OCTOBER 21, 2021

I. Market Overview - Mixed Signals

As the third quarter ended, the S&P 500 stood within 5% of its all-time high. Yet, investor sentiment was almost as negative as it was in the spring of 2020. The Bureau of Labor Statistics estimates that there are 10 million job openings in the United States, 33% more than in 2019. Yet, the number of unemployed Americans is almost 45% greater than before the pandemic. The Conference Board survey of consumer confidence declined each month during the quarter, yet those surveyed also felt that jobs were easier to find than at any time in the last 20 years. A quick Google search of the phrase "mixed signals" returns a cascade of dating advice but, sadly, no investment wisdom. Left to their own devices, equity investors marched nearly in lockstep, pushing most indices higher in July and August (small cap and emerging markets were notable exceptions) before reversing course in September to finish the quarter nearly where it began. Interest rates followed a similar path, but bond investors proved the more nimble, reversing course nearly a month ahead of the equity crowd.

As ever, all eyes are on global central bankers, especially Jerome Powell, chair of the U.S. Federal Reserve Bank. Since the beginning of the pandemic, central banks have uniformly pursued easy monetary policy, injecting a vast amount of liquidity into global economies. As we have written, we believe that this mountain of cash has been a key contributor to buoyant financial markets. Monetary support cannot last forever. We've reached a point in the economy where some accommodation can be methodically removed. The incremental gains from continuing to purchase Treasuries and mortgage-backed securities are minimal. Inevitably, central bankers will first turn off the spigots then slowly withdraw excess liquidity from the financial system. There is much speculation about when and how rapidly this will occur. The Fed has a tricky dance ahead of it. Removing accommodation faster than the market expects could risk slowing down the economic recovery. Many lines of copy will be written. Most predictions will be wrong, but time will tell.

"Markets Shrug off China and Focus on Easy Money Instead" – Barron's headline from September 24, 2021

While we agree that the direction of monetary policy should be vitally important to investors, we caution against getting locked into a single indicator. We believe that market participants are too easily inclined to ignore other events, some of which could have a real impact on certain asset prices.

China is just one of these, and there are two fronts that bear watching. The nation is clearly accelerating military aggression toward Taiwan. While an armed conflict seems far-fetched, a war of words could rattle markets. The other battleground is purely economic, as the Chinese government has unleashed a torrent of regulations aimed at constraining the free-market ambitions of some of the country's largest and most successful enterprises. The first targets have been internet stocks and tech entrepreneurs like Alibaba and its founder Jack Ma, and Didi

Chuxing, China's version of Uber. The once highly prosperous for-profit tutoring industry has been virtually wiped out. Investors in the sector's largest players, Tal Education Group and New Oriental Education, saw billions of dollars of market value evaporate as the companies' stock prices declined 75% virtually overnight. What happens next is anybody's guess. What is clear is that the Chinese government has the power to act swiftly and unilaterally in ways that are outside the frames of reference of western investors.

"It would be catastrophic to not pay the government's bills." – Janet Yellen, U.S. Secretary of the Treasury

Legislators in the U.S. also deserve attention, though investors should be more concerned about inaction than action. Secretary Yellen spoke forcefully and alarmingly on October 5. Stock markets seemed to pay no attention as prices actually rose afterwards. While an eleventh hour deal was struck to postpone a government shutdown, the issue of raising the debt ceiling has yet to be resolved. We hope that we will not be writing about this again in our year-end investment commentary. If the subject remains an open item, we suspect that investors will be paying closer attention. On the other hand, we remain optimistic that Congress will pass some form of spending bill. As we predicted last quarter, the final amounts will likely be lower than first advertised.

On a more optimistic note, we think that investors are underestimating the chances of good news about Covid. It may be difficult to recall that, as recently as June, it seemed that Covid might be under control. When vaccines became widely available in the spring, daily new cases declined rapidly, falling in half between the end of April and the end of June. There was a general return of optimism, which was reflected in broader economic strength. Airplanes, restaurants, and sporting venues started to fill up. Retail foot traffic increased.

In our July 22 investment commentary, we pointed out that some investors were just starting to become concerned that the Delta variant might slow or postpone the nascent economic recovery. We believe that consumer attitudes and behaviors did change in response to a Delta-induced rise of Covid cases. The drop in consumer confidence cited above is a good example. But, once again, the number of Covid cases is starting to fall. Our economy is set up for a stronger than anticipated rebound, which could lead to a faster-than-expected rise in corporate earnings. Companies that stand to benefit most from this rebound should see increased investor interest.

"*There is still a long way to go before reaching maximum employment," Williams said. "And over time it should become clearer whether we have reached 2% inflation on a sustained basis."*
– New York Fed President John Williams

A stronger economy could rekindle the debate about the duration of higher levels of inflation. However, we do not believe that a stronger economy will spur central bankers to raise interest rates too quickly. The statement above is a clear message that the Fed is sharply focused on getting people back to work. Inflation will take a back seat until the goal of "maximum employment" is close at hand.

As noted, we are concerned that investors are underestimating certain risks. Saber rattling in China or more partisan brinksmanship in Washington could lead to a quick decline in stock and possibly certain bond prices. Media outlets would trumpet the bad news. However, we believe that low interest rates and abundant liquidity would continue to underpin equity valuations and that a strengthening economy would be positive for credit markets. In such a scenario, markets could be uncomfortable for a period but provide ample opportunity to upgrade portfolios and make new investments at attractive valuations. In any case, we do not believe that market damage would be long-lasting or severe.

II. Portfolio Insight – The "Reopening" Theme

Investment themes can be useful tools when it comes to bridging the gap between seeing the big picture and focusing on the small details of specific investments. Themes can be either short-term or long-term. We often consider longer term themes or trends when trying to determine which businesses will enjoy sustainable competitive advantages, leading to continuing high levels of profitability. Shorter term themes can be both powerful, volatile and difficult to accurately or profitably predict. When short-term and long-term trends have conflicting impacts on individual investments, opportunity is often the result.

The Reopening Trade is Over – Barron's Headline June 25, 2021

The so-called "reopening trade" is a textbook short-term theme meant to take advantage of companies that would most benefit from the return to a more normal, post-pandemic economy. Airlines are a perfect example. Throughout 2021, the "reopening trade" has been an important arbiter of stock market success. For the first five months of the year, stocks considered to be reopening winners outperformed. Starting in early June and especially during most of the third quarter, these reopening plays underperformed as the Delta variant spread across the globe. In fact, the Goldman Sachs basket of stocks most dependent on reopening declined -14.3% from peak to trough (the S&P 500 was up 1.5% during the same period) and was down -0.9% during the third quarter.

The "reopening" theme subjects certain companies to a binary outcome. United Airlines' stock will soar (pun intended) if Covid is eradicated in the next few months and will decline if a troubling future variant emerges. Other considerations, such as whether corporate travel has been permanently disrupted or the price of jet fuel (the largest single input cost), are of secondary concern. In our investments, we generally look to avoid binary outcomes, and we have taken the same approach with "reopening trades".

That does not mean that our portfolios do not have exposure to the economic normalization that we believe will continue. In fact, we believe that, with so many market participants looking to bet on the extreme winners and losers, they are ignoring many businesses that sit in the middle, where reopening is of secondary concern. Examples would include our portfolio holdings that help facilitate credit card and other, faster growing electronic payments.

The central thesis behind these investments, is the inevitability of the shift from cash and even checks to digital forms of payment. On that score, the pandemic has been positive, accelerating the cash to digital conversion by multiple years. However, the collapse in cross-border travel, the closure of many small businesses, and the overall decline in retail sales had a pronounced negative impact on transaction volumes across the payments ecosystem.

As a result, these businesses were not seen as clear Covid winners (i.e. Zoom) or reopening winners (i.e. airlines). With shares of these companies still below pre-pandemic levels despite higher earnings, we are excited about their prospects. We believe there is a high probability of double-digit growth going forward and room for valuation multiples to expand.

Market participants with shorter time horizons seem to feel that they can capture greater profits by correctly predicting the path of the pandemic and its near-term effect on the economy. In our view, this is a strategy with a very poor chance of success and a severe penalty for being wrong. As we see with our payment processor investments, such trading activity tends to obscure the more durable advantages secured by exposure to long-lasting shifts in behavior or technology. We look to take advantage of these moments, when short-term traders create opportunities for long-term investors.

III. Personal Finance – Keeping an Eye on the Tax Code

Since the election, a clear priority of the administration has been to change the current tax code in order to fund their spending initiatives. Last month, the House Ways and Means Committee outlined its proposed legislation. While far from certain, the bill does contain some provisions that seem likely to be passed. While we urge you to consult your tax advisor about your own situation, we thought it would be helpful to provide an overview and some thoughts about how these changes may impact your income, your portfolio and your wealth (we would be happy to discuss anything below with you and your tax advisor).

Under the committee's proposal, the highest individual marginal rate would increase from 37% to 39.6% for single payers over $400,000 in adjusted income or married couples over $450,000, and for trusts over $12,500 in taxable income. There would be an additional 3% surcharge on adjusted gross incomes over $5 million (for married couples filing jointly) and on trust and estate income over $100,000. The top long-term capital gains rate would move to 25% from 20% for high earners (a large gain would of course automatically define a payer as a high earner).

There are several important proposals that impact the transfer of wealth, both while living and at death. Most broadly, the current lifetime unified credit (gift, estate, and generation skipping) of $11.7 million would be reduced to approximately $6 million per individual. There is also a broad proposal to limit the use of grantor trusts for wealth transfers. This proposal would require the inclusion of irrevocable grantor trusts in a settlor's estate (most are designed to be excluded from the estate) and would also deem as a gain, transfers between the settlor and the trust. This would nullify or reduce the usefulness of many popular planning techniques, such as intentionally defective trusts, grantor retained annuity trusts (GRATs), insurance trusts and others. These changes would be effective on the date of enactment, which could be earlier than December 31.

There is also a proposal to limit discounts that are commonly applied to certain gift or estate assets.

The committee also issued several recommendations regarding retirement plans. The proposals largely impact high income earners with large account balances (defined as $10 million). These proposals limit further contributions and would require certain distributions in these cases. They would also restrict the use of Roth IRA conversions for high-income individuals.

While these proposals may not impact your taxes directly, the committee is also proposing higher marginal corporate tax rates and the elimination of some of the benefits of income in offshore tax havens. These changes would mathematically have a negative impact on corporate net income and may weigh on equity prices. But the proposed rates are still less than the pre-Trump administration levels and may be negotiated lower still.

The committee's outline includes many other specifics that we did not address for brevity, and the legislation will likely go through several more iterations. Of course, the tax laws have changed before and will certainly change again.

We believe that tax awareness is critical to wealth preservation. But it is often counterproductive to make major shifts for tax purposes, especially when they are just proposals. That being said, the tax impact should be a factor in any planning decision. If you have the clear intent and ability to transfer wealth to your descendants, it makes sense to do it before the proposed changes are enacted. If you have gains that you expect to generate, again doing so before higher rates are enacted makes sense. Many of the increased tax rates are on income; where you can control the timing of your income to minimize taxes is good planning. Ultimately a well-allocated, tax-aware and long-term compounding portfolio will remain the best wealth preservation strategy.

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