RBC Wealth Management

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"Stuff…"

— Steve Spence, July 16, 2021

Dear Friends,

As you know, it is our custom to try and come up with some form of clever and relevant quotation to introduce the topic *du jour* for our Client Letters. At the moment things around our shop resemble a bee hive with much coming and going. It's hard to know where to start. Seems we have lots of *stuff* to talk about. Hopefully by the end of the letter we will come up with some clever form of inspiration to close this edition.

Inflation: A Natural Enemy to Stocks

Boy, do we have it. Starting with big things like homes that go on the market and sell in one day at a price above the inflated number at which the property was listed. New automobiles are very hard to come by and dealers are reported to be selling the few cars they get their hands on at prices above sticker. Anyone have a dishwasher quit recently? Be prepared to wait ninety days for a replacement and to pay *full* price for your third choice. What makes this so confusing is that inflation has come about during a time when the economy was largely shut down. Since we have not had a serious bout of inflation since the 1970s and early '80s, we thought it would be useful to discuss how inflation may impact stocks.

In its simplest form, a sustained bout of inflation will almost certainly result in interest rates finally waking from their Federal Reserve induced stupor and moving up to more traditional levels. Let's define this level as a 3% one year CD. While that figure would certainly not be characterized as high by the standards of the 1970s and '80s, it would be reasonable to conclude that a 3% low-risk return would inspire movement of money out of stocks and into safer harbors: clearly a tidal shift and one which could be expected to put downward pressure on the prices of stocks. Another aspect of inflation is that the costs of both labor and materials tend to escalate, squeezing profits for businesses if they are unable to pass along these costs to consumers in what may be a slowing economy. Given that stock valuations are now at near all-time highs in relation to earnings, there is little if any room for disappointment in reported profits. We find this picture to be worrisome and reason for breaking out the yellow caution flag.

Capital Gains

We are quite fond of them and know that you are as well. Governments like them, too, as they trigger payment of taxes. Let's take a look at Washington State which recently passed a new 7% levy on capital gains by cleverly but wrongfully relabeling such a tax as an *excise tax* as opposed to an income tax. (The state's constitution prohibits taxation on incomes.) At the same time, the Feds are proposing to raise the top tax rate to 43.4% from the current level of 23.8%. Looking to the south, the Wall Street Journal reports on a combined federal and state basis that California will have a top tax rate of 56.7%, Oregon at 53.3%, Washington at 50.4% and Idaho at 50.3%. The concept of governments imposing a top marginal tax rate at roughly half of investment returns while putting no capital at risk contorts our collective minds. Now for the good news. We are not defenseless. First, an increasing portion of our clients' assets are held in retirement accounts upon which no taxes on gains are due at sale. Secondly, we can minimize capital gains taxes by simply holding good companies throughout multiple economic cycles. No sales, no capital gains taxes. Taxation of *gains* at death as opposed to a step-up in basis is under discussion as well but the outcome there also remains open. Suffice it to say that we are highly attuned to this matter and are prepared to adapt our practices as necessary to maximize your returns *after tax* over time.

Irrational Exuberance

Roughly twenty-five years ago, then Federal Reserve Chair Alan Greenspan coined this phrase as it related to an investment mania then called dot-com stocks. Start-up technology companies were able to come public based on concepts as opposed to the measurable metrics that drive sustainable value such as sales, revenue and profits. Suffice it to say, this story did not end well. In some cases, companies went round trip from IPO to bankruptcy in a year or less leading to a bear market lasting nearly two years. As the old saying goes, history may not repeat itself, but it does often rhyme. This cycle's dot-com clones include the following categories, none of which are of interest to us.

Special Purpose Acquisition Companies (aka SPACs): A financial sponsor raises capital in an initial public offering with the intent of *then* attempting to find a company that can be taken public via the SPAC. For reasons we cannot explain, these SPACs have until recently tended to move up in price based upon simply having been formed.

Nonfungible Tokens (*aka NFTs*): This one is so new that spellcheck does not even recognize it! An NFT is defined as a digitally based token that evidences ownership of a one-of-a-kind asset such as a particular photograph, recording, artwork or sports trading card. Not the original: just a digital copy.

Crypto Currencies (Bitcoin and its growing number of clones): You know this one… digital "money." Useful to crooks for payment of such things as ransom. Crypto currencies have slumped 40% in price over the past six weeks. Not our idea of a place to safely store your savings.

Meme Stocks (Meme is defined as an element of "culture" that is passed from one person to another): Financial information provider Morningstar describes these stocks as "a pure child of the 2020s" and characterizes them thusly: "Jokes apart, meme stocks are stocks that trade wildly, mostly fueled by people on social media. These stocks rarely have fundamentals which back a rise in price and whose chief characteristic is volatility."

Our point in bringing all of this up is that there is a rich history of silly behavior in the name of "investing," which in fact is just wild speculation *and which tends to occur near the end of bull markets*. As a form of excess, it is often driven by easy access to money, momentum, volatile markets and, of course, greed. You can count on us to leave all of this business to others.

Valuations for Stocks

Stemmy. Rich. Expensive. Priced to perfection. You get the point. There are always exceptions, but for the most part, stocks have already baked into the cake the benefit of a fully recovered economy. Earnings are about 15% higher than they were *two* years ago (this comparison chosen so as to blunt the COVID effect) but the S&P 500 is trading at nearly 50% higher than it was in July 2019. Clearly there is some form of disconnect taking place. Perhaps the market is collectively seeing a far better economy over the next year or two than current consensus, which would normally result in better corporate earnings. But we should not forget that elements of Congress are considering a rather dramatic increase in both corporate and personal income taxes which, if enacted, would clearly present a meaningful headwind to growth. We discussed inflation earlier in this letter, which could become another headwind. Higher interest rates could cause money to move away from equities and into fixed income investments. Bottom line: we see lowering allocations to stocks as being timely for most clients and are so engaged on your behalf.

A Personal Note

Come Labor Day, your writer will celebrate his 50th anniversary in the investment business. It is fair to say that I consider myself to be an extraordinarily fortunate person primarily because I have had the opportunity to work with all of you, dear Readers. The enjoyment I have experienced has been hugely magnified by my partners of decades, Marcia, Chris and retired partner Kip Acheson, as well as the rest of our team, Kathy, Shana and Sam. These penultimate professionals have made it possible for me to stay on the job I love for many years. While I have no plans for immediate retirement, I do look forward to more time with family and at our home and on the boat in the San Juan Islands. My thanks go out to each and every one of you, our remarkable clients, for your support and encouragement over these many years and for more of same for our team in the years to come.

We began this edition of our Client Letter by referring to the *Stuff* we wanted to discuss with you but deferring our customary (yet clever) quote to the end. For those of you who are thirty-year readers, you know we love quoting the King of Malapropos, Yogi Berra. Herewith follows one of his classics, especially relevant to our times:

> "When you come to a fork in the road, take it…"
>
> — Circa 1987

Best regards,

Steven N. Spence	Marcia M. Hull	Christopher P. Klavins
Senior Vice President	Senior Vice President	Senior Vice President
Sr. Portfolio Manager-Focus	Sr. Portfolio Manager-Focus	Sr. Portfolio Manager-Focus
Financial Advisor	Financial Advisor	Financial Advisor