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KENDALL CAPITAL
Serving Middle-Class Millionaires®

3rd Quarter 2021:
U.S. Economic Growth Slows in the Face of Delta. Stocks Retreat from Record Highs; Confront a Bevy of Challenges

By Clark Kendall

In This Issue

The Quarter In Brief

Overcoming rising Delta variant infections, a slowing economic expansion, and growing inflation worries, stocks raced higher through the course of the first two months of the third quarter, propelled by strong corporate earnings, the absence of compelling investment alternatives to stocks, and a "buy on the dip" investor mentality. Investors, however, turned more cautious in September, wary of the season's rocky reputation, persistently high levels of COVID-19 cases, the length of time that the market has gone without a meaningful retreat, and the fiscal and tax policies under discussion in Washington, D.C.

Amid this caution and absent any positive catalysts, September turned volatile, with stocks retracing their earlier gains as seasonal weakness was exacerbated by the mounting financial difficulties of a debt-laden, large property developer in China and rising bond yields.

Stocks steadied briefly following a Federal Reserve announcement that its bond buying would continue, with tapering of monthly purchases likely beginning in November and extending into mid-2022. However, a surge in bond yields in the closing week of the quarter unsettled investors and led to steep declines, especially in the technology and other high growth stocks. (Higher interest rates decrease the value of future cash flow, often resulting in lower current stock price valuations.)

In the end, September erased the gains built

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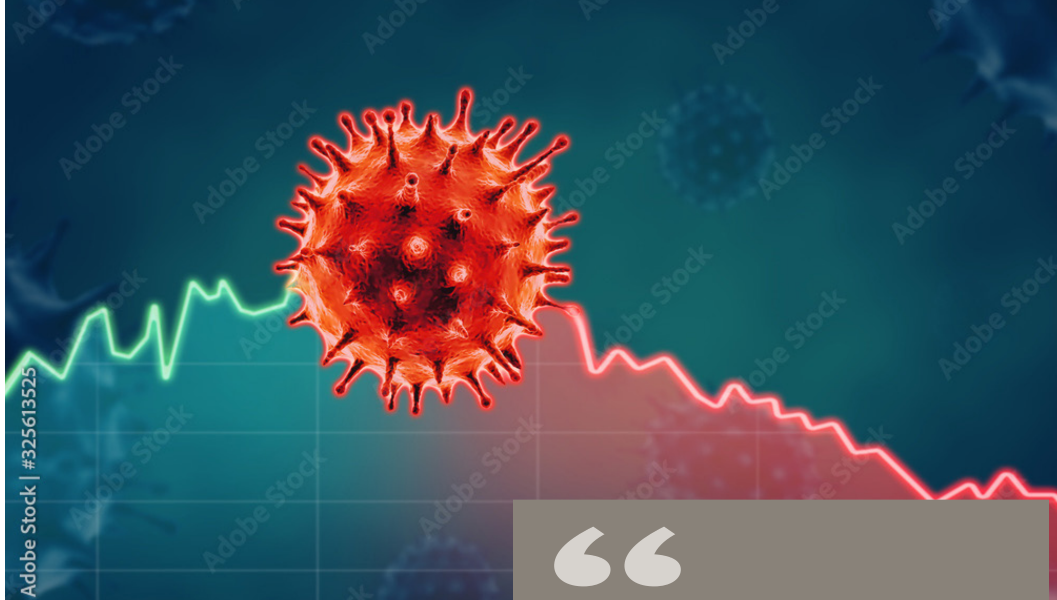

over the previous two months, leaving major indices largely flat for the third quarter.

Investors saw another quarter of exceptional corporate earnings growth. Second-quarter earnings exceeded Wall Street estimates for 87% of the companies comprising the S&P 500 index. Anticipating continued strength in earnings growth, market analysts have increased earnings estimates by 3.7%, expecting that the earnings growth rate will come in at 27.9% for the third quarter. If these estimates are realized, this would represent the third highest year-over-year earnings growth rate in over a decade.

The U.S. Economy

The U.S. economy continued its remarkable recovery in the second quarter, aided by a substantial pick-up in the pace of COVID-19 vaccinations nationwide, an increase in economic reopenings at state and local levels, and by government stimulus spending.

Though second-quarter economic growth won't be known until July's release of the Q2 GDP (Gross Domestic Product) report, the economy looks to be building on its first-quarter gains.

According to the Federal Reserve Bank of Atlanta, which tracks economic data in real time, their model is pointing toward a 8.3% real rate of GDP growth in the second quarter.

Economic data released during the quarter suggest that the Federal Reserve Bank of Atlanta's estimate looks realistic. Manufacturing activity, as measured by the ISM (Institute for Supply Management) Manufacturing PMI (Purchasing Managers Index), rose in May, marking the 12th consecutive monthly increase. The central challenge for U.S. manufacturers has been meeting high-consumer demand, as the combination of increased consumer spending and supply chain bottlenecks have created temporary shortages. Meanwhile, the ISM Services PMI reached an all-time high in May, rising for the twelfth straight month, as well.

Consumer confidence is high, with June's reading reaching its highest level since the onset of the pandemic in March 2020, according to the Conference Board's Consumer Confidence Index.

This elevated level of consumer confidence is backed by some $2 trillion in personal savings that Americans may be looking to spend as the summer unfolds and vaccination rates increase further.

The labor market recovery, which has lagged other parts of the economy, such as consumer spending and manufacturing, saw meaningful improvement in the second quarter. The weekly initial jobless claims fell below 400,000 for the first time since the pandemic began, while job openings reached 9.3 million, the highest number ever recorded by the Department of Labor's Job Openings and Labor Turnover Survey (JOLTS).

The Federal Reserve's revised outlook on economic growth grew a bit more optimistic. In its June publication of members' economic projections, the median view was that GDP growth would come in at 7%, a half percentage point higher than its March projection. Accompanying this higher economic growth revision was also a change in members' inflation expectations. The median inflation expectation for 2021 jumped to 3.4%, up from its 2.4% March estimate. Its view on the unemployment rate was unchanged, projecting the unemployment rate to end the year at 4.5%.

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Global Economic Health

After a decline in output in the first quarter, economic activity in Europe picked up in the second quarter thanks to a widening vaccination distribution and a relaxation of economic restrictions. Despite its slow start to the year, the Euro area economy is projected to grow by 4.3% in 2021, powered by consumer spending, fiscal support, and exports. Unemployment levels are expected to fall to near pre-crisis levels.

As vaccination rates have hit 70% in the U.K., the return to economic normalcy has been quicker than on the continent. This high rate of vaccinations, along with accommodative fiscal policy, is expected to lead to a 7.2% growth in GDP this year.

China's vaccination rollout has only recently gathered steam, with its slow start limiting full recovery from the pandemic shutdown. Nevertheless, China's recovery has been strong,

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MARKET INDEX	Y-T-D CHANGE	Q3 CHANGE	Q2 CHANGE
DJIA	+10.58	-1.91	+4.61
NASDAQ	+12.11	-0.38	+9.49
S&P 500	+14.68	+0.23	+8.17
BOND YIELD	9/30 RATE	1 MO AGO	1 YR AGO
10 YR TREASURY	1.53%	1.29%	0.68%

Sources: Wall Street Journal, September 30, 2021, Treasury.gov (Bond Yield)

The market indexes discussed are unmanaged and generally considered representative of their respective markets. Individuals cannot directly invest in unmanaged indexes. Past performance does not guarantee future results. U.S. Treasury Notes are guaranteed by the federal government as to the timely payment of principal and interest. However, if you sell a Treasury Note prior to maturity, it may be worth more or less than the original

with economic growth this year projected to be 8.5%. Investment has led the recovery, with consumer consumption growth rebounding more slowly. Imports and exports have seen a solid improvement.

After finding early relative success in recovering from the pandemic's economic impact, Japan declared a state emergency in April due to rising infection rates in certain prefectures. The economic containment measures subsequently implemented were insufficient to stem the virus's resulting in muted economic growth in the second quarter. Despite this, Japan's economy is anticipated to expand this year, albeit at a tepid 2.6% rate.

The MSCI-EAFE Index, which tracks developed overseas markets, rose 4.37% in Q2, while emerging markets, as measured by the MSCI-EM (Emerging Markets) Index, gained 4.42%.

Looking Back, Looking Forward

The third quarter was a reminder of how difficult it is to project the future amid a global pandemic. Investors entered July increasingly optimistic about an acceleration of the economic recovery, the prospect of rising vaccination rates, the reopening of schools, an easing in labor shortages, and a return to the office. By September, with the Delta variant lingering, employers delayed their plans for a return to the office, some mask mandates were reinstituted, and consumers pulled back on spending and travel.

Despite the deceleration in economic expansion, markets managed to climb to new record highs through most of the third quarter, though they stumbled in September.

If the market is to add to its year-to-date gains in the fourth quarter, it will need to climb a wall of worry. The worries include the expected start of tapering, global central bank tightening, fiscal and tax policy uncertainties, Covid infection levels, inflation, and whether corporate earnings can continue to impress in the wake of this quarter's economic slowdown.

With the Federal Reserve's September announcement that it may be set to begin tapering, the Fed joins a growing number of global central banks that have begun winding down the accommodative monetary policies that were put in place in response to the pandemic.

Of course, the pace of monetary tightening may be dictated, in part, by the prevalence of Delta variant infections over the course of the fourth quarter, as well as the state of labor market recovery, which continues to be prioritized over inflation by the Fed.

Inflation has touched levels not seen in over 40 years. Supply chain constraints continue to be a major factor in higher prices for businesses and, in turn, consumers. Especially troubling is that these bottlenecks may last for another year or longer. For now, the credit and equity markets seem to agree with Fed Chair Jerome Powell's argument that inflation is transitory.

The question for investors is whether the markets will continue to accept that inflation is a transitory phenomenon should price pressures continue to rise through the fourth quarter.

While Washington may have been a tailwind for the market since hitting pandemic lows, it may turn out to be a headwind in the months ahead. Investors are wary of the impact on investments and corporate profits included in the proposed infrastructure plan and the new, higher taxes under discussion to pay for such spending.

Lastly, corporate profits and sales have exceeded market expectations in recent quarters, laying the foundation for the markets to move higher. As earnings are reported over the course of October and November, American businesses will need to once again show earnings growth that not only supports current price levels but also helps provide the rationale for higher valuations.

It's a formidable wall to climb. Still, many of the conditions for continued stock market strength remain in place, specifically, a financially healthy consumer, an accommodative monetary policy (the Fed is not expected to hike rates until late 2022), strong corporate earnings, healthy economic expansion, and improving corporate cash balances.

Annual Financial To-Do List

By Carol Petrov

What financial, business, or life priorities do Middle-Class Millionaires need to address for the coming year? Now is an excellent time to think about the investing, saving, or budgeting methods you could employ toward specific objectives, from building your retirement fund to managing your taxes. You have plenty of choices. Here are a few ideas to consider:

Can you contribute more to your retirement plans this year?

In 2022, the contribution limit for a Roth or traditional individual retirement account (IRA) is expected to remain at $6,000 ($7,000 for those making "catch-up" contributions). Your modified adjusted gross income (MAGI) may affect how much you can put into a Roth IRA. With a traditional IRA, you can contribute if you (or your spouse if filing jointly) have taxable compensation, but income limits are one factor in determining whether the contribution is tax-deductible.

Once you reach age 72, you must begin taking required minimum distributions

from a traditional Individual Retirement Account in most circumstances. Withdrawals from Traditional IRAs are taxed as ordinary income and, if taken before age 59½, may be subject to a 10% federal income tax penalty.

To qualify for the tax-free and penalty-free withdrawal of earnings, Roth 401(k) distributions must meet a five-year holding requirement and occur after age 59½. Tax-free and penalty-free withdrawal can also be taken under certain other circumstances, such as the owner's death. Employer match is pretax and not distributed tax-free during retirement.

Make a charitable gift.

You can claim the deduction on your tax return, provided you follow the Internal Review Service guidelines and itemize your deductions with Schedule A. The paper trail can be important here. If you give cash, you should consider documenting it. Some contributions can be demonstrated by a bank record, payroll deduction record, credit card statement, or written communication from the charity with the date and amount. Incidentally, the IRS does not equate a pledge with a donation. If you pledge $2,000 to a charity this year but only end up gifting $500, you can only deduct $500.

Make certain to consult your advisor here at Kendall Capital and/or a tax professional before modifying your record-keeping approach or your strategy for making charitable gifts.

> "Tax-efficient asset location is one factor that can be considered when creating an investment strategy."

See if you can take a home office deduction for your small business.

If you are a small-business owner, you may want to investigate this. You may be able to write off expenses linked to the portion of your home used to conduct your business. Using your home office as a business expense involves a complex set of tax rules and regulations. Before moving forward, consider working with a professional who is familiar with the tax rules as they relate to home-based businesses.

Open an HSA.

A Health Savings Account (HSA) works a bit like your workplace retirement account. There are also some HSA rules and limitations to consider. You are limited to a $3,650 contribution for 2022 if you are single; $7,300 if you have a spouse or family. Those limits jump by a $1,000 "catch-up" limit for each person in the household over age 55.

If you spend your HSA funds for non-medical

expenses before age 65, you may be required to pay ordinary income tax as well as a 20% penalty. After age 65, you may be required to pay ordinary income taxes on HSA funds used for nonmedical expenses. HSA contributions are exempt from federal income tax; however, they are not exempt from state taxes in certain states.

Pay attention to asset location.

Tax-efficient asset location is one factor that can be considered when creating an investment strategy.

Review your withholding status.

Should it be adjusted due to any of the following factors?

- You tend to pay the federal or state government at the end of each year.
- You tend to get a federal tax refund each year.
- You recently married or divorced.
- You have a new job, and your earnings have been adjusted.

Consider consulting your tax, human resources, or accounting professional before modifying your withholding status.

Did you get married in 2021?

If so, it may be an excellent time to review the beneficiaries of your retirement accounts and other assets. The same goes for your insurance coverage. If you are preparing to have a new last name in 2022, you may want to get a new Social Security card. Additionally, retirement accounts may need to be revised or adjusted.

Are you coming home from active duty?

If so, go ahead and check on the status of your credit and any tax and legal proceedings that might have been preempted by your orders.

Consider the tax impact of any upcoming transactions.

Are you preparing to sell any real estate this year? Are you starting a business? Might any commissions or bonuses come your way in 2022? Do you anticipate selling an investment that is held outside of a tax-deferred account?

If you are retired and in your seventies, remember your RMDs.

In other words, Required Minimum Distributions (RMDs) from retirement accounts. In most circumstances, once you reach age 72, you must begin taking RMDs from most types of these accounts.

Vow to focus on your overall health and practice sound financial habits in 2022. And don't be afraid to ask for help from your advisor here at Kendall Capital who understand your individual situation.

If you are retired and in your seventies, remember your

Carol Petrov
CFP®

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The Pros and Cons of Early Retirement Plan Rollovers

By Brian Mattox

Should you withdraw and reinvest your retirement plan money while you are still on the job?

Did you know you may be able to take your 401(k), 403(b), or 457 plan and roll it into another type of retirement account while you are still working? We often have clients here at Kendall Capital wondering if they should make this move. Let's look at how these rollovers can happen and the pros and cons of making them.

To start, some basics

Distributions from 401(k) plans and most other employer-sponsored retirement plans are taxed as ordinary income, and if you take one before age 59½, a 10% federal income tax penalty commonly applies. In addition, 20% of the withdrawn amount is withheld for tax purposes. Generally, once you reach age 72, you must begin taking required minimum distributions.

Now, the fine print.

You may be able to take a distribution from your qualified, employer-sponsored retirement plan while still working, via an in-service non-hardship withdrawal. This is done by arranging a direct rollover of these assets to an Individual Retirement Account (IRA) in order to potentially avoid both the 10% penalty and the 20% tax withholding in the process. It's important to note that this option is only available if allowed by your employer.

Generally, distributions from traditional IRAs must begin once you reach age 72. The money distributed to you is taxed as ordinary income. When such distributions are taken before age 59½, they may be subject to a 10% federal income tax penalty.

The criteria for making in-service non-hardship withdrawals can vary. Some workplace retirement plans simply prohibit them. Others permit them when you have been on the job for at least five years or when assets in your plan have accumulated for at least two years or you are 100% vested in your account.

Weigh the pros and cons

Who knows if your reinvested assets will perform better in an IRA than they did in your company's retirement plan? Only time will tell. Right now, you can put up to $7,000 into an IRA, annually, if you are 50 or older. The limit on annual additions, however, is much more impressive at $58,000 for 2021. Lastly, if your employer matches your retirement plan contributions, getting out of the plan may mean losing future matches.

We encourage you to speak to your advisor here at Kendall Capital before making any changes.

> "You may be able to take a distribution from your qualified, employer-sponsored retirement plan while still working."

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Chief Investment Officer, Vice President

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Managing your Health Savings Account Effectively in your Estate

By Katelyn Murray

Health Savings Accounts, called HSAs for short, function differently than most other kinds of accounts.

I call them financial planning "unicorns" because of how differently they're handled from a tax and estate planning standpoint. During your lifetime, an HSA can be a very effective savings tool for funding medical expenses, especially since the IRS allows people with a high-deductible, HSA-eligible health insurance plan to contribute money on a pre-tax basis to an HSA ($3600/year for individuals and $7200/year for those on a family plan as of 2021) and to then withdraw that money, both principle and earnings, completely tax-free, provided the funds withdrawn are used to cover qualified medical expenses.

Based on that information, it would seem that funding an HSA is a no-brainer, and we do recommend that many of our clients leverage this unique account that can provide triple-tax savings. However, large HSAs can often become liabilities in the context of estate planning, when proper forethought and care is not given to understanding how HSA-inheritance is structured from a tax perspective.

There are three common outcomes for an HSA in the event that the account owner dies:

1. **If the HSA owner has listed his or her spouse as beneficiary on the HSA,** the inherited HSA becomes the spouse's own HSA as of the account owner's date of death. The money stays invested in the HSA and the surviving spouse's name is simply added to the account so that he or she may make tax-free distributions from the HSA to pay for his or her own qualified medical expenses just like the original account owner would have. In this instance, the HSA is not included in the estate, since it becomes the property of the spouse on the account owner's date of death.

2. **If the HSA owner has listed a non-spouse beneficiary,** such as a child, on the HSA, it's a completely different story. As of the date of death of the account owner, the HSA is no longer considered an HSA for tax purposes and an immediate, taxable distribution of the entire balance in the HSA is made to the non-spouse beneficiary. Again, this distribution is taxable to the non-spouse beneficiary, so he or she must include the HSA balance in his or her taxable income in the year of the account owner's death. Since the distribution is due to death, the normal 20% penalty that applies to distributions taken from an HSA that are not used for qualified medical expenses, does not apply—so the beneficiary will pay income taxes at his or her marginal tax rate on the full amount of the HSA balance, but no penalties will apply. Additionally, any portion of an inherited HSA balance used to pay for outstanding medical expenses of the account owner within one year of the account owner's death will not be taxable to the non-spouse beneficiary. In this case, the HSA is not included in the estate, since the full HSA balance is taxed as income to the non-spouse beneficiary on his or her own individual tax return.

3. **If the HSA owner has listed his or her estate as the beneficiary on an HSA**, the account balance in the HSA is simply included in the deceased owner's gross income for the year of his or her death. In this case, the HSA is still not included in the gross estate because it is considered income received by the account owner in the year of his or her death and is reportable as income on his or her final tax return.

The key takeaways here are:

1. Make sure you have your living spouse listed as beneficiary on your HSA to avoid your death resulting in a taxable distribution of the account!

2. If you have no living spouse, consider the tax ramifications of listing a non-spouse beneficiary such as a child, given that 100% of the account balance will be distributed to that child in the year of your death, and it will be taxed at the child's income tax rate at that time.

3. If you are charitably inclined and plan to leave a portion of your assets to charity, consider listing a charity as beneficiary on your HSA, since they will receive the full amount of the account balance with no taxes or penalties due. You can always leave the rest of your estate—your IRAs, Roth IRAs, 401ks, brokerage accounts, etc.—to your children, who will benefit from the tax-advantaged status of these accounts and the step-up in cost basis at death.

4. Prioritize spending down your HSA (to the extent of your qualified medical expenses, and potentially beyond that extent once you reach age 65 and are no long subject to the 20% penalty for withdrawals not spent on medical expenses) rather than your retirement accounts, because your children and other non-spouse heirs would rather inherit a tax-advantaged retirement account than an HSA.

If you're interested to learn more about how your HSA will be handled after your death, or if you don't have an HSA and are interested in learning more about these unique savings vehicles, feel free to reach out to our team at Kendall Capital! We'd love to help you and your family plan efficiently.

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