asset management associates

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Inflation and Infinity?

Inflation is too much money chasing too few goods. When consumers have extra cash in their pockets they tend to spend it. This puts excess demand on goods and services and prices rise.

For the past decade, the Federal Reserve has been trying to create inflation by increasing the amount of money available to consumers. They have had limited, if any, success. They brought interest rates down to zero and began to purchase various government bonds on the open market in order to keep rates at near zero levels. The hope was that extremely low rates would spur consumer demand and allow businesses to borrow and grow. Although this helped the stock market recover, inflation remained very low. Economists could not understand why inflation was not flaring up.

In early 2020 the pandemic hit. To most astute investors, it appeared that there was nothing the government or the Federal Reserve could do. The shutdown meant that the economy would rapidly deflate and the absence of corporate revenue caused the markets to plunge.

But the Fed came to the rescue by saying it would print money to ***infinity***. This unprecedented action worked, but it gave rise to a number of distortions that will reverberate for some time.

Help Wanted

The first major impact has been the absence of workers. No one has a clear explanation for this. Some have attributed this to the pandemic-enacted government subsidies. It was clear several months ago that many workers were earning more money not working than they would have if they went back to work. But a lot of these subsidies have ended. Workers are still scarce and some are walking away from jobs they don't like. Others are retiring early. A typical contractor has job offers but can't find help. At the same

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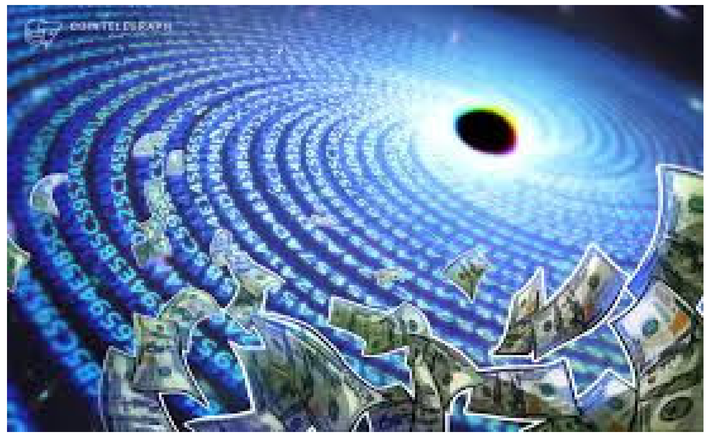

Year End Tax Considerations

Inherited IRAs: The rules on IRA accounts and inherited IRAs are complex and there are exceptions, but, in general, if you inherit an IRA from someone other than your spouse, there are a few things to keep in mind. First, the money will get dropped into a new "Inherited IRA" account. Under the new rules, this new account has to be liquidated over a period of 10 years. You could wait until the last year or take the money out any way you want. The income will be taxable at whatever your tax rate ends up being after the money is received. For those that inherited an IRA before Jan 1, 2020, you can continue to take a distribution based on your age and the corresponding IRS table.

If you are leaving a significant sum of IRA money to children, this new rule will make you want to think again about the benefit of a Roth conversion. With a Roth conversion, you withdraw money from your IRA, pay the tax and then put that money into a new Roth IRA. The benefit of the Roth is that you earn all of the return tax-free and you never have to withdraw it. If you have it in the Roth for 5 years after the Roth is opened, then you do not pay any tax on the amount distributed. If you leave it to a beneficiary, the beneficiary also gets the same benefit of tax-free growth and tax-free disbursements. It is a great plan if you are not going to use the money.

Many retirees have significant savings sitting in IRA accounts, but not a lot of taxable income. For those it would make sense to consult with an accountant and calculate what a reasonable and tax favorable IRA withdrawal would be. Then every year withdraw a certain amount from the IRA and do the Roth conversion.

401K Contributions for parents with children: The new law allows for tax credits if you have earnings under $150,000 for

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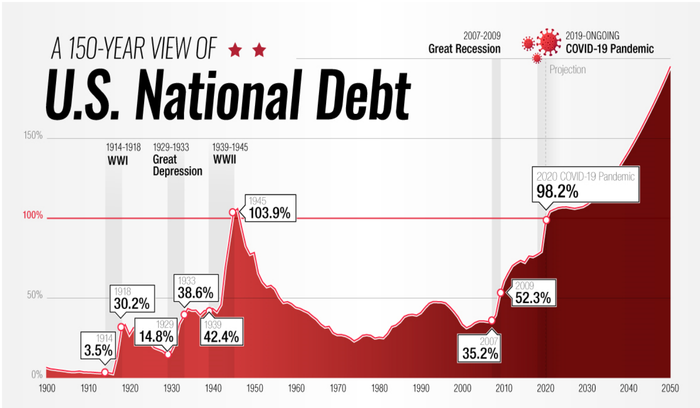

time, we still see lines of individuals at various food banks. Fed Chair, Jerome Powell, indicated that many workers are displaced due to a skill matching problem. Engineers are not so keen to wait on tables. Others say there are still a lot of subsidies. Workers may be afraid they will catch the virus, but at the same time they are afraid to get vaccinated. There are multiple issues here and it is very difficult to isolate the source of the problem.

Supply Chain

Labor shortage has led to supply chain issues in all industries. Food, computer chips and all household supplies. Ships in Southern California are lined up for miles at dockyards ready to be unloaded. Meanwhile companies are waiting for parts and supplies. If one small fastener is missing, the entire car or jet engine can not be built.

There are also delays due to the virus overseas. Manufacturing facilities in some third world countries, such as Thailand, are experiencing shutdowns due to sporadic breakouts. These countries have not been as vigilant in getting vaccines to the public.

One of the biggest and most publicized shortages has been in computer chips ranging from various memory chips and computer processors to those used as sensors in cars. Most of these comes from Asia. For this reason there are cars almost fully assembled but can not be sold because of the shortage of sensors and other electronic components to these "computers on wheels".

Shortages cut deeply into revenues of companies like Bed Bath & Beyond (BBY) and FedEx (FDX). Both stocks are down some 50% and many other companies are feeling the pressure on earnings. The problem is not that demand for their business is down, it is that they can not provide the service because they don't have the supplies or the help!

Oil and Gas

The price of gas and oil is also going up! The lack of truck

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a married couple or $75,000 for a single parent. After that there is a phase out limit. The benefit is $300 per month for each child under 6 and $250 for children between 6 and 17 years old. Keep in mind that 401k or contributions to any deductible retirement plan reduces your income. So, if you are anywhere near those cutoffs it makes sense to ask your employer to increase your contributions to your 401k for the next 3 months to reduce your income. Parents with 2 children can get $7,200 in credits if they drop their income below those levels. We don't know if these numbers will be renewed for 2022 so you should keep an eye on the numbers.

If you are self employed with no employees it should be noted that sole 401k plans need to be established prior to the end of this year. You could contribute to the plan up until April tax filing and/or October 15th of 2022, if you file an extension. A sole 401k allows you to put away 100% of your income up to $19,500 or $26,000 if you are over age 59 1/2. Plus, you can contribute a profit sharing portion, which could bring your total contribution up to $58,000 in 2021. A $58,000 deduction could save you $16,000 to $25,000 in taxes. Plus, you will have $58,000 in an investment account that can grow for your retirement.

For high earners that are sole owners, an actuary can be hired to develop a defined benefit plan. This type of plan defines what benefit or income you would receive at a certain age and then the calculation would allow for a predetermined contribution to meet that benefit. So, to obtain a certain income at age 72, you may have to contribute $110,000 for the next 8 years. All would be federally and state tax deductible making the actuarial fees worth it.

Also, if you have children, you can contribute to an education 529 plan and use the funds to pay for a private K-12 school or college. In Connecticut (not all states) you can deduct $5,000 for a single parent or $10,000 for a married couple from your state return. The funds and earnings could be withdrawn tax-free if used for educational fees. There is no holding time limit. As a matter of fact, you could put the money in this year and then spend it next year on a tuition payment to capture the state deduction for the current year. Although the actual investments in these plans are limited, they are a good benefit for most families with children.

Finally, now is the time for charitable donations. The limits for the deductions have changed. Keep in mind that everyone gets a deduction: $300 if you're a single filer or $600 for a married filer. No income minimums.

Larger donors can actually donate highly appreciated stock. Let's say you have shares of Apple Computer that you purchased years ago and have a significant capital gain. These shares can be donated to a charity. You realize the full deduction and the charity sells it tax-free and keeps the proceeds.

Finally, if you are 72 or over, you must take a required minimum distributions (RMD) from your IRA or retirement account. If you are working and currently contributing to a 401k you do not have to do the RMD. You can also donate your minimum required distribution or any part of it directly to a charity and avoid the income tax on the distribution. Better to donate out of the IRA than from other monies. There is a lot to consider in the fall and now is the time to do it - the year ends fast!

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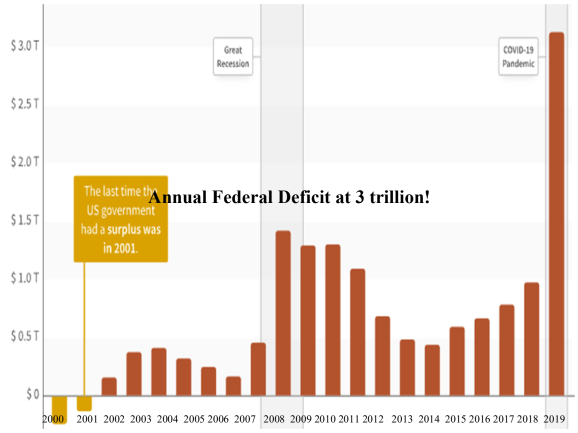

drivers delivering gas to service stations in Britain created gas lines and left many stations with no gas. Labor shortages, however, are only part of the problem. Britain and Europe have had a large shift in energy production from fossil fuels to renewable energy. But a sudden lack of wind has drastically reduced their wind power and they are now scrambling to obtain fossil fuels to pick up the slack. China is also having an energy crisis after trying to convert over to cleaner energy. They are experiencing rolling brownouts in some areas and need oil, gas and coal after they had shut off imports from some foreign suppliers. It takes time to turn on the old fossil fuel machine after you turn it off.

In the U.S and the world, oil demand dropped tremendously after the pandemic hit in 2020. But over the past six months demand has surged. As usual, no one was prepared. As in Europe, weather has had an impact here. Texas and other parts of the country had extensive damage to oil refinery and production. All of these issues are temporary but there have been multiple problems in disparate places and it has stacked up and added to the overall mess. The old OPEC nations also cut production due to lack of demand and again they have been slow to ramp up production. Also producers everywhere are not sure the direction the virus will take. It could get worse or it could subside. They do not want to over-produce and end up with a glut. The fate of renewable energy is also uncertain. It is difficult to predict how much production renewables will replace and don't forget ...winter's coming!

China's Tech and Debt Problems

China is hard to read. In addition to suffering from an energy crisis, their government is at war with their own tech companies that have become too powerful. In the U.S, we interrogate Facebook and other tech execs and debate as to what kind of action should be taken. In China they just tell an internet company what to do with no questions asked. Although the Chinese economy resembles a large capitalist society, it is still a communist nation and the current president seems to want to regress to old communist ways. The U.S is also trying to reign in Chinese corporations as they do not provide financial transparency. There is a hit list of companies that may be delisted from the NYSE and many institutional investors are already unloading U.S. shares of these companies and buying them on other exchanges.

China is also suffering from a debt overload exemplified by this past month's meltdown of a massive real estate conglomerate that may default. The WSJ noted that the amount of real estate owned by this one company is equivalent to 513 Empire State buildings! Then we have to wonder how many other Chinese real estate companies are out there that we have not heard of that are also in trouble. Again, it is difficult to predict how their government will react to this. They do not want to destroy their own economy, but they also do not want private companies to have too much power. So the combination of Chinese debt issues and their reigning in of their tech companies is contributing to supply problems around the world. One of the triggers of a U.S. meltdown has always been the concern of a meltdown in China that will spread throughout the world.

All of these things are inflationary. It has nothing to do with an economy growing too fast or consumers buying more because they have better jobs. It is just a reduction of supply under conditions we can not control. The only thing that we can do is to hope this cycle will quickly burn itself out. The Fed Chair, Jerome Powell, first indicated that the cycle would be short. This past week he said he was not so sure.

Annual Deficit

The elephant in the room that few have focused on is the annual Federal ***deficit*** and the total amount of U.S. debt that is rapidly piling up. The deficit is the difference between the tax dollars brought in and the amount that the Federal Government spends each year. Historically, we almost always spend more money than we bring in. Because of the pandemic, our deficit increased dramatically in 2020 to over 3 trillion dollars! This year will be less but just under the 3 trillion level. That is almost three times pre-pandemic levels! There are several spending bills on the table. The total amount of the proposals is running between 2 - 5 trillion. At this moment nothing has been approved.

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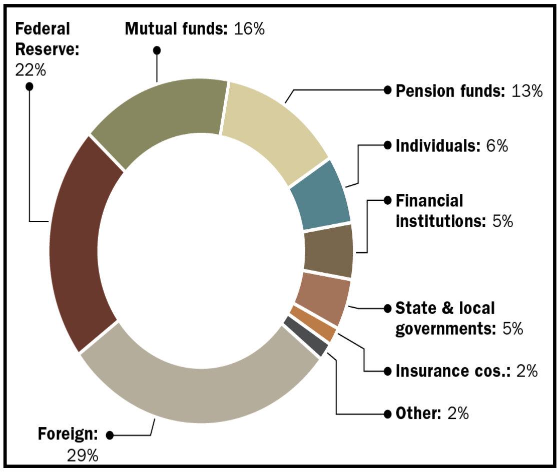

Above illustrates who is buying our debt.

Deficit added to Debt

Just like a credit card that is not paid off, the three trillion deficit is added to the balance of our Federal debt. Big numbers are meaningless to most of us. We used to talk about billions and now it's trillions. Apple, Microsoft, Amazon and Google all exceed 1 trillion in market value and all are approaching 2 trillion. In terms of deficits and debt, these numbers are growing at a rate that we have not experienced since WWII. As mentioned before, in WWII we reaped the benefit of a manufacturing infrastructure that was the best in the world. The debt we are building today is offering almost nothing in return. We are still in dire need of money to rebuild our tired infrastructure from the 1950s.

Who Buys the Debt?

The government borrows money by issuing treasury bonds. You hand the government $10,000 and lock into fixed rates up to 1/4% for 2 years to maybe 2% for 30. Not very exciting. So who would want this? The largest purchasers are foreign entities. In Germany and many European countries rates have been negative. The second largest buyer is our own Federal Reserve. Prior to 2008, they had very little to do with buying our own debt. Then it mushroomed to some 4 trillion after the banking crisis over a decade ago and they are now well over 8 trillion. The Federal Reserve Bank is buying some 120 billion in bonds on the open market every month! That's almost 1.5 trillion a year! If they didn't buy these bonds, our Treasury would have to pay higher rates to make the rates more attractive to investors. The Federal Reserve has been trying to "taper" the purchases of these bonds. So far they have not been able to pull it off without spooking the markets too much. They plan to start sometime this quarter or early next year. We will see. Unfortunately the stock market is addicted to these extremely low rates and the Fed does not really want to see a market crash due to rising rates.

Infinity and the Debt Ceiling

The above process of the U.S. Treasury borrowing money and the Federal Reserve buying debt is considered to be ***"printing money".*** The Federal Reserve Chair said he could print money to infinity. Experienced investors don't know what to make of this and they are very concerned about what will happen when they stop. Politicians are now arguing about the debt limit or ***debt ceiling***. They do this every few years. This is the maximum the government can borrow. We are now at 28.5 trillion, up almost 20 trillion over the last decade. At this rate, to add another 20 trillion in the next decade would be easy. Since they are paying bills with a credit card, we can't shut off our own credit limit so we have to continually raise the debt limit. Politicians try to use this as a bargaining chip to get other things, but at the end of the day, they raise it. They have no choice. Everything will collapse if they don't!

Conclusion

The virus, various supply shortages, labor shortages, oil prices and the growing amount of debt are distorting our normal flow of commerce. The solution thus far has been for the Federal Government to spend more money and for the Federal Reserve to print more money. The good news is that the Fed will have a tough time raising rates when doing so will not bring people back to work or help ships unload at a dock. So the situation remains the same as it has been for several years. With rates so low, there is no where else to put money, so it gravitates toward stocks and keeps investors afloat. Just be sure to have a good life jacket ..***infinity*** is a pretty long time to float!

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