Wealth Management Bulletin

SPRING 2021

Welcome to Spring …

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It's that time of the year when warmer weather and April Showers lead to the blooming of the flowers and allow the trees to change into their summer wardrobe. It's like clockwork. The ground thaws, the sun shines brighter, and new life starts to appear, seemingly out of nowhere. A perfect cycle, never interrupted by… wait, what is that noise?

Cicadas. Swarms and swarms of Cicadas. Every seventeen years they appear to wreak havoc on the landscape. They live, they mate, they make noise, and they die, ending up as debris piles to be swept up and discarded. But why?

One hypothesis for the reason behind the periodical cicadas' seemingly unbreakable selections of 13- and 17-year increments for their reproductive cycle centers around the fact that both numbers are prime. The idea is that by popping out of the ground only in prime numbered intervals, periodical cicadas avoid ever synching up with booming populations of predators, which tend to rise and fall on two to ten year cycles.

Real life can be like that. You and your loved ones are in a comfortable lifecycle as regular as the cicada appearance. Marriage, births, kids in school, summer vacation, new house, careers, work, retirement, and travel are all stages of real life that occur, we hope, as we avoid "real life predators."

But the unexpected "real life predators" do reveal themselves. Job transitions, relocations, a health crisis, negative financial markets, an untimely death, or even a pandemic may appear no matter what we do to try and avoid them. And even though we know that some of these events may be inevitable, planning for them is as important as ever.

The professionals in our Wealth Planning Group have the knowledge, expertise, and experience to help you meet the predatory challenges of real life. We know that unlike the cicadas, who only appear every seventeen years to be safe, people need to be constantly vigilant, planning for life's inevitable predators. Investment, estate, financial, insurance, and educational planning are just some of the things that we can assist you with. Whatever the need, we coordinate with your other professional advisors so you can be ready when the unexpected occurs. We can't tell you when the "real life predators" will appear, but we do know how to recognize and respond to them.

It's Spring. Get outside and enjoy the new life blooming everywhere. And as you progress through another season, please let us know how we may be of service to you and your family. Me? I'm heading to the nearest hardware store for some earplugs before the Cicadas arrive.

Welcome to Spring. Be safe, enjoy the season, and thank you for your relationship with LCNB Wealth.

Best Regards,

Mike

TAX UPDATE

Potential Changes to Tax Law – How They Impact Wealth

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A perpetual question is what changes Congress will enact that affect estate tax, income tax and gift tax laws. President Biden's new administration faces many challenges. With his narrow majority in Congress, tax law changes might not be his first priority. Still, tax law changes endorsed by Mr. Biden indicate that change is on the horizon. What might those changes be?

For Federal estate tax, the exemption amount—the amount that you can shield from estate and gift tax and generation-skipping transfer tax—doubled in 2017 from $5 million and is indexed for inflation. In 2021, the exemption amount is $11.7 million. The sunset provision of the 2017 law provides that the exemption amount will revert to $5.49 million at the end of 2026. If your net worth exceeds that amount (or for married couples, if your net worth exceeds $11.7 million), you might consider lifetime gifting strategies. If you aren't ready to make large transfers of your property, then you could consider alternate strategies to "freeze" the value of your estate and shift future appreciation to lower generation beneficiaries.

During the Presidential campaign, Mr. Biden proposed lowering the exemption amount to $3.5 million. The exemption has not yet been lowered, but we should be aware of such proposals. President Biden also said he would seek to repeal the cost basis step-up at death and would seek to tax capital gains as ordinary income. Under current law, the cost basis of assets owned by the decedent is stepped up to the value of the assets at the date of death. Beneficiaries or trusts receiving low basis assets will get a step up in basis of inherited assets and could sell those appreciated assets immediately after the property owner's death, with no capital gains taxes.

Let's look at an example of an individual who was sufficiently fortunate to have invested $10,000.00 each in Amazon, Apple, Facebook, Netflix and Google stock at their lowest price in the last ten years. Just to add some stocks whose performance is more ordinary, let's also say that same individual also purchased $10,000 of Pfizer, Procter & Gamble and Berkshire Hathaway Class B, at their lowest price in the last ten years, and still held all 8 of those stocks. That $80,000 investment would be worth over $1.2 million today. If that person passed away today and you inherited those 8 stocks, you would receive a step up in basis to $1.2 million and could sell them and pay no capital gains taxes.

Some of the ideas currently being discussed in Congress would take away the step up in basis. Other proposals would permit a step up of $1 million but would impose capital gains taxes on any additional gains. There is also frequent discussion of increasing the rates for both income tax and capital gains tax. If basis step up were eliminated and if capital gains were taxed the same as ordinary income, the inheritance of the 8 appreciated stocks listed above could result in approximately $400,000 of income tax.

Any such changes passed by Congress probably would not take effect until 2022. It is within Congress's power to enact retroactive tax legislation, but administration officials have said they aren't considering any retroactive changes. Potential tax savings should never be the sole determinant of your financial planning decisions. However, 2021 is a good year to review your existing estate plans, particularly if you have large amounts of low basis investments or if your net worth is near the current or prospective Federal estate tax exemption amounts. These reviews should be undertaken with your advisors and your estate planning attorney. Your LCNB trust officers would be delighted to assist in that review.

ECONOMIC SUMMARY

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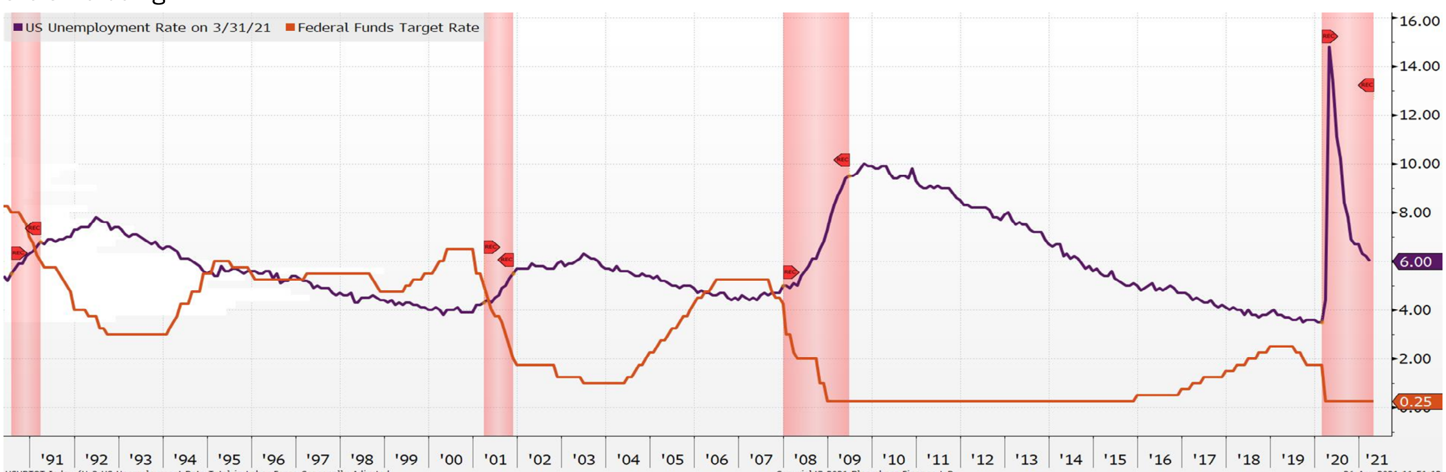
A Blooming Economy

Spring is a time to bloom. Will this spring represent the start of a fresh expansionary period? And if so, how long will the new expansion last? Economic output, as measured by GDP, was still in the recovery phase as of year-end 2020 with annual output measured at $21.5 trillion. This was just over 1% below the pre-Covid high annual pace of $21.75 trillion at 12/31/19. With GDP growth expected to be above 5.6% for 2021 according to the OECD, we are likely now in the early stages of a fresh expansionary period.

The strong expected growth rate is supported by increasing vaccinations, an economy that is still opening back up, and massive fiscal and monetary stimulus efforts. Monetary stimulus, in the form of low interest rates and quantitative easing, will continue, according to Fed Chief Powell, until employment fully recovers, and we see persistent inflation above 2%. The most recent fiscal stimulus is just starting to hit the economy and comes via the recently passed $1.9 trillion American Rescue Plan.

The expected growth rate mentioned above is certainly showing up in labor force data. According to the Bureau of Labor statistics, the economy added 916,000 jobs in March and the unemployment rate dropped to 6%. Despite the strong month, the labor force remains 8.4 million jobs below the pre-pandemic level. Even at this rapid pace of recovery, we are not likely to reach the Feds employment target until late this year or early 2022. The Fed will therefore remain accommodative for the time being.



The vigorous recovery and growth rate expected for 2021 is a stark contrast to what we saw in the early stages of the past two economic cycles. Those cycles saw muted growth rates of near 2%, but both lasted much longer than typical cycles. With this cycle burning hotter at the start, many economists and market participants are starting to question the longevity of this run.

Assuming we reach full employment some time over the next 12 months, and inflation continues to run hot (see housing and material comments below) the Fed will almost certainly begin to curtail bond purchases late this year or early next. Emergency fiscal funds will start to dry up at some point, and potential tax hikes could also threaten growth into 2022 and beyond. An infrastructure plan could help engineer a soft landing and transition from the current rapid growth to a more sustainable growth rate. However, as fast as things are developing, investors should consider the possibility that by the time economists declare the expansion has started, we may already have reached mid-cycle.

Charging Ahead

If the Fed is having trouble finding inflation, they need to look no further than financial assets and stocks. Domestic stocks have continued their bull run through the first quarter of 2021 with the S&P 500 up over 6% and smaller stocks, represented by the Russell 2000 Index, returning 12.7%. The robust economic backdrop and an abundance of liquidity is clearly supporting stock prices. Returns for the prior 12 months are artificially high, as the starting point was near the COVID-19 bottom in March of 2020. Still the 3- and 5-year returns shown above indicate just how strong this market has been.

We started positioning portfolios into small caps well before any mention of COVID as we felt they were undervalued at the time. With smaller stocks now outperforming larger issues for the prior 3-, 12-, and 60-month periods, it may be time to reevaluate this position. This could be especially true if we are likely to see a shorter cycle as noted above. In addition to small stocks outperforming larger issues, value stocks (as shown below) have significantly outpaced growth stocks. This rotation is common in the early phases of an economic cycle.

International equities cooled off in the first quarter as compared to domestic issues. Year-to-date returns of 3.49% and 12 month returns near 50% are certainly impressive. However, the slower global dissemination of vaccines has certainly dampened the global economic recovery and hurt relative returns. We continue to see attractive valuations in foreign issues. As vaccine distributions improve globally, we would expect those economies and markets to play catch up to the red-hot domestic markets.

Equity Summary:	1st Qtr	YTD	12 Month	3 YR	5 YR
S&P 500 (Large Cap Domestic)	6.17	6.17	56.35	16.78	16.29
Russell 2000 (Small Cap Domestic)	12.70	12.70	94.85	14.76	16.35
MSCI ACWI Ex US (International)	3.49	3.49	49.41	6.51	9.76

FIXED INCOME UPDATE

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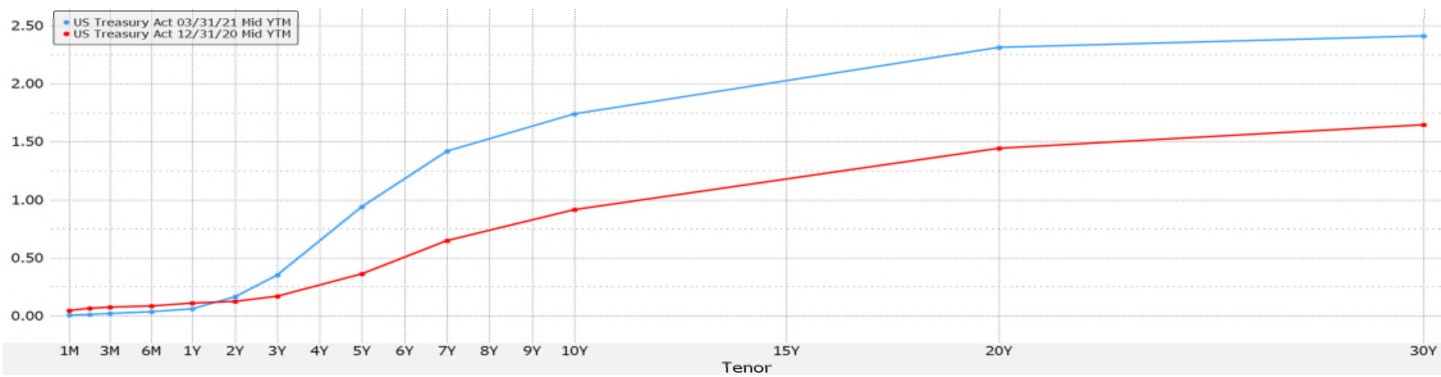
Hitting Slope

As equity markets marched to new all-time highs during the first quarter of 2021, most major bond indices traded lower. Global economies reopened, economic growth expectations improved and the possibility of potential future inflation pushed investors into stocks and out of bonds. The US Bloomberg Barclays Government Credit Index was down 1.86%. The first-quarter sell-off hit high quality Treasury bonds the hardest with high-yield bonds being the only positive returning category. This was attributable to spreads continuing to narrow reaching historically low levels.

In the first quarter, slope returned to the yield curve causing it to steepen as seen in the chart below. The 10-year treasury moved higher 83 basis points (bps) from 0.91% to 1.74%. During that period, the 2-year moved up 4 bps from 0.12% to 0.16%. By quarters end, the spread between the 2 and 10-year Treasury settled at 1.58% - its' highest level since 2015. Starting in March of 2020, the Federal Reserve (the Fed) moved rates to 0%-0.25% and has kept interest rates unchanged since. The Fed's inflation target is 2% yet most indices are signaling inflation expectations will surpass that mark by years end. The Fed has also continued its commitment to its bond purchase program causing credit risk to be at historically low levels. The inherently low level of credit risk has in turn pushed credit spreads lower.



Collectively, global interest rates moved higher in the first quarter yet several European countries still have negative interest rates. A great example of this is the 10-year German Bund which moved from approximately -0.55% to -.030% during the quarter. Even though some countries rates have moved higher finally creeping out of negative interest rate territory, these rates still remain extremely low. For instance, the Japanese 10-year closed the first quarter below 10 bps. With international bond rates at such low levels, it is easy to see why some international investors prefer to buy US Treasury Bonds.

As most interest rates, domestic and global, moved higher and the yield curve continued to steepen, we began looking to take advantage of more opportunities in the bond market. We are always evaluating investments on the risk we take versus the potential returns and the beginning of 2021 provided us with some opportunity to invest a bit of the cash in our portfolios into conservative bond investments. When looking back at interest rates and the economic cycle, we acknowledge that interest rates could move higher and recommend a shorter average maturity versus the benchmark.

Fixed Income Summary:	**1st Qtr**	**YTD**	**12 Month**	**3 YR**	**5 YR**
US T – Bill 90 Day Index	0.01	0.01	0.10	1.32	1.11
BC Municipals 5YR	-0.35	-0.35	4.29	3.88	2.45
BC Intermediate Government/Credit	-1.86	-1.86	2.01	4.36	2.75
BC High Yield Corporate	0.85	0.85	23.72	6.84	8.06

ALTERNATIVES UPDATE

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Lumber, Copper, and Gold, Oh My!

Despite gold being down almost 10% during the first quarter of 2021, a general commodities basket returned investors a healthy 6.92%. This increase was mostly driven by commodities connected to home construction. Materials used in new home construction have rapidly risen – oil has continued to surge in 2021 ending the quarter up another 22%, the cost of copper is up almost 33% from the fall and lumber prices have soared 180% since the beginning of the pandemic. Sawmill and other factory shutdowns decreased supply; people spending more time at home and completing home renovations amplified demand. Low interest rates strengthened borrowing capabilities, further increasing homebuilding and demand of these materials. This perfect storm has led to an increase of more than $24,000 in the average price of building a new home!

This growth in home prices has led to a rise in the prices of rent and other shelter expenses which are evident in the Consumer Price Index (CPI) – which is the index that measures the average change in prices over time, i.e. it is a measure for inflation. The housing specific portion of CPI, making up 42.4% as of December 2020, rose 1.7% over the last 12 months. The CPI rose 2.6% overall for the 12 months ending March 2021. At least in the near term, it does not appear that this trend will reverse.

For this reason, we continue to recommend allocating to gold as an inflation hedge even with the recent decline. Moreover, with credit spreads at such low levels and stock valuations remaining stretched, we continue to maintain an overweight recommendation to alternative investments as a whole. The merger space and global real assets are other areas that we currently recommend in addition to gold. The goal of our alternative allocation is to enhance the risk adjusted return of our portfolios. We benefitted from this recently with the commodity index and broad hedge index outperforming both the S&P 500 and ACWI ex US indices. We expect to continue to see added value in the near future.

Alternative Investments Summary:	1st Qtr	YTD	12 Month	3 YR	5 YR
Bloomberg Commodity	6.92	6.92	35.04	-0.20	2.31
Dow Jones Global Real Estate	5.26	5.26	33.19	5.98	6.20
Morningstar Broad Hedge Fund TR	9.85	9.85	30.94	5.23	5.58

Wealth Team - Causes for Celebration

- **Employment Milestones**: Melanie Crane – 35 years; Michael Nusbaum – 10 years; Josh Shapiro – 5 years;
- Michael Nusbaum and his wife Andrea welcomed Jonathan Nusbaum into the world in December;
- Izabela Camacho received her MBA, with a concentration in Finance, in December;
- Erin Hawk passed the Level III exam of the CFA Program in December;
- Brady Fening passed the CFP exam in March.