The chart below shows stock market returns on the S&P 500 index dating back to the beginning of the great depression in the late 1920's. This quarter's commentary will use this chart to tackle some of the biggest concerns we hear on a regular basis and our approach to addressing those concerns to help you reach your long-term goals. Today the concerns we hear the most about are taxes, inflation, and rising interest rates. While all are concerning (in different ways), none of them are unprecedented.

Source: Clearnomics, Standard and Poor's © 2021 Clearnomics, Inc.

Concern #1: The Potential for Higher Taxes

Currently, the Biden administration suggests 4 main tax increases in their tax proposal:

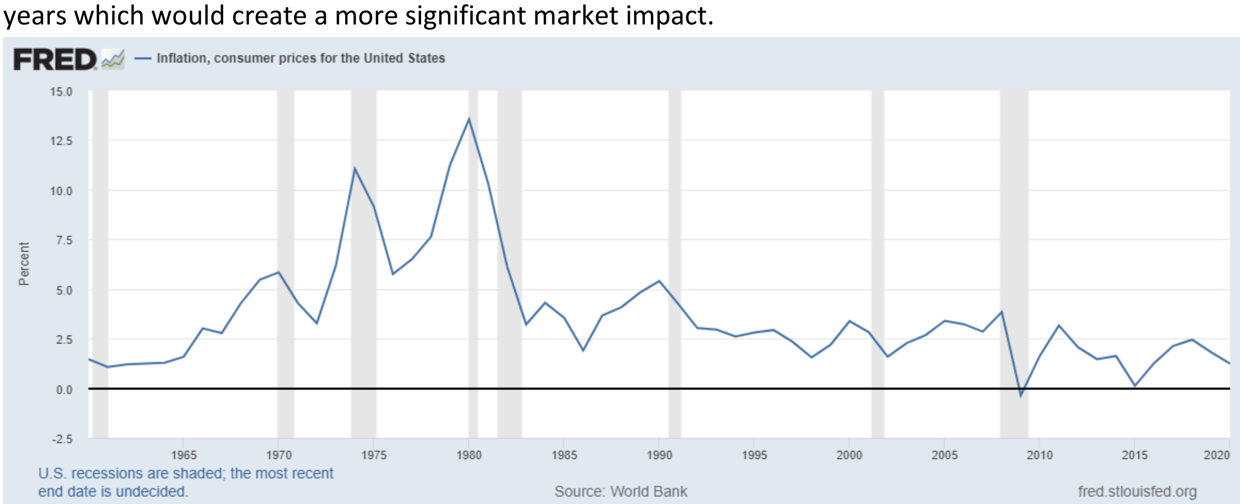
1. Increase the corporate tax rate to 28% (up from 21%)
2. Increase the top marginal tax bracket to 39.6% (up from 37% currently)
3. Increase the capital gains tax rate to 43.4% on taxpayers with annual income of more than $1 million (up from 23.8%)
4. Lowering of the estate tax exemption which is currently $11.7 million ($23.4 million for couples)

While this may seem like a big change, breaking down each component individually can give us a historical sense of the implication for the market. First, an increase in the corporate tax rate would most likely create a one-time 7% market pullback. However, that 7% will likely be priced in over a period of time as expectations change about the likelihood it will be implemented. It is likely that some of the price impact is already reflected in the market. Second, increasing the top marginal tax rate to 39.6% is a step back to where taxes were prior to 2017. As the chart on page 1 illustrates, the market performed very well from 2010-2017. Next, an increase in the capital gains tax rate would likely lead to fewer stock transactions which has the potential to reduce volatility in the stock market. The tax rate itself is targeted at top earners where most of their income originates from investments (not wages). Further, if we look at history, the top marginal bracket throughout the 1950 -1970's was over 70%. Again, referring to our chart on page 1, the stock market performed well in these periods. While exact estate tax exemption proposals are unknown, it is expected to be somewhere between $3 - $5 million ($6 million - $10 million for couples) adjusted for inflation. This is within the range that we have seen over the last several decades where the markets have continued their upward trajectory.

What does this mean for Legacy and our clients? From an investment perspective, very little. From a financial planning perspective, a lot……for some clients. With investments, we know that markets are upward trending and have been under low tax environments and high tax environments. All current proposals are still relatively low tax environments compared to most of the last 100 years. With financial planning, there will be a bigger emphasis on tax planning for certain clients that may be subject to some of these increased taxes. We are here to work with clients to manage and minimize the overall tax picture as policy changes.

Concern #2: Inflation

The graph below shows year over year inflation going back to 1960. It shows us that in that 60-year span, inflation has peaked near 15% and bottomed with slight deflation in 2009. The Federal Reserve currently targets inflation at 2% but has also said they are willing to let it run above that level for some period since it has been below 2% for so long. With April and May 2021 bringing year over year inflation readings of 4.2% and 5% respectively, many people are beginning to wonder what they should do with their portfolios if inflation remains elevated. The simplest answer is that April 2020 and May 2020 inflation readings were 0.3% and 0.1% respectively. Therefore, if we annualize these over 2 years, inflation is in line with the Federal Reserve's target of 2%. The reopening of our economy is increasing demand and therefore prices in many aspects of society, particularly dining, automobiles and travel where prices had collapsed during the pandemic. Gas prices and airline travel are also getting back to (or closer to) their pre-pandemic levels. Comparing current reflated prices in these and other areas of the economy with last year's pandemic-low prices (the base) leads to higher readings for inflation. This "base effect" phenomenon of comparing low prior year prices to current reflated prices should continue through February 2022. This is due to the fact that February of 2021 was the first time prices started recovering to normal levels since the pandemic started. It is also possible, although we believe less likely, that the inflationary pressures are not transitory in nature and may be a new normal for a few years which would create a more significant market impact.

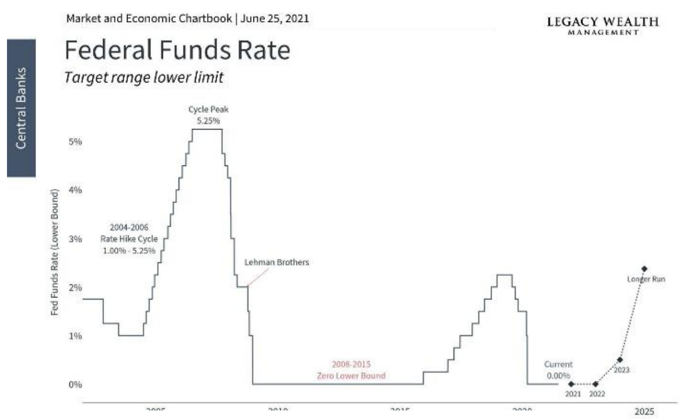


If inflation is indeed transitory as we believe and due to base effect measures, there is not much to change from a planning or investment perspective. If inflation is here to stay, then historically equities are the best place to earn a real return after inflation. Recall that the chart on page 1 was still moving higher through the 70's and 80's when we had significant inflationary pressures. Therefore, positioning the portfolio in equities and fixed income securities more highly correlated with equities (such as high yield bonds) is a sound strategy. The good news here is that we have already positioned our portfolios to reflect this as we have been holding a high yield bond fund since last March on the prospects of an opening economy. Additionally, from a planning perspective, we factor inflation into our financial plans. We update these assumptions annually and will adjust as necessary to provide you with the best information and help you make confident long-term planning decisions.

Concern #3: Rising Interest Rates

The concern over rising interest rates has been around since the financial crisis when the Federal Reserve first cut rates to 0% to boost the economy. Since then, rates have been at 0% more than they have not as you can see on the Fed Funds chart.

Additionally, the 10-Year U.S. Treasury Bond has bounced between around 4% (2010 highs) and 0.6% (2020 lows) with most of the period between 1.5%-2.5%. Currently, the 10-year Treasury is at 1.5%. The magnitude of a rate change matters to investors in fixed income and earlier this year we saw rates move from 0.6% to 1.5% (almost tripling). It is unlikely, in that short of a period, that we will see the 10-year Treasury triple again, so the biggest move is likely already behind us.



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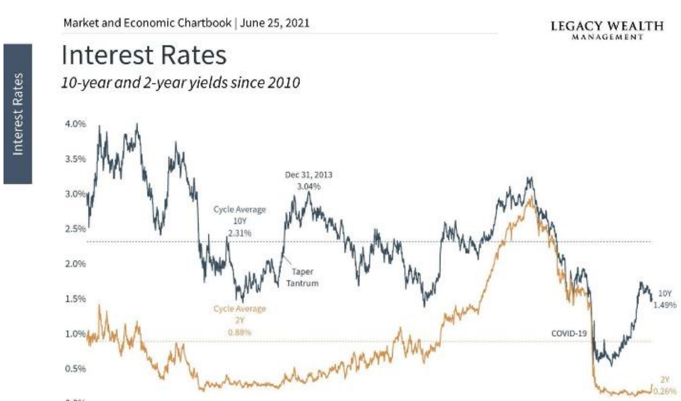

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Additionally, once the Federal Reserve starts to increase rates, the first few increases will have the biggest impact. Each subsequent move will have a smaller impact (assuming the moves are of equal size). The risk with rising interest rates is that they make bond prices decline. These price declines can be offset with enough interest from the bonds. This is another reason we added high yield bonds into the portfolio. Additionally, we have a shorter duration (time until bonds mature) than the index. A shorter duration is good in rising interest rate environments because you will get your principal investment back sooner and can then reinvest that cash in bonds with a higher interest rate. While bond prices may fluctuate, their primary role in the portfolio is to provide stability. Last March when the market went down, bond prices held up, minimizing the drawdown in portfolios. Higher interest rates are also a way to counteract concern #2 (inflation).

In summary, it is important to keep long-term goals in mind. That is what Legacy helps you do by focusing on financial planning, not just investments. At the end of the day, financial planning creates a plan for savings and spending goals, and how we allocate those savings to meet your goals knowing minor adjustments will take place as things change. We do our best to understand and forecast market returns, interest rate policy, or tax policy but cannot control their outcome. As the initial chart shows us, we do know that a disciplined saving and rebalancing approach has worked well for the last 100 years, and we believe that this long-term disciplined strategy will continue to work well into the future.