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Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

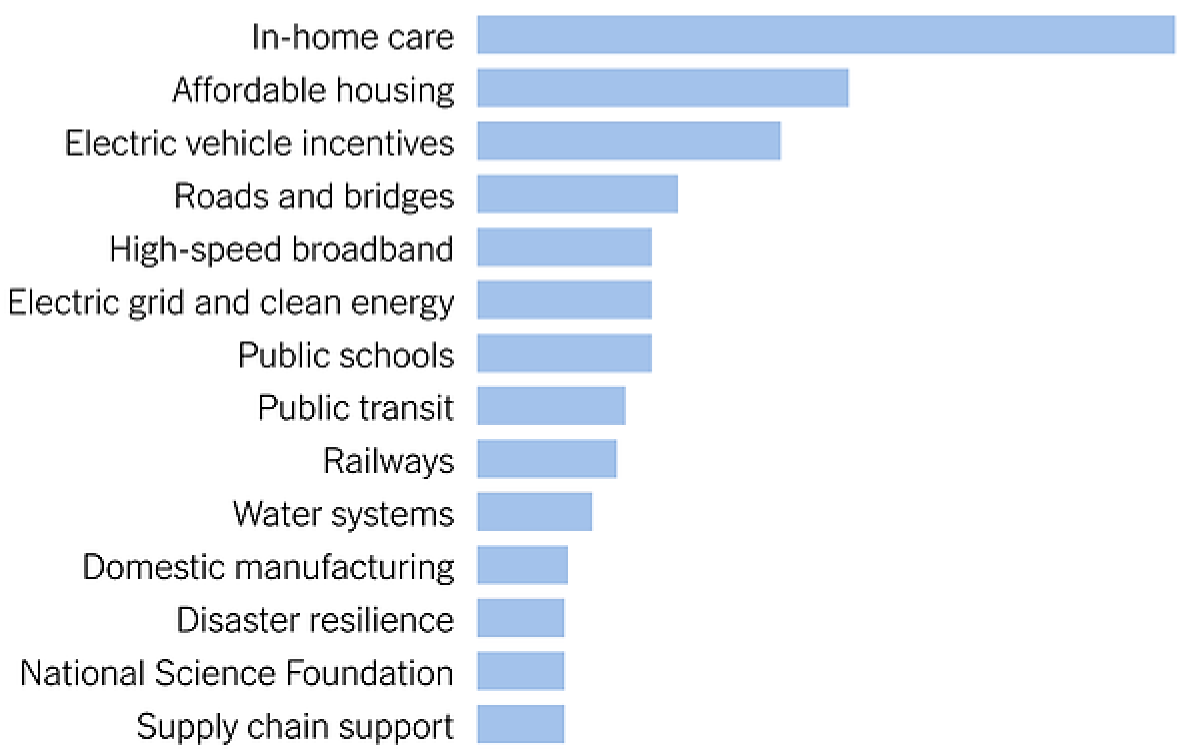
Jamie Dimon, JPMorgan Chase's CEO, says in his annual letter to shareholders released this week that the economic boom in the U.S. will be with us for at least the next 18 months. We're living in a Goldilocks moment, he says, in which economic growth, excess savings and manageable inflation are the new normal. This coincides with SFG's three pillars of the recovery all showing positive trends. Investors should keep in mind that SFG's fourth pillar, the wildcard scenarios outlined in previous *Chats*, remain a reason why many investing areas may experience a bumpier ride in the economic recovery.

The White House formally unveiled its $2 trillion, eight-year infrastructure package which, if passed, will have numerous economic and market implications.

The spending in the plan covers a broad range of physical infrastructure projects including transportation, broadband telecommunications, the power grid and housing. A key objective is to jump-start advanced manufacturing as well as other industries viewed as vital in capturing and maintaining America's competitive edge around the world.

The package also includes funding to train millions of workers and initiatives to support labor unions and providers of in-home care for older and disabled Americans, while also increasing the pay of the workers who provide that care.

How the $2 trillion in proposed spending breaks down.



The Georgetown University's Center on Education and the Workforce has estimated that Biden's infrastructure plan will create or save 15 million jobs over a decade. https://cew.georgetown.edu/cew-reports/infrastructure/

While criticism from the U.S. Chamber and many Republicans will likely adjust some parts of the phase one plan, it is expected to progress given the offsetting tax increases proposed, which will maintain the ability of the plan to be approved by a simple majority vote under budget reconciliation rules.

The next phase of this two-part plan will be introduced in the coming month. Part two will have a similar price tag over the next 10-15 years ($2 trillion) and be paid for with personal tax increases on couples earning more than $400k in taxable income. This future "grow America" spending will likely focus partially on health care and upgrading the U.S. education system, again an attempt to keep pace with China in the battle for future economic growth.

SFG's Take: The proposed phase one infrastructure plan will likely pass by September/October, despite goals to pass it by July 4th. **It is increasingly likely that tax changes for corporations and individuals will occur in 2022.**

Many parts of the proposed plan fit what SFG has been discussing in recent years – the need to accelerate research and development spending as well as job re-training programs in an effort to cushion the loss of jobs resulting from ongoing technological advances.

We agree with economists at Goldman Sachs and Moody's that the increased economic activity resulting from the proposed infrastructure plan will not be significant until 2023 and beyond, while a 2022 tax hike could slow down the economy before it speeds up. Fortunately, such a slow down would coincide with an uptick in economic activity resulting from the stimulus packages already passed, ameliorating the risk of recession on the near-term horizon.

Our three pillars of recovery (i.e. COVID-19 vaccine progress, corporate earnings growth and economic health recovery) are still moving in a positive direction. Our fourth pillar of recovery, the wildcard scenario (shifting market sentiment, interest rate/inflation trends, tax changes, unwillingness to vaccinate, COVID-19 variant growth, etc.), remains a concern and a reason to stay grounded. SFG remains positive on certain investment areas and cautious in others.

Key Points to Consider

- **Strategas research high level analysis of the proposed Biden corporate tax increases:** "We expected Biden's proposal to increase the corporate tax rate to 28 percent as part of his infrastructure package. However, 25% may be the rate after political wrangling.

  "The plan also includes a number of international tax changes which are far more expansive than what Biden campaigned on and the net impact is likely underappreciated. The proposal is a $1 trillion corporate tax increase over 10 years, with the international portion taking up more than half of the tax increase. **This will impact U.S. tech and biotech companies in particular.**

  "The Biden Administration likely understands that U.S. companies would be at a competitive disadvantage to their foreign competitors with this new tax increase which is why Treasury Secretary Yellen is calling for a global minimum tax to prevent arbitrage. A global minimum tax is likely wishful thinking and companies that will be most impacted by these tax changes will be lobbying members of Congress for changes to be made.

  "We do not believe that the full Biden tax proposal will go through, but at some point investors need to begin assuming that potential tax increases will lower S&P 500 earnings by 5-10% in 2022."

  SFG's Take: The proposed increase in corporate income tax, along with a new corporate minimum tax that will be imposed regardless of what the rest of the world does (bolstering the existing de facto corporate minimum tax already in place) will likely offset expected earnings growth in 2022. In our view, this tax impact alone won't create a significant correction, but clearly provides another headwind to U.S. stocks.

- **Jobs, Jobs, Jobs – Good news on many job fronts.** Job openings rose to a two-year high in February. We also saw better-than-expected March employment data, including nonfarm payrolls and a measure of service-industry activity. Several factors are contributing. First, U.S. vaccinations hit a seven-day average of more than three million a day last weekend. The travel and leisure industry also began rehiring as it gears up for pent up consumer demand. Note, however, that these unemployment numbers don't incorporate the many women (estimates range from 3-5 million) who have permanently left the work force due to childcare needs resulting from the pandemic.

  Another factor in the strong job growth is increasing confidence in the economic recovery. Both the U.S. and global economic rebounds this year are looking strong, with the International Monetary Fund upgrading its forecast for the globe to 6% in 2021, up from the 5.5% growth it estimated in January.

COVID-19 Updates

While the vaccination program is going well in the U.S., many are asking how big a danger the new COVID-19 variants are to their health, their children and grandchildren's health and the nascent economic recovery in the travel and leisure industry. Somewhat dangerous is the answer. More than one variant is currently racing through the U.S. causing numerous spikes in COVID-19 cases. Preliminary studies have concluded the P.1 variant, more prevalent on the east coast of the U.S., is up to 2.2 times as contagious as the original coronavirus and up to 61% more infectious. Which means, despite all the good efforts to treat those who get infected, those who still aren't vaccinated (and a small % of those who are) could get a variant and have a rough time recovering.

One variant is infecting younger people, including children. Infectious diseases experts in our network all say those who worry about vaccine side effects should worry more about long-term side effects of having COVID-19.

The good news is the vaccines being administered remain effective against the current variants. It is also true that most variants are expected to respond to shifts in the vaccine formula. The longer it takes the U.S., or other parts of the world in our global economy, to reach herd immunity, the more chances there are of a variant mutating that doesn't respond to current vaccine technology. Health officials here and abroad believe the risk is relatively low of that happening, but are concerned with the large numbers of young people and others who view COVID-19 and its variants as nothing to worry about.

Here is Bills Gates' latest blog post on five things you should know about variants:
https://www.gatesnotes.com/Health/5-things-you-should-know-about-variants?WT.mc_id=20210330100000_COVID19-variants_BG-EM_&WT.tsrc=BGEM

COVID-19 End-Game Travel Planning

Reading *Treasure Island* is one thing, but living it is probably more fun. That's why families with kids who love classic children's stories and have a healthy travel budget are splurging on travel packages built around immersing their kids and grandkids in re-creations of some of youth literature's most iconic titles. Travel outfitter Black Tomato offers a trip to Oxfordshire for *Alice's Adventures in Wonderland*, or to Iceland for the experience of a *Journey to the Centre of the Earth*. Adding to the adventure: traveling with kids during a pandemic.
https://www.bloomberg.com/news/articles/2021-04-07/family-travel-with-kids-during-covid-luxury-outfitters-offer-solutions

Frequently Asked Questions

Q: Your recent inflation/deflation Live Chat and written *Chat* suggest that inflation will be moving higher later this year and into 2022, but is unlikely to be "hyper." How well is our investment portfolio prepared for higher inflation? Is gold a good inflation hedge? Bitcoin?

A: Over many decades, the best inflation hedges have been stocks and income-producing real estate. SFG also has inflation-protected government bonds and direct investment in many private assets in our portfolios that have good inflation hedge capabilities.

Stocks have historically been good inflation hedges because of the good returns experienced over inflation (the "real" return) during most 10- and 20-year rolling time periods. In addition, public companies (as well as many private companies) have the ability to pass along higher costs to their consumers. Today, due to the "Amazon effect," the ability to pass along higher costs has become more difficult as consumers have an unprecedented ability to shop online for better prices.

As noted in our recent commentary on dividend stocks, the average growth of dividends over many decades has exceeded inflation, making this a good inflation hedge for those who are very patient. With that said, a period of higher inflation coupled with a rise in interest rates might suddenly make bonds more attractive since investors would yield similar if not higher income with far less risk. Ultimately, such a scenario would negatively impact stock prices – obviously not the optimal inflation hedging strategy!

Consequently, we consider stocks to be more of a moderate inflation hedge going forward, although investing in areas of high growth or where values are discounted can provide returns that help offset rising inflation in your personal budget.

Income-producing real estate has been a good inflation hedge, especially in sectors where rents can be increased faster as inflation heats up. This has made multi-family housing (apartments) a good inflation hedge. As renters come and go, the apartment manager can raise rents to offset rising costs. But this only works in areas where the manager has pricing power – when there is a glut of apartments (not the case today in many markets around the country), competition limits pricing power in a similar way as the Amazon effect does for stocks.

SFG has significant portfolio assets in many different types of real estate, as well **as real assets** like infrastructure, timber and farmland where other factors like higher demand help produce inflation hedging. Our infrastructure investment managers also have solid long-term track records of producing positive real returns over inflation.

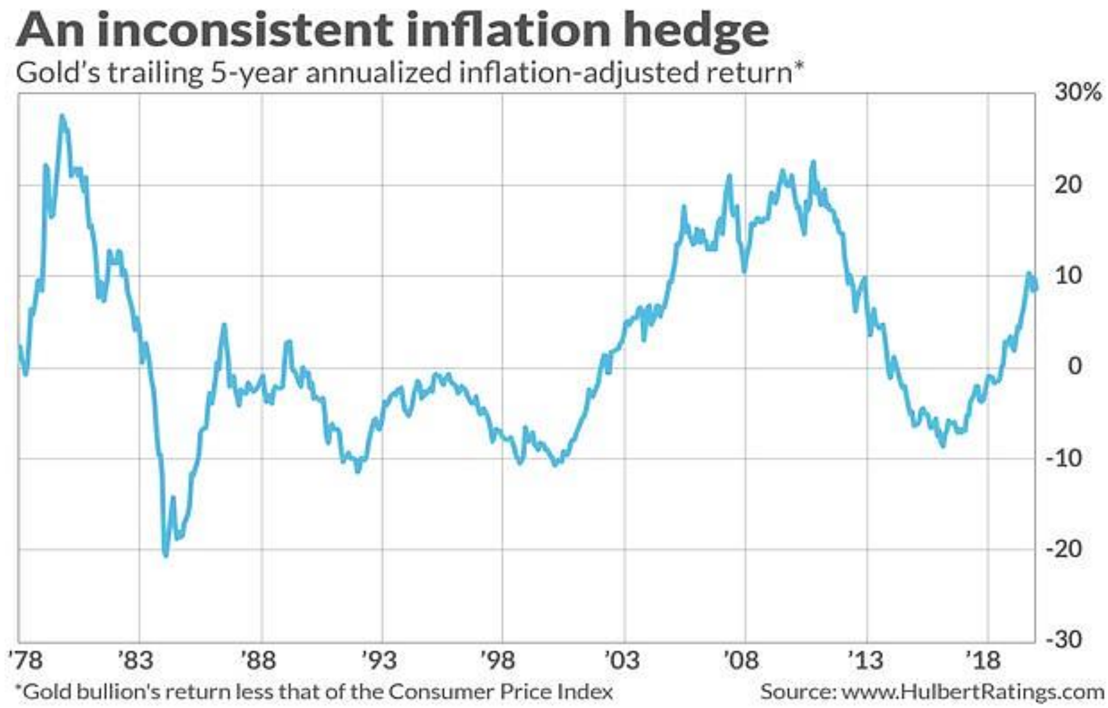
U.S. Treasury Inflation-Protected Securities (TIPS) have interest rates indexed to inflation. That means that their interest payments go up with the inflation rate – and down with deflation – ensuring the income produced isn't too badly eroded. Because they're backed by the U.S. government, TIPS are highly safe, and a good choice for conservative investors. However, they are priced today at expensive levels precisely for the benefits outlined above.

Contrary to popular belief**, gold** can be an inconsistent inflation hedge. The experience of the last 50 years suggests gold performs better as a hedge against inflation shocks – like the spike caused by surging oil prices in the late 1970s and early 1980s – than more moderate increases in inflation that we outlined in our recent SFG *Chats* on rising inflation expectations.

The chart on the following page looks at the inflation adjusted return of gold since 1978.

If you're looking to gold to provide an inflation hedge in coming years, this record should give you pause. As you can see, gold has largely marched to its own drummer with significant periods of time earning zero or negative real returns over inflation. As a result, SFG currently holds gold as an "uncharted waters" diversifier within portfolios rather than an inflation hedge.

With that said, gold does have a better inflation-hedging record when measured over periods longer than five years. Much, much longer, in fact. Research by Duke University professor Campbell Harvey and Claude Erb, a former commodities and fixed income manager at TCW Group, found that gold does a relatively decent job of keeping pace with inflation only when measured over periods close to a century or longer! https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2078535



Bitcoin's price history is too short to support robust conclusions about its inflation-hedging ability. Bitcoin doubled from mid-December 2020 to early-January 2021 as inflation started to heat up. But then, with no apparent easing of inflationary pressures, Bitcoin fell by more than $10,000 between January 8 and January 11, that is, by 25% of its value. It also fell by more than 75% between late 2017 and early 2019. SFG still views bitcoin as a speculative asset class with significant future risks.

One other inflation hedge is the I-Bond – these are U.S. Savings Bonds whose yield is pegged to the Consumer Price Index.

Two issues with I-Bonds – The first and biggest issue is that you can only purchase $10,000 of I-Bonds in any given calendar year. So, if you want to purchase a greater amount of guaranteed inflation protection (true for the majority of our clients) you will have to turn to Treasury inflation-protected securities like those discussed above.

The second issue is that I-Bonds don't trade in the secondary market – your only redemption option is with the U.S. Treasury. Not quite as convenient as other trading options that we have today.

Also note that you can't redeem I-Bonds in the first year of ownership. If redeeming between years one and five years, you forfeit three months of interest, making this a long-term investment.

Summary

The proposed infrastructure plan is massive. It invests in areas of our economy that have needed attention for a while, and other areas to make the U.S. more competitive on the global stage (and with China) in the future. However, the proposed corporate tax increases which will pay for the plan also have the potential to make select U.S. companies less competitive globally.

SFG is balancing numerous opportunities and threats in our portfolios, customized to our clients' unique circumstances. We are being more cautious as parts of the U.S. stock market have exhibited irrational exuberance in response to positive developments in ongoing stimulus, corporate earnings and COVID-19 vaccines.

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

In more conservative **growth and income** portfolios, we are taking more steps to be 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

Please keep in mind that we continue to 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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