ISSUE
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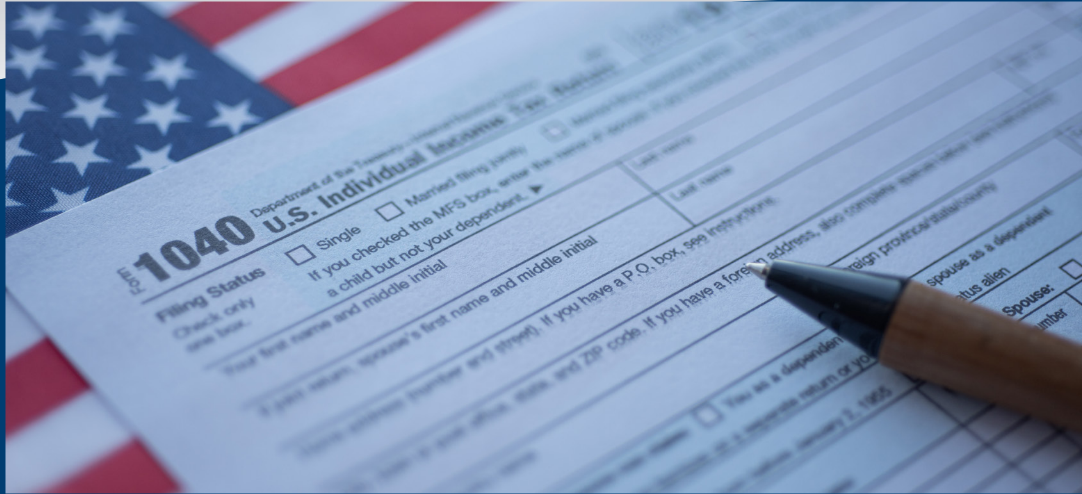
QUARTERLY NEWSLETTER
EDITION SPRING 2021

James River Wealth Advisors™



A Taxing Environment

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Our Values.

- To treat each client as they want to be treated.
- To give back to our community.
- To live by the principles of our faith.

Our Actions.

- Every client now receives a complimentary financial plan.
- We act on a model of service: to our clients, to our community, and to each other.

Overview *by Al Miller, Chief Investment Officer*

As has been famously and truthfully stated, "change is the only constant." Nine months ago, this letter previewed potential tax changes a Biden administration might propose. Now we have a bit more clarity, though still at the proposal stage.

Today's taxpayers need to prepare for the changes that are coming. Over time, deductions and credits have been eliminated, reducing the means available to reduce taxes. That makes it critical to maximize the tax benefits that remain. The president claims only a very small percentage of taxpayers will be affected by his proposals. But the dirty little secret of American tax politics is that there aren't enough of the very wealthy to move the needle. Over time, look for the threshold income levels to drop, snaring more of the middle class.

A key step in keeping your tax exposure as low as possible is to develop a financial plan. At James River Asset Management, we believe strongly in the importance of planning. So much so, we made the decision a year ago to make planning complimentary to all clients. At a time when many changes are on the horizon, our commitment to the planning process is even stronger. The proper combination of wills, trusts, beneficiaries, and account ownership is essential in seeing that your assets are protected and passed down as you desire with minimal loss to taxes.

Perhaps the most common concern addressed in planning is to answer the question, "Will I have enough money to last my lifetime?" Now an equally pressing question will be, "How can I protect the results of my lifetime of savings and investing?" Failing to properly plan can cost hundreds of thousands of hard-won dollars.

To assist our clients in navigating the new environment, we will be presenting informational calls and podcasts, bringing in experts in tax and legal issues. We stand by our commitment to prepare our clients for their best possible outcome.

James River Wealth Advisors™
15521 Midlothian Turnpike
Suite 100
Midlothian, Virginia 23113
804.323.0517
www.JamesRiverWealth.com

Biden's Tax Proposal: 10 Things You Should Know Now

To fund his large-scale infrastructure initiative, President Biden is planning to increase taxes. While these plans are still subject to significant change, it's time to start discussing key components. Forewarned is forearmed.

Today's tax rates are among the lowest U.S. citizens have experienced since the inception of the federal tax code in 1913. Unfortunately, good times can't last forever. Since the election, President Biden had been noticeably mum about raising taxes, but now that he has unveiled his $2.3 trillion infrastructure plan, the focus has shifted back to taxes as the way to pay for all (or at least some of this largesse. Because taxes are now once again front and center, it is time to revisit key components of his proposed plan and start discussing these items and who could be affected. And to be clear, the outlines of the plan are still hazy, and much is subject to change.

Corporate tax increases are on the front burner

Under the Biden tax plan, the corporate tax rate could increase from 21% to 28%, and there could be an increase in taxation of international corporate income earned by U.S. based companies. The proposal would increase the minimum tax on global profits of U.S. corporations to 21%. These increases could take effect as early as January 2022.

The President plans to levy a 15% minimum tax on the income that the largest corporations report to investors, known as book income, as opposed to the income reported to the Internal Revenue Service. Finally, Biden would make it harder for U.S. companies to acquire or merge with a foreign business to avoid paying U.S. taxes by claiming to be a foreign company.

And he wants to encourage other countries to adopt strong minimum taxes on corporations, including by denying certain deductions to foreign companies based in countries without such a tax. Janet Yellen, in the meantime, has recently called for a uniform taxation of international corporations to try to even the playing field and discourage using a corporation's location as the basis of their taxation.

According to Forbes, analysts from Goldman Sachs have predicted that Biden's entire tax plan would reduce 2022 earnings-per-share on the S&P 500 by 9%. They say it's more likely that Congress will end up passing a smaller rate increase to 25%, which would only depress earnings by 3%. But most of our work is not counseling multinational corporations, so we focus instead on changes that are being proposed for individual taxpayers and how you should be thinking about it.

Individual tax increases are not far behind

As for individual taxes, Biden would seek to reverse some of the 2017 Tax Cuts & Jobs Act (TCJA) changes and also return the estate tax to 2009 levels, thus increasing the number of estates that are subject to taxes.

Below we discuss the 10 major tax changes that could come to fruition soon under the Biden administration and how to address planning if you are concerned about taxes.

1. **Increase the top ordinary income tax rate for income over $400,000 to 39.6%.** It is unclear whether this is for families or individuals. It is currently 37% as enacted by the Tax Cuts and Jobs Act (TCJA).
   - **Planning tip:** Consider all strategies to bring down income, including funding traditional retirement plans, opening profit sharing/defined benefit plans, bunching deductions, and so on. Consider charitable giving to decrease taxes: QCDs (if 70½), CGAs, CLTs, DAFs, and donating appreciated stock to charity.

     Increase municipal bond holdings—they become more valuable when taxes increase as the tax-equivalent yield also increases. Consider barebones investment-only variable annuities to defer income. Consider decreasing dividend or other income-producing investments or placing them in retirement accounts.
2. **Eliminate step-up in basis at death and potentially create a taxable event at that time. This could be the most challenging of all to pass.**
   - **Planning tip:** Consider "basis management" as an ongoing strategy to bring down gains in portfolios, particularly if the step-up in basis is done away with. This may include paying more attention to annual rebalancing, placing stocks that are anticipated to appreciate into retirement accounts, transferring low-basis stocks to lower-income family members (up or down), gifting, charitable giving and CLT's, and so on.
3. **Replace deductions for contributions to IRAs, 401(k)s, and similar retirement accounts with a flat 26% credit.**
   - **Planning tip:** If enacted, this would make Roth accounts more attractive as you would not be receiving their full deduction for their retirement account contributions. It would also make funding retirement accounts more attractive for lower-income individuals, which is the point of this provision.
4. **Increase long-term capital gains rates on income $1,000,000 and over from 20% to 39.6%.** And don't forget the Medicare Tax of 3.8% on top of those amounts, regardless of whether the tax increase goes through or not.
   - **Planning tip:** Reduce the size of annual capital gains budget-keep to 23.8% versus potential 43,4% top rate. That may mean accelerating gains into this year, gifting highly appreciated stock to charity, more attention paid to tax-loss harvesting, and deathbed planning (depending on whether the step-up in basis is still available). Also, consider installment sales, funding retirement plans, accelerating deductions, increasing business expenses and otherwise leveling

income so as not to be in the highest tax bracket next year and not to exceed the $1 million capital gains threshold.

5. **Unified gift and estate tax exemption amounts would decrease from $11.58M to $3.5M for individuals and $23.16M to $7M for married couples.** Portability would remain, and those amounts would be indexed to inflation. There is also talk of amounts would amounts would with GRAT's (or requiring a 10-year minimum term and a minimum of 25% gift of the market value of the property). There is also discussion of getting rid of FLP discounts and limiting dynasty trusts and defective trusts, all very effective tools for the UHNW.
   - o **Planning tip:** If you fall in this category, consider aggressive gifting now, as there are no clawbacks. So use it or lose it!

     Review all trusts and estate plans in light of the SECURE Act and potential estate tax changes and consider setting up trusts now and aggressive gifting.

     Work closely with the estate planning attorney as there are risks connected with all these strategies, but your options may be limited, and there is also a lot at risk if planning is not addressed.

     Consider life insurance if illiquid assets exist in your estate, and taxes (whether through federal or state estate taxes or SECURE Act) remain a concern.
6. **The maximum amount of itemized deductions would be no more than 28% for those earning over $400,000 (again unclear whether that is individual or joint).**
7. **The earned income tax credit would be expanded to include workers age 65 and older without children living at home who are considered childless for tax purposes.**
8. **The Child and Dependent Care Tax Credit would increase from $3,000 to $8,000 for one child and from $6,000 to $16,000 for two or more children.** The maximum reimbursement rate would increase from 35% to 50%. The Child Tax Credit would increase from $2,000 to $3,000 per child ($3,600 for children 5 years old and younger). As it stands right now, these changes only apply to the 2021 tax year, but there could be an effort to extend the enhancements beyond this year.
   - o **Planning tip:** Married Filing Separately may be the best course of action.
9. **The first-time home buyer credit would be restored with a maximum of $15,000.** Under the current rules, there is no first-time home buyer credit.
10. **Tax-deferred exchanges for real estate performed under IRC 1031 would no longer be available.** Similar to IRC 1035 where there can be an exchange of one annuity for another annuity without recognition of gain, IRC 1031 applies to like-kind real estate when one property is exchanged for another held for business or investment.
    - o **Planning tip:** Consider performing like-kind exchanges this year in order to defer the gains, but make sure that any transaction qualifies under any tax law changes.

      And, contact us to discuss the hot buttons you discover.

Capital Gains at Death

- The plan also changes how wealthy estates pay tax on appreciated assets at death — the second major part of Biden's reform to the capital gains tax.
- The president would get rid of the so-called step up in basis at death for any gains of more than $1 million.
- Essentially, the appreciation of any unsold assets — also known as unrealized gains — would be subject to capital gains tax upon the owner's death. (Again, this would be as high as 43.4% for the wealthiest households.) That regime would be much different from existing law.
- Currently, an asset's appreciation isn't taxed at death. The asset gets a step-up in basis, meaning it transfers to heirs at its current market value, erasing the capital gain. Heirs could then sell the asset free of capital gains tax.
- (Estates of single individuals may owe a 40% federal estate tax on assets exceeding $11.7 million. The threshold is $23.4 million for married couples.)
- "This isn't the estate tax," Gordon Mermin, a principal research associate at the Urban-Brookings Tax Policy Center, said of Biden's proposal. "It's just taxing those gains that were never taxed."
- Wealthy estates would be able to omit $1 million of gains from tax at death. (It would be $2 million for couples.)
- This exclusion would be in addition to the existing tax break for appreciated real estate. (Single taxpayers can exclude up to $250,000 of capital gains from tax; it's $500,000 for married couples.)
- Family-owned businesses and farms would also get an exclusion—they wouldn't have to pay tax when the business or farm is passed to heirs who continue to run the business, according to the White House.
- It's unclear how Biden's proposal to tax unrealized gains at death would interact with the federal estate tax, experts said. (For example, might taxes paid on unrealized gains be deducted from the size of the overall estate?)
- "There are a lot of questions operationally how this might work," Herzig said.

• More IRS audits

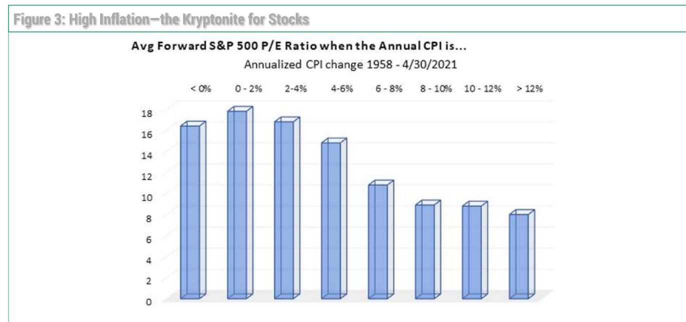
- The White House would also allocate additional resources to the IRS to enhance tax audits of households with more than $400,000 of income.
- Audit rates on those making more than $1 million per year fell 80% between 2011 and 2018, according to IRS data cited by the White House, which said its enforcement plan would raise $700 billion over a decade.
- IRC section 1031 (Real Estate Property Exchange). Limit the gains to $500,000 as a tax deferment.

Inflation Scare: Transitory or Worrisome?

Why investors care about inflation

Figure 3 shows how valuations tend to correlate negatively with the rate of inflation. The chart illustrates that, historically, when the consumer price index (CPI) shows an upward trend, the price/earnings ratio (P/E) of stocks listed on Standard & Poor's 500 (S&P 500) tends to decline.

Why might high inflation depress valuations? High inflation can lead to higher interest rates, which competes for investor cash. Put another way, higher rates reduce the present value of future cash flows. In addition, high inflation dilutes real earnings. For example, compare 10% earnings per share (EPS) growth with 2% inflation versus 10% EPS growth with 10% inflation. In the latter example, earnings are effectively zeroed out by inflation.

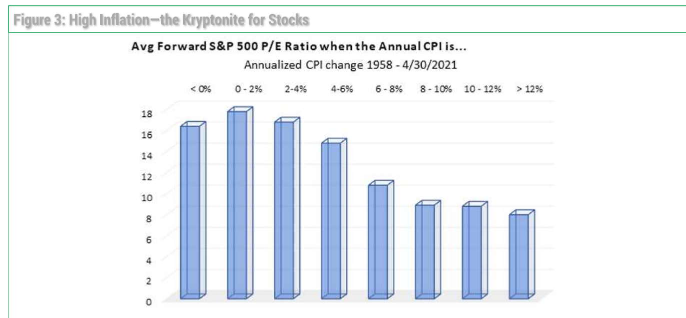


As the chart shows, an annual CPI between 0% and 2% is the sweet spot for valuations.

Why industrial production is exacerbating inflation worries

The savings rate is elevated and has been since the pandemic began, so consumers have plenty of cash and are spending it. Figure 4 highlights that retail sales are up a very impressive 17% since January 2020. Consumer goods have benefited enormously since the pandemic began; services have lagged. Some of the demand has been siphoned off by imports, which totaled a record $274 billion in March.

Strong U.S. demand should be met with a similar rise in industrial production, and the ISM Manufacturing Index, which reports U.S. production levels, has averaged a fairly robust 60.5 over the last six months. Yet, Figure 4 also highlights that manufacturing has failed to keep up with demand.



In plain language, too much money is chasing too few goods, which tends to drive up prices. Stretched supply chains are well documented. The supply side is much less flexible on the upside. It's this mismatch, coupled with April's inflation numbers, that is exacerbating inflation worries. We're learning that sparking demand is easier than bringing supply back online.

This article continues on the insert titled Inflation Scare: Transitory or Worrisome?

Upcoming Events

Market Update Calls Schedule 2021. Mark your calendar now for the following monthly Thursdays at 12:30 pm: June 17, July 15, August 19, September 16, October 21, November 18, and December 16.

Market Update Calls Enhanced. Beginning in August, clients will be offered the option to join us in person for our monthly hosted in a reserved conference room on site, providing ample space for the safety of social distancing, while also allowing for the opportunity to discuss timely relevant topics while enjoying a boxed catered lunch, courtesy of James River Wealth Advisors. The option to join by zoom will be ongoing.

Please let us know what you think about some of these newest efforts to keep our clients informed and connected, we would love to have your feedback! You can share your thoughts to our new dedicated email for clients customerappreciation@jrwealth.com

Helping exceptional families and business owners make wise decisions since 1982

15521 Midlothian Turnpike, Suite 100
Midlothian, Virginia 23113
804.323.0517
www.JamesRiverWealth.com

James River Asset Management, LLC is a Registered Investment Adviser. Securities offered through J.W.Cole Financial, Inc. Member FINRA, SIPC
4301 Anchor Plaza Parkway Suite 450
Tampa, FL 33634
Phone:
(813) 935-6776
Toll-free:
(866) JWCOLE1 (592-6531)

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Required Minimum Distributions (RMDs) and Qualified Charitable Distributions (QCDs)

Have you forgotten what a Required Minimum Distribution (RMD) is after the CARES Act (2020) allowed RMDs to be rolled back in 2020? If so, this announcement from JRWA is your refresher.

When you reach age 72, the IRS instructs you to start making withdrawals from your Traditional IRA(s). These withdrawals are also called Required Minimum Distributions (RMDs). For some of you, 2021 may be the first year you are taking an RMD. You will make them (annually) from now on.

Those of you who have taken RMDs in previous years know that if you fail to take your annual RMD (or take out less than the required amount), the I.R.S. will penalize you. You will not only owe income taxes on the amount not withdrawn, you will owe 50% more.

Many IRA owners have questions about the rules related to RMDs (especially in their first year), so let us answer a few.

When does my RMD have to be taken? Your initial RMD has to be taken by April 1 or the year after you turn 72. All the RMOs you take in subsequent years must be taken by December 31 of each year.

Is waiting until April 1 of the following year to take my first RMD a bad idea? The I.R.S. allows you three extra months to take your first RMO, but it isn't necessarily doing you a favor. Your initial RMD is taxable in the year that it is taken. If you postpone it into the following year, then the taxable portions of both your first RMD and your second RMD must be reported as income on your federal tax return for that following year and may drive up your taxes.

How do I calculate my first RMD? I.R.S. Publication 590 is your resource (see on IRS website here). You calculate it using I.R.S. life expectancy tables and your IRA balance on December 31 of the previous year. For that matter, If you Google "how to calculate your RMO," you will see links to RMO worksheets at irs.gov and a host of other free online RMO calculators.

We handle this process for you if your Traditional IRAs are held with TFGI. In a nutshell, we calculate your RMD and set up instructions to your liking (one-time distribution, monthly withdrawal, etc.). If this is your first year taking an RMO, please contact us directly and we will explain the process to you in further detail.

If your spouse is more than 10 years younger than you and happens to be designated as the sole beneficiary for one or more of the traditional IRAs that you own, you should use the I.R.S. IRA Minimum Distribution Worksheet (download PDF here) to help calculate your RMD.

If your IRA is held at one of the big investment firms, that firm may calculate your RMD for you and offer to route the amount into another account of your choice. It will give you and the I.R.S. a 1099-R Form recording the income distribution and the amount of the distribution that is taxable.

When I take my RMD, do I have to withdraw the whole amount? No. You can also take it in smaller (such as monthly) withdrawals. We can help schedule them for you.

What If I have more than one Traditional IRA? We then calculate your total RMD by calculating the RMD for each Traditional IRA you own, using the IRA balances on the prior December 31. This total is the basis for the RMD calculation. You can take your RMD from a single Traditional IRA or multiple Traditional IRAs. We do this for you. Some people choose to donate their RMD to a qualified charity. Doing this has many benefits, including tax savings.

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Qualified Charitable Distributions (QCDs)

If you are an owner of a Traditional IRA interested in donating to charity, a qualified charitable distribution may be an option.

Arguably. one of the biggest changes to the tax code from the Tax Cuts and Jobs Act or 2017 was the doubling of the standard deduction. The Joint Committee on Taxation estimates that nearly 90% of taxpayers are likely to take the standard deduction instead of itemizing. The decision not to itemize means that charitable giving doesn't offer a tax break.

But if you are over 72, qualified charitable distributions (QCOs) can be a favorable way to make donations to charities, because a distribution that meets the requirements as a QCD is excluded from gross income (so it's non taxable).

The biggest tax benefit of a QCD is that it counts towards satisfying your RMD, and therefore reduces your taxable income. By taking the RMD as a QCD, the QCD is never included in your Adjusted Gross Income (AGI). Also, by reducing your AGI, you may reduce the taxable portion of your Social Security benefits, as well as income-related adjustments to Medicare Part Band D premiums.

Now, let's review some questions that people tend to have regarding QCDs.

Do QCDs have a dollar limit? You can make a QCD of up to $100,000 for a calendar year. For married couples, each spouse is subject to a separate $100,000 limit, leading to a total of$200,000 for a married couple.

Do QCDs have a deadline? A distribution must be processed by the end of the year to be considered a QCD for that year. All distributions processed between January 1 and December 31 of a calendar year can be treated as QCOs for that year, as long as they meet the other requirements.

Must a QCD be paid directly to a charity? Yes. A distribution made to you is not treated as a QCD. Instead, the distribution must be made payable to the charity. However, distributions made in the form of a check payable to the charity can be delivered to you, and you can then deliver the check to the charity. The charity also must be eligible," meaning it meets the definition under Internal Revenue Code (IRC)170(b)(l)(A), other than an organization described in IRC S09(a)(3) or a donor-advised fund (OAF).

Can a QCD really be used to satisfy an RMD? Yes! A QCD can be used to satisfy an RMD if the QCD is processed BEFORE the RMD. Any IRA withdrawal processed before the QCD is treated as an RMD up to your RMD due for the year, and is therefore not eligible for rollover. Let's go through two common examples.

Example 1: Distribution Qualifies as a QCD

Jane's RMD for the year is $10,000. In the first week of December, Jane (age 74) submitted instructions to her IRA custodian to process a QCD for $20,000 from her IRA. At that time, Jane had not yet made any other distributions from her IRA for the year.

Even though the $20,000 is paid to the charity and not Jane, $10,000 of the $20,000 QCO is counted towards Jane's RMD for the year. As a result, Jane is not required to distribute any additional amount for the year for RMD purposes.

If Jane's QCD was for $8,000, she would need to distribute only $2,000 to satisfy her RMD ($8,000 QCD 52,000 regular distribution=$10,000 RMD).

Example 2: Distribution Does Not Qualify as a QCD

Tom's RMD for the year is $10,000. He had already withdrawn $10,000 during the last week or November. During the first week of December, Tom (age 75) Instructed his IRA custodian to process a QCD for $20,000.

When Tom heard that a QCD can be used to satisfy an RMD, he wanted to withdraw $10,000 over the amount distributed in November. However, the amount was not eligible because the first distribution made during an RMD year goes toward satisfying the account owner's RMD until the RMD is satisfied, which means that the S10,000 distributed in November is Tom's RMD. Had Tom taken that $10,000 IRA distribution after the QCD was processed, the amount would have been eligible as a QCD.

James River Asset Management, LLC is a Registered Investment Adviser. Securities offered through J.W.Cole Financial, Inc. Member FINRA, SIPC
4301 Anchor Plaza Parkway Suite 450
Tampa, FL 33634
Phone:
(813) 935-6776
Toll-free:
(866) JWCOLE1 (592-6531)

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Continued from newsletter back cover…

Inflation Scare: Transitory or Worrisome?

Figure 3 on the newsletter back cover illustrates the correlation between rising inflation and falling stock valuations. April economic reports showed a rise in certain inflation indicators, sparking stock-valuation worries.

The rise in inflation indicators

The Consumer Price Index rose 0.8% in April versus 0.6% in March. Economists had expected just a 0.2% rise. Year over year (YOY), the CPI accelerated to 4.2% in April versus 2.6% in March, representing the fastest YOY pace since 2008, when soaring oil prices lifted headline inflation. The core CPI, which excludes food and energy, rose 0.9% in April, the fastest pace in 40 years. Core inflation rose a moderate 0.3% in March. Economists had forecast a 0.3% rise in April. Core inflation rose 3.0% YOY in April, the fastest pace since 1996, versus 1.6% in March. While some of the increase was a baseline effect (comparing the April 2021 increase to the sharp decline one year ago), most of the YOY rise occurred due to the outsized gain in April 2021.

Is the trend transitory or worrisome?

Over the last 30 years, inflation hawks have sounded the alarm when concerns proved to be temporary. While today's environment is different, the Fed still insists any uptick in inflation will be transitory. The word transitory was used nine times in Powell's April press conference. Fed Vice Chair Richard Clarida said he was surprised by the April inflation report but maintained the Fed's transitory line. What's different about today's environment? What are the concerns? Several factors have helped boost spending and hiring over the last year. But, as it turns out, it's easier to fuel the demand side of the economy than the supply side of the economy. Demand is quite strong at a time when supply constraints are preventing manufacturers from meeting demand. Chip shortages are hindering auto production and driving up auto prices. Numerous commodities, including lumber, copper, corn, packaging materials, as well as labor, are in short supply. Tom Linebarger, chairman and chief executive of engine and generator manufacturer of Cummins Inc. said on a call this month, "You name it, and we have a shortage on it."

The unemployment gap

A severe labor shortage may be driving the manufacturing shortfall. If so, the labor shortage may drive up wages, which could get tacked onto prices. At first glance, however, the labor market looks weak. The unemployment rate is 6.1%. Since employment bottomed in April 2020, the economy has added 14.1 million jobs, but is 8.2 million shy of the prior peak. Powell said at his late-April press conference that the 6% jobless rate "understates the shortfall in employment." In February, he said the real unemployment rate was closer to 10%. Yet, a closer examination reveals that the number of job openings has risen by over 1 million over the last two months to a record 8.1 million as of March, topping the prior record of 7.6 million in November 2018. The record number of job openings is being blamed on lack of childcare, fear of catching COVID-19, generous jobless benefits, and even large stimulus checks, which may reduce the incentive to work. Anecdotal examples abound of employers who can't find workers and blame jobless benefits. From the Fed's April Beige Book, "Employers noted that unemployment insurance benefits have made it hard to attract workers for temporary and

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low-wage positions. Some noted that childcare and concerns about COVID-19 exposure continued to lessen worker availability as well." According to the April NFIB survey of small business confidence, 54% of business owners reported few or no qualified applicants for the positions they were trying to fill in April. Nonfarm payroll employment in April was expected to increase by 1 million workers, but the actually increase was only 266,000, which seems to suggest a reluctance to return to work. As the economy continues to reopen, we'd expect that in lesser-skilled fields (hard-hit restaurants, bars, hotels) the jobless rate would be dropping, but the opposite happened last month.

Note: The number of employed fell for those who have had some college and those with less than a high school diploma. It is one reason why generous jobless benefits are being viewed as a contributor, but not the sole cause, of labor shortages. This underemployment trend has the potential to drive up wages, spark inflation, and slow the economic recovery.

Is the trend a transitory spike?

Some arguments favor the opinion that supply constraints will eventually ease, relieving bottlenecks and pricing pressure. Few anticipate another round of stimulus checks. Inflation expectations have risen but have yet to come unanchored. The Fed dismissed a correlation between M2 (a measure of money supply that includes cash and highly liquid investments) and inflation. If you adhere to the M2 inflation argument, M2 growth has started to slow, and the velocity of money has plunged. For most businesses, labor is the biggest cost. The Employment Cost Index, which is a comprehensive measure of compensation, has risen but remains generally muted. The Fed is more attuned today than in the 1970s and would more likely hit the monetary brakes in order to meet its longer-term inflation goal if outsized price hikes continue. Labor unions have less power today than in the 1970s, when a wage-price spiral took hold. Demographic trends favor less inflation. Globalization has slowed but isn't ending, which favors slower inflation.

Is the trend unwanted inflation?

Certain arguments favor the opinion that current trends are signals of unwanted inflation. For example, the Fed's monetary policy is super-easy. The Fed insists it will not raise rates until the economy reaches full employment and isn't yet ready to talk about tapering. Consequently, investors fret that the Fed will fall behind the curve. Inflation expectations are rising in various market-based and survey-based measures. Year-over-year M2 money supply growth has exceeded 20% since May 2020. The savings rate remains quite elevated, which is likely to support spending, while supply constraints hinder production. Treasury Secretary Janet Yellen warned that an overheated economy might require rate hikes. She quickly walked back those comments, but her initial remarks suggest she is concerned about pricing pressures. Massive government stimulus is being pumped into the economy, including the latest $2 trillion relief package that included $1,400 stimulus checks for qualifying taxpayers. Huge increases in government spending have been proposed. Prices of commodities are rising.

These conditions may indicate that there is too much money on hand to chase too few goods amid strong demand and capacity constraints, tending to produce unwanted inflation. The situation demands close attention in coming weeks and months as conditions change, governments respond, and markets react.

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4301 Anchor Plaza Parkway Suite 450
Tampa, FL 33634
Phone:
(813) 935-6776
Toll-free:
(866) JWCOLE1 (592-6531)

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