RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

Second Quarter 2021 Market Commentary
July 2021

Current Status of Economic and Market Recovery from COVID-19

The second quarter saw a continuation of the economic and market recovery of the first quarter, with economic data points reflecting improving conditions domestically and the stock market increasingly pricing in a return to pre-Covid normal. The S&P 500 rose over 8% in the quarter, led by a rebound in the tech sector from its sluggish start to 2021. Year-to-date, equities ended the quarter up over 14%, led by value and cyclical stocks benefitting from the recovery, with the energy (+41%), financial (+24%) and industrial (+15%) sectors the biggest out-performers. For some investors, however, the strong economic rebound is a double-edged sword in that it could lead the Federal Reserve to tighten monetary policy sooner than expected.

Strong Economic Rebound Signals End to Crisis-Era Fed Policy is Near

Investor attention in the second quarter focused on economic conditions and the impact on interest rates from the Fed's expected response to inflation data. Regardless of the near-term path of inflation, discussed more below, the economic recovery will assuredly lead to an end of crisis-era Fed policy, with a course reversal likely to begin sometime in 2022. U.S. GDP recently rose over 6% from the prior quarter, with unemployment down to 5.8%, industrial production up 16% and retail sales up 28% year-over-year. Nevertheless, the Fed Funds rate is still set to 0 – 0.25% and the Fed is still buying $40 billion in mortgage-backed securities each month, in addition to $80 billion in U.S. treasuries. This is in the face of a red-hot U.S. housing market (highest annual price increase in 30 years in April at 14.6%) caused in part by ultra-low mortgage rates prevalent in the marketplace. As the recovery continues, it will be harder for the Fed to justify such a continued massive outlay in the fixed income markets, especially considering the Fed already holds $7.5 trillion in such securities on its balance sheet.

While it is likely that relatively low interest rates are here to stay for the next couple of years at least, it is also likely that the Fed will begin to taper its asset purchases sometime next year, based on Fed commentary. As monetary policy tightens and interest rates begin to rise, there will be implications for investors across the asset class spectrum. Higher priced growth stocks that are valued largely due to discounting earnings relatively farther out in the future will tend to under-perform in a rising rate environment. At the extreme end of the spectrum, the highly speculative so-called "meme" stocks like Gamestop, AMC and the like, which have been irrationally bid higher this year, will be hurt by tighter financial conditions. So will fixed rate securities currently held by investors as new issues at higher rates cause devaluation of outstanding issues. However, this will allow those currently near retirement to begin to shift savings allocations towards higher yielding conservative assets than retirees over the past ten-plus years have been able to access.

Inflation Uptick Distorted Somewhat by Base Effects

Markets paid close attention to spiking inflation numbers in the second quarter, as the recovery led to prices of everything from lumber to used cars rising significantly year-over-year. As anyone undergoing a home improvement construction project currently can testify, the scarcity of lumber led to prices rising over 80% year-over-year, even with a moderate pullback at the end of the quarter. Similarly, an uptick in demand for travel and vacation has led to previously dormant rental car companies stocking up on used vehicles, which, along with the global chip shortage, has led to increased demand for used cars, with prices up ~ 30%. Year-over-year inflation is currently running at a 5% rate, well over the Fed's goal of ~ 2%, and at a thirteen year high.

Many investors are concerned that skyrocketing inflation will lead the Fed to raise rates quickly thereby hindering the economy and sinking asset prices for, among other things, the stock market. The Fed, meanwhile, has asserted that current inflation data is transitory and will moderate back to the targeted 2% rate when temporary effects subside. To this point, much of the rise in inflation is due to unusual factors caused by Covid. First, Covid shifted human behavior in unusual and transitory ways. For example, Americans stuck at home during the lockdown planned home improvement projects or moved out of major cities to purchase homes that has caused the demand for real estate and construction materials to skyrocket. Those same people also delayed vacation and travel plans into 2021, which has led to an increase in demand and prices for rental cars and hotels.

Second, widely published inflation data is typically backward looking by one-year to 2020 levels when the economy was shut down and prices actually fell. When viewed in comparison to pre-Covid prices in the economy, the inflation picture is not so scary. This is an example of "base effects", or the base numbers used to gauge inflation against current numbers, skewing the picture somewhat. Due to the Covid-induced shutdown in 2020, prices for many goods fell last year due to a freeze in economic activity. When 2021 prices are compared to levels two years ago, rather than prices in the midst of the Covid shutdown, inflation is only up 2.5%, which is far more reasonable in an economic recovery and closer to the Fed's target.

Wealth Planning Update – Latest Tax & Regulatory Proposals

Since our last market commentary, the Biden administration has proposed multiple tax reform proposals that impact investors, in an effort to raise taxes for various spending initiatives within the American Families Plan.

Capital Gains Tax Rates

First, the administration has shifted focus from corporate tax increases to personal tax increases, specifically targeting capital gains rates for reform. On this front, the Biden proposal raises the top capital gains tax rate for long-term gains to 39.6% from 20%. If this rate were to become law, when combined with average state taxes on capital gains and the 3.8% federal net investment income tax, the U.S. would have the highest marginal long-term capital gains rate in the world (49%) and the second highest dividend tax rate in the world.

However, it is important to note that the proposed capital gains tax rate would only apply to taxpayers with annual income over $1 million, or 0.3% of taxpayers, and therefore wouldn't broadly impact markets on its own. Historically after past capital gains tax hikes there was minimal impact on market activity due to: 1) the limited number of investors that earn more than the income thresholds for the hikes – e.g. $1 million income threshold; 2) limited investment activity that is taxable to individual investors compared to the massive institutional and retirement money in the marketplace; and 3) ability of many taxpayers to wait to realize capital gains until legislative adjustment of rates back downward or cost basis step-up at death.

1031 Exchange Limitations

The Biden administration is proposing to cap the ability of Americans to conduct 1031 tax-free changes of like-kind real property to $500,000 in gains deferred per individual or $1 million in gains deferred for couples. Gains over those amounts would be taxed at ordinary income tax rates, rather than preferential capital gains tax rates. This proposal would be a significant change for many real estate investors that utilize 1031 exchanges as a regular business practice.

Elimination of Cost Basis Step-Up

On the estate front, the Biden administration included important provisions within the tax proposals that will impact high net worth families. Notably, a key change in the tax proposal would provide that a decedent's assets would be taxed at death as if sold at date of death, for assets with gains greater than $1 million per individual or $2.5 million per couple, with the higher proposed capital gains rates then applied. Currently, assets at death are only taxed when later sold by a beneficiary, who then pays taxes on the appreciation of those assets from the date of death valuation (known as a stepped-up basis). Large estates would still be subject to estate tax on assets over $11.7 million per individual at up to 40% rates, therefore implicating both capital gains and estate taxes on large estates. This presents a challenge for Americans with highly appreciated assets, including securities, closely held businesses and the like, to determine whether a lifetime gifting strategy would be more advantageous from a tax standpoint than the potential tax hit at date of death from a deemed sale.

As usual, all comments are welcome and appreciated.