

POSSIBLE TAX LAW CHANGES

In March, two anticipated government initiatives began to roll out. The first is the both maligned and anticipated “infrastructure week.” Having been a running joke for years, Biden announced a framework for spending nearly \$2 trillion on infrastructure: everything from replacing lead pipes, to paving roads to more solar. Meanwhile Democratic possible tax plans began to leak out and hundreds of articles were written about tax increases those impacted. Somehow, we have to pay for all this.

It is important to understand possible changes and how to plan for them. In a clickbait world, it is helpful to have perspective and reflect on what can get through Congress (taxes and spending are subject to reconciliation in the Senate requiring a simple majority) and not despair over proposals to tax people at 2001 levels. It is instructive to remember what happened with similar circumstances.

Under Obama, the estate tax disappeared for one year and returned to an exemption amount of \$5 million, not to the \$1 million as feared. Also under Obama, there was a movement to reform 529 plans but a revolt of Democratic upper-class supporters squashed any changes. Out of the gate in Biden’s term only 42 Democratic Senators voted to raise the minimum wage. In a year when Leader McCarthy declares the GOP the party of “The Working Class” and Democrats cannot increase the minimum wage, the lens which everyone has viewed the parties since Reagan no longer holds.

Changes are coming to income and estate taxes. While possible changes in estate tax exemptions garner the most headlines (\$11.7mm for 2021), what can attract a majority in Congress will likely be around the edges and appear more technical but having huge effects. The stepped-up basis at death is in the crosshairs and it seems possible this is where a major change could occur. If a change happens here, no longer will asset tax values reset to the date of death. Capital gains taxes will be assessed against the entire gain, possibly going back many decades. Removing the stepped-up basis will likely result in an exempted amount of gains, currently floated as \$1mm and perhaps exempting one residence. Politicians will not want to look like they are taxing a home someone lived in for decades and is leaving to heirs.

Many Americans favor raising taxes on “The Rich”, but rich people are always defined by voters as someone else. Since no one volunteers to pay more taxes, Congress must raise revenue by picking the easiest targets that won’t gain much sympathy from voters. Movement has begun to either outlaw or modify planning techniques used almost exclusively by the very wealthy. If your estate plan contains initials, your plan is at risk to be upended. Examples would be plans that have GRATs, FLPs, IDGTs and the like. Calling a congressman and demanding that he save the Reverse GRAT does not pull the same heartstrings as “we have to sell the family farm at Daddy’s death.” It is easier to defend the high exemption amounts as saving family businesses and property. Change is coming to sophisticated planning and it may be time to review your estate plan and be prepared to discuss changes with your attorney.

While estate tax changes are the focus of this note, other changes are likely. The corporate tax rate may increase; the payroll wage limit may rise (\$148,000 in 2021); the marginal rate may revert to 39.6%; and capital gain rates may increase. Somewhat lost in the pandemic were technical changes to retirement plans made by the Secure Act in 2019. These limited the ability of heirs to stretch IRAs, raising revenue downstream without impacting IRA owner’s during their lifetime. Changes that look like the Secure Act: technical, dry, and incremental are more likely to pass rather than massive tax increases.

It is doubtful we are about to have confiscatory rates. The same day that Biden announced his infrastructure plans, four New Jersey Congressmen announced they will support no new tax changes unless the full SALT deduction was restored. Politicians react to their constituents. Democratic growth in wealthy cities and suburbs leave it less likely we will have a shocking departure downwards in the exemption amounts. What we probably will have are changes that will read, “Loophole Closed.” Headlines that seem to only have the other guy’s oxen getting gored.

Stay in touch with your attorneys, CPAs and Colonial Trust. Seeming innocuous changes can make a big difference if you are not careful.



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In The Spotlight

Libby Adamson, Business Manager

Libby Adamson joined Colonial’s Spartanburg team at the beginning of August 2018. Her diverse professional experience and various skillset have abetted her role as Business Manager at Colonial. Libby is responsible for a range of tasks to ensure company productivity and efficiency, including bookkeeping, vendor management, HR, general operations, and more. Bert Barre describes her job as “anything and everything outside of working with clients and accounts.”

Clients in Spartanburg may have crossed paths with Libby during her tenure as Secretary at Pine Street School, Office Manager at The Junior League, or Executive Assistant to the Rector at The Episcopal Church of the Advent. She is also a First Presbyterian Church member, where she served as an Elder for six years.

Libby grew up in High Point, NC, graduated from Meredith College in Raleigh, NC, and has lived in Spartanburg for almost 30 years. She serves on the board of Casting Carolinas and has been a volunteer staff member since 2015. Casting Carolina is a non-profit organization providing comprehensive fly-fishing retreats for women surviving all types of cancer. Libby takes advantage of every opportunity to head to a NC river donning a pair of waders and boots with a fly rod in hand.

Market Commentary

The bullish sentiment from 2020 continued into the first quarter. The S&P 500 returned 6.2% for the quarter, while the DOW returned 8.3%. The Nasdaq returned 3.0% and the Russell 2000 small cap index outperformed their larger brethren with a 12.7% return. The US markets outperformed international markets, with the MSCI EAFE developed market index returning 3.6% and the MSCI Emerging Markets Index returning 2.2%.

Unlike equities, bonds returned -3.4% as measured by the Bloomberg Barclays US Agg. Bond Index. This index returned 7.5% for 2020 as interest rates fell with aggressive monetary policy. The benchmark 10yr treasury yielded 1.74% at quarter-end, up from 0.91% at year end. Yields remain low on a historical basis but increased 90% for the quarter.

The quarter began poorly, with January down 1.1%, as Reddit day traders wreaked havoc on stocks like GameStop and AMC Theaters. The market rebounded 7.0% in February and March. The change in market leadership that began in late 2020 continued. Growth stocks led the way in 2020, far outpacing value stocks. However, in the first quarter, large growth stocks returned 0.9%, while large value stocks returned 11.3%. The performance of the S&P 500 sectors for the quarter and full year 2020 illustrate this shift in leadership. The tech sector returned 44.0% in 2020 but was the second worst sector in the quarter, returning 2.0%. Conversely, energy returned -33.7% last year and was led in the quarter, up 30.9%.

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While GameStop occupied our minds in January, the markets spent the remainder of the quarter evaluating the implications for economic reopenings, vaccines, and the impact of stimulus.

Daily COVID cases peaked in the US in mid-January and fell 74% through quarter-end, while deaths have seen a similar reduction. While new variants are spreading around the world, the US vaccination rollout has produced superior results to other developed countries. According to the CDC, 106 million doses have been administered, with 18.5% of the population being fully vaccinated and counting. Falling cases and rising vaccinations are fostering an explosion of pent-up demand, albeit impacted by geography and government restrictions. Consumer related metrics, like OpenTable Reservations and hotel occupancy are improving. OpenTable reservations for early April were 27.6% below 2019 levels, compared to down 62.1% in January. For the week ending March 27th, US hotel occupancy rates were 57.9% compared to 40.1% in January. Perhaps there is no better example than the \$48.5mm in box office receipts from *Godzilla vs. Kong*, which played on 3,064 screens, while simultaneously streaming on HBO Max.

While the consumer economy slowly recovers, the V-shaped recovery in manufacturing continues. The ISM Purchasing Managers Index (PMI), which measures monthly changes in manufacturing activity, reached its highest level since 1983 in March. The same measure for the service sector is at its highest reading on record. Durable goods orders and auto sales have eclipsed pre-pandemic levels. Existing and new home sales are both at the highest levels in a decade and face supply issues. In March, US employment is 672k below the peak levels of March 2020 but is 14 million above the low point of April 2020.

Much of the economy has rebounded from the lockdowns and the lagging travel and leisure sector is turning a corner. The economy got another shot in the arm with the passage of \$1.9 trillion American Rescue Plan. This bill sent \$1,400 checks to individuals with incomes below \$75,000. It also provides \$300/week of additional unemployment insurance, along with a myriad of other stimuli to businesses, states, schools, and healthcare providers, to name a few. This brings the total pandemic related spending to \$6 trillion or 27% of US GDP. Biden's signature was barely dry on this package when he proposed the \$2.3 trillion



American Jobs Plan. This plan would spend \$1.3 trillion on “infrastructure” and \$980 billion on R&D, workforce development, manufacturing, and eldercare. Biden proposed increasing corporate taxes from 21% to 28% and closing loopholes. This infrastructure package will likely go through many machinations in Congress, both on the size of the package and financing. However, markets anticipate infrastructure spending in 2021.

With much of the economy improving since the fall, economists projected 2021 GDP growth of 3.9% in December. The quickening pace of vaccination and additional stimulus caused economists to increase their expectations for 2021 GDP growth to 5.7%. Reaching the average estimate of 5.7% would be the strongest growth since 1984.

Stronger economic growth typically leads to higher earnings growth. Equity analysts are increasing their expectations for earnings growth in 2021 and beyond. Earnings for the S&P 500 are projected to increase 41% in 2021 and 16% in 2022. Estimates for 2021 earnings have increased by 4.9% since December and by 6.9% since June. Wall Street expects more cyclical companies to drive earnings growth as the economy reopens. The sectors expected to make the largest contributions to earnings growth are energy, industrials, and materials. These are among the best performing sectors in the first quarter in anticipation of the rebound in earnings.

Prior to March, the economy was healing organically and aided by the \$4 trillion of stimulus passed in 2020. The addition of the American Rescue Plan and possible further infrastructure spending has bond investors worried about

inflation. In the face of rising growth expectations, the Federal Reserve continues to maintain an accommodative monetary policy, with the Fed Funds rate pegged at 0.0% and monthly purchases of \$120 billion of treasury and mortgage securities. Jay Powell has stated the Fed will maintain this policy until it reaches its mandate of full employment or until inflation runs above its 2.0% target for a period. This is a significant change in Fed policy, which has anticipated inflation and acted pre-emptively since The Volker Fed in 1979. The Fed's willingness to let the economy run hot has caused inflation expectations and bond yields to rise. The market implied inflation rate for the next five years is 2.43%. This is moderately above the Fed's 2.0% target but is the highest reading since the summer of 2014.

Inflation is evident at the producer level, with the Producer Prices increasing 2.8% in February and projected to be up 3.8% in March. Producers are facing higher demand as the economy reopens, coupled with supply shocks driving prices higher. Semiconductor shortages have caused automakers to curtail production and the Suez Canal blockage impacted global trade. Additionally, lumber prices have doubled since the fall and copper prices are up 36% in five months, and both are inputs into housing, where prices increased 11.1% over last year. This has yet to manifest into higher consumer prices, with the Consumer Price Index up only 1.7% in February but rising from 1.4% at year end.

The future path of inflation is likely the most important factor for capital market returns going forward. There is widespread consensus, even among the Fed, that we will see higher inflation in 2021. The Fed's March projections include PCE inflation running at 2.4% this year, compared to consumer expectations of 3.1% based on Sentiment Surveys. The Fed believes higher near-term inflation is the result of the supply demand mismatch as the economy reopens and “base-effects” where the low inflation of 2020 makes 2021 price increases overstated. The Fed believes inflation will trend back to 2.0% after increasing in 2021. The bond market is more concerned about the deleterious impacts of inflation and the possibility that stimulus could cause lasting inflation. Bond investors point to the 84% increase in the Fed's balance sheet over the last year, the \$3.6 trillion federal deficit over the last year, and the projected \$3.4 trillion deficit in 2021 – before any infrastructure. The market is trying to determine if higher inflation is cyclical due to supply issues and base effects or secular and possibly lasting.

This is a critical issue because higher and sustained inflation will push interest rates higher and force the Fed to change policy. Valuations for all financial assets are influenced by interest rates. Most equity market valuations finished the quarter elevated compared to long-term averages, albeit down slightly from year-end. The S&P 500 is currently trading at 21.9x next year's earnings, compared to a 25-yr average of 16.6x. The only metric where equities are undervalued compared equities to interest rates, due to these low rates. In the first quarter, we witnessed the impact of higher yields on stocks with the highest valuations. The higher valued Nasdaq index underperformed the S&P 500 for the quarter and many of 2020 highflyers were down double digits as rates increased.

Interest rates and inflation could increase due to stronger economic growth, which is good for equities. This positive relationship breaks down when interest rates move to a level where they begin to slow growth, hurt earnings, and pressuring valuations. We are not there yet; however, the future path of interest rates and inflation bears watching. The positive side of this story is that we are likely to see economic growth in 2021 at levels many have never witnessed, and earnings growth not seen in a decade. This was not our expectation when we wrote this newsletter last April.

We expect interest rates to move higher over the next year, but to remain low on a historical basis. Inflation will increase in 2021, but we don't expect a 1980's redux. Prior to the pandemic, the forces of higher debt levels, demographics, technology, and globalization have been deflationary. The pandemic has exacerbated debt levels and accelerated the adoption of technology to drive down prices. We expect these forces to offset some of the inflationary pressures of fiscal and monetary policy. Moreover, central bankers around the globe have attempted to manufacture inflation for decades with little success. They have the added ammunition of fiscal policy, which may make their efforts more potent. On a visceral level, we struggle with higher sovereign debt levels and their long-term impacts on economic activity. As we have learned from Japan, this level of deficit spending can last for decades if you borrow in your own currency. For the intermediate term, we expect higher growth to lead to higher interest rates which will pressure certain highly valued stocks. But the growth prospects for the overall market should allow for continued progress in the equity markets.