Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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Jim Armstrong: Hello, and thanks for joining Market Sense. I'm Jim Armstrong with Fidelity.

To say the least, these days Washington is certainly keeping us all on our toes. You may certainly already know about the Infrastructure Bill that passed after several rounds of negotiations, but what's still being hotly debated at the moment is President Biden's Build Back Better legislation contains a massive amount of social spending as well as tax reform legislation, and that's what's caused a lot of Americans to start to question just how these proposals might affect their own tax bills.

So, today, to help us wade through what this legislation could mean—mean to each of us, is Fidelity's Jurrien Timmer. He's also going to give us an update on what the markets and economy are up to sort of at a high level.

And we're also joined by Leanna Devinney who is going to help us understand how these proposed changes might well affect our finances and importantly, maybe give us some things that we can do to better prepare ourselves for whatever comes our way.

So, Leanna, Jurrien, thank you again for making time to be with us this week.

Leanna Devinney: Thank you. Great to be here as always.

Jurrien Timmer: Good to see you as always. Yes, every week.

JIM: It is Tuesday, November 16th, Jurrien, and before we dig into this, the new proposed legislation as far as taxes go, I did want to start off this week with just a check-in on the economy through the lens, I think, particularly, the current unemployment situation as well as last week's inflation news.

JURRIEN: So, economically speaking, the news has of course been very good. You know, the economy weathered the delta wave pretty well in terms of, you know, not having to lockdown in the way that past waves had forced.

So, you know, when you look at for instance earnings growth, you know, we just wrapped up the third quarter. Very, very good results. You know, 81% of companies beating estimates by about nine or ten percentage points. So, certainly good news in terms of corporate America but also in terms of employment, very good news.

You know, you can see here in this chart, the level of jobless claims. So, weekly jobless claims pretty much round tripped from that pandemic surge. When you look at the output gap which is the difference between actual GDP and potential GDP or you look at the ratio or the spread between the employment rate and what is considered full employment, or the ratio between job seekers and job openings, all of those indicators tell the same story and that is that the economy, by and large, has recovered from the pandemic, and you know, things are slowing a little bit at the margin but I'm not particularly worried about that. I think there's good momentum still.

But of course, the big news as we heard last week was that inflation continues to run pretty hot, right? So, in the bottom panel, you see in the orange line, the weekly economic index from the New York Fed and you can see things are pretty even keeled there. But then you look at the ten-year TIPS breakeven which is a complicated way of saying, this is what the market thinks the inflation rate is going to be over the next ten years. It's accelerating. You know, the CPI rose of course last weekend, is running at 6.2% year over year change. That is a—that is a big number. So, it has people worried and talking about stagflation which I think is very, very premature. Everyone thinks of the 1970's when they think of stagflation. We're very far away from that kind of scenario.

But inflation is running hot in part for predictable reasons such as the supply chain bottlenecks and the reopening and all of the—all of the dislocations that that has created, but part of it is also perhaps potentially more structural. Very tight labor market. And of course, a booming housing market that we can probably all—all attest to as well.

So, that really is the big news and it puts the Fed squarely in center stage. Of course, the Fed is starting its taper, by which I mean it's starting to reduce its purchases of bonds basically right now and should be running, you know, be done with that by the middle of next year.

And then the market is right on its heels in terms of expecting the Fed to then start raising rates. And so, that is the next chapter that we're going to have. It makes sense, right, because if the economy has recovered and if inflation is running a little hot, then the Fed really should not be running policy as accommodative as it has been and needs to start normalizing.

JIM: Leanna, I want to bring you into the conversation. As everything that Jurrien just listed there, we as savers, as investors, as planners need to keep everything he just said in mind at least in the back of our minds. Taxes these days feel like they're more at the front of our minds. It was just I think a handful of weeks ago, the three of us on this very show talked about what was then the list of proposals coming out of Washington. They've changed substantially since the last time we spoke about them, so can you just catch us up on what they look like now, with the caveat that they're almost certainly going to continue to evolve?

LEANNA: Yes. So, many of the proposals we were just discussing a few weeks ago have been removed and changed, so we'll talk through that. But first, high level, it's true still that about 99% of US taxpayers will not see an increase to their personal tax bills. So, almost all of us, talking about 99% of US taxpayers, earn less than half a million dollars a year. So, the current proposals would not affect us.

So, a few weeks ago, we were going over the proposals that may—and again, those are no longer part of the conversation, so there is no longer talk on increasing the highest personal income tax rate. There is no longer talk about increasing the corporate tax rate. No current changes to capital gains tax rate on the table. And no current cuts to the estate tax exemption being discussed at the moment. That had been a topic of conversation for many of our clients.

So, that's a lot of good news but it is still that top 1% of earners who stand to be potentially affected by the current proposals if that does become law. So, just reminding everyone, even those top 1%, the current proposal really only targets the highest of high income earners.

So, for example, here are some of the proposals that we're seeing. A proposed charge of a surcharge of 5% of taxpayers—I'm sorry—5% surcharge on taxpayers whose adjusted gross income is more than 10 million for single file or 5 million for married, filed separately.

There's a proposed 3% surcharge for taxpayers exceeding 25 million in the modified adjusted gross income or 12.5 million for married individuals separately. Again, the highest of high income earners.

So, where does my team come in? Well, we use opportunities like this to remind people that when we invest, it's based on the goals that we have, not potential policy changes. Oftentimes we want to have these kneejerk reactions, so I just want to emphasize they're potential changes.

But a few weeks ago actually, a client had called in on a popular article or a popular news source that had an article that said, in quotes, "Wealthy retirement savers targeted."

So, when you actually read the article and not the headline, you saw again, that it was a sliver of people that may be impacted, but that's where the news headlines come in and we're here to help talk you through.

JIM: Yeah. Sometimes even just going by the headlines alone, probably not a great idea. Even reading the article, you might still have some questions after the fact, but definitely you want to read the article to get some context there.

So, I get what you said about potentially the vast majority of us being shielded from big tax changes but I do know there are some—some proposed changes that could affect more of us in terms of what we have access to for our investments. So, maybe just explain what's happening there.

LEANNA: Yep. So, there's some potential, and again, I say keyword, "potential" changes. I'm going to say that a lot throughout this time. But one potential proposal would be the elimination of your ability to convert after tax savings in a 401(k) or traditional IRA to a Roth IRA. And that could start as early as next year.

There is also a potential prohibition on converting your pretax IRA and 401(k) to a Roth for wealthy taxpayers. That wouldn't start until 2032.

There's talk of restricting contributions to IRAs or any retirement accounts for single tax filers with taxable income over 400,000 or joint filers who earn more than 450,000 and have a total IRA or total retirement contribution plan of over 10 million.

So, sliver of people. Again, that would go into effect in 2029.

And then last, finally, there's talk about modifying the current cap on the deduction for state and local taxes, this is known as SALT. So, after changes made by the Trump administration, you can only deduct the first 10,000 in the SALT taxes and that's been an unwelcome change for many. We've heard a lot about that. So, again, that's still in the works.

Like I said before, my team helps make sense of all this. Roth conversions are how we take income in retirement. Just recently, we had a client who is retiring early at age fifty-five and had the bulk of his money in IRA money and Roth IRA money from years of contributing, so the conversation comes around how do we take income in retirement? What is the most efficient way to do that? And this is where we can help all tax savers as well to be most efficient in doing so.

JIM: Right, and spreading out their tax liability.

Can you—I think there was another person that you had mentioned as we were getting this webcast ready, a woman who had come into your team with a similar question.

LEANNA: Yes. So, that was in—Roth conversions had come up, and Roth conversions can be a major buzzword. So, people hear Roth conversions and doing so and they want to incorporate them in their plan. But again, when you meet with people on our team, we want to make sure it's appropriate.

This woman was actually still working in her mid-sixties and she came in wanting to do Roth conversions, but it came out that she was still in a very high tax bracket and if she were to do the Roth conversions, she'd be taking on a lot of a tax burden now in order to do so.

So, we go through the options.

Another time though, if you're retiring early, let's say, and you may not need all of your IRA money to live, you may not need your RMD when it's mandated to come out, that's when it may make sense to convert small chunks over time and do Roth conversions. But all of this, it's consulting with your tax advisor to make sure it makes sense for you.

JIM: And RMD is required minimum distribution, right? That's the amount you have to take every year once you reach a certain age?

LEANNA: Yes. Required minimum distribution starting at age seventy-two.

JIM: Got it. Okay. Thank you for that.

Jurrien, I want to—before I forget, Leanna, I know that there's also some possible benefits to taxpayers in the pending legislation, so I want to sort of put a pin in that and come back in a moment. But first, Jurrien, in terms of some other stuff that's being contemplated right now, I wanted to ask you specifically about one, a 15% minimum tax on corporate profits for large corporates, those with more than a billion dollars in profits, and a proposed 1% surcharge on stock buybacks by publicly traded corporations.

I know you've talked a lot about—about stock buybacks in the past. So, what's your sense of how those possible changes could affect the overall market and our decisions as investors?

JURRIEN: Yeah. So, in terms of the 15% minimum tax, that's not really a market mover and actually it probably comes as maybe a relief to the market in terms of it could have been worse in terms of, you know, taxes.

If you remember, during the Trump administration, corporate taxes went way down, but it's interesting that the—that the investors never really rewarded companies for that because it was seen kind of maybe as a one-time thing or—so, it's not like the market started trading at a much more higher multiple because of that tax cut and now that the tax cut gets reversed, at least partially, that there has to be like a big hit to the market, right?

So, we never got that—that adjustment because the investors tend not to reward. They reward higher earnings, of course, which are impacted by taxes, but they don't tend to reward extremely high earnings just because it never seems like it's sustainable.

So, you know, compared to what was discussed a few months ago, a 15% minimum tax, I think, for the market is a fairly benign outcome.

You know, I think that the share buyback tax of 1%, I think is more—is more interesting because share buybacks are, in my view at least, have been a large driver of market returns.

And you know, in this slide here, you see revenues per share in the top, so that's how much—how much sales companies have. And then in the bottom you see capital spending in the blue, dividends in the pink, and buybacks in the orange, and that's all as a percentage of revenues, of sales.

And so, you can see that Capex has been very, very steady at around 5% of sales. Dividends have been pretty steady at around 4% of sales. And buybacks of course move up and down because you know, they need earnings to happen, so they only happen when earnings are growing and then when you have a contraction of earnings like we saw during COVID or the financial crisis, the buybacks disappear, and then when earnings come back, the buybacks come back.

So, that has been a very important part of kind of the—the math of how investors earn a return on their portfolio, so dividends and buybacks are very prominent features of that. And so, the 1% tax on buybacks is of course a new thing. We haven't had that. It doesn't seem onerous to me. You know, if companies are buying back $500 billion worth of shares a year and investors, instead of getting that 500 back, they don't get it back directly because they're buybacks. But instead of the 500, they get 495. I don't think that that's really going to change anyone's behavior both on the corporate side as well as on the investor side, but it's certainly a shot across the bow when we think about the pendulum swinging between capital and labor that, you know, that we're in an environment where maybe corporates are slightly more on notice that they need to, you know, pay their fair share at least in the eyes of the politicians. And so, it's an interesting development in those terms.

JIM: Thank you for that. That's great. And I love—I love having you two together in particular because you can bring two sort of sides of the same coin. So, Jurrien is explaining at that very high, macroeconomic level what could and might happen, but Leanna, I want to switch back to you to talk more about at that individual, more micro level. What—what are some of the possible benefits to individual taxpayers, individual investors in the—the Build Back Better legislation in DC these days?

LEANNA: Yeah. There are benefits through the spending provisions that remain in the bill and as a new mom, I like these benefits so I'll list them out.

So, the overall 1.7 trillion price includes an extension of the child tax credit which is now available even for those meeting the income requirements. The second is childcare and preschool subsidies and the details are still to be determined there. Home care benefits for certain seniors on Medicare. And then premium tax credits under the Affordable Care Act for those in states that did not expand the Medicare—Medicaid eligibility, excuse me.

So, like all the other elements of this bill though, we're not sure what the final product will look like but there are some benefits there.

JIM: Yeah. I'm glad you said that because I was going to repeat it as well. It's hard to say what the final product could look like, so it's something that we will certainly keep our eyes on here and as you mentioned as well, talk to a—talk to your tax professional if you have any questions about your specific situation.

But before we go this week, I was just curious to sort of pick both of your brains here about—about sort of the bigger picture about what you think everything—the discussion in DC happening now means to us for the rest of the year and beyond. I mean, what do you suppose markets will do when some ultimate version of this bill passes? What sort of—what thoughts go through your head, again, at that macro and micro level about what thoughts should be in investors' minds at the moment?

JURRIEN: I guess I'll go first. From my perspective, you know, the Build Back Better plus the Infrastructure Bill, obviously those are large numbers, but they are far less large than what's—what was originally discussed, you know, in the months, you know, that have gone by. And of course, you know, there's a midterm election looming. There was—I don't want to call it infighting but there was disagreement within the Democratic Party of how big this program should be.

So, I think from the market's point of view, what we always look at is the fiscal multiplier which is a fancy way of saying that if you spend a dollar more, do you get more than a dollar in economic growth or less than that dollar? And by—from my—from what I understand, you know, reading the experts, is that there is a positive fiscal multiplier for even this smaller program which means that it will—it will have benefits on the economy but it won't be so large that it might upset the bond market, for instance.

And also, and this is very counterintuitive, but the more you spend today and if you don't spend that same amount of money next year, you get what's called a fiscal drag, meaning that the rate of change of the growth and spending goes down and so the fact that the program in its current form is maybe half of what people were talking about, you know, six months ago, also means that kind of the hangover in 2023 I guess it would be, might be less as well and it might require less action from the Fed in terms of raising rates, et cetera.

So, my understanding is that for the markets, this is a pretty positive and maybe benign outcome in terms of it's not—it's big enough to matter but not so big that investors should worry about, you know, ongoing interest rate hikes, et cetera.

LEANNA: I agree. And just to reiterate, it's all potential changes and we never want to make changes to our portfolio based on potential changes or things that are likely not going to impact the bulk of us or have a big impact on the economy.

So, I think it's just a reminder again of the benefits of having that well diversified plan that's aligned with your goals, not aligned with different potential policies and changes. And hearing this today, again, if it's saying I haven't met with anyone recently, this is a time for checkup or how could this impact me? That's what we do day in and day out, so certainly take advantage of that.

JIM: That makes a lot of sense. Appropriate to ask those questions just to get a better sense of where you are, especially given what's happening in the world around you. It makes perfect sense. Thank you both again for taking the time to be with us this week.

For folks watching or listening, thank you again for taking time to be with us as well. We talked about a lot today as always. If you're interested in learning more about anything we talked about today, you can certainly visit Fidelity's website or download our app and begin the process of learning more yourself.

And of course, always feel free to give us a call here at Fidelity if you have any specific questions about your situation.

Again, huge thanks to Jurrien Timmer and Leanna Devinney. We hope to see you back here next week.