

INVESTMENT INSIGHTS

THIRD QUARTER 2021

Cantlay wins BMW Championship in Baltimore, MD

Key Topics

- Investors Are Focused on Heightened Market Risks
- Substantial Tax Changes Expected to Fund Build Back Better Act

MARKET UPDATE

Rising Volatility Leads to Mixed Results for Global Stock Markets

Investors Are Focused on Heightened Market Risks

After large and small company U.S. stocks rose 14.3% and 17.5%, respectively, during the first half of the year, it was not surprising to see headwinds emerge in the third quarter. In fact, stock market volatility has risen approximately 50% since mid-year. U.S. large company stocks remained resilient, posting gains for the sixth quarter in a row with a return of 0.6%. Real estate performed similarly with a gain of 1.0%. Developed international companies declined this quarter by 3.0% and domestic small company stocks dropped by 4.4%.

Investor concerns center on several factors, including global supply chain issues contributing to growth downgrades and upside inflation surprises, the political impasse over the U.S. debt ceiling, growing China concerns and the Covid Delta variant.

Central banks worldwide seek to unwind the unprecedented liquidity pumped into the financial system during the pandemic. As expected, the U.S. Federal Reserve did not change the Fed Funds Rate at its September meeting but did indicate its bond purchases will decline over time, effectively reducing the size of its \$8 trillion balance sheet. The pace of the Fed's balance sheet reduction and, ultimately, its ability to manage rising interest rates will be critical in determining future market volatility.

Despite rising risks for stock markets, long-term investors cannot rely on fixed income as a viable alternative due to historically low interest rates. For example, 10-year Treasury bonds only yield 1.5% versus 4.0% historically and their prices could significantly decline if interest rates rise since bond yields and underlying prices have an inverse relationship. Low rates also expose bond investors to negative real rates of return (i.e., Treasury yields today are lower than inflation). Bonds can be an important component of a portfolio by providing for liquidity needs. However, current returns in the bond market are truly unremarkable.

Comparative Returns

	Annualized Performance					
	Q3 2021	YTD	1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks ¹	0.6%	15.9%	30.0%	16.0%	16.9%	16.6%
Small Cap U.S. Stocks ²	(4.4%)	12.4%	47.7%	10.5%	13.5%	14.6%
International Stocks ³	(3.0%)	5.9%	23.9%	8.0%	8.9%	7.5%
Real Estate ⁴	1.0%	23.0%	37.2%	10.1%	6.8%	11.2%
U.S. Bonds ⁵	0.1%	(1.6%)	(0.9%)	5.4%	2.9%	3.0%

¹ S&P 500 index, which includes 500 of the largest U.S. companies in all sectors of the economy

² Russell 2000, which includes the 2000 smaller stocks of the Russell 3000 index

³ MSCI ACWI ex-U.S. index, which includes large and mid-capitalization stocks from developed and emerging international markets

⁴ MSCI U.S. REIT index, which includes domestic publicly traded real estate stocks

⁵ Bloomberg Barclays Aggregate Bond index, which includes a representation of the performance of the entire U.S. investment grade bond market

Substantial Tax Changes Expected to Fund Build Back Better Act

On September 13th, the House Ways and Means Committee unveiled their tax proposal to help fund \$3.5 trillion of new spending within the Build Back Better Act. The proposed legislation primarily impacts corporations and individuals earning more than \$400,000 per year with provisions changing corporate and capital gains tax rates, the estate tax exemption and the effectiveness of intentionally defective grantor trusts designed to reduce estate taxes. The proposal has several hurdles to overcome before it becomes law and will likely undergo numerous changes. However, many of the included tax provisions listed below could become law and go into effect on January 1, 2022.

Tax Provisions – Build Back Better Act
Raises top marginal tax rate from 37% to 39.6% for single and joint filers with incomes of \$400,000 and \$450,000, respectively
Raises the top corporate tax rate from 21% to 26.5%
Increases capital gains tax rate from 20% to 25% for filers in the highest tax bracket (effective September 13, 2021)
Adds a 3% surtax for modified adjusted gross incomes above \$5 million for joint filers and \$2.5 million for single filers. The 3% surplus also applies to trusts that generate \$100,000 or more in income.
Prohibits all Roth conversions for taxpayers in the highest bracket starting on January 1, 2032
Prohibits Roth conversions of after-tax funds starting on January 1, 2022, eliminating the back-door Roth and mega Roth conversion strategies
Reduces the estate tax exemption by 50% to \$6.0 million in 2022 (adjusted for inflation annually). The tax rate on amounts above the exemption is 40%
Changes the nature of donations to intentionally defective grantor trusts by including the trust assets in the grantor's estate. This reduces the viability of a very popular strategy to reduce a taxable estate.
Applies the wash sale rule to cryptocurrencies, digital assets, foreign currencies, and commodities

In the months leading up to the proposed bill, several significant provisions considered by lawmakers were ultimately excluded. The bill would not eliminate the basis “step-up” at death, a mechanism under which a deceased individual’s assets are deemed to have been purchased at fair market value on the person’s date of death. The bill does not impose the “deemed realization” provision suggested by President Biden, which would have caused an income tax realization event at the time of the transfer (such as by gift or death) without the basis step-up benefit. In addition, the bill does not include Biden’s original proposals to limit the effectiveness of grantor-retained annuity trusts (GRATs) or limit deferred gains in a 1031 exchange to \$500,000. The outcome of the bill will become clearer once the Senate adds input to the legislation.



ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment advisor with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, returns optimized, and tax-efficient. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is well-below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

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