thoughts

FROM HANSON+DOREMUS

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How worried are we about the world?...

How worried should we be? The list of potential investing headwinds is growing. The economy looks like it's decelerating as the Delta variant, supply chain constraints, and hiring challenges throw sand in the cogs of growth. Inflation is running hot. Some are even talking about stagflation, the combination of low growth and high inflation that plagued the 1970s. Throw in climbing oil prices, energy shortages in Europe and China, and rising great-power geopolitical tensions, and you may indeed think you're back in the 1970s.

All this is happening as we enter an earnings season wondering if earnings and margins finally have peaked. Analysts have raised their earnings estimates the last five quarters, and companies have beaten them the last four. And as the *first chart here shows*, profit margins are at an historic high. While companies have been able to keep up with rising input costs and labor shortages so far, things won't be easy if these challenges persist.

The period of easy earnings comparisons is over. But saying that easy times are over is not the same as saying that doom is imminent. We don't think it's time to panic yet.

Still, there are two things we can't help thinking about. One is whether labor markets are changing in ways we haven't yet fully fathomed. Workers have been quitting or choosing not to return to work in surprising numbers, and the common thinking is they will come back when they feel safe and well compensated -- a matter of time. But what if worker demands and labor markets are changing in more profound ways? *The second chart above shows* that workers have not won much of the last decades' rising corporate profits, and they may demand more.

PROFIT MARGINS AND WAGES

S&P 500 profit margins
Quarterly operating earnings/sales

Labor share of income and profit margins* Compensation and adjusted after-tax corporate profits, SAAR

Source: Chart from J.P. Morgan Asset Management with data from BEA, Compustat, FactSet, Standard & Poor's.
*Labor Guide to the Markets – U.S. Data are as of September 30, 2021.

The other thing has to do with inflation. Harvard economist Kenneth Rogoff recently wrote in *Project Syndicate* that we tend to see inflation "as a purely technocratic problem" that central bankers can solve by applying the brakes or revving up the gas. If that's the case, there's good reason to think inflation is "temporary" rather than "persistent." But, he says, long-term inflation also has roots in "political economy" problems -- geopolitical challenges, demographic aging, and sharply rising government debts. Those aren't easy fixes. Likewise, economist Nouriel Roubini has suggested that deglobalization, balkanization of supply chains, cold wars, aging populations, tighter immigration rules, and climate change all are possible contributors to sustained inflation.

- Julie Won

Hanson+Doremus Investment Management is an investment counsel firm managing portfolios for individuals and institutional clients.
The firm also consults with individuals on financial planning, and works with self-directed retirement plans on investment options.

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LOOKING BACK

By Eric Hanson

Remember that book, *Dow 36,000*?...

We are almost there now...but this is not the timing the authors had in mind. The book, *Dow 36,000*, was written by James K. Glassman and Kevin A. Hassett and published in 1999. Their thesis was that stocks were worth a lot more than they were then trading at. In fact, an awful lot more. Stocks, they argued, should be four times higher and this level could be reached in three to five years (their "best guess").

(UN)HAPPY ANNIVERSARY (2000 - 2003)

Below are some key figures showing the declines in equity wealth and stock valuations, and the diminished risk appetite of investors, since the broad market peaked nearly three years ago on March 24, 2000

	3/24/2000	2/27/2003
S&P 500	1527	837
US stock-market cap	$17.8 Tril	$9.7 Tril
Mkt cap as % off US GDP	184%	90%
1-yr fwd S&P est. Oper. Earns.	$57/shr	$52/shr
Forward P/E ratio	26.2	16.0
10-yr Treasury yield	6.17%	3.78%
Schwab avg. daily trade vol.	320,000 shrs	126,000 shrs
Investors Intelligence bulls/bears	55%/26%	40%/36%

Source: Barrons

Boy did they miss the mark. *As the chart to the right shows*, the S&P 500 went down 45% from the peak in 2000 to 2003. The Dow did a little better, off "only" 30%.

But let's back up and set the stage. The Dow in 1999 was trading at roughly 10,000, up almost continuously from the low of 777 in the summer of 1982. This amounts to a 16% average annual gain even before dividends are added back. A golden time for stocks.

James Glassman was the personal finance columnist for *The Washington Post* in the 1990s. I read all of his pieces. He was very good. He emphasized saving to the max, thinking long-term, limiting your trading, being careful about costs, and diversifying your holdings. He said all the right things.

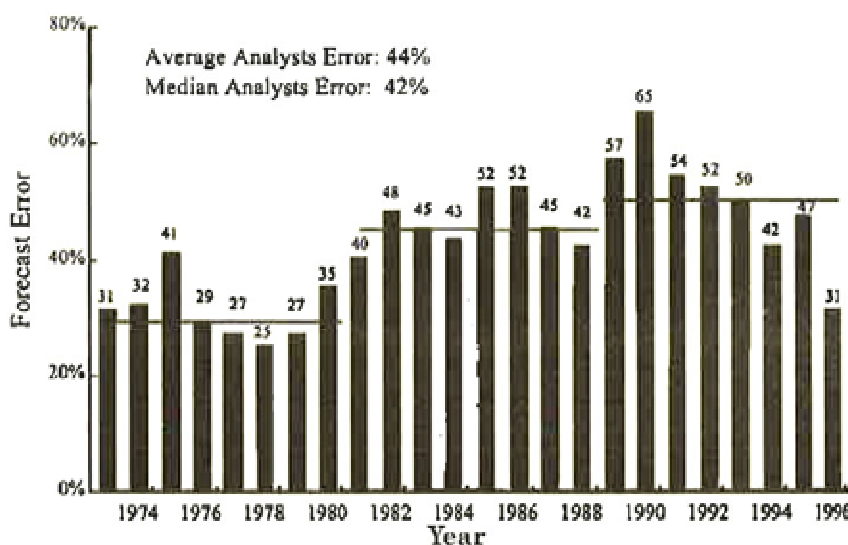
Then came the book. Glassman and Hassett argued that although stocks are volatile over the short term, you might be up 40% one year and down 40% the next, over the long term, 20 years or so, you were almost certain to get a positive return, and the volatility of this return was very low. In fact, no more volatile than long-term Treasuries. And yet stock investors have historically gotten a return 7% more per year than bonds. The authors argued if this "risk premium" went away stocks would be 4X present levels. But this meant stocks would have to sell at 100X earnings, up from an already elevated 25X in 1999! It obviously didn't happen.

What are the lessons to be learned here? First, the future is uncertain. Be careful predicting it. The authors tried to forecast earnings five, 10, and 20 years out with a degree of precision that just can't be done. David Dreman, the author and money manager, and Michael Barry of James Madison University studied analysts' quarterly earnings estimates between 1973 and 1996. They looked at 94,000 different estimates and let analysts revise their estimates up to two weeks before the end of the quarter. How accurate were they? Not very (*see chart in the lower left*). Although this data is from the time of Glassman/Hassett, I doubt the record has improved since.

The second lesson from *Dow 36,000* is that long-term investing still pays. We are at a market PE today not much different than 1999. Should we sell now? If you look back to 1999 and had invested at Dow 10,000 and then suffered through the 2000 Tech Crash and then the Housing Crash of 2008 and then all the political turmoil since, your return would still average 8% per year, with dividends added back.

Not everyone has 20 years to wait with their investments, and you should be diversified between long-term risky assets and short-term stable ones, but with your stock market money, the best advice still is to be patient and stay focused on the long term. It will pay off.

FORECAST ERROR AS A PERCENT OF REPORTED EARNINGS - 1973 - 1996



Source of data: A-N Research Corp. (formally the research department of Abel Noser Corp.) and 1/B/E/S, 1973-1996. Source: Contrarian Investment Strategies, David Dreman, 1998

RENEWABLE ENERGY

By Liz Ford

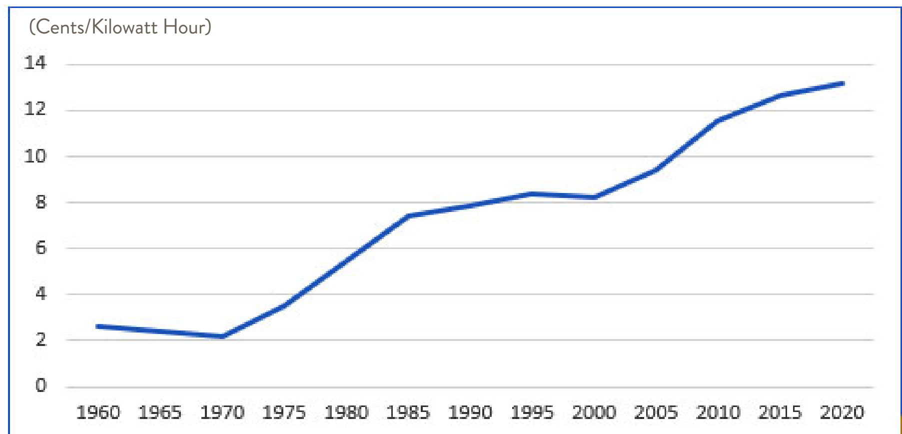
Tales from a Rooftop Solar Shopper...

Installing solar panels has been a goal since I bought my home in 2019. As my little ranch house is a classic 1971 fixer upper, my solar dreams have gotten shelved somewhere between asbestos abatement and eradicating carpenter ants. This changed for me in August with the Intergovernmental Panel on Climate Change's report that we're set to pass 1.5C of warming by 2040. The news made me feel powerless and desperate for anything to do in response. Galvanized, my south-facing roof and I are now ready to join the fight.

Researching a big investment is never easy and solar is no exception. The average U.S. residential rooftop solar array costs around $20,000 and has an expected life of 25-plus years. This doesn't include accessories, like heat pumps or batteries.

Solar company ads can make the investment appear painless. However, it's important to understand the details to avoid unexpected cash outlays, especially if you're on a tight budget.

AVERAGE U.S. RESIDENTIAL ELECTRICITY PRICES 1960 -2020



Source: Liz Ford with data from the U.S. Energy Information Administration

The Economics of Solar

Net Metering – Most solar owners remain connected to the grid, but this relationship becomes a two-way street. You get credits from your utility for contributing your excess solar to the grid, then these credits (generally good for a year) pay for electricity you draw at night or on cloudy days. If you don't use all your credits, you lose them with no cash payoff. So, it's important not to get more panels than you need. Your electricity bill won't go away completely as credits don't apply to some basic fees. It can also take up to a year to see the full reduction in your bill, especially if you install in the fall. The long, sunny days of summer will be a major source of your credits for the year.

Electricity Inflation – Since 1960, residential electricity prices have risen at an average rate of 2.8% per year (*see graph*). If your solar generation goes as planned and covers most of your electricity needs, you'll be trading these variable (and likely rising) prices for the fixed cost of your solar project. This makes the most economic sense if you plan to own your home for a long time and can benefit from the potential savings yourself. Future home buyers may or may not appreciate the value of your solar project.

Financing – Paying in cash will have the lowest project cost, but for many of us this isn't a viable option. Thankfully, a wide variety of loans are available. Those looking for the lowest monthly payments may be eligible for low-rate "solar mortgages" requiring little to no money down. Payments are generally a little higher than your current electricity bill, with the idea that much of your bill will eventually be offset by solar credits. The trade-off is that these 20-plus year loans will likely have the highest total project cost given the length of financing.

Tax Benefits – The 26% Federal Investment Tax Credit can be applied to most project costs (including financing fees and batteries) for projects installed before 2023. In 2023, it drops to 22%. To claim the credit, you must have taxes to offset. You have 20 years to use the credit, which is good if your tax burden is very low. If you're financing, it's important to estimate how long it will take to get the full credit, as many lenders expect you to hand over this credit quickly as a principal repayment. Other tax benefits vary by state but may include exclusion from sales and property taxes.

Unexpected Startup Costs – Unfortunately, you may need to budget for more than the solar provider's estimate. You may need roof repairs, tree trimming, and electrical upgrades for a successful installation.

So where am I now? After consultations with several solar companies, I feel confident that I can get this project done by the end of 2022. They've helped me understand how many panels I will need, and I've decided to include heat pumps which will decrease my gas bill but raise my electrical use. Long-term financing is within my budget, but I also want to give myself time to save a larger cushion for unforeseen extras. The aspect I've found most challenging, though, is planning for future renewable upgrades. Do I include more panels to charge the electric car that I don't own yet?

By Anne W. Doremus

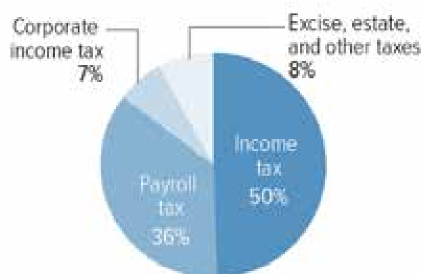
The tax man cometh...

Eventually some version of Joe Biden's big social spending bill will pass. While we don't know the final price tag, we can be sure of one thing: higher taxes will be needed to pay for the wide range of health care, education, childcare, and climate initiatives embedded in the bill. To understand the proposed tax changes, it helps to step back and look at how our federal government levies taxes today. *As the chart below shows*, half of what the U.S. raises today comes from the personal income tax. Another 36% comes from payroll taxes – this includes the 12.4% that is used to fund Social Security and the 2.9% tax that funds Medicare. Of the remaining 14%, only half comes from corporate taxes. Given the funding challenges associated with Medicare and Social Security and the limited scope of corporate tax revenue, it is clear that the personal income tax will have to play a central role in any serious revenue raising effort.

Current proposals aim to raise approximately $2 trillion in new tax revenue. On the corporate side, there are two main initiatives: increasing the tax rate from 21% to 28% and expanding the tax on foreign earned income. Many of the tax breaks enacted in the 2017 tax reduction bill would also be eliminated. On the personal income tax side, the top "marginal" tax rate would rise from 37% to almost 40%. Those earning more than $5 million annually would face another 3% surcharge. Especially relevant for investors, the federal long-term capital gains rate for the wealthiest would rise from 23.8% to 31.8%. Changes to the federal estate tax are also possible.

There are a few things to note regarding these proposals. First, Joe Biden's campaign promises included a pledge not to raise taxes on households with incomes below $400,000. That pledge together with broad voter concerns regarding income inequality are putting the very wealthiest Americans in the crosshairs. According to the non-partisan Joint Committee on Taxation, under the current proposals, households earning more than $1 million a year would see their taxes increase by 11% in 2023 while taxes would drop for those making less than $200,000.

SOURCES OF FEDERAL TAX REVENUE, 2019



Note: "Other Taxes" category includes profits on assets held by the Federal Reserve. Figures may not add due to rounding.

Source: www.cbpp.org; Office of Management and Budget

Second, while marginal income tax rates are likely to go up and no one likes higher taxes, tax rates would still be at historically low levels. *As the chart above shows*, between roughly 1931 and 1981, marginal tax rates exceeded 60%, sometimes by a substantial amount. Rates dropped to 50% under the Reagan administration and since 1987 have remained below 40%. The last tax increase occurred over 28 years ago. Since then, the substantial spending increases, under both Republican and Democratic administrations, have been largely funded by increased borrowing.

Finally, it is important to view U.S. tax policy in a global context. In a recent article, *The Economist* reported that in 2019, the U.S. had an overall tax-to-GDP ratio of 24.5% -- a full nine percentage points below the average for our peer OECD developed countries. If enacted, the long-term capital gains rate would be at the high end when compared to our global peers while corporate rates would be about average.

TAXING THE RICH: HOW AMERICA'S MARGINAL TAX RATE EVOLVED.

Historic highest marginal income tax rates in the U.S *

*Marginal tax rate is the highest tax rate paid on someone's income and only applies to income over a certain level. - e.g. earnings above $200,000 in 1960 were tax at 90%.

Source: www.statista.com; Tax Policy Center

It is too early for investors to start making portfolio adjustments given the uncertain state of the bill's tax provisions. But there are a few things we do know today. Taxes are likely going higher in the years ahead. This means that any number of tax reduction strategies, things like capital loss harvesting and the use of tax deferred accounts, will become increasingly important ways to maximize after-tax returns – the key metric that investors of all tax brackets should keep an eye on.

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