WOODSTOCK

Quarterly Market Perspectives

SPRING 2021

A quarterly newsletter offering our views on the market and economic topics of interest to investors.

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Risk Factors: Regulatory Oversight and Inflation

William H. Darling, Chairman & CEO

Adrian G. Davies, President

As investors, we watch, measure and weigh. Some of us already know what we're going to do. After measuring our needs for cash over the next 18 to 24 months, we will attempt to secure the benefits of investment value compounding at an equity-like rate of return in the US stock market. Watching the financial markets, we see the likelihood of increased oversight by federal and state regulators, the chance of rising inflation which would damage the value of most financial investments (we look to invest in those with the best likelihood of recovering their former value in a reasonable amount of time), and, always, some ways to refine our philosophy of investing. Measuring the effects of increased oversight and regulation brings us to the fiduciary rule: always putting the client's interest ahead of our own. Since this is part of the Investment Company Act of 1940, we at Woodstock have been complying with this rule for all of our registered investment company life. We plan to follow it in the future.

The current regulatory push is to attempt to describe the fiduciary rule in a way that can include broker-dealers whose commission-based financial model, on its face, violates the fiduciary rule. We rely on broker-dealers to do our job. We understand they are not fiduciaries. Caveat emptor is fine with us. But our regulators don't like "relying on educated consumers" or "useful differences." Now layer in the fact that approximately 70% of the financial services industry, as measured by assets under management, is currently dual-registered as both an investment advisor under the fiduciary rule and as a broker-dealer. "Dual registration exposes fiduciary clients to unique conflicts" notes *Financial Planning*.[1] If "unique" means "unsolvable," we agree. This regulatory effort may cause short-term difficulties for firms, even ours, but

seems unlikely to change human nature. It is aimed at the wrong target.

Inflation and Monetary Policy

Sizing up the risk of inflation falls on another large federal bureaucracy, the Federal Reserve. Through the various monetary tools at its disposal, the Fed is increasing the money supply to stimulate the economy toward full employment. A stable monetary environment used to be its principal mandate (i.e., controlling inflation to preserve the purchasing power of the dollar), but in modern times it seems the emphasis is more on full employment. The path to full employment through monetary policy is complicated, however. The Fed provides an increased money supply, which commercial banks loan to entrepreneurs to grow businesses and hire more people. Commercial banks have to trust that businesspeople will pay them back and businesspeople have to trust that inflation won't make their loans too expensive, or that politicians won't arbitrarily shut down the economy, or that federal, state and local governments won't take their profits by raising taxes.

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[1] *Financial Planning, September 2020, p. 29.*

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> *"We know approximately what we will do from an investment perspective, even in extraordinary times."*

> *"Your investment advisor owes you a fiduciary duty, which means putting your interest before his, hers, or the firm's interests."*

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The Federal Reserve's efforts to boost inflation towards its target with increased money supply have animated asset prices and probably have contributed to the economic recovery. Historically, a combination of monetary policy from the Federal Reserve and fiscal policy from the executive and legislative branches (i.e., cutting taxes) have worked best. The fiscal move creates business confidence. The Federal Reserve looks like it's aiming monetary policy at a difficult target, unless supported elsewhere.

Our philosophy of investing is described in this issue and past issues of our *QMP*. As we've noted, we know approximately what we will do from an investment perspective, even in extraordinary times. We believe we've received some confirmations from disparate sources. A current entrepreneur and former US Olympic gymnast was quoted as saying, "when you go past the edge of balancing everything in your life properly (health, happiness), you're working against yourself".[2] We're watching others obsess and aim at the wrong or difficult targets. Also, goals-based financial planning tends to miss its goals because in trying to plan for 10, 20 or 30 years out "most people don't even know what's possible in the first place."[3] No one tells them that Woodstock is where they want to be. How to tell them? We're obviously not the best salespeople. We are trying very hard to "know who to approach, what to say and how to educate and motivate prospects to become clients."[4]

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

[2] *Wall Street Journal Magazine, Spring 2021, p. 32.*

[3] *Financial Planning, March 2021, p. 29.*

[4] *Financial Planning, January/February 2021, p. 31.*

A Case in Contrast

William H. Darling, Chairman & CEO

Adrian G. Davies, President

When we're thinking about how to describe Woodstock's services and to educate potential clients about the advantages of being at Woodstock, an image and a saying come to mind. The image is the *New Yorker* cartoon captioned "Where are the customers' yachts?" (see *QMP* Winter 2018) and the saying is the English description of a person who's "too smart by half."

A number of the advantages of being at Woodstock often go overlooked. Under the Investment Company Act of 1940, your investment advisor owes you a fiduciary duty, which means putting your interest before his, hers, or the firm's interests. Being invested in an individually managed account ("IMA") at Woodstock means that you own the assets in your portfolio, unlike in a pooled investment vehicle where you are probably merely a creditor of the real owner. At Woodstock, your investment manager is able to take taxes into account and in combination with asset allocation decisions, effectively offset any fees that you pay us by exercising those levers to leave the full appreciation of assets in your account.[1]

Note also that Woodstock is singly registered under the 1940 Act. Many of our larger competitors are dual registrants, operating as both investment managers with a fiduciary duty under the 1940 Act and as broker-dealers with a former "suitability" standard and, as of June 30, 2020, a "best interests" standard which cannot be as firm as a fiduciary standard because broker-dealers charge commissions.

We tend to look at our competition in general terms. We contrast our high-quality, US stock investing style with the endowment model that picks from up to 12 different investable asset classes. With rare exception, we invest clients' funds in just three asset classes: high-quality stocks, investment-grade bonds, and cash. For stock allocations, our goal is to manage portfolios of 30 to 40 stocks with a strong but not too aggressive active share,[2]

[1] *Vanguard Research, September 2016.*

[2] *"Active share" is a measure of the difference between a portfolio's holdings and those of its benchmark. For example, 30-40 stocks versus 500 almost guarantees a strong active share.*

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providing the opportunity to outperform our benchmark, the S&P 500 Index.

However, we recently had the opportunity to look at a prospect's set of accounts currently being managed by one of Wall Street's leading investment banks. A few things stood out to us. First, the accounts were divided into five or six different strategies, each with its own subaccount and accounting statement. There was one subaccount for "equity yield enhancement" stocks, one for an "opportunistic" strategy, one for call writing, one for private equity investments, one for tax loss harvesting, and so on. The result was a set of accounting statements that ran about 120 pages long. Some of these subaccounts used leverage and options, some didn't. Some even carried negative balances. The entire web of accounts made it extremely difficult to understand what the advisor was actually doing in any of the accounts and to track performance.

Upon request, the investment bank provided the performance of the equity exposure across the various strategies. Surprisingly, the overall equity performance across the diversity of strategies was remarkably close to the performance of the S&P 500 Index. This suggests the use of "optimization" software that recommends incremental portfolio changes so as to bring portfolio performance in line with an index. There's nothing wrong with using optimization software per se, but it suggests that there were considerations driving trading recommendations beyond the subaccount strategies as described.

Second, a sizeable share of the client's assets was dedicated to ten different private equity funds. Such funds require their investors to make capital funding commitments many years into the future. In this particular case, the advisor had committed the client to potentially doubling their private equity allocation in future years, requiring funds to be drawn from other subaccounts, although some of the capital commitments could possibly be satisfied with distributions from other private equity funds. From the time the initial investment was made until all the proceeds were returned, it seemed to us that the client was locked into about a 20-year investment cycle for this private equity segment. The funds' managers would be able to extract

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steep penalties for any unplanned liquidation or failure to fulfill future commitments.

The goal for private equity investing used to be to double or triple your money in 5 to 7 years. Since the 2008 recession, that goal has been elongated, as exits became more difficult to achieve. Also, returns have suffered because too many assets are chasing too few good deals or too few good private equity managers.

A final oddity was the use of a separate "tax advantaged" strategy. Some component of the set of accounts was set aside to satisfy their client's interest in tax efficiency. As long as capital losses were realized by the end of every tax year, the manager would seem to have broad discretion as to how the funds in this subaccount were invested. More importantly, the tax efficiency for this portion of the client's investable funds could be entirely undermined if other investment strategies were "tax inefficient." Indeed, other strategies involved high turnover, generating significant short-term gains when successful.

At Woodstock, tax efficiency is a cornerstone of our approach to investing – we invest all of your assets with the long term in mind so as to minimize taxes. At the same time, we keep your assets in readily tradeable investments because life's circumstances and market conditions are constantly changing. Most portfolios can be sold in a day if necessary. We prefer to hold investment-grade bonds to maturity, but they too can be sold if necessary.

The investment bank's approach seems to serve its own interests better than their clients' interest (back to the question about the customers' yachts). At Woodstock we believe clients are best served by understanding what they own and why they own it. Stocks are valued at quoted market prices every day and calculating performance is relatively straightforward. We don't believe in locking clients into their investments or their investment manager ("too smart by half"). The fact that you can move your money easily keeps us honest and focused on earning your trust every day. We are grateful that you appreciate Woodstock, and are pleased when you recommend us to others who may appreciate our approach as well.

Bright Light at the End of the Pandemic Tunnel: The Great American Reopening

Maureen J. Murphy, Vice President / Portfolio Manager

Over the past year the American economy has confronted unprecedented challenges. We haven't seen the likes of COVID-19 during our lifetimes, with a severe human toll of more than 559,000 deaths in the United States and 2.8 million globally,[1] and the financial impacts it has had on all of us. As the COVID-19 pandemic began to rage early last year, individual state-mandated shutdowns across the country brought the US economy to an abrupt halt and caused a short but deep economic recession. Notably, by early April 2020, about 300 million Americans in 43 states and Washington, D.C. -- over 90% of the population -- were under stay-at-home or shelter-in-place directives to help contain the spread of the virus.[2]

While the US economy proved resilient in the second half of last year, for all of 2020, gross domestic product (GDP) shrank by 3.5 percent. It was the first time the US economy contracted for the year since 2009, when GDP declined by 2.5% during the depths of the Great Recession. The next-worst plunge was in 1946, when the economy shrank by 11.5% as the US wound down its wartime spending. The economic damage from the pandemic has been evident in staggering job losses, with unemployment spiking to nearly 15% last April (from a previous 50-year low of 3.5% in February 2020, pre-pandemic) and waves of small-business closures.

Now, one year later, while risks still remain, we see light at the end of the tunnel. The Great American Reopening has begun and the US economy is expected to soar in 2021 at the strongest rate of growth in nearly 40 years.[3] While recent developments are mostly positive, perhaps the bad news for investors is that much of this economic optimism is

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[1] *Centers for Disease Control and Prevention, www.cdc.gov.*

[2] *Jason Silverstein, "43 states now have stay-at-home orders for coronavirus," CBS News, https://www.cbsnews.com/news/stay-at-home-orders-states/.*

[3] *Janet H. Cho, "The US economy is ripe for the strongest growth in 40 years," Barron's, 2/4/2021.*

"The US economy is expected to soar in 2021 at the strongest rate of growth in nearly 40 years."

"The Great American Reopening is four-fold: economic stimulus, record savings, pent-up demand, and herd immunity."

"'Go bold and big' has been the mantra from many (mostly Democratic) lawmakers."

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likely already largely reflected in equity market expectations.

The Economics of the Great American Reopening

The thinking behind the Great American Reopening is four-fold: economic stimulus, record savings, pent-up demand, and herd immunity. Each of these economic boosters is powerful individually and even more so collectively; they explain why economists and policymakers have been increasing their forecasts for how the US economy will perform in 2021.

Federal Reserve policymakers now project that real (inflation-adjusted) GDP will grow by +6.5% in 2021, an increase from their projection of +4.2% back in December. The Fed expects real GDP growth to moderate to a still-strong 3.3% in 2022.[4] Growth expectations for 2021 have steadily been moving higher since the end of last year. A recent survey conducted by *The Wall Street Journal* found that the economists surveyed have boosted their average forecast for real GDP growth in 2021 to +6.4 percent.[5] Of course, this is an average, with some economists forecasting even higher growth. Bloomberg economists now forecast GDP growth of +7.1% in 2021[6] and Goldman Sachs recently upped their GDP growth expectations for the US economy to 8 percent.[7] The bright forecasts for GDP growth cite overwhelmingly positive developments in recent months on accelerated rollouts of COVID-19 vaccinations and more direct-to-household stimulus payments. If these forecasts come true, 2021 will mark the year of the fastest growth the US economy has experienced on a fourth-quarter-to-fourth-quarter basis since 1983. Indeed, some economists feel that if COVD-19 doesn't flare up again, and variants don't prove challenging, even these optimistic forecasts for the economy might still be too conservative.[8]

A closer look at each of the economic boosters behind the Great American Reopening helps explain why the US economy is on track for such an expected sharp economic recovery and expansion.

Economic Stimulus: "Bold and Big"

"Go bold and big" has been the mantra from many (mostly Democratic) lawmakers in Washington in describing the urgent need to provide federal stimulus to help relieve the severe economic disruption caused for almost every American by COVID-19. So far, the federal government has enacted six major bills, costing a staggering total of $5.3 trillion,[9] to help manage the pandemic and lessen the economic burden on families and businesses. The latest round, the American Rescue Plan (enacted on March 11, 2021), provides an additional $1.9 trillion of federal relief in a variety of ways, including: direct payment to individuals ($411 billion); direct aid to state, local and tribal governments ($362 billion); extension of unemployment benefits ($203 billion); tax incentives ($176 billion); health-specific measures ($174 billion); education support ($170 billion); and other programs ($301 billion), such as funding for small businesses, emergency rental assistance and mortgage assistance.

The five relief bills enacted (under the Trump administration) prior to the American Rescue Plan include the following:[10]

Coronavirus Preparedness and Response Supplemental Appropriations Act – An initial response policymakers enacted in early March 2020 that provided $8.3B in emergency funding for public health agencies and coronavirus vaccine research.

Families First Coronavirus Response Act – Legislation totaling $192B enacted on March 18, 2020, to provide support to those in need. Key components included enhancing unemployment benefits, increased federal Medicaid and food-security spending, and

[4] *Federal Reserve, "Summary of economic projections – March 17, 2021," federalreserve.gov/monetarypolicy/files/fomcprojtabl 20210317.pdf.*

[5] *Gwynn Guilford and Anthony DeBarros, "Forecasters brace for uncharted liftoff," Wall Street Journal, 4/12/21.*

[6] *Tom Orik and Bjorn van Roye, "Global Insight: It's a 'V' – World growth to hit 60-yr high," Bloomberg, 4/1/2021.*

[7] *Dion Rabouin, "Goldman Sachs predicts US economy will grow to 8% this year," Axios, 3/15/2021.*

[8] *Justin Lahart, "Optimistic forecasts on economy might still be too dismal," Wall Street Journal, 3/29/2021.*

[9] *Data and analysis on Federal economic stimulus bills provided by Peter G. Peterson Foundation, "Here's everything the federal government has done to respond to the coronavirus so far," 3/15/2021, pgpf.org/coronavirus.*

[10] *Ibid.*

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free coverage for coronavirus testing under government health programs.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act – A relief package of approximately $2T, enacted on March 27, 2020, to address the near-term economic impact the virus was having on families and businesses. Key components included: financial assistance to large companies and governments ($500B), economic support for small businesses ($380B) which included the creation of the Paycheck Protection Program (PPP), direct payments to taxpayers ($290B, included $1200 stimulus payments to individuals based on established criteria plus an additional $500 per qualifying child), further extension of unemployment benefits ($270B), further aid to hospitals and healthcare providers ($150B), and various tax incentives.

Paycheck Protection Program and Health Enactment Act — This bill enacted on April 14, 2020, totaling $483B. It provided an additional $383B in economic support for small businesses ($321B to replenish the PPP, $60B for emergency lending for small businesses, and $2B for salaries and expenses to administer such programs), another $75B in funding for hospitals, and about $25B to fund more testing for the pandemic.

Consolidated Appropriations Act, 2021 – Enacted on December 27, 2020, the bill included $868B of federal support to help mitigate the economic impact of the pandemic. Key components included: aid to small businesses ($302B); direct payments to individuals ($164B, individuals making upto $75K per year received a payment of $600, with an additional $600 for each dependent child; all payments phased out at higher incomes); increased unemployment benefits ($119B, this package restored unemployment insurance benefit enhancements – albeit at more modest levels -- included in previous legislation that were ultimately allowed to expire. It added $300 per week in unemployment benefits and lengthened the maximum period that a worker could collect unemployment to 50 weeks, among other components); aid for schools ($82B); health-specific measures ($78B); and other measures ($123B)

The tally of $5.3 trillion in economic stimulus seems likely to not end here, given President Biden's proposed $2.3 trillion infrastructure bill announced on March 31, 2021.

Importantly, in addition to the massive fiscal stimulus, the Federal Reserve has provided aggressive monetary stimulus through implementation of a number of easy monetary policies to help stem the pandemic's damage to the economy and support financial markets. In March 2020, the Federal Reserve slashed the short-term federal funds rate to near zero percent and has indicated that it is committed to keeping rates at this level through the end of 2023. The Federal Reserve also continues to flood the financial system with money, buying $120 billion of bonds every month. This monetary action has lifted markets and kept asset prices elevated.

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Record Savings

The last two COVID-19 relief bills approved by Congress paid individuals $600 in early January and $1400 in March of this year. Ethan Harris, head of global economic research at Bank of America, estimates that there is now $3.5 trillion in leftover stimulus money sitting in American consumers' bank accounts above and beyond the normal level.[11] Consumer spending is about two-thirds of the economy; whether consumers spend their cash as well as how quickly depends on how confident they feel about a jobs recovery and their ability to safely return into the economy. The Conference Board consumer confidence index surged 19.3 points in March to 109.7, from a revised 90.4 in February.[12] The index's March 2021 reading is a pandemic-era high but is still down from its close to 20-year high reading of 132.6 in February 2020, shortly before the pandemic exploded in the US. Still, the index's climb last month is one of the largest increases on record and comes at a time when more federal stimulus payments are being doled out, more states are reopening, and hiring is speeding up.

The latest jobs report, released on April 2, was much better than expected. According to the Labor Department, US employers added 916,000 jobs in March (well ahead of the consensus estimate of 630,000), twice as many as in February and the most since August 2020. The unemployment rate fell to 6.0% in March 2021 (from 6.2% in February), its lowest level since the pandemic began.[13] The unemployment rate was 3.5% in early 2020 before the pandemic came to the US, jumped to 14.8% in April 2020 and has fallen steadily since then. The US labor market is expected to rapidly improve over the remainder of 2021 and well into 2022, thanks to aggressive monetary and fiscal stimulus and widespread vaccinations. The Federal Reserve expects the unemployment rate to end 2021 at around 5% and end 2022 at around 4 percent.[14] Job growth is expected to be especially strong in service industries, including leisure, hospitality, and entertainment services.

Pent-up Demand

While pent-up demand for goods is thought to have been largely satisfied, as evidenced by the Institute for Supply Management's (ISM) Manufacturing Purchasing Managers' Index, which has been firmly in expansion mode (with index >50) for months, there remains tremendous pent-up demand for services. According to a JP Morgan Asset Management analysis of the ISM data, “The US recorded a strong March ISM manufacturing index of 64.7, far exceeding the consensus forecast of 61.5. This 37-year high is a reflection of robust manufacturing activity driven by strong growth in orders, production and employment, along with increases in prices paid for inputs. The services sector also had a stellar March, coming in at 63.7, +8.4% from February, with all 18 service industries exhibiting growth. Previously lagging behind manufacturing, the service sectors appear to finally be catching up.”[15] The consensus view is that service sector growth is likely to remain elevated due to the pent-up demand for services that remains.

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[11] *Patti Domm, “The economy is expected to boom in the second quarter, and that's good news for stocks,” CNBC, 4/1/2021.*

[12] *The Conference Board, “The Conference Board consumer confidence index surged in March,” conferenceboard.org, 3/30/2021.*

[13] *Bureau of Labor Statistics, www.bls.gov.*

[14] *Federal Reserve, Summary of economic projections – March 17, 2021, federalreserve.gov/monetarypolicy/files/fomcprojtabl 20210317.pdf.*

[15] *JP Morgan Asset Management, weekly U.S. market recap, 4/12/2021, analysis of Institute of Supply Management data*

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> "Consumer spending growth is expected to be strong."

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> "Vaccines are becoming much more available with increased supply, more vaccination sites, and expanding eligibility guidelines."

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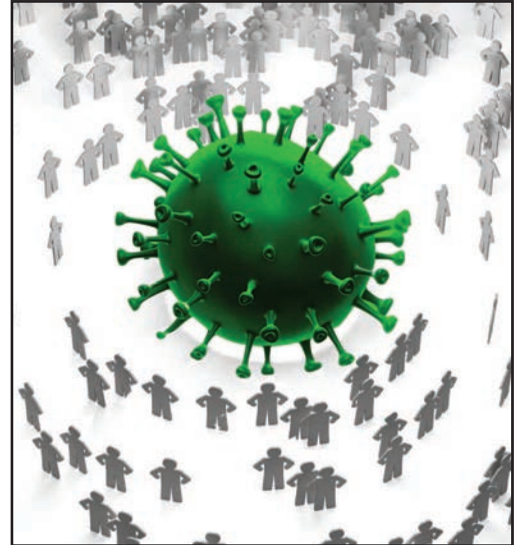
The feeling that people have about missing out on life as usual with the loss of daily, monthly or annual pleasures during the pandemic explains the tremendous pent-up demand for services. Dinner out at a restaurant, a movie, a concert, a family vacation, a wedding reception, a graduation celebration: these are all just some of the pleasures that have been on hold due to the pandemic. With vaccination efforts ramping up and households receiving over $400 billion in stimulus payments last quarter, pent-up demand is expected to come through pretty fast. Consumer spending growth is expected to be strong as retailers, restaurants, hotels, gyms and service-oriented businesses are likely see a surge in demand.

Herd Immunity

Herd immunity is the term used to define when a sufficiently large part of the population is protected against a disease such that the disease starts to peter out. While the actual number required to achieve herd immunity from the COVID-19 virus is somewhat elusive, most medical expert estimates regarding when herd immunity would be reached range between 70% to 85% of the US population.[16] The US is not there yet, but herd immunity is becoming a potential reality more quickly every day and some experts believe that the US could reach herd immunity by late summer.[17]

There are two critical elements to why we are getting closer to herd immunity: a large percentage of the population has already recovered from the virus and we are making significant progress on vaccinations. "The CDC estimates that more than a quarter of the population may have been infected by COVID-19."[18] Further, life-saving vaccines have come more quickly than many people expected and vaccinations in the US have ramped up quickly. We also have more than one vaccine being widely administered in the US.

The pace of COVID-19 vaccine administration continues to improve each day, bringing us closer to herd immunity. Data from the Centers for Disease Control and Prevention (CDC) shows that the US COVID-19 vaccination program which began on



December 14, 2020, has made significant headway. "As of April 1, 2021, 153.6 million vaccine doses have been administered. Overall, about 99.6 million people, or 30% of the US population, have received at least one dose of vaccine. About 56.1 million people, or 16.9% of the US population, have been fully vaccinated (representing the number of people who received the second dose in a two-dose COVID-19 vaccine series or one dose of the single-shot Johnson & Johnson vaccine). As of April 1, the 7-day average number of administered vaccine doses reported to the CDC per day was 2.9 million, a 15.7% increase from the previous week."[19]

On April 6, US President Biden moved the date by which he wants all adults to have access to a vaccine to April 19 (two weeks earlier than his previously stated target of May 1). Vaccines are becoming much more available with increased supply, more vaccination sites, and expanding eligibility guidelines. Speaking at the White House on April 6, Biden said that he was pleased with US progress on vaccines, but he stressed that the US must continue to ramp up efforts to beat the pandemic and Americans must remain on a "war footing."

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[16] VOA News, "Fauci: US could reach pre-pandemic 'normals' by September," March 10, 2021.

[17] Deirdre McPhillips, "US could reach herd immunity by summer through vaccinations alone," CNN, 3/5/2021.

[18] Ibid.

[19] Centers for Disease Control and Prevention, weekly COVID tracker, www.cdc.gov, 4/1/0221.

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Optimistic Expectations and Risks

Optimistic economic expectations are likely largely reflected in financial market prices and risks are present. The CDC has relaxed federal guidelines on pandemic-related restrictions as more people get vaccinated. Increasingly, states are reopening and rolling back the COVID-19 restrictions and mandates that have been in place for most of the pandemic. "According to recent data from the Kaiser Family Foundation, at least 22 states have fully reopened, removing COVID-19 economic restrictions, while almost all other states have eased their restrictions."[20] These developments, along with stimulus packages, record savings and pent-up demand, are all providing fuel for the US economy. The Great American Reopening is underway with aggressive fiscal and monetary policy having laid the groundwork for a quick recovery of the US economy.

"The Great American Reopening is underway with aggressive fiscal and monetary policy having laid the groundwork for a quick recovery of the US economy."

Equity markets have been trading higher for months on positive vaccine news, the fiscal stimulus, and economic optimism. Stocks had a strong first quarter of 2021. For the three months ending March 31, 2021, the Standard & Poor's 500 Index advanced +5.77% in price (+6.17% total return with dividends) and the index was up +17.33% (+19.63% with dividends) from its pre-pandemic high on February 19, 2020. Following the extremely positive jobs report released on April 2 and the drumbeat of other reported positive economic datapoints on the reopening front, including the surge in consumer confidence, the S&P 500 has continued to advance strongly in April. With its closing price of 4,128.80 on April 9, the S&P 500 has now advanced +9.92% in price (+10.39% total return with dividends) since the start of the year.

At 23.6 times 2021 estimated earnings and 20.5 times 2022 estimated earnings,[21] the S&P 500 index is expensive relative to historical standards. While estimates continue to be revised higher, much of the positive economic news may already be reflected in stock valuations, and future stock gains may be more limited. However, individual stocks trade along a range of valuation levels and forecast growth profiles,

suggesting there are still attractive investment opportunities to be found. We continue to be positive on our outlook for equities, particularly for the long term, and believe equity selection will be particularly critical.

"Turning to the fixed income side, bond yields are a good indicator of economic expectations."

Turning to the fixed income side, bond yields are a good indicator of economic expectations. Unlike equity markets, which tend to thrive with economic growth, bond yields tend to increase (and bond prices decrease) as economic growth prospects improve. For the first quarter of 2021, the Treasury market had its worst quarter in more than 40 years[22] as bond investors worried that a hot economy, coupled with easy monetary and fiscal policies, may lead to higher inflation. Treasury yields steepened along the curve and the yield on the US 10-year Treasury increased 81 basis points to 1.74% at March 31 from 0.93% at year-end.[23] Bond indices turned in negative total returns. For the quarter ended March 31, 2021, the Barclays US Aggregate, Barclays Investment Grade Credit, and Barclays Municipal 10-year indices provided total returns of -3.37%, -4.65%, and -0.35%, respectively.

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[20] *Talal Ansari and Melanie Grayce West, "Covid-19 vaccinations are picking up pace, but new cases are also rising," Wall Street Journal, 3/31/2021.*

[21] *FactSet, using 4/9/2021 S&P 500 Index value and earnings estimates.*

[22] *Alexandra Scaggs, "The treasury market just had its worst quarter since 1980," Barron's, 4/1/2021.*

[23] *US Department of the Treasury, https://treasury.gov/resource-center/data-chart: center/interest-rates.*

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"The threat of inflation is perhaps the greatest risk to the financial markets."

"There is also the potential drag from lagging overseas economies that could undercut US economic growth in 2021."

"Fundamental research, security selection, agility and confidence will likely all be more critical in the years ahead."

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Risks to Markets Are Present

The threat of inflation is perhaps the greatest risk to the financial markets. Economists recently surveyed by *The Wall Street Journal* "see the Federal Reserve starting to raise rates in mid-2023, rather than 2024 or later, as officials at the central bank have indicated."[24] While expectations are running high for US economic growth, the outlook also remains highly uncertain. In the past year, economists' forecasts have alternated between excessive optimism and pessimism. "Economists have noted that we are in uncharted territory as the scale of fiscal stimulus is greater than in previous recoveries, at nearly $6 trillion, or nearly 25% of annual GDP.[25] Allen Sinai, chief global economist and strategist at Decision Economics, Inc., noted, "It makes it hard for a forecaster because I've not seen anything like this, ever."[26]

There is also the potential drag from lagging overseas economies that could undercut US economic growth in 2021, and the Biden infrastructure bill is expected to be paid for in part with tax increases, which could act as a further headwind to economic growth and corporate earnings. Further, we are not yet out of the woods with COVID-19. Experts note concerns over a potential fourth surge of the virus in the US and worry that some new variants threaten progress, potentially lessening protection offered by vaccines as well as reducing some degree of natural immunity. Vaccine hesitancy, which may create some limitations, is also a concern.

For now, however, optimism is running high and investors seem pretty complacent about the risks present. Equity markets continue to surge higher to record territory. A recent research report from Bank of America (BoA) investment strategists noted that more money has gone into stocks in the past 5 months than in the previous 12 years.[27] Some $569 billion has gone to global equity funds since November, compared to $452 billion in the previous 12 years that go back to the beginning of the longest bull market in history, according to BoA Chief Investment Strategist Michael Hartnett.[28] Yet, BoA notes, "more than half of global stocks are still trading below their record highs."[29]

Market volatility is likely to remain elevated. In an environment of somewhat rich valuations for US stocks and rising interest rates, we expect future long-term investment returns could be more muted. We continue to endeavor to position client portfolios consistent with individual client investment objectives and risk tolerances and the outlook we expect ahead, while making use of the advantages of our active fundamentals-based investment approach. Fundamental research, security selection, agility and confidence will likely all be more critical in the years ahead. As always, we encourage you to contact your portfolio manager should you have any questions or concerns regarding your portfolio or our investment strategy.

[24] *Gwynn Guilford and Anthony DeBarros, "Forecasters brace for uncharted liftoff," Wall Street Journal, 4/12/21.*

[25] *Ibid.*

[26] *Ibid.*

[27] *Jeff Cox, "Investors have put more money into stocks in the last 5 months than the previous 12 years combined," CNBC.com, 4/9/2021.*

[28] *Ibid.*

[29] *Ibid.*

Tax Update: Income Inequality and Tax Collection

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Understanding when news is good probably requires disregarding what's called the "precautionary principle," which is the rule that "strongly encourages caution among regulators working in any field with scientific uncertainty."[1] Throwing caution to the wind, let's look at the state of US household wealth and income inequality. The US Federal Reserve's March 2021 quarterly release of household net worth data showed that "the value of Americans' total assets minus their liabilities swelled to $122.9 trillion" at the end of 2020, up from $111.4 trillion at the end of 2019.[2] Further, when US Census Bureau data are adjusted to count all of the government's transfer payments as "income" to recipients and when taxes paid are counted as "income lost" to taxpayers, then "income inequality" is lower than it was 50 years ago.[3]

"'The value of Americans' total assets minus their liabilities swelled to $122.9 trillion' at the end of 2020, up from $111.4 trillion at the end of 2019."

One complaint has been that the US, when compared to other countries, has a higher Gini Coefficient than it should. The Gini Coefficient measures relative wealth within a country, with 0 indicating perfect equality and 100 indicating perfect inequality. With African countries in the 50s and 60s and with our North American and European peers in the mid- to low 30s, a score of 45 for the US is considered poor and needing change. However, adjusting Census Bureau data as described above moves the US Gini Coefficient from 45 to approximately 32 and our trend line is downward sloping, which is an improvement.

Tax Collection Woes Exaggerated

While it is good to be prepared for hard times, there is no occasion for thinking of them as certain. With a balanced economic outlook, the Internal Revenue Service should be looking at collecting the revenue the government needs from compliant taxpayers paying their fair share in what turns out to be good economic times. However, if one were to listen to such diverse sources as the Congressional Budget Office, news reports about former President Trump's tax returns, or former Treasury Secretary Lawrence Summers and former IRS Commissioner Charles Rossotti, one might believe that the short-staffed IRS won't be able to collect the $600 billion of taxes owed but not paid, primarily by the owners of closely held US businesses.[4] In fiscal year 2019, the US government took in $1.7 trillion in individual income taxes with total collections of $3.4 trillion. These supposedly nefarious small business owners either do not report or misreport "up to 55% of their business income."[5] The problem is determining whether or not these small business owners are underreporting their income. The proposed solution from Washington is to require "11 million small business owners to give bank account information to the IRS and reconcile their accounts with their tax returns."[6]

"The Internal Revenue Service should be looking at collecting the revenue the government needs from compliant taxpayers."

The better solution is one the IRS uses now, and has been using, for audits. As an example, a husband and wife both have small businesses. Between their individual and

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[1] *WSJ Letter 3/26/21*
[2] *WSJ 3/13-14/2021*
[3] *WSJ 3/24/21*
[4] *Laura Saunders, "It's Easier to Avoid Taxes When You Own a Business. Just Ask Donald Trump (and Joe Biden)," WSJ, 10/10-11/2020.*
[5] *WSJ 10/10-11/2020, op. cit.*
[6] *Op. cit.*

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business accounts, they have a total of seven bank accounts. The cash portion of revenues which might not be deposited in a bank account is substantially less than 5% of revenue. During an audit, the IRS asks for all bank statements -- 12 monthly statements for each account for the audit year -- then adds up all the deposits made to each account and asks why the total of $1 million isn't the couple's revenue for the year. After backing out transfers between accounts and non-revenue items like loans, the IRS agrees that $500,000 is the correct revenue, as was reported on the couple's tax returns. The result: no change.

"The solution will prove that most US taxpayers are compliant."

The problem described by former commissioner Rossotti isn't believable because his estimates mostly inflate a minor and correctable problem. The solution will prove that most US taxpayers are compliant. Two of the seven wonders of the modern world are the US electricity grid and the cohort of mostly compliant and paying US taxpayers. Making each one of these serve too many purposes might damage the usefulness and efficiency of each. We will have no shortage of suggestions over the next year or two on how to make the US tax system more fair. The unintended consequences of radical change are hard to control. Hopefully our elected officials will realize a good thing operating compliantly and efficiently when they see it.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

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