QUARTER NOTES

Third Quarter 2021

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Inflation jitters

According to a recent Harvard CAPS/Harris poll, reported at thehill.com, 85% of respondents are concerned about inflation. Some 45% are very concerned. The astonishing spring price increases in lumber and used cars probably triggered the sensitivity to price increases. Then the May Consumer Price Index (CPI) came in with numbers not seen in a decade or more, 5% above the year-earlier level. Even the core inflation rate, excluding food and energy, was well above the Fed's inflation target.

The initial thought was that the price spikes were transitory. In some sectors, such as airline tickets and hotel rooms, the increases were simply a return to pre-pandemic levels after the drastic medicine of lockdowns. There was a release of pent-up demand by many after the long period of isolation. What's more, the pandemic had also led to supply chain bottlenecks, notably in semiconductors, that were rippling through the economy in unexpected ways. These problems could be resolved; they could be temporary.

On the other hand, as the economy returned to normal and then began heating up, employers were faced with an unanticipated

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Going up?

According to the Bureau of Labor Statistics, in May the prices for furniture and bedding were up 8.6%, sporting goods up 9.0%. Prices for used cars and trucks rose a whopping 29.7% compared to a year earlier, and home prices are soaring as well. That has created inflation wariness in many investors, the subject of our feature article in this issue of *QuarterNotes*.

On page 3 we review the tax rules for 2021 for long-term capital gains. Taxes are a secondary consideration in making buy and sell decisions, but they should not be ignored entirely.

If you have questions about your investments, please bring them to us.

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labor shortage. Some people, having learned to love working from home, decided to quit when their employers called for a return to the offices. The response to a labor shortage, at least in the short term, has been as expected, an increase in wages.

Taken individually, wage increases are wonderful. But in the aggregate, they may fuel sustained inflationary pressures. In June, the Fed acknowledged that interest rate hikes will be coming sooner than earlier predicted—but probably not until 2023, not until after the next election.

We don't yet know that inflation will become a problem. The Federal Reserve may have the tools needed to keep inflation at reasonable levels, avoiding another "stagflation" of the sort experienced in the 1970s. On the other hand, one should not wait until the rain begins to buy an umbrella. How can investors put some inflation insurance into their portfolios?

TIPS illustrated

Assume that a TIPS is purchased with a face value of $10,000 and a dividend rate set at 2%. Assume as well, for the sake of this illustration, that inflation runs at a constant 2.5% annual rate. Finally, assume that the 2% dividend is paid in two coupons each year, of 1% each.

- The first coupon would pay $100 (half of the 2% dividend times the $10,000 face value).
- After a year the value of the bond would rise to $10,250, given the 2.5% inflation adjustment. Accordingly, the interest payment would rise to $102.50.
- After ten years of 2.5% inflation, the value of the bond would rise to $12,800, bringing the coupon payment to $128.
- However, if there is one thing that we know for certain, it is that inflation will not stay at a constant rate for ten years.

This example is for illustrative purposes only, and the return is not indicative of any actual investment. Actual investments may differ substantially.

CPI-linked returns

Since 1997 the U.S. government has provided investors with a convenient tool for building inflation protection into their portfolios. That tool is Treasury Inflation-Protected Securities, or TIPS. These securities are issued in maturities of five, 10 and 30 years. The principal value of the TIPS is adjusted annually for inflation, and that, in turn, affects the semiannual interest payments.

The coupon payments from TIPS are subject to ordinary income tax. One of the drawbacks of TIPS is that the principal adjustment is subject to ordinary income tax as well, in the year that it is made, though there is no cash distribution to draw the tax payment from. For example, if the value of a $10,000 bond is raised to $10,250 to account for 2.5% inflation, that $250 adjustment is fully taxable. Because this situation can create a cash flow problem for meeting the tax obligation, often TIPS are recommended for tax-deferred accounts, such as IRAs.

In the event of deflation, the value of TIPS will decline. However, the redemption will be at face value, and the dividend can't fall below zero, so there is a deflation hedge built in as well.

TIPS are traded on the secondary market. Their price fluctuates with changes in interest rates as well as changes in the inflation rate. TIPS at times have been even more sensitive to interest rates than conventional bonds. Such volatility indicates that they are best suited for longer-term time horizons, reinforcing the idea that they are a good choice for IRAs.

Some investment funds include TIPS among their holdings, and some funds specialize in TIPS. Funds can provide for diversification of maturities and easy reinvestment choices. On the other hand, funds do not have a maturity date, and so can present risks not present when TIPS are owned outright.

Can we tell you more?

TIPS are not the only inflation-fighter to consider for one's portfolio. Dividend-paying stocks or commodities are alternatives favored by some investors, for example.

If you would like a second opinion about your portfolio management strategies, we would be pleased to share our expertise with you. Just call on us!

Taxes on your 2021 gains

Although there was much tax legislation enacted in 2020, the rules for taxation of investments were not changed. Capital gains and dividends are a special category of income with special rules that are important for investors to understand as they plan and manage their portfolios.

The profit from the sale of an asset held for a year or less will be taxed as ordinary income, and so falls into each taxpayer's highest tax bracket. Assets held for more than a year, as well as qualified dividends, are eligible for preferential tax rates, ranging from 0% for the lowest income taxpayers to 20% at the top. The boundaries for the 2021 tax year are given in the table below.

However, there is a bit more to the story. A 3.8% surtax applies to the net investment income of higher-income taxpayers, including dividends and long-term gains. The threshold is $200,000 of adjusted gross income for singles and $250,000 for marrieds filing jointly (a potential marriage penalty there). Therefore top taxpayers will typically be paying a 23.8% tax on long-term gains, and there is an 18.8% bracket below that.

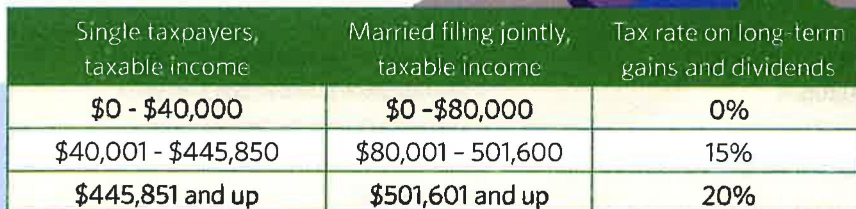
It is possible that realizing a long-term gain will lift a taxpayer into a higher bracket, as shown in these examples:

Example one. Single taxpayer Jack has $30,000 of ordinary income and realizes a $20,000 long-term gain. The first $10,000 of his gain will be tax free, and the second $10,000 triggers tax at a 15% rate. Total tax on investment income comes to $1,500.

Example two. Single taxpayer Jill has $150,000 of ordinary income, $60,000 of long-term gain, and $15,000 in qualified dividends. The first $50,000 of her net investment income will be taxed at 15%, with the remaining $25,000 at 18.8%. Total tax on investment income is $12,200.

Example three. Jack and Jill get married, so their combined ordinary income is $180,000, their long-term gains are $80,000, and qualified dividends are $15,000. The first $70,000 of investment income will be taxed at 15%, the remaining $25,000 at 18.8%. Total tax on combined investment income comes to $15,200. That's $1,500 more than they would have paid by staying single.

Tax consequences are only one factor to account for in making buy and sell decisions, and usually not the most important factor. See your tax advisors to learn more.



Single taxpayers, taxable income	Married filing jointly, taxable income	Tax rate on long-term gains and dividends
$0 - $40,000	$0 -$80,000	0%
$40,001 - $445,850	$80,001 – 501,600	15%
$445,851 and up	$501,601 and up	20%

Source: Internal Revenue Service

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Just Ask Us

Q. I'm 75, so I've been taking my Required Minimum Distributions (RMDs) from my IRA for several years. I skipped last year, when Congress suspended the rule because of the pandemic. Do I have to make that up now this year?

A. No, you do not. Your RMD will be calculated in the same way as in other years, based upon the value of your IRA at the end of 2020 and the age-based factor from the IRS table. Presumably your IRA grew in value during 2020, and as you age the IRS factor gets bit smaller, so your 2021 RMD will most likely be larger than those in the past.

Note that if you turn 70½ this year, you don't have to begin your RMDs, because that rule was changed by the SECURE Act in 2019. Now RMDs don't begin until age 72—of course, you can withdraw money from the IRA earlier if you wish without tax penalty, if you are over age 59½.

If you don't need the IRA money for your living expenses, you can arrange for a direct transfer of up to $100,000 from your IRA to charity. Such transfers won't be included in your taxable income; they won't boost the income tax on your Social Security benefits, but they do satisfy the RMD requirement.

See your tax advisor to learn more.

Information is provided by Paul R. Mancuso, Jr. and written by Merrill Anderson Co., a non-affiliate of Cetera Investment Services LLC.

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The return and principal value of bonds fluctuate with changes in market conditions. If bonds are not held to maturity, they may be worth more or less than their original value.

Distributions from traditional IRAs and employer sponsored retirement plans are taxed as ordinary income and, if taken prior to reaching age 59½, may be subject to an additional 10% IRS tax penalty.