Market Insights: New Developments, What to Consider, and Top Questions Answered

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello and welcome to Market Insights. Thanks for joining us today. I'm Jim Armstrong with Fidelity. If you've been following the news even a little bit, you've heard about the ongoing pandemic recovery plans. In fact, just last week, the president spoke to Congress about the elements of his trillion-dollar plans, and that level of spending has a lot of people thinking about the potential tax hikes needed to pay for it. So today, we wanted to take a step back and look at the past to see what's happened historically when taxes have increased, especially before we make any personal decisions about our money or our investments. So to have that discussion, we are joined by Jurrien Timmer, who will catch up on his ongoing work, of course, studying the economy's big picture, and what it might mean to us, particularly when it comes to taxation. And Jenn Sirois is back again this week to talk about how she helps Fidelity customers build and update their financial plans in the face of tax uncertainty and other factors as well. Jenn, Jurrien, thanks for coming back this week.

Jenn Sirois: Thanks for having me back. Happy Tuesday, everybody.

Jurrien Timmer: Yeah, happy Tuesday. With all the talk about inflation these days, I figured I'd channel my inner 70s—by which, I don't mean my age because I'm not, but I'm not. What the heck. Here we go.

JIM ARMSTRONG: Very nice. Before we start, a quick note for our regular viewers—especially our regular viewers. The Market Insights family has grown by one. By one small but beautiful baby girl. Liana Devinney gave birth just a couple of weeks ago. Everyone's doing well, and we've actually got a picture to share at the end of our discussion. So a reward for sticking up to the—sticking through the end of the conversation. So, Jurrien, it is May 4th—Tuesday, May 4th. And before we get too deep into the taxes conversation, you've built a new chart that tells a story about where we are as a whole, but it's a chart I think you're going to need to walk us through a little bit, because at first, I'm not super sure what to make of it.

JURRIEN: Yeah, well, it's a good thing I'm wearing my reading glasses. But—so, you know, every few months or so, I like to update kind of where we are and we're now four months into the year—so one third along the way. And so what I like to do is you is just, you know, you might remember this from your high school chemistry class, but this is the periodic table but, in this case, not of the elements but of investment returns. So I don't expect you to be able to read all of this, of course, but it gives you a sense of how the asset classes that I look at, at least, rank from year to year from best to worst. And, you know, the thing I want you to take away from this is—actually two things. One is this is why we diversify or why we should diversify because as you can see, these little colored dots are never in the same for place very long. They're all over the place, so if you have a portfolio consisting of one thing, it's going to move around a lot, but if you have a portfolio consisting of many things, they're all going to balance each other out most of the time, so that's kind of one take away. The other one is that if you look closely, you can see that the assets that worked best last year are kind of towards the bottom this year and the ones that were towards the bottom last year are at the top this year. So commodities were these second to last one—you know, the second from worst last year—they are the third from the best this year. Or the fourth one. The same with value, small caps. Real estate was the worst last year—it's the third best this year. And so the point is that this has been a year of mean reversion, right? So whatever it was—worst last year is first this year because, of course, a year ago, we were in the midst of a lockdown and a pandemic and the more cyclically oriented classes obviously suffered the most, and now they've come roaring back, and the asset classes that provided safety—long term bond storages are now at the bottom. So it's just kind of a fun visual way of catching us up in terms of where the world is at—at least from an investing point of view.

JIM: Thank you for that. That's great. I like starting with a bit of fun, especially when the rest of the conversation will end up with talking about taxes. So, Jenn, we'll turn to you to talk about that. And Jurrien, I do want to certainly follow up with you about taxes as well. But Jenn, I thought we'd start with you to sort of set the table in terms of what's on the minds of our customers. You know, again, as I mentioned last week, President Biden talked about a massive vision for the country post-pandemic—a vision that includes a lot of spending and therefore probably a lot of taxation. We know that resonates with customers—everyone watching right now has an opinion on taxation. I think we can guess where most folks' opinion lies. First, what are you hearing? And then how do you sort of—how do you respond to what you're hearing?

JENN: That's a great question, Jim. And I'll tell you, I'm hearing a lot—a lot of discussion. So first, I'll mention that we're discussing today tax strategies that apply to personal investments. So, brokerage account, for example—but your work place savings like 401K, 403B, IRAs—those are tax savings vehicles in and of themselves and should be leveraged to help cut down overall taxes for your household. A lot of the families and individuals I've been speaking with lately—just to give you an age range—mid 50s to mid-70s—I'd say their top question, if it's not the number one, is:

what is going to happen to taxes? I already feel like I'm paying a lot. So, I'll admit, Jim, no crystal ball here. So what we do talk about is controlling what they can with the current tax information that we have, and there are ways for them to, you know—are there ways for them to stay invested for growth potential but at the same time have a strategy that's efficient on the tax front? So it's always a good go-to to help manage expectations if we take a trip down memory lane, so I'm going to speak to the chart here for a moment. But if we go back to 1950, we can see that there are 13 different tax increases—combinations of higher taxes on personal income, on corporate income, on capital gains, or sometimes all three at once, but the takeaway here is in almost every case, the S&P 500, you know, the stock index that tracks most major companies in the U.S., has shown higher average returns and higher odds of an advance when taxes are increasing. It can get complex, but the thing to remember is that changes to the U.S. tax code are not happening in a vacuum. There's usually a lot of other action going on in Congress around the economy in general because there are economic needs driving the actions. If tax money is getting spent—that's on infrastructure, for example—that means jobs and salaries. So really, to sum it up, when families are asking about taxes, we go back to the conversation around the debt that's been created within the country. How does that eventually get paid back? And talking about the challenge—going back to this chart here—is the challenges of what taxes could actually be increased. And, again, no crystal ball there for you on that one, Jim.

JIM: Unfortunately not. I do want to go a little bit deeper with you in a moment on tax strategies for investors. But first, Jurrien, I'd like to hear from you—again, just as a student of history. I know you think and work a lot about this. What can the past tell us? What do you think investors should make of the potential for higher taxes?

JURRIEN: Yeah, and, you know, I think Jenn makes some excellent points. You know, we have to look at the totality of the policy. Right? So, obviously, we're hearing a lot about the Biden administration's fiscal policy, and that includes spending as well as taxes. And, you know, we have to look at what's called the multiplier—like, the fiscal multiplier of spending. How much growth does that add versus the negative multiplier on taxes, right? So if the positive multiplier on spending exceeds the negative multiplier on taxes, the economy is still going to grow. Now, that may not help us individually who pay higher taxes, but still, from a macro point of view, that's kind of how I look at it in terms of what it means for the market. So, you know, as Jenn pointed out, oftentimes the market actually goes up when taxes go up, which maybe is counterintuitive but that's because there's other things going on that are driving growth but, you know, when you look at this chart—this goes back to 1900. I show the dead level in the top panel, and that little orange line is the CBO's projection of where debt to GDP is going to go and, you know, it's a pretty scary line. You know, we're going to have a lot more debt in this country, and you can see historically, that when debt goes up, you know, it doesn't always get paid for, but it ultimately, you know, got—policy makers will try to get it paid for in one way or the other by growing the economy fast enough that—as a percentage of the economy, the debt stock goes down. Sometimes they'll just try to inflate their way out of it through negative through rates, and we've talked about that many times in the past year, but oftentimes, taxes will go up as well, and we see, for instance, in the 19, you know, 20s—like, often the taxes go up during periods of war, which is also when the debt goes up. Right? So you'll see on the left, World War I, then a big dip in taxes during the 20s when we had the, you know, the roaring 20s, basically. Then they went back up again in the 30s in the aftermath of the great depression and then in the 40s, during World War II, and then, you know, slowly, gradually went down again, but there's always nuance, right? For instance, in the 1930s, the tax rate went way, way up, but the but the income level at which those taxes would apply also went way up. It actually went to—the top bracket was actually—would be triggered at $5 million of income, and this is during the 1930s. I mean, that would be a lot of money in any year, but especially in the 1930s. And then in the early 40s when the U.S. went to World War II, the tax rate went up even higher to, like, 88 percent.

But, again, at a $5 million income level, that 88 percent applies to almost nobody. But at that point, the rate went up even further and the income threshold was lowered from 5 million to 200,000, and now all of a sudden, it applies to a lot of people. And so there's always these nuances—so when we see, you know, the headlines—oh, my God, taxes are going up—we just need to make sure we understand the totality of that picture. But the bottom line is when debt is rising, it's a pretty good bet that taxes will rise with it.

JIM: All right, Jenn, with that context in mind, can you set us up with a handful of strategies for the average investor to potentially use in that environment?

JENN: I absolutely can. So this is a big question here, but we do believe investors should be thinking about taxes and the effect they have all the time. Not just when they're in the news or, you know, not just a certain time of the year. Jim, I could spend a full webcast on each of these six items, so I'm going to try and bullet it down for us. So number one: managing, excuse me—managing capital gains so generally investors can take advantage of different tax rates for long term and short-term investments. For example, you might consider the strategy of gifting assets that have gone up in value to avoid paying the capital gains on that appreciated amount. You might do this instead of selling the asset, paying the tax, and then donating cash. So there are some strategies when it comes to long- and short-term gains. Number two: you can sell some of your securities at a loss. And usually, I have people say, "Jenn, why would I do that?" But it does provide an opportunity to offset taxes on other gains and income you may have that year, or you may be able to carry over those losses into future years, offsetting potential larger gains you might have down the road. So that would be number two. Number three: you can manage exposure to mutual fund distributions. This may help avoid some costly tax implications and the mutual fund distributions I'm referring to—they're typically those year-end payouts that come out somewhere in November or December, so that's something to keep an eye on. Number four: when we talk about tax-smart withdrawals, we mean taking distributions from your holdings at the right time and being strategic about it. Number five: location, location, location. So, investing in tax exempt securities may also be smart, especially if they're in a taxable account like a brokerage account. Investing in taxable securities can provide—give you some benefit when they're kept in a tax-exempt account like your IRA, your Roth IRA, or your employer plan 401K, 403B. Lots of similar words there, but to sum it up, it's really about location. So finally, number six: if you're looking to make changes to your investments you have in your brokerage account, a thoughtful approach to have it done in a tax-efficient way. So how do we do that is a great question. We definitely have some strategies that you can learn more about on Fidelity's website. You can also connect with a financial representative or even your tax professional. So, a lot in there, Jim—we definitely could spend more time in future webcasts, but I hope people are able to take some good notes.

JIM: Yeah, definitely a starting point at the very least. Now you know what may be better requests to ask when you sit down with somebody. You said one question you get a lot from customers is around taxes, but there was another pretty common one that we wanted to put in front of Jurrien, so go for it.

JENN: Yeah, sure. It's very common. So, Jurrien, families and individuals I've been meeting with for a while—they've been asking: when do you foresee interest rates increasing? Because their cash just isn't earning that much these days. So what can we tell them?

JURRIEN: Well, so when you—when we were talking about interest rates, of course, there is a distinction between short-term rates, which are directly set by the federal reserves via monetary policy, and then there are bond yields—so usually of longer duration. I do think that the Fed is still having a very close eye on the unemployment overhang from the pandemic, right? So when we look at the broadest measure of unemployment—so, that's called the U6 rate of unemployment—that includes people who are working part-time who would like to be working full-time, discouraged workers—like, basically, everyone who is kind of at the margin of employment or being unemployed. The gap between that rate and what is considered full employment is still about six to seven percent. So, that's a very large gap, so normally, the Fed manages monetary policy with an eye on full employment—that's one mandate—and price stability, two percent inflation—and that's the other mandate. My sense is that right now, because of the pandemic and over the past 10, 12 years, the Fed has undershot its inflation target, so inflation has been less than two percent. My sense is that the Fed is focusing much more on the unemployment gap than on inflation, but inflation is, you know, all over the news; that's what we're talking about. We know that inflation is happening right now because we have these bottlenecks—these supply chains have been so disruptive because of COVID. You know, try renting a car or getting on an airplane—prices are much, much higher than they were, and part of that is what we call the base effect, meaning that a year ago, prices were much lower, so any incremental change kind of gets exaggerated. We see the same thing with growth rates for GDP or earnings, et cetera. So part of that will be transitionary or transitory, but, you know, if inflation ends up becoming stickier because the Fed is being too loose in its policy and then inflation expectations become entrenched because it's very much a behavioral thing, then yields could rise. But, again, you know, to your point, yields could be rising which will be good for savers who are then getting a higher income, but if they're rising because inflation is rising, then, you know, they kind of cancel each other out, right? Because then you're losing purchasing power at the same thing. So, long story short, you know, yields—bond yields have been rising. They were a half percent a year ago. They were one and a half percent today. But about half of that has come from rising inflation expectations, so real yields—so yields minus inflation—are still fairly low. But, you know, the reason why this chart is up here—for us asset allocators, this is an important long-term question because if inflation was to rise in a more structural way—and that's not a prediction by any means; I don't think anyone knows the answer to this—but if it were to do so, we'd have to think long and hard about kind of our 60/40 split. Right? So we're not all 60/40, but generally, our portfolios are part equities or stocks, part bonds. And historically, when inflation has been rising, the bond side hasn't really been as good of an insurance policy against the stock side. So, in that scenario—and we've talked about this in the past—maybe you have a little bit more cash, maybe you own some inflation-protected securities or tips instead of long bonds—so there's a lot that we can do to kind of tinker around the edges of the 60/40, but that would happen only if yields were to rise from here, which, so far, they're doing, but it's a big question. And certainly if our readers are not comfortable that they're in the right position, they should be talking to people like you to make sure they are properly, you know, diversified per that very first chart that I showed 20 minutes ago.

JIM: Got it. Thank you both again for that explanation and for that context. I appreciate it. And thanks, of course, for being here today. Before we go, as promised, the world's first look at baby Isabelle Devinney. There she is. Leanna sent us this picture and a note that everybody is happy and healthy and trying to get some sleep, I would imagine. A sleeping newborn is the best time to look at a newborn in my humble opinion. Beautiful, right there. She's doing great. Again, she's about two weeks old now. Leanna is doing great. She says Isabelle has super healthy lungs and I think we all know what she means about that. So Leanna will continue her maternity leave, you know, through the summer, which is great. She's got a lot of stuff to work on that isn't related to the markets at the very moment, so we hope to see Leanna again soon, but when Isabelle is a little bit older. For our viewers, thanks for watching. And just a reminder that if you need help with your financial planning or you just have questions about what we offer, you can visit Fidelity's website or download the Fidelity app on a mobile device. Those are really good ways to explore our planning solutions, maybe get some of your questions answered, and then just learn more about the topics we covered today like taxation and a whole lot more topics as well. Again, huge thanks to Fidelity's Jenn Sirois and Jurrien Timmer. Next week, if you'll join us, we're going to be taking a look at whether or not we could be headed for a breather, for lack of a better word, in our current bull market and what you might consider for your own investments if that is, in fact, the case. Big, big discussion to be had next week so we hope you'll join us for that. Until then, have a great week.

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