Q QUARTER NOTES

First Quarter 2021

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Outlook 2021

As 2021 begins, the nation is hopeful that the vaccine for COVID-19 will soon return our economy to normal. However, "normal" may prove to mean something other than what life was like in 2019, before the pandemic took hold. An unknown number of businesses will have failed to survive. The habits of citizens regarding dining, travel, and entertainment may prove to have been altered permanently. State and local tax collections have been hit hard, and the means for addressing those shortfalls are not yet clear.

Although economic and political uncertainty is unusually severe, we must do what we can with the information that is at hand.

The economy

There has been considerable debate over how quickly the economy may be able to recover from the pandemic. The damage has been mitigated in 2020 by both monetary policy (very low interest rates) and fiscal policy (expanded federal spending). Interest rates can't go much lower, and the divided Congress suggests that spending will not continue at 2020 levels. The economy will have to begin to grow on its own.

Housing starts recovered during 2020, and are already close to pre-pandemic levels, in part thanks to the continued low interest rates. Commercial real estate may be another matter. The success many companies had with having employees work from home may have altered business dynamics for the long term, suggesting that we have an oversupply of office space in many cities.

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Is the fog lifting yet?

When one considers how the unforeseeable events of 2020 made a hash of the prognostications of one year ago, one is almost tempted to just give up. The things we don't know and can't know simply swamp what we can know with real confidence.

But quitting is not an option. We must push ahead into 2021 with the best investment intelligence we can muster. That is the subject of this issue of *QuarterNotes*. Also in this issue, what you need to know for your IRA contributions for the 2020 and 2021 tax years—see page three.

Please bring your investment questions to us.

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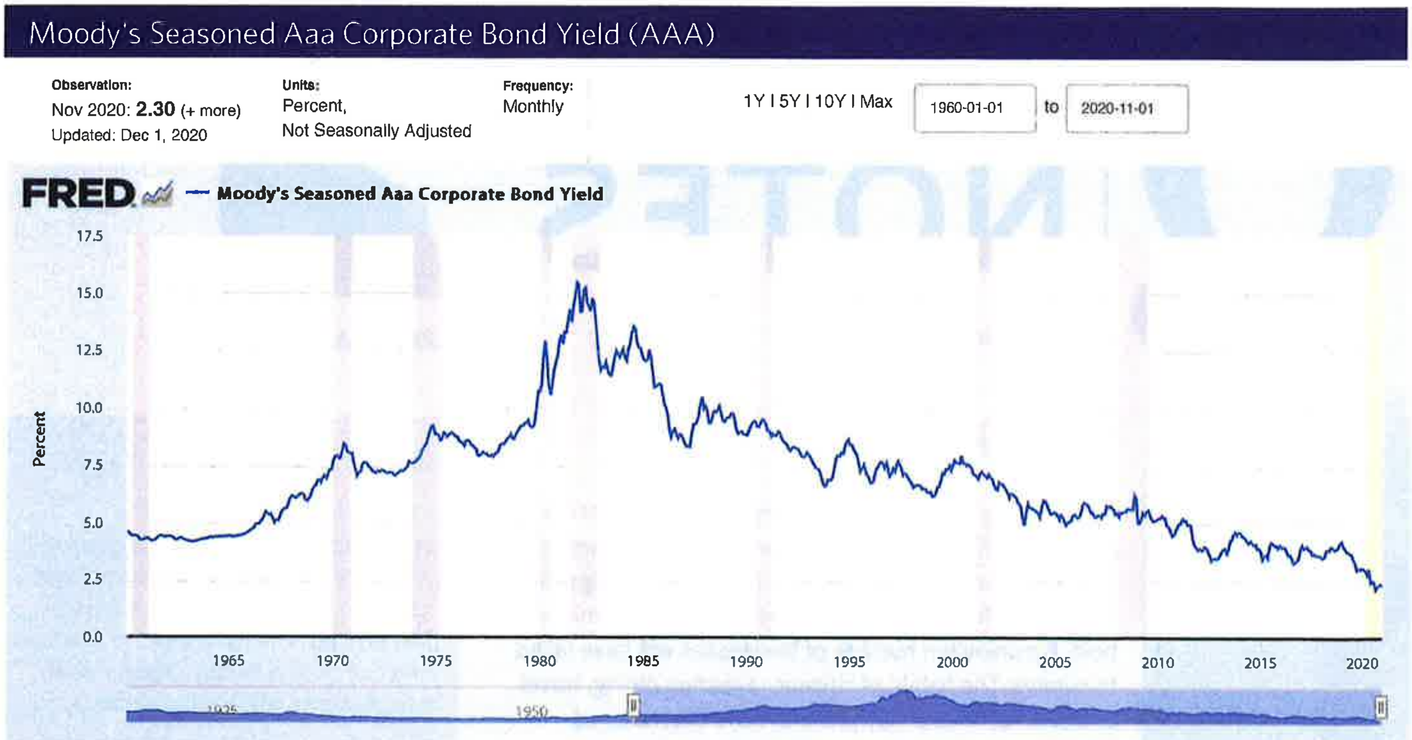

Source: Moody's, Moody's Seasoned Aaa Corporate Bond Yield [AAA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/AAA, December 21, 2020.

The continued shift of consumer preferences to making purchases online offers a similar grim outlook for retail commercial space.

Consumers have shown a willingness to spend, which is important because consumer spending accounts for 70% of gross domestic product. Spending was supported by the estimated $4 trillion stimulus bill in 2020, but that is not likely to be repeated in 2021.

Equities

The large-capitalization stock indices have largely recovered from their pandemic-induced lows of March 2020. That's welcome news, but it is also a signal for caution.

The price of a stock is what an investor is willing to pay for a stream of future earnings. Therefore, the price/earnings ratio is a measure of how expensive a stock is relative to its expected earnings. The P/E ratio S&P 500 was very high as 2020 closed, as high as it had been since the dot-com bubble of 2000. For perspective, over the past 15 years, that ratio has been higher only 0.5% of the time.

Three factors may account for this. First, earnings contracted sharply as the lockdowns were ordered, have not yet fully recovered, and prices have gotten ahead of earnings. But investors may be looking beyond the current reports to a future in which the vaccine has delivered herd immunity and a return to the robust economic growth of 2019.

Second, with interest rates so low, stocks may be seen as the better alternative for many investors. Finally, the S&P 500 may be perceived by many as a "safe haven," even though the index is dominated by the top 10 stocks that account for 30% of its total value.

Value stocks, which trade at lower P/E ratios than do growth stocks, have lagged in performance during the past several years. They may be poised to benefit greatly from a return to normal. Smaller capitalization stocks are not trading at such high P/Es, perhaps because investors are worried that smaller companies don't have the resources they may need for recovery. The S&P mid-cap 400 P/E has been higher only 16% of the time, while the S&P small-cap 600 is 0.2% below its 15-year average. It has been higher 66% of the time.

Bonds

Bond prices rise as interest rates fall, and those rates have been falling since 1980. See the graph below from the St. Louis Federal Reserve Bank of AAA-rated corporate bond yields for the past 60 years.

The 40-year bull market for bonds may be coming to an end. In March 2020 the ten-year Treasury bond hit an all-time low of 0.32%, but it has been generally rising since then. The yield curve is positive and steepening, suggesting that investors see a better economy ahead with the possibility of a return of inflation.

The Federal Reserve is expected to keep short-term interest rates low throughout 2021. The Fed has set an inflation target of 2%, and further modified that last September to an average rate of 2%. That means that months of little to no inflation will be taken into account before there is another rate increase. Accordingly, mortgage and corporate borrowing costs are expected to remain low this year.

Similar to equity markets, diversification is key in bond portfolios. First, make sure that your bond portfolio acts like a bond portfolio and as a countermeasure against falling equity prices. Understanding what you own is critical. A bond portfolio that correlates to equities by having too much high-yield exposure could be detrimental in a market sell-off.

The value of trusted guidance

Finding good help for investment management is no easy matter. You have to find someone with experience and knowledge, someone you can trust, someone with whom you feel comfortable.

That someone should be us. We offer objective investment guidance, designed with the needs of you and your family in mind. We utilize a team approach to investment and financial management, with professionals from a range of disciplines to provide you with a complete financial management solution.

If you haven't yet taken advantage of our services for investors, we invite you to make an early appointment to learn more about our offerings.

The 2021 IRA rules

In 2019 Congress revisited the rules for qualified retirement plans and IRAs, with an eye toward boosting retirement savings. To that end, the age limit of 70½ for making a contribution to a traditional, deductible IRA was eliminated, beginning in 2020. However, you still must have "earned" income to make any IRA contribution—income from investments, pensions, gifts, and Social Security benefits does not count.

In addition, the age at which required minimum distributions must be made from IRAs was lifted to 72. The required minimum distribution rules were suspended entirely for 2020, but they are back in place for 2021.

The amount that may be contributed to traditional and Roth IRAs has not changed, $6,000 for 2021, as it was in 2020. Those 50 and older may make an additional $1,000 "catch-up" contribution. You have until the tax-filing deadline to make a contribution for the 2020 tax year, and it would be wise to go ahead with your 2021 contribution as soon as practical for maximum tax-deferred growth.

Key IRA boundaries

		2020	2021
Contribution limit		$6,000	$6,000
MAGI phase-out range for IRA deduction for those covered by employer plan	Single	$65,000 - $75,000	$66,000 - $76,000
	Married filing joint	$104,000 - $124,000	$105,000 - $125,000
	Married filing separately	$0 - $10,000	$0 - $10,000
MAGI phase-out range if only one spouse has employer coverage	Married filing joint	$196,000 - $206,000	$198,000 - $208,000
	Married filing separately	$0 - $10,000	$0 - $10,000
MAGI phase-out range for allowable Roth IRA contributions	Single	$124,000 - $139,000	$125,000 - $140,000
	Married filing joint	$196,000 - $206,000	$198,000 - $208,000
	Married filing separately	$0 - $10,000	$0 - $10,000

Source: Internal Revenue Code; M.A. Co.

A contribution is one thing, the deduction is something else. Those who have no employer retirement coverage are permitted a full deduction for IRA contributions, regardless of income. Those who have such coverage will find the deduction phases out as their modified adjusted gross income (MAGI) grows, as shown in the table below. A person whose spouse has an employer-provided retirement plan also has limits on the deduction.

The Roth IRA should be considered, especially by those whose income exceeds the deductibility threshold. There is no deduction for the contribution, but there is the possibility of complete tax freedom for all distributions. Income limits apply to Roth IRAs as well, but those limits are higher than for deductible IRAs.

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Just Ask Us

Q. I got my retirement distribution check from my employer's 401(k) plan. I'm planning to roll the money into an IRA. The account was $100,000, but the check is for just $80,000. What happened? What now?

What happened is that 20% of your retirement distribution has been withheld and sent to the IRS on your behalf. When you receive a lump sum distribution from a qualified plan, and the check is made out to you, the plan administrator is required to assume that you won't be rolling the money over to an IRA. That's the rationale for the withholding.

You can roll your $80,000 into an IRA and file for a tax refund. However, you will owe income tax on the $20,000 in tax withholdings (yes, that does sound like a tax imposed on a tax, doesn't it?) The amount of the $20,000 that you get back will depend upon your tax bracket.

To avoid this result, you might consider adding $20,000 from your other savings to the IRA rollover, to bring the total rollover up to the amount of the lump sum distribution. If you take this course, IRS can refund the entire amount withheld on the distribution. However, many taxpayers would have trouble coming up with that $20,000.

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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.