April 2021 | Volume 6 | Issue 2

FINEMARK NATIONAL BANK & TRUST

FINE POINTS

The Quarterly Trust and Investment Publication of FineMark National Bank & Trust

FIRST QUARTER REVIEW & COMMENTARY

By Christopher Battifarano, CFA®, CAIA
Executive Vice President & Chief Investment Officer

" 'Tis the part of a wise man to keep himself today for tomorrow, and not venture all his eggs in one basket."

—Miguel de Cervantes (1547-1616), *author of Don Quixote de la Mancha*

THE LONG, SUCCESSFUL HISTORY OF PORTFOLIO DIVERSIFICATION

Miguel de Cervantes, author of Don Quixote de la Mancha, is known as the most famous novelist in Spanish history (and, quite possibly, the world). In pondering the author's quote, above, it's worth noting that individual investors are inclined to view the quote and think that simply having a greater number of securities in a portfolio achieves portfolio diversity. Investment professionals, on the other hand, are trained to build portfolios using a variety of different securities and strategies to comport with the risk levels and return objectives of the client. To build in portfolio diversity effectively one must include a variety of different types of risk exposure that have discrete drivers to be effective at creating an allocation that can endure a variety of market circumstances.

The current environment, however, has created a multi-year conundrum in which diversification away from high-equity risk has blunted overall portfolio returns. While this dilemma has prompted challenging conversations with clients over the merits of diversification, we continue to believe that diversifying exposure across geographies, strategies, and security types remains the best way to build enduring portfolio allocations that will generate robust performance in varied economic environments.

FIGURE 1

RETURNS	MOST RECENT QUARTER (MARCH 2021)	ONE YEAR (MARCH 2021)
S&P 500	6.17%	56.35%
Russell 2000	12.70%	94.85%
MSCI EAFE	3.48%	44.57%
MSCI EM	2.29%	58.39%
Barclays US Aggregate	-3.37%	0.71%
Barclays US 5-year Municipals	-0.31%	5.07%
HFRX Equity Hedge	2.65%	23.88%
Barclays BTOP 50	2.52%	10.06%
HFRX Global Hedge	1.29%	16.15%

Source: eVestment

Historically, bear markets in equities occur every 4 to 5 years. However, it's been almost 13 years since a traditionally defined bear market has occurred in the United States. While some assert that the nature of our economy is different than it once was—and classic boom-bust cycles are a thing of the past—we disagree.

While our crystal ball remains foggy in terms of predicting a "new" bear market, we ardently believe that this business cycle isn't dead. In fact, we expect to experience equity market sell-offs in which portfolio diversification will demonstrate its merit once again. Until then, we'll continue to advise against holding "all of your eggs in one basket," even if that basket is filled with equities.

First Quarter 2021 proved to be another financial season in which equity markets rose confidently, and risk (as measured by market volatility) ground steadily lower. Much of this optimism was driven by both further economic stimulus and a significant drop in new virus cases and deaths.

In January, COVID-19 death rates averaged more than 3,000 per day; these numbers fell steeply (to nearly 1,000 a day) by late March and continue to fall. The rollout of vaccines across the nation has progressed rapidly; about 16% of the U.S. population had been fully vaccinated by quarter's end, with that number continuing to rise.

As we wrote in last quarter's newsletter, we expected the Biden administration to pass another COVID-19 relief bill early this year. On March 11, 2021, President Biden signed the American Rescue Plan, authorizing an additional $1.9 trillion stimulus. This plan brings the total federal response to COVID-19 to approximately $5.2 trillion (or 24% of the U.S. Gross Domestic Product (GDP). Resulting optimism led to a swift uptick in interest rates as 10-year Treasury yields doubled, producing a negative effect on the value of fixed-income instruments.

FIGURE 2

Covid-Era Fiscal Stimulus

When	What	Amount	% GDP
6-Mar-20	Coronavirus & Vaccine R&D	$8 Billion	0.0%
18-Mar-20	Paid Sick Leave & Un. Claims	$192 Billion	0.9%
27-Mar-20	CARES ACT	$1.7 Trillion	7.9%
21-Apr-20	Payroll Protection Plan	$483 Billion	2.2%
27-Dec-20	Phase 4	$900 Billion	4.2%
11-Mar-21	American Rescue Plan	$1.9 Trillion	8.8%

Source: Strategas Securities, LLC

In our Q4 2020 newsletter, we also discussed our lack of enthusiasm for investment-grade bonds and expressed that sentiment through our significant underweight position in the asset class. While our disposition remains unchanged, we believe the worst of the erosion of principal has already occurred. However, there is little prospect for re-rating in this space as we expect a lower-for-longer rate posture from the Federal Reserve to limit rates for now. In that communication, the Federal Reserve has been clear: It will focus distinctly on returning the economy to full employment while perhaps allowing inflation to run above the normal 2% target level.

THE WASHINGTON AGENDA: WHAT IT MEANS FOR WALL STREET

We believe that the next step on the new administration's legislative path will be a significant infrastructure bill. Though talk of such a bill has been discussed since the 2016 presidential campaign, we believe it will happen with certainty this year; likely in the third quarter.

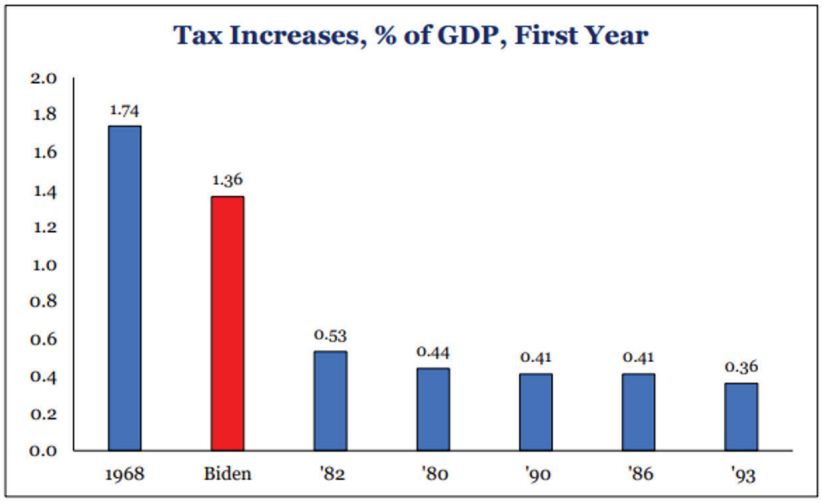
With talks of a $2.3 trillion plan, this bill will have major economic ramifications. While it's too soon to tell what its impacts may be, we suspect the effects to differ from the COVID-19 stimulus impacts we've seen to date.

To temporarily supplement the void caused by shrinking economic activity and alleviate the level of permanent damage, our government's pandemic relief plans essentially administered money to be distributed to individuals and businesses. These funds were dispensed quickly—within days and weeks —to help people in immediate need, preventing permanent economic damage from the pandemic.

Infrastructure spending will be much slower to impact the economy as the funds will flow out more slowly, over quarters and years. Traditionally, the long-term impact of such aid money would have been driven significantly by the projects themselves. For example, if such projects are well thought out, economically viable, and have a positive impact on an area (such as a rail-system expansion designed to alleviate highway congestion), the impact will be positive and long-lasting. On the other hand, if the strategies have no real economic purpose (e.g., Congress decides to build a bridge connecting two sparsely inhabited islands in Alaska), the impact will be negative.

While we hope that this administration's strategy will be a purposeful investment in America's future, we suspect that a mixture of these two scenarios to be used.

FIGURE 3

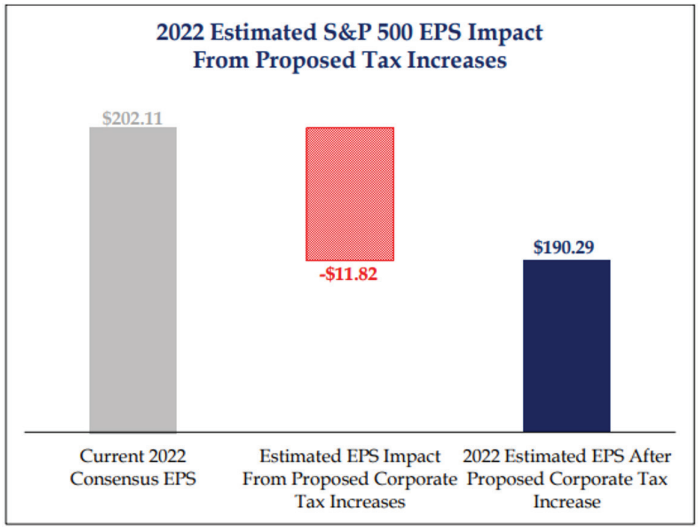


Source: Strategas Securities, LLC

While an infrastructure bill will certainly represent additional fiscal stimulus, an impending tax increase will be the first dose of fiscal tightening observed since the pandemic began. We expect the infrastructure bill to have a lagged economic effect; however, the impacts of a tax increase would be immediate.

Based on percentage of the GDP, the size of the proposed tax increase is the largest in 50 years, and it's expected to reduce S&P 500 earnings per share (EPS) in 2022 by nearly $12 a share. The current consensus EPS estimate for the index of $202.11 would fall to approximately $190.29.

FIGURE 4



Source: Strategas Securities, LLC

INFLATION: FRIEND OR FOE?

One of the most written about concerns on Wall Street recently is the risk of rising inflation. While we do believe this risk is real, we don't expect inflation rates to resemble those experienced in the 1970s and 1980s.

In those days, inflation ran well into the double digits, reaching 14% by 1980. This is not a scenario we see unfolding today. Rather, we foresee a transitory period of increased inflation possibly ranging between 2.5 to 3.5%, as the U.S. recalibrates to meet pent-up and returning-to-normal service demands largely in the hospitality, travel, and leisure sectors.

Several deflationary factors support our conviction. The first factors are the inflation-defeating lessons learned from late Federal Reserve Chairman Paul Volcker (1979-1987). In 1980, Volcker raised the federal funds rate to a peak of 20%. Initially, these interest-rate hikes drove the economy into the ground and spurred an increase in unemployment to more than 10%. By 1983, however, inflation had retreated, falling below 4%. Though unpopular at the time, Volcker proved to the market that he was willing to do what was necessary to beat inflation, regardless of the risk. Through his actions, Volcker demonstrated that while the medicine administered might taste awful initially, the resulting cure could be deeply effective.

Permanent behavior changes resulting from the COVID-19 crisis are the second deflationary factor, which includes consumers' migration to online shopping. While this trend was already popular pre-pandemic, it has since accelerated and, we believe, it is here to stay.

The ramifications of this shift are deflationary. As of late 2020, the U.S. held approximately 59 square feet of retail space per American household (compared to ~49 square feet in 1990).[1] Over the next 2 to 3 years, we expect to see the U.S. retail footprint shrink significantly as retail activity continues to move online and existing retail space is shuttered and repurposed.

The final deflationary factors we're seeing are the current changing demographics within the United States and the rest of the developed world. In 1950, the birth rate of women in developed countries averaged 4.7 children. That number fell to just 2.4 in 2017 and is expected to fall below 1.7 by 2100. Consequently, the ramifications of this decrease in global population and subsequent economic output will be significant as populations in the most productive nations shrink in size while simultaneously aging, leaving a smaller percentage of working-age people.

The numbers supporting this fact are staggering. For example, Japan's population is expected to fall from a peak of 127MM in 2017 to less than 53MM by 2100; in Italy, the population is expected to fall from 61MM to 28MM over the same period.[2] Similarly, the fertility rate in the U.S. hit a low of 1.7 in 2019, far below the 2.1 rate required for population replacement. Hopes for a baby boom fueled by mandatory COVID-19 lockdowns failed to materialize. As populations shrink, this macro headwind greatly diminishes the prospects for higher inflation rates. Considering all of these factors, we believe the risk of destabilizing inflation will not come to pass.

FINALLY…AT LONG LAST…SUMMER!

As temperatures begin to rise, bringing us closer to the freedoms of a long-awaited summer, we know that many of you will leave your warm-weather homes for cooler, northern locales. We wish each of you safe travels and good health and remind you that we're here to serve you no matter where you may reside. As always, we're grateful for your continued confidence and look forward to assisting you in any way we can. In the meantime, we wish you a relaxing and enjoyable summer season!

[1] Lauren Thomas, "80,000 stores will close in the U.S. by 2026," CNBC.com, April 5, 2021.
[2] James Gallagher, "Fertility Rate: 'Jaw-dropping' Global Crash in Children Being Born," BBC.com, July 14, 2020.

IS IT TOO LATE TO MAKE A GIFT OF MY EXEMPTION?

By Grace Gutierrez
Vice President & Private Wealth Advisor, Trust

That is the question we have been hearing from clients for the last few months that are still on the fence about gifting their unused exemption amount. The hesitation is justified after all, gifting a sizable amount of wealth should be carefully considered. We saw a flurry of activity at the end of last year with clients gifting their available exemption. If you chose not to make a gift last year and are still hesitating, the opportunity provided by the Tax Cuts and Jobs Act of 2017 ("2017 Act") may not be lost.

Thanks to the 2017 Act, the federal estate and gift tax exemption amount was doubled from $5,000,000 to $10,000,000 (adjusted annually for inflation). For 2021, the inflation adjusted federal estate and gift tax exemption amount is $11,700,000. The higher exemption amount we have enjoyed since 2018 will expire (sunset) at the end of 2025 under the terms of the 2017 Act. With unprecedented government spending to combat the pandemic and a Democratic President and Congress (technically the Senate is 50/50 but a tie is broken by the Vice President), we expect the sunset of the 2017 Act before the end of 2025 or, worse yet, acceleration of the sunset and a reduction of the exemption amount below $5,000,000. That brings us back to the original question, is it too late to make a gift of your unused exemption?

The power of gifting assets during life is that both the value of the gift and the future appreciation are excluded for estate tax purposes. Most clients considering a substantial gift are not willing to completely give up control , instead preferring an irrevocable trust to be the recipient of the gift so that their wishes can be carried out in life and beyond the grave. For a married couple, the trust is typically for the lifetime benefit of the donor's spouse. The spouse has access to the income and principal of the trust, if needed, and at the spouse's death the assets continue in trust for children or other beneficiaries.

There has been a lot of buzz about retroactive application of new legislation but our concerns are more broad based. A nuance most clients do not realize is that the taxation of a gift made early in the year is based on the law in effect at the end of the year. If an irrevocable trust is created and funded with $11,700,000 in February 2021, the full exemption is utilized and zero gift tax is due, right? What if legislation is passed in November 2021 accelerating the sunset of the exemption amount back to $5,000,000? Are you in the clear since the gift was made nine months before the law changed? Not necessarily.

Under the Internal Revenue Code, the estate and gift tax is a unified system. Determining the amount of the federal exemption available for a gift made in February is based on the exemption which would apply "if the donor died as of the end of the calendar year." What does this mean exactly? The gift you made in February is a taxable gift of $6,700,000 ($11,700,000 minus $5,000,000 exemption) and, at a 40% tax rate, that is a sizeable tax bill no one wants to be surprised with. Any planning undertaken this year should have flexibility built-in to take any tax law change into consideration. There are several creative ways for your attorney to incorporate flexibility into an otherwise irrevocable gift.

The first option was discussed above and involves the donor creating an irrevocable trust for the initial benefit of the donor's spouse. A properly drafted trust may qualify for the unlimited marital deduction which would defer the tax until the death of the spouse beneficiary. A gift made in 2021 is reported on a gift tax return that must be filed by April 15, 2022. This allows the donor spouse to take a wait and see approach and only claim a marital deduction for the taxable portion of the gift, if any. Essentially, this gives the taxpayer options to decide what path to take based on how any new legislation is applied.

Another option is to base the amount of the gift on a formula equal to the donor's remaining exemption "as finally determined for federal gift tax purposes." The trust would initially be funded with the full exemption amount but if the law changed before the end of the year, the amount of the gift is capped at the new exemption amount and the excess would be redirected as provided in the trust. For example, the excess assets could be distributed to charity and qualify for a charitable deduction or to the donor's spouse and qualify for a marital deduction.

There are many other creative ways to incorporate an escape hatch into this type of planning, none of which are simple and all of which require a clear understanding of your objectives and a keen understanding of the tax implications. It is not too late to do this type of planning but you should not delay consulting with your estate planning attorney. If you do not have an estate planning attorney, please reach out to us, we work with a number of excellent attorneys in each of our markets that we can introduce you to.

FINEMARK
NATIONAL BANK & TRUST®

Fort Myers • Bonita Springs • Charleston • Estero • Naples • Palm Beach • Scottsdale • www.finemarkbank.com • (877) 461-5901
Trust and investment services are not FDIC insured, are not guaranteed by the bank and may lose value.