Setting Sail
Third Quarter 2021

Stocks Are Our Inflation-Fighting Warriors

As the pandemic has wound down, businesses open back up, and the economy heats up, it seems we have found a new enemy in inflation. Indeed, the Bureau of Labor Statistics reports that the Consumer Price Index (CPI) rose 0.9% in the month of June and is up 5.4% over the last 12 months. Some of this gain is due to increases in food and energy, but even the core inflation rate, which removes food and energy, is up 4.5% over the past 12 months, the largest gain since 1991. This large jump in consumer prices is quite dramatic compared to what we have seen this century.

Economists are split on whether this phenomenon is a short-term disruption or the start of a long-term trend. The massive fiscal stimulus packages from Congress, and the very accommodative monetary policies of the Federal Reserve, have pumped the system full of dollars. Meanwhile, the usual international supply chains are much slower to come back online as the developing world is getting access to the vaccine at a much slower pace than here in the US.

The argument for inflation as a short-term adjustment is that these causes are temporary in nature; therefore, the effect should be temporary too. The stimulus packages seem to be done, and eventually, the supply chains should come back online. On the other hand, the size of both the stimulus packages and the Federal Reserve's efforts are truly unprecedented. Some predict that it would take several years of high inflation to reach equilibrium again.

As long-term investors, it is not our job to outguess the market and make investing riskier than it needs to be by timing it. However, it is our job to have a diversified portfolio that is ready for all different markets. So how do we prepare for the possibility of higher inflation? By holding stocks.

If the prices of goods and services go up, the seller of those products are often publicly traded companies. As they pass on their higher costs to their customers, their profits and thereby their stock price will also increase. The effect on stock values may not be immediate, but it does come. The weighty evidence of history confirms this.

Setting Sail is written by **Alan S. Campbell, MBA, CFP®** and published quarterly by **Spinnaker Financial Advisors, LLC,** a Registered Investment Adviser. The firm provides ***fee-only*** wealth management services, including investment advisory and management services and comprehensive financial planning and consulting.

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For example, the index value of the S&P 500 in June of 1971 was 100. It ended June 2021 just shy of 4,300. That's an increase of 43 times over 50 years. The dividend of the S&P 500 was $3.10 in 1971 compared to $57.87 in 2021, an increase of 18 times. Meanwhile the Consumer Price Index increased of 6.6 times. Most long-term periods will have similar results. Stocks outpace inflation by multiples over long time periods.

Whether the inflation wave stays for the long-term, retreats in a few months, or does something in between, having a healthy dose of stocks is essential to meeting most long-term goals. Stocks come with extra risk when it comes to short-term volatility, but they reward patient and disciplined long-term investors with inflation-adjusted gains.

President Biden's Proposed Capital Gains Taxes

In April of this year, the Biden Administration outlined their proposed framework for The American Families Plan, a combination of programs to help families with income and education along with new capital gains taxes. At this point, the American Families Plan is a proposal that has not been passed by Congress and may either be different when it is passed or not passed at all. However, the changes to capital gains taxes are significant enough that we should start planning for the possibilities now.

The proposed changes are relatively simple in nature but would open up complex strategies to avoid the new taxes for investors. There are four basic changes being proposed.

1. ***Increase the ordinary income rate for the highest tax bracket from 37% to 39.6%.*** This rate was reduced to 37% by the 2017 Trump tax cuts, and 39.6% is the old rate that existed before 2017. This tax rate applies to ordinary income (not long-term capital gains and qualified income) on taxable income over $628,300 for married filers and $523,600 for single filers.

2. ***Tax long-term capital gains and qualified dividends at the ordinary income rate for income over $1 million per year.*** The current long-term capital gains rate (assets held for over one year) ranges from 0% to 20%, depending on the amount of income a household has. For a married couple with taxable income under $81,050, their capital gains rate is 0%. If their taxable income is between $81,050 and $628,300, their capital gains rate is 15%. If their income is over that range, their capital gains rate is 20%. This provision would nearly double the capital gains rate from 20% to 39.6% for households with income over $1 million.

3. ***End the step-up in basis rules and tax unrealized gains at death.*** This provision comes with a $1 million exemption, but dying with assets that have appreciated more than $1 million would lead to a capital gains tax at death. Furthermore, if the amount of those taxable gains after the exemption is more than $1 million, they would be subject to the new higher tax rates.

4. ***Taxing the gains of appreciated assets gifted during your lifetime.*** The tax on these unrealized gains would apply in the year of the gift. The $1 million lifetime exclusion applies here too. However, it is the same exclusion allowed at death, so any lifetime gifts would reduce the exclusion remaining at death.

A part of the tax code that would not be affected, but is still relevant to the discussion, is the Net Investment Income Tax (NIIT) which applies a surtax of 3.8% to any investment income for single households with more than $200,000 of income and married households over $250,000 of income. With this surtax in place, there really isn't a 20% capital gains tax bracket because anyone in that bracket is already subject to the 3.8% surtax. The effective capital gains tax rates are really 0%, 15%, 18.8%, and 23.8%. This means that taxpayers with over $1 million in income would pay a rate of 43.4% (39.6% + 3.8%).

First, the good news, very few people will fall into this higher tax bracket for capital gains. It is estimated that this will only affect the top 3/10 of 1% of American households. The bad news is that it is possible that even though your income is well below a million dollars per year, you could have one year in which your "income" rises to that level when you sell an asset that has appreciated over decades, such as a business or farmland. Even those who have appreciated assets that hold them may be subject to these taxes when they die.

So, what can be done to avoid or minimize the possible new capital gains tax rates? There are a few strategies to consider.

1. ***Accelerate capital gains in 2021.*** The proposal from the President includes the provision that these new tax rates would apply to any sales made after the announcement of the plan in April 2021. However, with slim majorities in the House and Senate, the final result will likely have a start date of Jan 1, 2022. If you are retiring and selling a business or farm, this may be the year to do it. These can be complex transactions that take time, so starting now and watching the progress in Congress could end up saving you a large tax bill.

2. ***Spread out gains over multiple years.*** This is the easiest strategy that applies to the greatest number of people. Keeping your income under $1 million isn't too hard for most taxpayers. Still, it may serve you well to voluntarily take gains each year while staying under $1 million per year to avoid having it all taxed at death if the amount of gain is over $1 million. Suppose you are selling a business or real estate property. In that case, you should consider an installment sale on which you hold a note to the buyer and you spread out the capital gains over multiple tax years as the note gets paid down.

3. ***Use losses to offset gains.*** A well-diversified portfolio is sure to have a position or two that are lower than when you bought it. Selling shares of the positions with losses will offset gains that are taken in the same year.

4. ***Gift appreciated assets to charity.*** Assets given to charity avoid the capital gains taxes and come with a charitable deduction equal to the asset's value. This is one of the best tax strategies available. If you don't have specific charities or dollar amounts in mind, you can make the donation to a Donor-Advised Fund that lets you distribute the donated funds over multiple years while taking the charitable deduction in the year of the contribution to the fund.

5. ***Make sure your estate plan is set up with taxes in mind.*** If charities are part of your estate plan, giving the right assets to charities upon death while saving other assets for your family can make a large difference in overall taxes paid. This is already the case and will only be amplified if these changes are passed.

I usually reserve tax planning advice until after the legislation is passed because the final version often looks a lot different from the original. In this case, I think it is important to start planning now and to be flexible as we watch the process unfold. As your advisors, we will be bringing specific planning opportunities to you on an individual basis.

Mid-Year Update

As we turn the page to the second half of 2021, my first observation is that this year seems to be going much faster than 2020 did. With the proliferation of effective vaccines against COVID-19 and the retreat of the pandemic, the economy and regular life is opening back up and making life much more enjoyable.

Over the past year, we have seen a historic series of fiscal stimulus packages in response to the pandemic and our shutdown of some parts of the economy. In addition, we've also seen the Federal Reserve take unprecedented action to increase the supply of money in our economy.

The employment market has shifted its power towards workers. There are now more job openings than people looking for work even as unemployed people have not returned to pre-pandemic levels. Many American workers are using this pro-employee market to look for new jobs that better fit their skills and priorities.

The broad US stock market as measured by the S&P 500 ended the first half of the year at 4,297, up 15.3% including dividends. If the market ended the year at the same place, that would be an above-average year. Companies are making nice profits and the expectations for the second half of the year and beyond are that they will make even more profits.

Consumers are doing quite well in terms of cash on hand and loan balances compared to asset values. Armed with cash, they are doing their job of helping the demand side of the economy. The supply side is not quite ready to meet the demand for goods and services with labor shortages and imbalances in the global supply chain. The debate among economists is when these supply-side shortages will be worked out. For long-term investors like us, it is less important to figure when these blockages will clear than our belief that they will be worked out over time.

The historic stimulus and money printing by our Federal government have created an experiment that is impossible to predict. The question of the day is how much inflation will come from the possible overstimulating of the economy. Federal Reserve Chairman Jerome Powell has addressed this possibility and stands ready to take action, although the timing of that action may be up for debate.

All of this begs the question, "what do we do now?" First, let's acknowledge that it's OK to be scared by the unknowns in front of us. We are human, after all. If we didn't experience any emotions, good or bad, this life would lose its meaning. Our fears are more than just numbers on a monthly statement or flashing on a computer screen. Our investment portfolio represents trips we didn't take and clothes we didn't buy so that we would be better prepared for the future. When we talk about markets, we're really talking about our greatest hopes, goals, fears, and dreams, like sending our kids to college or not running out of money in retirement.

If we can press the rewind button in our minds, let's revisit the reasons why we started investing in the first place. Good investing is always goal-focused and planning driven, so ideally, we started with certain goals. A common one is retiring at a certain age and with a certain income. The goals have probably evolved over time and may include multiple generations, but they are still goals to invest for.

The design of your investment portfolio is based on taking the least amount of risk to achieve the stated goals. Our portfolios are designed with the weighty evidence of history to give us a sense of how markets behave over time. That history includes economic recoveries like this one with high asset values and rising costs.

If our goals haven't changed and the investment process is solid and based on the long-term history of the markets, then our best course of action is to stay the course. That may sound like a cliché at a time when you want something more complicated, but that doesn't mean that something else will work better.

Most of our goals are not in the next 12 months. If they are, we shouldn't be taking risks with those funds. Most of our goals are multi-decade and even multigenerational. As of June 30th, the interest rate on the 10-year US Treasury bond was 1.5%, while inflation over the previous year was 5.4%. Fleeing to bonds may feel like the only solution to market turmoil, but it is no way to meet our goals.

Having advised clients through multiple market cycles, I have found that predicting market tops is impossible. In the past, when the market reaches a high, it is more likely to reach another new high than to suffer a correction or bear market. Simply being at a high isn't reason enough for a decline. Now is the time to trust the plan and have faith in the future.

> ***"Inflation is the one form of taxation that can be imposed without legislation."***
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> ***--Milton Friedman (1912-2006)***
> ***American economist, statistician, and Nobel Laureate***