Planning & Investment Strategy

Summer 2021

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Topics Reviewed in this Edition

- **International vs. Domestic Equities: In our beginning of year newsletter, we highlighted the better relative performance we had started to observe from international equities. That trend lasted for a while but faded in recent weeks as the first half of 2021 ended.**

- **Also, in our last newsletter, we described master limited partnerships (MLPs) as a "fat-pitch" opportunity. We turned out to be right and returns for this sector have more than doubled the performance of the stock market over the first half of the year.**

- **Will inflation be a problem? There are transitory causes of inflation and then there are more permanent forces. We will review some of these herein.**

- **No changes have been made to the tax code yet, but chances are good that taxes will rise, at least moderately, for many investors in the next couple years. Tax-smart investing and planning will have renewed importance. We are ready to help.**

International vs. Domestic Equity Performance

We continue to experience unprecedented outperformance by U.S. companies compared to the foreign stock markets of the world dating back to the period following the Great Financial Crisis. We have written about this several times over the last few years when we noted brief periods of international equities doing better than the U.S., but it hasn't continued for more than a few months so far. Another example of this occurred in the first half of this year when foreign stocks did about the same as the U.S. at least until early June. Since then, the U.S. indexes have outperformed, primarily to the large technology companies that control the movement of the indexes. We think this is likely due to the emergence of some COVID-19 variants that may have investors worried about the durability of the current economic recovery. See the chart below for this recent perspective.

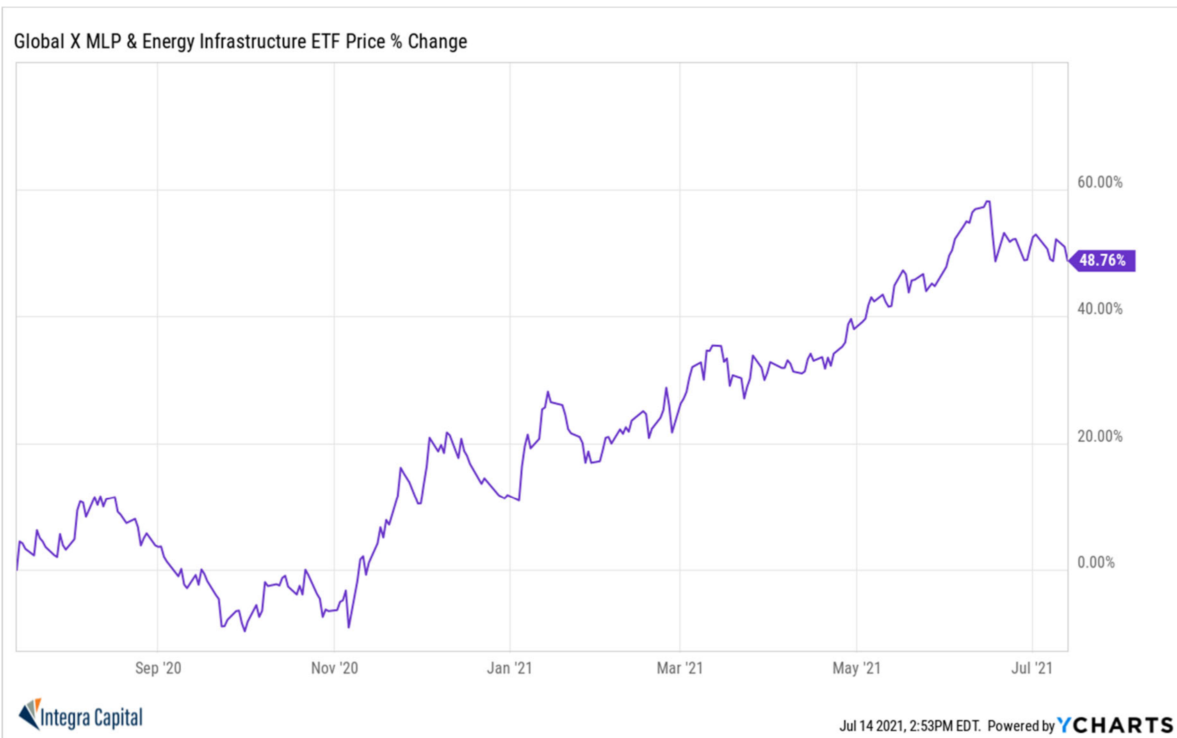
At some point we will embark on a period where the rest of the world's stock markets are more competitive with the U.S., but for now our focus remains primarily domestic.

Master Limited Partnerships (MLPs)

Master Limited Partnerships are a special corporate structure that companies engaged in the transportation of natural resources may use. The largest segment of MLPs, by far, are the pipeline companies which transport crude oil, natural gas and gasoline from and to the places it is needed for refining, storage and distribution.

The share prices of MLPs suffered greatly during the economic slowdown caused by the COVID pandemic and the shenanigans between the Russians and Saudis late last spring that caused oil prices to drop dramatically. We established a position in our diversified portfolios around that time. We added to the position later last year as we began to note signs of the economic recovery and a rise in the price of oil. MLPs really returned to favor in the first half of 2021 and we have enjoyed some nice gains as well as a relatively high income distribution over the last 12 – 13 months.

We called this a “fat-pitch” opportunity because although there was some risk of some pipelines going out of business, quite simply the country cannot operate without these businesses. If you think the COVID recession was serious, imagine not being able to get fuel for motor vehicles or natural gas for homes and electric power generation. In other words, these vital businesses would not be allowed to go out of business. The chart below shows the recovery of this asset class over the last year.



Inflation or No Inflation?

The debate of the year so far in 2021 seems to be whether we will witness the return of higher inflation. For some perspective, the long-term rate of inflation over the last 90 years or so has been around 2.9% average. But, for the last decade the rate has been in the range of 1.5% to 2.0%.

The current economic recovery combined with shortages of some materials, caused by supply chain disruptions from the pandemic have created recent inflation readings to come in higher – around 5% or so. We believe these recent measurements are mostly transitory (temporary) and will come back down as higher prices incentivize manufacturers to produce more.

There are also still some deflationary forces at work in the world. Declining populations in Europe, Japan, and soon China may act as a damper on inflation. Technology advances continue at a high rate allowing companies and individuals to do more with less labor and materials input.

One measure of inflation expectations are bond yields. Early in 2021, the yield on the 10 Year U.S. Treasury Bond rose from just under 1% to about 1.75%, a large increase as investors became spooked by inflation concerns. In the last three months, the yield has come back down to about 1.36%. This decline in yield shows that bond investors aren't as worried today about inflation as they were a few months ago. It is foolish to assume we can predict the future of inflation with any certainty, but it makes sense to prepare for potentially higher inflation with the extreme levels of monetary and fiscal stimulus in the economy already, and more likely to come in the next couple years.

Inflation is actually a positive factor as long as the rate remains fairly low and steady. Think about it this way. Inflation is a sign that there is growing demand for goods and services, which in general indicates increasing employment and rising corporate profits. If the opposite occurs and demand for goods and services falls, then prices can drop, profits fall and workers are laid off. This is how a recession starts and that isn't fun for anyone, including investors.

At the moment we are watchful on the matter of inflation and bond yields. If the 10 Year Treasury Bond yield stays under 2% - 2.5%, it would signal that the rate of inflation will remain under control. A rise to over 3% would send a message that higher inflation may be here to stay for a while.

Tax Policy

No tax policy changes have occurred so far under the Biden administration, but there is a high likelihood of some tax increases for the wealthy and high-income earners in 2022. Potential changes seem to include an increase in the top federal tax bracket back to 39.5%. This would affect those with taxable income greater than $400,000.

There is also speculation on increasing taxes on capital gains and dividend income, again for the higher wage earners. We believe these rates will remain preferential to ordinary income tax rates but are still likely to rise. The current estate tax exemption is likely to be reduced from the current level of $11.7 million per individual, which would make more estates subject to the tax. We doubt the exemption will be reduced all the way back to levels before the 2018 tax law changes were implemented but be ready for some changes.

There are actions you can take to minimize the impact of potential tax increases. The first of these is to have the correct “asset placement”. This refers to holding certain types of investments where the tax impact is most favorable to you.

For example, if you are a long-term holder of high-quality dividend paying stocks, placing these in your taxable brokerage account is an effective way of minimizing tax due to the preferential tax treatment of qualified dividend income and long-term capital gains. Placing investments that generate ordinary income, which is taxed at higher rates, in tax qualified accounts, like IRAs, doesn't hurt anything since you are only taxed on IRA distributions as they are taken. Proper asset placement isn't always easy but a review of your allocation and a conversation about this during your next review meeting with us would be time well-spent.

Integra Capital Advisors has invested in a tax efficiency software program that we can use to help our clients with more complicated tax situations identify changes you can consider to minimize your level of tax liability. The software requires an electronic copy of your most recent tax return. Call your advisor here at Integra to discuss if this analysis would be appropriate for your situation.

In closing, while it is easy to get worked up by the thought of tax increases, a review of history over the last several decades reveals that we dealt with higher tax rates for most of the time. Yet, the economy grew, the stock market rose and technology and healthcare advances continued to make our lives better each decade. Current challenges always are the most daunting but looking back there have always been challenges to deal with and we made it through each one with more prosperity on the other side. We believe optimism is a self-fulfilling cycle and we look forward to working with you on the challenges and your prosperity. Have a great summer!