Trust Company Oklahoma

INVESTMENT PERSPECTIVES

JULY 2021

FLEETING OR FOREVER?

Evaluating Whether Inflation Is Temporary or Here to Stay

When I first became interested in investing and financial markets (more years ago now than I care to admit), I made it a regular practice to watch "Wall Street Week with Louis Rukeyser" every Friday night on public television. One of Rukeyser's frequent guests was the late Martin Zweig, a well-respected investor, investment adviser and financial analyst. I remember well one episode in which Rukeyser asked Zweig which economic indicator he believed to be most important to monitor. Without hesitation he replied, "inflation." He went on to explain that because one of the mandates of the Federal Reserve (Fed) is to maintain a stable price environment, and because the resulting monetary actions of the Fed have such an important influence on the economy and financial markets, inflation in his opinion was the single most important factor to watch.

Ever since the 2008 global financial crisis and the Fed's extreme monetary policies in response, economists and central bankers have continually warned about the risks of inflation. Yet over the last four decades, inflation declined substantially, from 7.4% in the 1970s to a mere 1.8% in the 2010s. The 2.0% inflation target established by the Fed in 2012 has rarely been breached. Near-zero interest rates and supportive fiscal policies have led to predictions of possible runaway inflation, but instead it has remained stubbornly low.

RISK TO FINANCIAL MARKETS

Recently, however, concerns about inflation have been rising. According to Bank of America/Merrill Lynch's widely followed survey of global investment managers, inflation is now seen as the greatest risk to financial markets, ahead even of the pandemic. A significant and lasting speedup in inflation would damage the U.S. economy, affecting consumers' buying power and future economic growth. It would also be a risk to buoyant financial markets by putting upward pressure on interest rates.

The April Consumer Price Index (CPI) showed prices surged by the most in any 12-month period since 2008. The data partly reflects a recovery that is picking up steam as the pandemic eases. Many consumers emerged from the pandemic with enhanced buying power thanks to stimulus checks and savings accumulated during lockdowns. In a sense, that has created increased demand for more items than companies still attempting to reopen can currently supply.

A combination of rock-bottom interest rates, the Fed purchasing $120 billion per month of U.S. Treasury/Agency bonds and aggressive fiscal spending may be compounding the problem, against a backdrop of labor shortages, increasing transportation costs and supply chain disruptions that have been seen across many areas of the economy.

TIM HOPKINS, CFA
Senior Vice President

REBOUNDING FROM PANDEMIC RESTRICTIONS

While the directional change in

Continued on page 2

MARKET RECAP

The S&P 500 continued its strong run for the year, posting the best first six months of a calendar year since 1998. International stocks continue trailing the U.S. despite a generally weaker U.S. dollar on a year-over-year basis.

	YTD	Past 3 Months	Past 12 Months
S&P 500	15.2%	8.5%	40.8%
EAFE (International)	8.8%	5.2%	32.4%

VIEWPOINT

A Message From the Desk of Jim Arens

If you're anything like me, it doesn't seem like 1981 was 40 years ago. Walter Cronkite signed off the CBS Evening News for the last time. Muhammad Ali fought his last match. Ronald Reagan was sworn in as the 40th president. And Trust Company of Oklahoma opened its doors.

The past 40 years have seen many ups and downs. We've been through many bull and bear markets, technological innovations and social changes, but the one constant is our commitment to protect our clients' assets, grow their wealth and advise them for life.

In the beginning, we only had a few clients. We now manage over $5.7 billion in assets for many clients. We take pride in being the oldest and largest independent trust company in Oklahoma.

We would not be in business these 40 years if it were not for our clients. It is an honor to help you secure and protect what you have worked so hard to build over a lifetime. The trust you place in our team is never overlooked, and we never take lightly our responsibility and dedication to our clients.

We look forward to building our relationship with you and your family for generations to come.

JIM ARENS, Chairman, President & CEO

consumer prices in April was broadly expected by economists, the magnitude of the increase was well above expectations. According to the Labor Department, the CPI jumped 4.2% from April 2020 to April 2021. On a month-to-month basis, which strips out the effects of price declines in last April, prices rose 0.8%, far above consensus expectations of 0.2%. Core CPI (excluding food and energy) rose an even larger 0.9%, the most since September 1981. Used car prices spiked 10% in April compared with March, accounting for more than one-third of the overall increase, according to the Labor Department.

Almost all of the April CPI increase was driven by outsized increases in sectors that are seeing demand recover as pandemic restrictions ease. Airline fares rose 10.2% from March to April, hotel prices were up 7.6%, and car rental prices jumped 16.2%. So far, these price increases are seen as a reversal in prices from early in the pandemic.

Surging car rental prices reflect limited supply as rental agencies are now rebuilding previously slashed fleets, driving up the prices of both rentals and used vehicles. Depending on the strength of pent-up demand for leisure and travel, similar price increases may occur in other categories over the coming months.

The May CPI shows that headline consumer prices rose 5% year-over-year in May, higher than Wall Street expectations. The 3.8% rise in the core inflation rate was the largest increase in nearly three decades. Categories sensitive to pandemic reopening dominated price pressure for a second straight month, with an estimated 52% of the month-over-month increase coming from only six components: used cars, rental cars, vehicle insurance, lodging, airfares, and food away from home.

Recent inflation measurements are affected by comparisons with the figures from early in the pandemic when prices dropped steeply as demand collapsed for many goods and services during lockdowns. These "base effects" and the broad macro environment suggest to some that the surge in inflation will be mostly "transitory," with inflation expected to fall back to target next year as base effects fade, supply bottlenecks ease, and the current increase in suppressed demand runs out of steam. This is the view shared by the Biden administration and members of the Fed.

WAGES AND UNEMPLOYMENT

Concerns about inflation often center on wages. Labor is usually a company's biggest expense, and employers can be reluctant to raise wages because reversing course usually isn't realistic. Many in the "inflation is transitory" camp point out that while the unemployment rate declined significantly to 5.8% as of the time of this writing from the peak of 14.8% last year, it is still higher than the pre-recession low of 3.5%. They believe this unemployment gap will limit compensation growth and inflation.

However, those who take the opposite view also point to wage/labor market issues to support their stance. They cite data that show wages and benefits grew quickly for U.S. workers in the first quarter of 2021, a sign that businesses are starting to offer higher pay in order to fill available jobs. U.S. workers' total compensation rose 0.9% in the first quarter, the largest gain in more than 13 years, up from a 0.7% increase in the fourth quarter of 2020.

The May National Federation of Independent Business survey paints a similar picture. The share of small firms reporting that jobs are hard to fill climbed to a record high of 48% in May, suggesting that labor market conditions might be far tighter than the elevated 5.8% May unemployment rate would imply. Filling vacancies for low-wage and hourly workers is especially a challenge. Many firms have had to increase pay or offer signing bonuses to attract applicants.

Continued on page 3

Those who expect inflation to persist note that central banks, led by the Fed, are less concerned about inflation now than in the past. At a recent news conference, Fed Chairman Jay Powell reiterated that the central bank will be in no rush to remove monetary stimulus even if inflation accelerates above its 2% target. In August 2020 the Fed even adopted a revised target of *average* inflation of 2%, meaning the Fed will be comfortable with it overshooting 2% for an unspecified period of time to make up for the past decade's misses.

In addition, fiscal policy has shifted. Instead of worrying about rising federal debt, many economists expect aggressive action to offset shortfalls in demand. As a result, Congress likely will not remove fiscal stimulus as quickly as it did following the 2008 financial crisis. That abrupt removal led to a disappointingly slow recovery, which no one has been eager to repeat.

CONSUMERS COULD DRIVE INFLATION

In the University of Michigan's consumer sentiment survey released in June, inflation remained a top concern of consumers. For the next year, consumers expect prices to increase by a relatively high 4%. The risk is that as inflation expectations rise, they become embedded in consumer behavior and business decisions. Workers may demand higher wages to keep up with prices. Businesses pay to keep those workers, then raise prices to maintain margins.

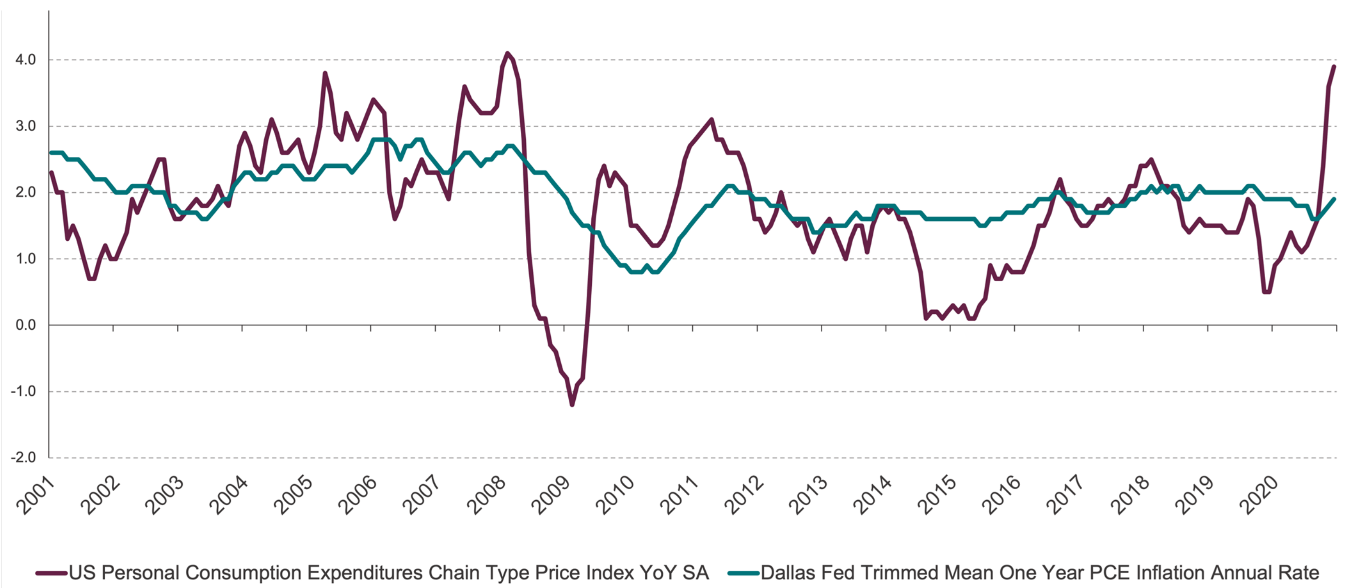
INFLATED CONCERNS?

The majority of economists and investment strategists seem to agree with Powell and the Fed that the recent surge in prices is temporary due to the acceleration in economic growth caused by the reopening of the economy and that once growth returns to a normal pace, the inflationary pressures will subside.

However, higher and longer lasting inflation than currently expected could cause the Fed to raise interest rates faster and higher than financial markets anticipate. In a June 16 press conference, Powell said, "As the reopening continues, shifts in demand can be large and rapid, and bottlenecks, hiring difficulties and other constraints could continue to limit how supply can adjust — raising the possibility that inflation could turn out to be higher and more persistent than we expect."

It is generally thought that it will be several more months before it's clear whether the current period of rising prices is temporary or not. The one thing that does seem certain is that, as Martin Zweig stated many years ago, inflation will be the most important economic indicator to monitor for the foreseeable future.

INFLATION RATES OVER 20-YEAR PERIOD



PCE (Personal Consumption Expenditures): A country-wide indicator of average price changes in all categories of personal consumption. This measure is calculated by the Bureau of Economic Analysis.

Trimmed Mean PCE: A measure of PCE that trims the most extreme observations, both highest and lowest, from the data in each period. Then, the inflation rate is calculated as a weighted average of the remaining elements. This measure is calculated by the Dallas branch of the Federal Reserve.

Source: Bloomberg, LP. (Root source: Bureau of Economic Analysis/Federal Reserve Bank of Dallas)

UNRAVELING BIDEN'S TAX PLAN

Revenue Proposal Could Affect Income, Capital Gains, and Estate Tax Rates

As a kid, I loved creating wish lists. Perhaps not all my wish list items were realistic, but what kid doesn't want a pet tiger? President Joe Biden recently released his American Families Plan revenue proposal, which is essentially his tax policy wish list. This request might never become law, but it provides a road map for tax changes that might be enacted by Congress. The overall proposal is expansive, but let's dive into a few key pieces.

TAX RATE CHANGES

The tax cuts passed in 2017 lowered the top ordinary income tax bracket from 39.6% to 37%. Biden's proposal would restore the 39.6% top tax rate for married taxpayers filing jointly with taxable income over $509,300 and for single filers over $452,700.

Additionally, the plan would tax long-term capital gains and qualified dividends at ordinary income tax rates of 39.6%, when total taxable income exceeds $1 million. Under current law, individuals earning over $445,851 per year are only subject to an effective long-term capital gains rate of 23.8%.

Most of the proposals include an effective date of Jan. 1, 2022, but interestingly the capital gains rate increase would have a retroactive effective date of April 2021. Notably, no prior tax increase enacted by Congress has been retroactive. This fact, combined with the reality of the political climate, suggests the most likely effective date for any proposals passing Congress would be Jan. 1, 2022, including capital gains rate changes.

CAPITAL GAINS TREATMENT FOR GIFTING

Currently, gifting appreciated assets does not trigger the recognition of capital gains. Instead, the giver's basis carries over to the receiver. For example, if you give your daughter XYZ stock currently worth $1,100 and your adjusted basis is $500, she does not pay capital gains tax at the time of the gift. Rather, your basis of $500 carries over to your daughter. If she later sells the stock for $1,300, she would recognize a capital gain for the difference of $800.

The proposal would reclassify gifting as a trigger for recognition of capital gains. Under this change, in the same example as above, you would recognize a $600 capital gain at the time of the gift, and your daughter's basis in the stock would be $1,100. If she later sells the stock for $1,300, she would only recognize a capital gain of $200.

Likewise, the proposal would reclassify in-kind distributions from irrevocable trusts and partnerships as similar triggers for capital gains recognition. However, the proposal would delay capital gains recognition on the gifting of family-owned and -operated business interests, including farms, until the business is sold or ceases to be family-owned and -operated.

CAPITAL GAINS TREATMENT FOR ESTATES AND THE END OF FREE STEP-UP IN BASIS

Currently, if an estate's fair market value exceeds the individual's lifetime exemption amount ($11.7 million per person for 2021), then the estate pays 40% estate tax on the value exceeding the exemption amount. However, the heirs' basis in the assets they receive are given a free "step-up" in basis to the fair market value of the assets as of the date of the decedent's death. It is a free "step-up," because the unrealized capital gains are erased and never subject to capital gains income tax.

The proposal would not erase those capital gains. Instead, the estate would pay capital gains income tax on all unrealized gains at the decedent's death, potentially at the proposed increased rate of 39.6%, along with the existing Net Investment Income Tax (NIIT) of 3.8%. Additionally, the estate would still be subject to the 40% estate tax on any value exceeding the decedent's lifetime exemption amount. The heirs' basis in assets received would still "steps-up" to the date of death value, but it would come at the cost of the estate paying capital gains taxes on the appreciation.

To slightly soften the blow, each individual would receive a new $1 million lifetime exemption, or $2.5 million per couple, for capital gains triggered by gifting or by death. Additionally, any capital gains tax paid by the estate would lower the overall estate value subject to the 40% estate tax.

The higher the unrealized gains in the estate, the higher the potential effective total tax rate charged to the estate. See the **chart on page 5** for examples.

ITEMS NOT INCLUDED

During his campaign, Biden discussed many potential tax reforms that were not included in this current proposal. Some of the more notable items omitted include:

Continued on page 5

BRI GHOSN, CPA, CFP®, CDFA®
Vice President
& Controller

POTENTIAL TAXES ON ESTATES UNDER THE AMERICAN FAMILIES PLAN PROPOSAL

(All dollar figures in millions)

Fair market value of estate	**$30.0**	**$30.0**
Decedents basis in estate assets	*($5.0)*	*($25.0)*
Estate unrealized capital gains	$25.0	$5.0
$1 million proposed estate capital gains exclusion	*($1.0)*	*($1.0)*
Estate unrealized capital gains subject to tax	$24.0	$4.0
Estate capital gains tax at 39.6% + 3.8% NIIT = 43.4%	**$10.4**	**$1.7**
Value of estate after capital gains tax paid	$19.6	$28.3
Lifetime estate exemption amount	*($11.7)*	*($11.7)*
Estate value subject to estate tax	$7.9	$16.6
Estate tax at 40%	**$3.2**	**$6.6**
Total taxes paid on the estate	**$13.6**	**$8.4**
Effective total tax rate	**45.2%**	**27.9%**

- **Lifetime Exemption Amount**: Biden spoke of reducing the lifetime estate and gifting exemption limits to "historic norms." However, his proposal contains no changes to the current $11.7 million lifetime exemption.
- **Qualified Business Income (QBI) Deduction**: On the campaign trail, Biden proposed eliminating the QBI deduction, which allows various "pass-through" business owners to deduct 20% of their business income. This deduction would remain completely intact under the proposal.

The American Families Plan proposal will lead to negotiations in Congress and will likely produce a smaller tax increase than the proposed amount, if anything at all. Given the uncertainty, preparation is wiser than making predictions, especially when politics are involved.

We will have to wait and see which of Biden's wish list of tax changes come to fruition. Just like the items on my childhood wish list, some of the tigers included in Biden's list may morph into house cats by the time new legislation passes Congress, but only time will tell.

SPOTLIGHT

According to the National Institutes of Health, two to three of every 1,000 children born in the U.S. are born with hearing loss in one or both ears, and approximately 37.5 million American adults aged 18 and over report some trouble hearing.

TSHA, or Total Source for Hearing-loss & Access, has been providing services to Oklahomans who are deaf or hard of hearing since 1953. Those who are in need of support turn to the organization for resources, advocacy and language accessibility.

TSHA helped more than 6,000 clients in 2019, offering support to all ages of the deaf and hard of hearing community throughout Oklahoma, as well as the families of those affected.

Services provided by TSHA include support for those needing hearing aids, ASL/Spanish interpreters, programs for children and teens, community events, accessible movie theaters and a list of local churches providing accommodations for the deaf or hard of hearing.

The Children's Hearing Aid Program (CHAP), a program of TSHA, helps families with the cost of purchasing hearing aids for their child. Many insurances exclude hearing aids as a benefit or provide only minimal assistance. With hearing aid prices running in excess of $6,000 a pair, CHAP helps families afford devices to give children the gift of hearing.

Hearing loss is America's No. 1 physical disability. To learn more about how TSHA is helping those with hearing loss in Oklahoma, visit **TSHA.cc**.

P.O. BOX 3627
TULSA, OK 74101-3627

FORWARDING SERVICE REQUESTED

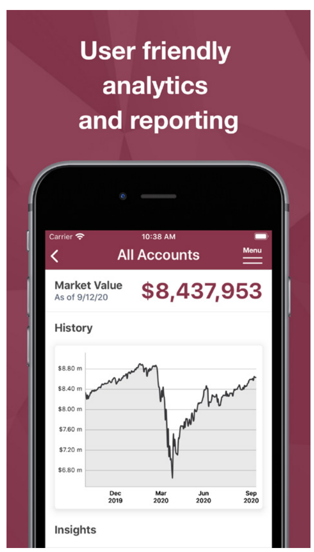
INTRODUCING **TCO MOBILE**

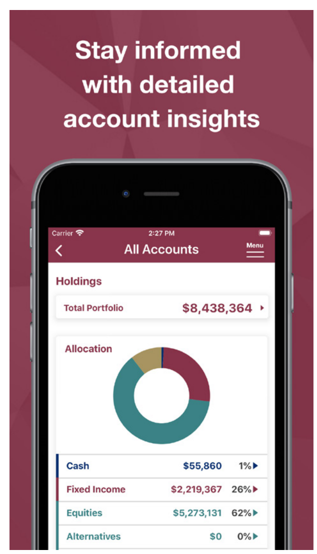
Trust Company of Oklahoma has an app!

TCO Mobile provides a safe and secure way to access your TCO account information. You can easily view market values, holdings, and even transaction details while on the go.

For more information on how to download and login to TCO Go, please contact your account administrator.

Download on the App Store





Trust Company Oklahoma
(918) 744-0553 | (405) 840-8401
TrustOk.com

Protecting Your Assets
Growing Your Wealth
Advising You for Life.