you to withstand inflation and other challenges that will inevitably come our way.

- **Michael Allbee, CFP®**
  **Partner/Senior Portfolio Manager**

## Talk With Us!

Deferred compensation plans offer a wonderful way for people to delay income which can potentially be taxed at a tax bracket in retirement and create a cash flow stream for a part of retirement. When these plans are structured effectively, they can allow you to retire early and have a stream of income in your early and middle years of retirement. The challenge though lies in the options people choose for when to receive the money in the future.

*Understanding the Basics*
A Non-Qualified Deferred Compensation (NQDC) plan allows individuals to defer a portion of their income now and then withdrawal the money typically in retirement when their income is lower. Most of the time the amount of money deferred can be invested in stocks or bonds so the money can grow over time.

Deferred Compensation plans are called non-qualified because they do not have to comply with Employee Retirement Income Security Act (ERISA) like a 401(k) or 403(b) and can be offered to a certain group of employees like executives. These plans will have a written agreement between the employer and employee that outlines all the rules like how much can be deferred when the payout can occur and what investment options are available.

You will make annual elections on how much income you would like to defer and when you would like to receive that money back in the future. Most commonly you can choose a lump sum option or receive payments over a set amount of time like five or ten years. For example, if you defer $50,000 in 2021 you could choose to receive that $50,000 at retirement or as a $10,000 a year payment over five years.

*Rules You Need To Know*
Deferred Compensation plans do not follow ERISA guidelines, so it is very important to fully understand the rules for your plan. For example, some plans will have many investment and distribution options while others may only offer limited (or no investment) options.

The deferred compensation stays on the company's financial statements, so it is not fully protected if the company has financial issues down the road like filing for bankruptcy. When choosing to use a deferred compensation plan it is important to have strong faith in the company's long-term viability.

*Choose Your Distribution Option Wisely*
Once your distribution elections are made it can be difficult to make changes. Most plans limit the number of changes you can make and require you to work at least another 12 months before you retire. Another common rule is that any changes made will delay the distribution by five years. For example, an individual that is 59 and plans to retire at age 60 makes some changes to her elections for the distribution. As a result, the new changes typically will be paid out at age 65 at the earliest based on the five-year rule.

Let's take a look at an example and why you typically want to spread the payments out over time. An individual retires in 2022 with deferred compensation of $600,000 and chooses to receive everything as a lump sum. Assuming no other income sources the $600,000 would be taxed at a Federal income tax rate of 35% for a couple filing jointly (based on current Federal income tax rates and not factoring in deductions). However, if they choose to spread the payments over five years, they would receive $120,000 per year for five years. Assuming no other income sources they would be taxed at a Federal income tax rate of 22% each of those five years. By delaying the payments, the individual greatly reduces the tax burden and creates an income stream for the first five years of retirement.

*How We Can Help*
We can look at your plan documents and provide guidance on how much you should save each year and provide recommendations on the best distribution options. If you have a plan in place already, we are happy to review it and see if any changes should be made to how you will receive distributions from the plan. These decisions vary for each individual based on their income needs and tax situation.These plans can be complex, and it is important to understand how to most effectively use this great employer benefit – Talk With Us!

- **Paul Horn, CFP®, CPWA®**
  **Senior Financial Planner/Wealth Manager**

## The Score Board

| | 06/30/2021 | YTD Change |
|---|---|---|
| Dow Jones Industrial Average | 34,502.51 | 13.79% |
| S&P 500* | 4,297.50 | 14.41% |
| NASDAQ Composite* | 14,503.95 | 12.53% |
| MSCI EAFE (USD)* | 2,304.92 | 7.34% |
| Bloomberg Commodity Index | 94.54 | 21.12% |
| Barclays Aggregate Bond Index | 2,353.64 | -1.60% |
| 10 Yr U.S. Treasury Bond Yield | 1.47% | 55bps |
| 30 Yr Fixed Mortgage Rate | 3.13% | 26bps |
| Prime Rate | 3.25% | UNCH |
| Crude Oil ($ / Barrel) | $73.47 | 51.40% |
| Gold ($ / Oz.) | $1,770.11 | -6.80% |
| U.S. $ / Euro € | $0.84 | 3.02% |
| Core Inflation (excluding food / energy) | | 3.80%** |
| Inflation (including food / energy) | | 5.00%** |

**Without Dividends; **Unadjusted 12-Months ended May 2021; bps (1 Basis Point = 1/100%); UNCH (Unchanged)*
*Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve*

**Sources:**

1. The S&P 500 is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
2. Source: FactSet, Compustat, Standard & Poor's, J.P. Morgan Asset Management. Earnings Per Share (EPS) levels are based on annual operating earnings per share. 2021 earnings estimates are based on forecasts from FactSet Market Aggregates. Data as of June 30, 2021.
3. The Barclays Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market.. Total return quoted.
4. Source: Federal Reserve (https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm)
5. Source: Federal Reserve, Bloomberg Economics
6. Source: U.S. Bureau of Labor Statistics (https://www.bls.gov/)