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TAGStone CAPITAL INC

Second Quarter 2021

## SECOND QUARTER MARKET OVERVIEW

Stocks at home and abroad continued their upward climb in Second Quarter 2021, with all major U.S. market indices hitting record highs during the period.

In the U.S., the S&P 500 index of large-cap stocks posted a gain of 8.55% during the quarter, while the Russell 2000 index of small U.S. stocks gained 4.29%.

Stocks also enjoyed sizeable gains in foreign markets during the quarter. The MSCI EAFE index of large stocks in Europe, Australasia, and the Far East gained 5.17%, while the MSCI EAFE Small-Cap index gained 4.34%.

Alternative asset classes also continued their upward climb. The Dow Jones U.S. Select REIT (real estate stock) index soared 11.76%, while the Dow Jones Global REIT index gained 6.91%. Meanwhile, the MSCI Emerging Markets index gained 5.05%.

Bonds posted scant gains for the second quarter as the prospect of rising interest rates continued to weigh on that asset class. The Barclays U.S. Aggregate bond index gained 1.83%..

It's certainly possible to make a case that stocks are due for a downturn. The pundits point to inflation, rising interest rates, geopolitical concerns, and even just the length and breadth of this market recovery as reasons to be "cautious" about stocks. But the reality is that there are always reasons to doubt stocks; indeed, we don't ever recall a time in the past four decades when concerns about stocks weren't in the headlines.



# Is Inflation Haunting Your Financial Dreams?:

## *Part 1: What We Know*

Has the specter of inflation got you spooked? Recent headlines are filled with sightings. In this two-part series, let's take a closer look at what to make of all the commentary and what you can do about it as an investor. First and foremost, we caution against succumbing to fear or panic in the face of inflation. As usual, careful planning remains your best guide.

**What Is Inflation?**

Inflation is the rate at which a currency loses its purchasing power as prices increase over time. So, say a cup of coffee cost $1.00 twenty years ago. If the average annual inflation rate had been 2% between then and now, that same pour would now cost you $1.49. Various goods, services, and sectors often experience different inflation rates at different times, but general inflation is usually calculated based on the **Consumer Price Index** (CPI) or a similar broad pricing index.

Recent headlines have been reporting a noticeable uptick in inflation. Superlatives like "best" and "worst" grab the most attention, so outlets have been abuzz with reports of how a 5% May consumer pricing surge was "the biggest 12-month inflation spike since 2008."

**SELECTED 2021 EQUITY INDICES**

| | Jun. '21 | 2nd Qtr. | YTD |
|---|---|---|---|
| S&P 500 Total Return (Large-Cap Stocks) | 2.33% | 8.55% | 15.25% |
| Russell 2000 Total Return (Small-Cap Stocks) | 1.94% | 4.29% | 17.54% |
| MSCI EAFE (Developed International Stocks) | -1.13% | 5.17% | 8.83% |
| MSCI Emerging Markets (International Emerging Stocks) | 0.17% | 5.05% | 7.45% |

**SELECTED 2021 FIXED INCOME INDICES**

| | Jun. '21 | 2nd Qtr. | YTD |
|---|---|---|---|
| Barclays U.S. Aggregate (Broad Domestic Bonds) | 0.70% | 1.83% | -1.60% |
| Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds) | -0.13% | 0.61% | 0.04% |
| Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds) | 0.92% | 2.79% | -1.22% |
| Barclays U.S. TIPS (Treasury Inflation Protected Securities) | 0.61% | 3.25% | 1.73% |
| FTSE World Gov't 1-5 Yr. Hedg'd (Short-Term Global Bonds) | -0.10% | 0.07% | -0.30% |

**Putting Inflation in Proper Context**
Before you read too much into these recently rising numbers, it's worth remembering their context. We're comparing May 2021 to May 2020, when we were still deep into what *The Wall Street Journal* called a "screwy" pandemic economy. The WSJ explained, "If a company takes a hit in one year and then gets back to normal the next, it can look like its profits are soaring when in fact they are just getting back on track."

Zooming out even further, the Federal Reserve's 10 Year Break-Even Inflation Rate is one common estimate of the market's *expected* average annual inflation rate for the next ten years. As of mid-June, that rate stood at **2.3%**. That's up from the lower **1.2%** rate expectation from mid-June 2020, but it's still not eye-popping.

This leads to another important point: ***Not all inflation is bad.*** A bit of inflation goes hand in hand with economic growth and reasonable interest rates for lenders and borrowers alike. A 2% annual inflation rate is typically considered a desirable norm for greasing the wheels of commerce without destroying the working relationship between currencies and costs.

**What if Inflation Runs Amok?**
And yet, while inflation has its purposes, it concerns many savers and investors if it goes on a rampage. When it does, uncertainty has spiked as well, wreaking havoc on commerce, the economy, job markets, real estate, and financial markets. (Deflation—the opposite of inflation—can also upset the economy if prices drop too precipitously.)

Investors who were around in the 1970s may remember the last time the U.S. experienced red-hot inflation and what it felt like when it spiked to a feverish 14.8% in 1980.

*The New York Times* described it as an era when "prices of real assets like houses, gold and oil soared. Average mortgage rates exceeded 17 percent, and interest rates on bank certificates of deposit approached 12 percent. It was hard to know whether a 5 percent pay raise was cause for celebration or despair." While 12% CD rates may sound great, when interest and inflation rates are comparable, the real returns from even high-interest CDs essentially become a wash.

After the 1980 high-water mark, the Volcker-era Federal Reserve tamped inflation back down. So younger investors have heard of, but never experienced such steep inflation for such an extended time. Despite occasional alarm bells, inflation has mostly continued to hit the snooze button for decades. At least so far.

## *Part 2: What We Can Do About It*

What if inflation does get out of hand and stays that way for a while? Depending on who you heed, the possibility ranges from unexpected, to possible, to a near certainty. For investors, it's essential to take a step back and look at the big picture before acting on breaking news. As usual, prudent planning is preferred over rash reaction.

In Part 1, we covered the recent uptick in inflation and what to make of it in a historical context. In Part 2, we'll cover why forecasts remain as fuzzy as ever and how investors can best prepare for whatever may happen next.

The Federal Reserve has been suggesting rising rates should wane. We hope they're right. But we also know the future remains uncharted. Nearly any outcome is possible, and none is inevitable. This means diversified investing remains our preferred strategy for being prepared for whatever the future holds.

**Explaining Inflation Doesn't Predict It**
If higher inflation does materialize, will it arrive sooner or later? Will it be moderate or severe? Brief or prolonged? Forecasts vary widely because we often forget the academic evidence that informs us: ***Even excellent explanatory models rarely serve as effective predictive models.***

For example, scientists can readily explain why earthquakes occur, but our ability to forecast times, locations, and severities remain shaky at best. The same can be said for inflation. We can explain its intricacies, but accurate predictions remain as elusive as ever. There are simply too many variables: COVID-19, climate change, political action, the Federal Reserve, other central banks, consumer banks/lenders, consumers/borrowers, employers/producers, employees, investors ("the market"), sectors (such as real estate, commodities, and gold), the U.S. dollar, global currency, cryptocurrency, financial economists, the media, the world, time … and **YOU**.

Each of these could throw off any predictions about the time, degree, and extent of future inflation. Besides, as an investor, you only have control over the last two: You and your time in the market. ***What will you do with your time?***

**Because We Don't Know, We Diversify**
It stands to reason: Some investments seem to shine when inflation is on the rise. Others deliver their best results at other times. Because we never know precisely when inflation might rise or fall, we believe an investor's best course is to diversify into and across various investments that tend to respond differently under different economic conditions.

For example, until earlier this year, value stocks had been underperforming growth stocks for quite a while. You may have been tempted to give up on them during their decade-plus lull (during which inflation remained relatively low). And yet, when inflation is high or rising, value stocks have tended to outperform growth, as has been the case year-to-date.

Another example is Treasury Inflation-Protected Securities (TIPS) versus "regular" Treasury bonds. Neither is ideal across all conditions. But if you hold some of both, they can complement each other over time and across various inflationary rates.

In short, if you've not yet done so, it's time to define your financial goals and build your personalized, globally diversified portfolio to complement them. If you've already completed these steps, you should be positioned as best you can to manage higher inflation over time, which means your best next step is most likely to stay put. This brings us to our next point.

**Stocks vs. Inflation: It's a Knock-Out**

*Provided time is on your side; the stock market is your greatest ally against inflation.*

Over time, global stock market returns have dramatically outpaced inflation. For example, as reported by Dimensional Fund Advisors, $1 invested in the S&P 500 Index from 1926–2017 would have grown to **$533** worth of purchasing power by the end of 2017, ***after*** adjusting for inflation. Had that same dollar been held in "safe" one-month Treasury bills over the same period, it would have grown to an inflation-adjusted **$1.51**.

That T-bill growth is more than nothing and welcome relief during bear markets. That's one reason we advocate for maintaining an appropriate mix between wealth-accumulating and wealth-preserving investments. But what's "appropriate"? It depends on your personal financial goals. The point is, as long as you have enough time to let your stock allocations ride through the downturns, you can expect them to remain well ahead of inflation simply by being in the market.

It's important to add; no fancy market-timing moves are required or desired when participating in the stock market. Moving holdings in and out at seemingly opportune times is more likely to detract from the vital, inflation-busting role stocks play in your portfolio. In the words of Nobel Laureate Eugene Fama: "The nature of the stock market is you get a lot of the return in very short periods of time. So, you basically don't want to be out for short periods of time, where you may actually be missing a good part of the return."

**What If You're Retired?**
So far, so good. But not *all* your wealth is for spending in the far-off future. What if you depend on your portfolio to provide a reliable income stream here and now? If you're retired (or you have other upcoming spending needs such as college costs), eventual expected returns offer little comfort when current inflation is eating into today's spending needs.

Again, you can't control inflation, but you can manage your own best interests in the face of it.

**Engage in Retirement Planning:** Along with a globally diversified investment portfolio, you'll want a solid strategy for investing for and spending in retirement. For example:

- **Asset Location:** Among your taxable and tax-favored accounts, where will you locate your stocks, bonds, and other assets for tax-efficiently accumulating and spending your wealth?
- **Spending:** How much can you safely withdraw from your investment portfolio to supplement your other income sources (such as Social Security)?
- **Withdrawal Strategies:** Which accounts will you tap first and then next?

**Revisit Your Retirement Planning:** Especially when inflation is on the rise, it's worth revisiting your existing investment and withdrawal strategies. What are the odds your current portfolio won't deliver as hoped for? We typically use odds-based "Monte Carlo" simulations to ask this critical question and guide any sensible adjustments the answers may warrant.

**Don't Panic:** What if inflation is taking too big a bite? A common misstep is to abandon your carefully structured investments in pursuit of short-cuts. For example, it may be tempting to unload high-quality bonds and pile into gold, dividend stocks, or other ways to seek spendable income. Unfortunately, we believe such substitutes detract from effective retirement planning. The goal is to optimize expected returns ***and*** manage unnecessary risks in pursuit of a dependable outcome. As such, we suggest avoiding dubious detours along the way.

**Have a "Plan B":** What can you do instead? In "Your Complete Guide to a Successful and Secure Retirement," authors Larry Swedroe and Kevin Grogan describe how to prepare an honest "Plan B." If a worst-case scenario is realized, you're then better positioned to make any difficult decisions required to recover your footing. The authors explain:

"Plan B should list the actions to be taken if financial assets drop below a predetermined level. Those actions might include remaining in, or returning to, the workforce, reducing current spending, reducing the financial goal, and selling a home or moving to a location with a lower cost of living."

These sorts of belt-tightening choices are never fun. But you should prefer them over chasing unsubstantiated sources of return that could dig your risk hole even deeper.

**How Can We Help?**
While anyone can embrace the strategies we just described, implementing them can be easier said than done. Plus, there are more steps you can take to defend against inflation, near and far. Examples include engaging in

additional tax planning, annuitizing a portion of your wealth, tapping lines of credit like a second mortgage, optimizing Social Security benefits, and more.

We hope you'll contact us today to discuss these and other retirement planning actions worth exploring. After all, making the most of your possibilities is always a smart move, whether or not inflation is here to stay.

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