Update on the Economy and Investment Markets

Welcome to the Stearns Financial *Poolside Chat.*

The U.S. Federal Reserve posted its latest "dot plot," a summary of how various Fed members view the timing of a potential rate hike in the context of rising inflation. Based on this data, the Fed collectively expects to begin raising interest rates by year end of 2023, though the majority won the day by only a slim two-member margin (out of 18 members). Consequently, some in the financial industry believe an interest rate hike may come sooner based on the assumption that current inflation trends are not transitory. If this is the case, expect the Fed to raise rates more quickly and possibly reduce bond purchases at the same time (otherwise known as "tapering").

The U.S. stock market agreed with the skeptics, posting its worst week since February, following this news. While it is unclear at what point the Fed may begin to taper or raise rates, we at SFG believe the U.S. economy can withstand tighter monetary policy while continuing to post solid gains. In the near-term, however, expect any news signaling a change in the Fed's accommodative stance to create some bad days (and weeks) for stocks.

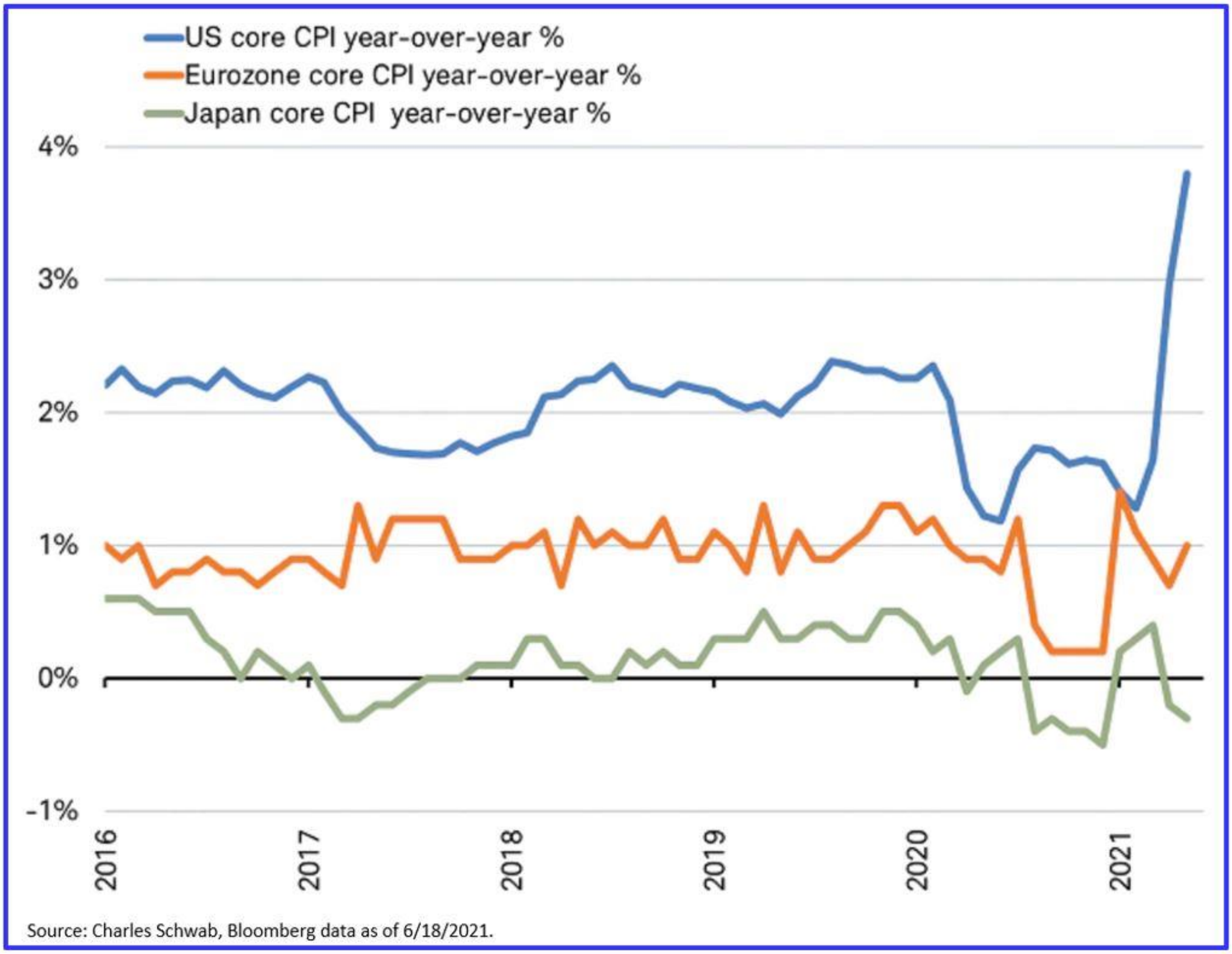
The market regained much of this mini-correction as investors got more comfortable again. In the words of Mohamed El-Erian, chief economic advisor at Allianz, "The market is getting back to its comfortable mode. Growth is strong. They still believe inflation is transitory. They believe the Fed is going to be relatively slow in tapering [monthly asset purchases], and that's why you're seeing" stocks higher. The rise in inflation, one of our wildcard risks for the U.S. stock market, remains a concern but as this checklist from Bank Credit Analyst suggests, high, persistent inflation that would derail stocks and many businesses is far from certain. Only 4 of 12 inflation danger signs are currently concerning, meaning higher and persistent inflation is not yet on the horizon.

LABOR MARKET INDICATORS	
Labor Supply/Utilization	☐
Labor Demand	X
Wage Gains	☐
PRICE INDEXES	
Marquee Indexes	X
Refined Indexes	☐
PIPELINE PRESSURES	
BCA Pipeline Inflation Indicator	X
Dollar Exchange Rates	☐
Global Inflation	☐
INFLATION EXPECTATIONS	
Market-Based	☐
Survey Measures	☐
POLICY REACTION FUNCTION	
Fed Commentary	☐
FOMC Dots	☐

Source: BCA Research – U.S. Investment Strategy: *Checking In With The Inflation Checklist, 6-21-21.*

Still, given the United States economy leads the world in "reopening," it's no surprise that we are experiencing inflation fears. As the chart below indicates, the U.S. leads both Europe and Japan in core CPI measures, year over year. Consequently, neither the European Central Bank (ECB) nor the Bank of Japan (BOJ) have indicated potential changes to monetary policy.

- In the United States, core consumer price inflation (CPI) has accelerated to an above average +3.8% in May from a year ago.
- Eurozone core CPI returned to its five-year average of just +1.0%.
- In Japan, core CPI has fallen below average and negative at -0.3%.

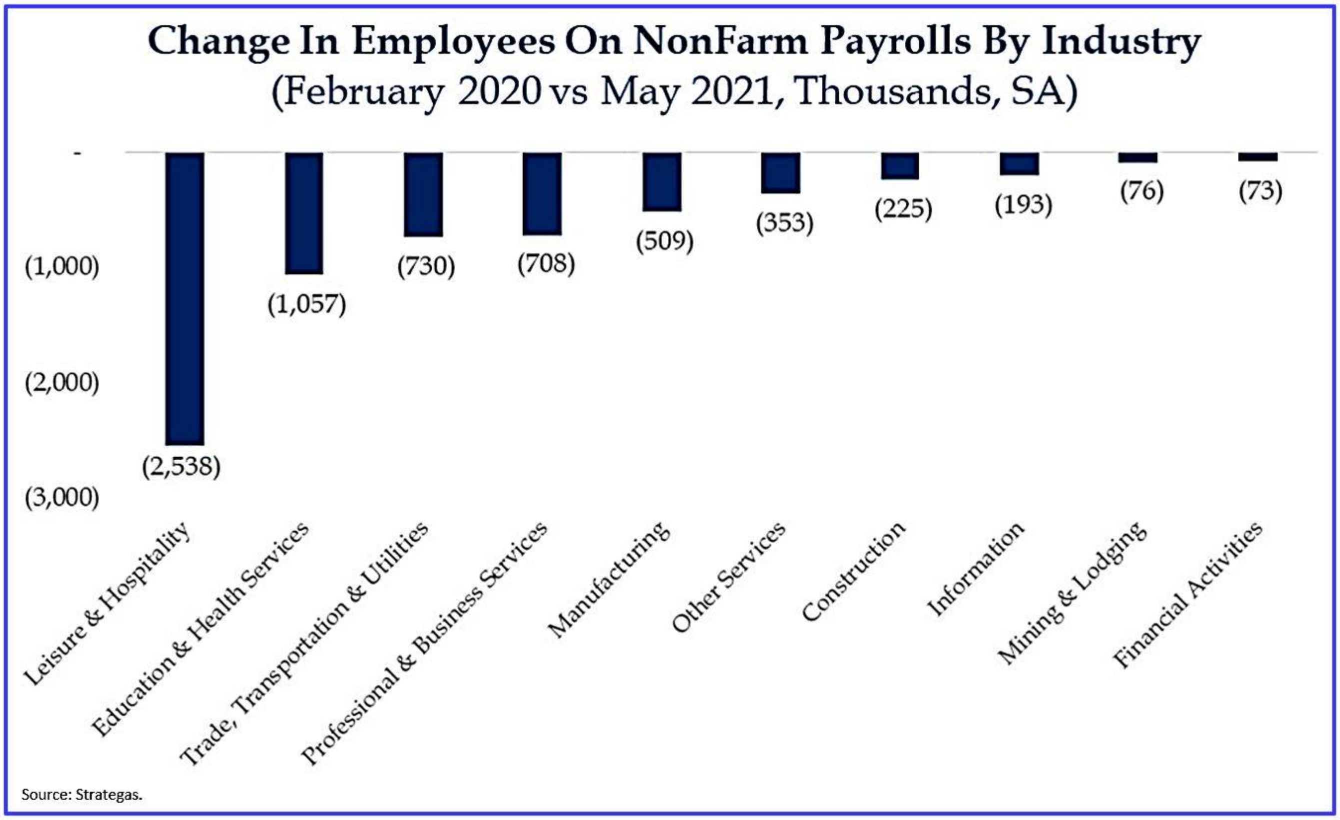


SFG's Take: U.S. stocks have become more volatile for a variety of reasons. Some stocks that have been in the crosshairs of higher corporate tax rates have rallied on news that corporate taxes may increase more moderately, or possibly not at all, depending on continued arm wrestling in Congress. Others are whipsawing in response to potential Fed hike increases and inflation fears, as discussed above. Still others are part of the "re-opening" trade and are experiencing increasing demand that will likely taper as we continue to normalize the economy.

SFG believes U.S. stocks still have room for growth, though with less upside potential than international stocks. We also believe our alternative assets provide good return vs. risk reward potential while also diversifying portfolios away from traditional asset classes.

Key Points to Consider

- **Leisure and Hospitality Still Home to the Biggest Decline in Payrolls –** While the economy still has roughly 7.5 million fewer individuals employed than it did prior to the pandemic, the leisure and hospitality industry accounts for the largest share. While it may take until the fall when the extended unemployment benefits expire to fill some of these positions, it's likely not going to return to prior levels immediately as companies have learned to operate with fewer employees.



- **Treasury Secretary Yellen Update – Cracks in the Armor? –** Strategas research believes the agreements reached at the recent G7 meeting will be difficult to enact. Their take:

  "Our base case remains a 25 percent corporate tax rate and a tax rate increase on GILTI* income. We do not expect the U.S. to shift from a quasi-territorial to a worldwide tax system.

  - **"Yellen Acknowledged an OECD Deal Will Need Congressional Approval:** Should an OECD agreement be reached, Congress will need to act. Our sense is that Congress will need to change treaties and that requires Republican votes. The idea of treaties did not come up.

- **"Yellen Expects America to Go First and Other Countries to Follow with Tax Increases:** Congress is concerned that if the U.S. enacts tax increases on multinational income first, other countries will not follow and then exploit that competitive advantage for their own gain. As such, we were struck by the lack of concrete assurances from Yellen that other countries will move in tandem with the U.S. on the global minimum tax rate and the removal of digital goods taxes. This lack of assurances means that the large-scale changes proposed to taxing multinational income are not likely to occur.
- **"Yellen Suggested the U.S. Should Impose a Country-By-Country GILTI Tax so other Countries Can Follow:** When Biden took office, the prevailing view was that Biden wanted an OECD agreement to give assurances to Congress that the world was moving together on higher taxes. Yellen specifically responded to Senator Crapo that the U.S. should act first in imposing a higher GILTI tax on a country-by-country basis to help get other countries to an agreement at the OECD. Outside the tax policy implications of this, Yellen was saying she expects Congress to act before an OECD agreement is even reached."

[*SFG note: GILTI = Global Intangible Low Taxed Income – GILTI is income earned abroad by controlled subsidiaries of U.S. corporations. It is designed to discourage companies from easily moving intangible assets, such as intellectual property rights. The tax on GILTI is intended to discourage moving such assets and their related profits to countries with tax rates below the U.S. corporate rate.]

- **"Yellen Could Not Commit To Europe Repealing Digital Goods Taxes In A Timely Manner:** Part of the OECD negotiations is that other countries will repeal their digital services taxes and replace them with a 20% tax on the largest 100 companies with profit margins over 10 percent. Senate Finance Committee Chairman Wyden started the hearing by looking for assurances that these digital taxes would be repealed and Yellen went in the other direction by noting that foreign governments have political considerations like the U.S.
- **"Yellen Could Not Provide a List of Companies Impacted by the New Windfall Profits Tax Being Negotiated at the OECD:** Before the House Ways and Means Committee, Yellen was unable to provide a list of companies negatively impacted by the windfall profits tax. This will be a bare minimum requirement of Congressional consideration. More broadly, not having the list raises questions of how much work is actually being done on these proposals.**"**

[Strategas analysis – U.S. companies make up 62 percent of the companies paying the GILTI tax and there is a belief that Treasury does not want Congress to see that taxes will be imposed on U.S. companies to fund other governments. But that position is unsustainable. Yellen noted in response to other questions that a higher GILTI rate on U.S. companies will ensure the U.S. does not lose money to other governments.]

- **"Yellen Noted That Countries May Opt Out, But Biden Proposals Pressure Companies and Countries to Join:** A real Achilles heel for an OECD agreement is that some countries do not want to participate or are asking for major exclusions. This includes China. Under Biden’s SHIELD proposal, companies will lose tax deductions if they are located in countries that have not joined the OECD agreement. This could include COGS. Yellen believes this will force these countries to join over time. We just don’t see much support for Biden’s SHIELD proposal in the Senate.

- **“Yellen Claimed That the GILTI Rate Would Be 21%, But It Really Is 26% Under The Biden Plan:** In response to a question, Yellen noted that the effective GILTI rate would be 21 percent. But Yellen also noted that proposal was not changing existing rules related to haircuts on foreign tax credits and interest, which means the effective tax rate is 26 percent.

“Summary: Taken together, it is unlikely a full OECD deal can be reached this year; therefore, it means that a large portion of the Biden taxes on multinational income is unlikely to receive full Congressional support. The more likely case is a modest increase in the corporate tax rate and a modest increase in the GITLI tax rate should the Democrats pursue budget reconciliation this year.”

Frequently Asked Questions

Q: We’ve been contemplating whether to increase our investment risk profile now that many pandemic risks are getting behind us. However, it would seem there are other risks to take their place. You suggested in the last *Chat* that most of the risks in your wildcard risk bucket have below average probability of occurring in the next 12 months, although some risks could still have a high impact. How do we consider a risk change?

A: Some SFG clients are tilting their risk level up by using the core and explore approach discussed in previous *Chats*. Adding 5-10% into “explore” growth opportunities means reducing something elsewhere in your portfolio that has more defensive attributes. Too much exploring can result in a change to your overall risk vs. reward balance which, in turn, may cause consternation during an unanticipated downturn.

How do you determine the right balance?

Having an updated Financial Independence Roadmap™ is helpful. This provides more information on return needs versus risk with each unique fact pattern. SFG overlays our custom economic and lifestyle scenarios to fire test and “life test” variables that could derail financial independence. Note there is no need to be overly aggressive if your plan works, however, being too conservative can also jeopardize financial security. We suggest discussing this issue with your financial advisor in conjunction with your financial planning.

One example where raising portfolio risk is less dangerous – higher fixed sources of income during retirement help provide a greater ability to take on more portfolio risk. Examples include pensions, social security and income from your portfolio. With that said, our clients’ desire to take on risk is generally informed more by their psychological makeup than their ability to take on risk. This is a personal decision that each client should make in coordination with their financial advisor.

One example where raising portfolio risk is more dangerous – trying to fund a lifestyle that includes many fixed expenses like second homes or excessive spending beyond one's means limits the amount of portfolio risk one can safely take. If one or more of our future wildcard risks becomes a problem, it may be difficult to adjust the lifestyle and the portfolio at the same time.

Here are SFG's primary risk and objective levels:

I. Aggressive Growth – as the name implies, this category is growth-focused with very little downside risk hedging although SFG attempts to maintain less downside risk than a pure stock index. Diversification is still an objective with occasional "fat pitch" allocations.

Target returns over full market cycle: Inflation + 6-8%.

Alternatives (for those who qualify): venture capital; private equity, FutureTech, long/short biotech.

Best suited: Clients with a longer time horizon for capital needs and an ability to weather occasional bouts of high volatility.

II. Moderate Growth – consistent with a 75% stock and 25% fixed income risk level, this category is ideal for those who want modest growth without higher downside risk.

Target returns over full market cycle: Inflation + 4-6%.

Alternatives (for those who qualify): venture capital (more diversified or secondaries); private equity (more diversified or secondaries).

Best suited: Clients with a longer time horizon for capital needs and a desire to moderate occasional bouts of high volatility.

III. Moderate Growth - to - Moderate Growth and Income – a "tweener" or transitional category between our Moderate Growth and Moderate Growth and Income strategies designed especially for those who want or need to transition to a lower volatility strategy but maintain a desire for more growth than a traditional 60% stock / 40% fixed income portfolio.

Target returns over full market cycle: Inflation + 3-5%.

Alternatives (for those who qualify): Private real estate, private credit [Higher net worth or Explore options: venture capital; private equity]**.**

Best suited: Ideal as a transition strategy to retirement for clients with a more moderate five-year time horizon for capital needs and a desire to add more downside risk protection.

IV. Moderate Growth and Income – considered the gold standard for retirement plans for decades, reinforced by numerous studies that show a more balanced allocation provides good withdrawal potential, with inflation hedging, and protection against multi-year stock market volatility that could derail a retirement strategy if stocks have to be sold to fund lifestyle needs.

Target returns over full market cycle: Inflation + 2-4% (lower than historical averages due to sub-par fixed income returns expected in the next three to five years).

Alternatives (for those who qualify): Private real estate, private credit [Higher net worth or Explore options: venture capital; private equity]**.**

Best suited: Ideal as a retirement strategy for many of our clients in the "go-go" years of retirement. Or for our clients with a more moderate five-year time horizon for capital needs and a desire to add more downside risk protection.

V. **Conservative Growth and Income –** our most conservative portfolio designed for capital preservation first with inflation protection and growth a secondary consideration.

Target returns over full market cycle: Inflation + 1-2% (lower than historical averages due to sub-par fixed income returns expected in the next three to five years).

Alternatives (for those who qualify): Private real estate, private credit [Higher net worth or Explore options: venture capital; private equity].

Best suited: Ideal as a retirement strategy for many of our clients in the "slow-go" or "no-go" years of retirement who have large resources relative to their income withdrawal needs. Or for those who don't need higher returns to meet their long-term goals and want a smooth investment experience with less turbulence.

SFG's Take: Risk analysis is unique for every individual or couple. We have clients in their mid-80s who have decided the "growth-moderate risk" category is the best fit, while we also have clients in their 30s who are high savers and conservative, desiring a growth and income strategy. And we have some clients who have segregated part of their portfolio at one objective/risk level and another (often smaller) part at a higher objective/risk level.

We can discuss the many factors that go into the right objective and risk level.

Summary

SFG's three pillars of recovery remain in positive trend territory. Wildcard risks in our fourth pillar remain elevated but not overly worrisome at the present time. 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 have favorable forward-looking risk/reward relationships.

In more conservative **growth and income** portfolios, we are balancing striving for positive real returns over inflation with risk mitigation.

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

Our offices returned to more normal on-site hours effective June 1.
We are offering in-person meetings and virtual meetings depending on client preference, so please feel free to reach out and schedule accordingly. At least initially this will be a hybrid plan to afford our staff members the flexibility to continue to work from home part time.
Please continue to call or email beforehand if you intend to drop by our office just to make sure we have the right person available to help you best on that particular day.
