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QUARTERLY NEWSLETTER
3RD QUARTER 2021

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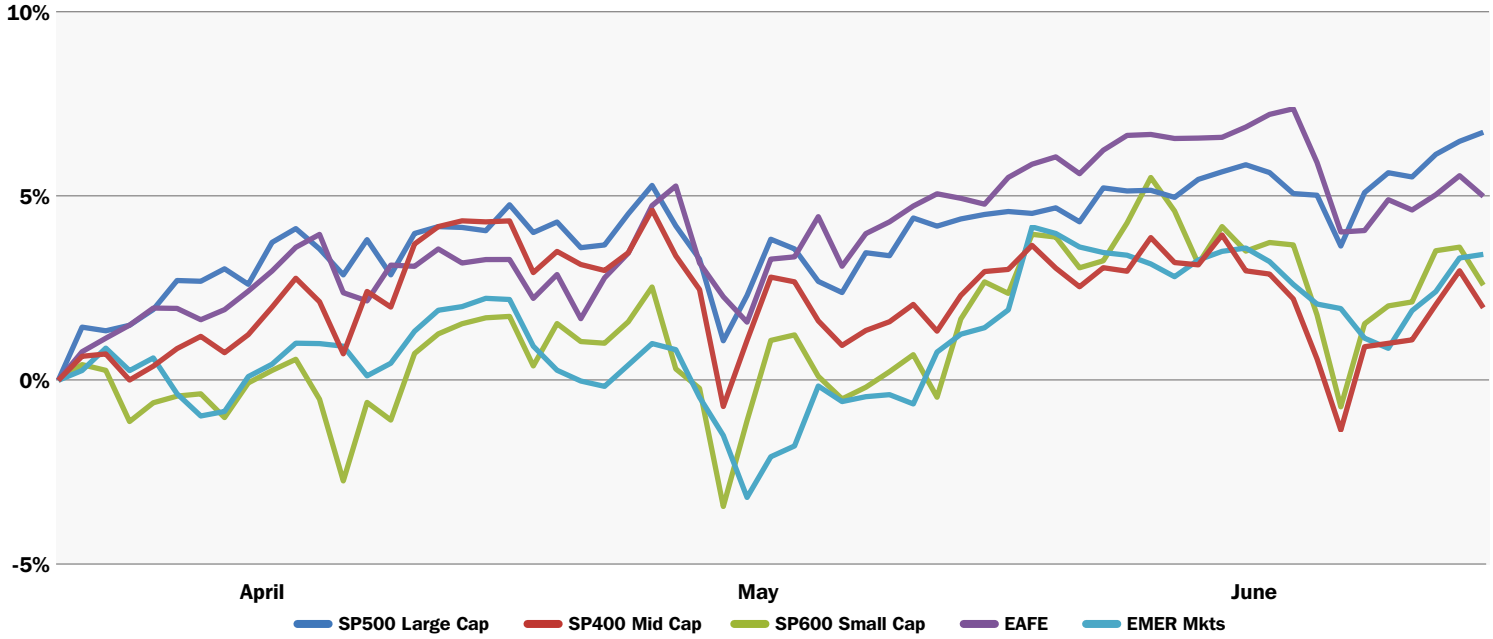
SECOND QUARTER 2021 MARKET COMMENTARY

By **Richard A. Hewitt**

The continued reopening of the U.S. and world economies played the major role in the second quarter's robust market performance. All five indices turned in positive returns for the quarter. Additionally, all are positive for the year to date.

U.S. large cap stocks regained their momentum due in part to the Federal Reserve's continued commitment to keep interest rates low for at least the remainder of 2021. Some of the large cap growth names in the technology sector are relatively interest rate sensitive and negatively overreact when the Federal Reserve even discusses *when* they will start to raise rates from near 0%.

2nd Quarter 2021 U.S. & International Equity Market Performance



Source: Yahoo! Finance

Praetorian Guard continues to be overweight in Health Care, Consumer Discretionary, Communication Services and Industrials. We believe the infrastructure bill, when passed in some form, will benefit Industrials (as will the continued reopening of the economy). Health Care, Consumer Discretionary and Communication Services are all outperforming the broader S&P 500 returns since we added them to our models in April 2019, November 2020 and March 2021, respectively. We anticipate maintaining these allocations for the foreseeable future.

We expect markets will continue to expand over the next several months—the pent-up demand is too much to overcome and any major administration policy changes won't be signed into law until early fall.

BIDEN ADMINISTRATION FY 2022 BUDGET PROPOSAL

By **Joseph P. Clark**

On May 28, 2021, the Biden Administration transmitted their FY 2022 budget recommendations to Congress, laying out their annual discretionary spending plan for the upcoming fiscal year as well as their long-term infrastructure and social spending plans. On the same day, the Treasury Department released a report called "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" which reflects the most detailed explanation of the administration's current legislative priorities for the U.S. tax system. The "American Jobs Plan" and "American Families Plan" would reportedly cost over $4 trillion but be offset over a 15-year period by tax measures also recommended in the budget document. The administration's budget recommendations are only recommendations that Congress can accept, reject, or modify as part of the legislative process. Congress can also choose to offset all or only a part of any spending programs it approves. Here are just a few of the highlights of the tax proposals:

Corporate and international tax proposals:

- Increasing the statutory corporate rate to 28% from the current 21%
- Imposing a 15% minimum tax on global book income of certain large corporations

Individual and investment-related tax proposals:

- Increasing the top individual ordinary income tax rate to 39.6%
- Taxing long-term capital gains and qualified dividends at ordinary income rates for taxpayers with adjusted gross income (AGI) exceeding $1 million (potentially retroactive to gains recognized as early as April 2021)
- Treating transfers of appreciated property upon death or by gift with unrealized capital gains appreciation in excess of $1 million as realization events, with exclusions for donations and certain tangible personal property and deferral of gain for family-owned and operated businesses—special rules providing for spousal portability and treatment of capital gains attributable to a primary residence also would apply
- Repealing deferral of gain over $500,000 from section 1031 like-kind exchanges completed in tax years beginning after December 31, 2021 (regardless of when exchange began)

In addition to its revenue-raising proposals, the Biden Administration also included as part of its long-term plans a number of tax credits and preferences for social programs and income support, including:

- Extending the expansion of the Child Tax Credit to certain children through 2025 and making the credit fully refundable
- Making permanent the expansions to the Child and Dependent Care Tax Credit
- Making permanent the expansions to the Earned Income Tax Credit for childless workers
- Extending the expanded Affordable Care Act (ACA) premium tax credits

The administration also recommended over $300 billion (over 10 years) of tax incentives for clean energy, including:

- Extending and enhancing of renewable and alternative energy incentives
- Establishing new tax credits for advanced energy manufacturing
- Establishing tax credits for heavy and medium-duty zero emission vehicles
- Providing tax incentives for renewable aviation fuel
- Extending and enhancing the electric vehicle charging station credit

The Biden Administration has set out an ambitious, long-term infrastructure and social support program. Congress may act on all or part of that program, or indeed, could add to it. The revenue-raising tax proposals set out in the budget are designed to offset the cost (over time) of the proposed increases in spending and tax incentives. Many of the tax increases will be controversial and could be modified or eliminated during congressional consideration of legislation. Additional revenue-raising proposals could be added, as well. Several proposals put forth by President Biden during the presidential campaign have not been included in the budget—such as further changes to the taxation of estates; repeal of the section 199A deduction for pass-through businesses; a 28% cap on the tax benefit of itemized deductions; a tax on the assets of financial institutions; and a modification of the income cap for payroll taxes. It would not be surprising if there were significant modifications made to the Biden Administration's tax proposals when they are considered in Congress.

Reference: https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf

PRESIDENT'S COMMENTARY

By **Richard A. Hewitt**

For the first time in 18 months, the light we can see is not a train headed towards us. Like virtually everything in our hyper-politicized existence, COVID-19 succumbed to a Rorschach Test of a choice between the group or the individual—We or Me? I believe this is the wrong question to ask right now. Better to ask the following: to whom do I need to give thanks and why? Many of the heroes of the last year and a half wore scrubs, work boots, had a commercial driver's license or kept their business running in the face of changing, conflicting and confusing dictates from "experts" so we could buy essentials. They did it with grace, humility and courage. They did it because it had to be done. As we all return to whatever "normal" we choose, thank a hero—they are literally all around us.

POLITICAL AND ECONOMIC ENVIRONMENT

By **Marc A. Wehmeyer**

What a difference a year makes. This time last year the world was on lockdown. Graduation ceremonies were virtual. Summer vacations were cancelled or postponed. There was no baseball and the Olympics had been postponed. The daily rate of new COVID-19 infections had eclipsed 50,000 a day and an effective vaccine was still months away. Although the U.S. stock markets bottomed in March 2020, economic activity had not. Real U.S. Gross Domestic Product (GDP) fell at a record annual rate of 31.4% for the three months ending in June 2020, following a 5% decline in the previous quarter.

Look around now and the differences since last summer are dramatic. Nearly 180 million eligible Americans have received at least one vaccine dose. Although the pandemic is not over, there are signs of improvement and a return to normalcy. Travel is on the rise, stadiums and beaches are filling up, and masks are disappearing from everyday life. Most estimates of real GDP growth for the second quarter of 2021 are in the 8-9% range.

Much of the rebound in the U.S. economy can be attributed to the unprecedented fiscal and monetary policy response. Fiscal policy measures so far have included three different rounds of stimulus payments, expanded unemployment benefits, and forgivable loans to small businesses under the Paycheck Protection Program (PPP). Monetary policy measures included traditional expansionary tools like lowering the target range for the federal funds to near zero. The Federal Reserve also implemented some programs that went beyond steps used during the 2007-2009 financial crisis, such as direct purchases of financial assets and emergency lending programs.

Not surprisingly, the enormous amount of fiscal and monetary stimulus has put upward pressure on prices. The Consumer Price Index for All Urban Consumers (CPI-U) rose at a non-seasonally adjusted rate of 5.0% from May 2020 to May 2021, the largest 12-month increase since August 2008. There is no consensus about whether the increase in inflation will be a transitory phenomenon related to supply-chain disruptions during the pandemic, or will lead to a persistent increase in prices.

Price stability is one of the Federal Reserve mandates and the traditional way to counter rising prices is to implement contractionary monetary policies to shrink the money supply. It is an open question how and when the Federal Reserve will respond to rising prices if they continue. Complicating the way ahead is the Fed's new policy approach of average inflation targeting announced in August 2020. Under this framework, the Fed may let inflation overshoot its 2% target for some time to support full employment as long as average inflation remains around 2%. Full employment is the other half of the Fed's "dual mandate", and the labor market has not completely rebounded. The unemployment rate spiked to 14.8% in May 2020 and has rebounded to 5.8% as of May 2021, still significantly higher than the pre-pandemic rate of 3.5% as of February 2020. For now, the financial markets seem to trust that Jerome Powell and the rest of the Fed will be able to do what it takes to maintain price stability and full employment. The Fed is not expected to start raising interest rates until late 2023.

On the fiscal policy side, the most prominent legislative initiatives in the works include the following: a nearly $1 trillion dollar compromise "physical" infrastructure bill crafted out of the President Biden's American Jobs Plan by a bipartisan group of Democratic and Republican senators; a second bill known as the American Families Plan focusing on "human" infrastructure elements such as education, child care and paid family leave; and a third bill called the Made in America Tax Plan to raise revenue to pay for the new spending programs.

The fate of the three different proposals is far from certain. Most legislation requires the support of 60 senators to avoid a filibuster. There is a complicated separate process known as reconciliation that would enable Democrats to pass tax and spending legislation with a simple majority of 51 votes (or 50 votes with Vice President Harris breaking a tie). Since the Senate is currently split 50/50, passing legislation by reconciliation would challenge the discipline and unity of the Democrats to gain the support of all their members if no Republicans were willing to vote for the proposals. The House of Representatives would also have to be willing to support the same bill as the Senate. With momentum already building towards the 2022 mid-term elections, the Democrats face tough choices about how to proceed and limited time on the legislative calendar to get things done.

The second half of 2021 promises to be full of economic headlines and political drama, most of which is beyond any one individual's direct control. As we have stated in the past, for the long-term health of your portfolio and financial plan, we encourage you to focus on those things in your life you can control and avoid worrying about things you cannot control.

IRS FORMS FOR RETIREMENT ACCOUNTS AND HOW TO DECIPHER THEM

By **Richard A. Hewitt**

Paperwork and the IRS seem to be inseparable and the annual flow of documents around tax time in addition to later dates is confusing. Here we will attempt to provide clarity on what documents are generated from what activity and some specific items to know about the various forms:

Form 1099-R: Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. You will receive this form generally in the first two weeks of February if you take a distribution from a Traditional or Roth IRA, 401K, 403B, 457, or Thrift Savings Plan (TSP). There is a chance of errors from the issuer so pay special attention to the Distribution Code in Box 7 (and refer to the IRS instructions as there are many). Also note that if you chose to do a Qualified Charitable Distribution (QCD), the distribution amount will be reported but there is NO code for a QCD that will go into Box 7. You have to work with your tax preparer to make sure you do not pay income tax on the distribution. This form goes to both you and the IRS.

Form 5498: IRA Contribution Information. The Form 5498 documents funds that have been contributed INTO a Traditional/Roth IRA, SEP IRA or SIMPLE IRA. It can be thought of as the bookend to the Form 1099-R (which covers funds being distributed OUT of the account). You can expect to receive this form in early June. It is for informational purposes only and you only need to review and file away.

EXAMPLE: I left a job and rolled my 401K into my traditional IRA. The 401K provider will issue me a Form 1099-R showing that funds were distributed from the 401K. The custodian of my IRA will issue me a Form 5498 showing a rollover contribution of the same dollar amount. This is a "completed rollover" and I will have no taxes due (and a complete paper trail for the IRS).

Form 8606: Nondeductible IRAs. When your Adjusted Gross Income (AGI) is above the limit for making a deductible contribution to your traditional IRA, you can still make the contribution but it will be nondeductible (for tax purposes). You are establishing what is referred to as "basis" in your traditional IRA. If you want to document it (and NOT pay taxes years from now at the time of distribution), you need to file a Form 8606. Technically, this is a stand-alone tax return so if you need to go back and file for previous years, you can do that without amending your Form 1040 for any given year. If you and your spouse both make nondeductible contributions, each of you need to file a Form 8606. Note that the "tax basis" carries over to anyone who inherits your IRA in the future. Therefore, if you want your beneficiaries to pay less tax, make sure someone (CPA, attorney, financial planner) has a copy of your tax return(s) with the Form 8606.

Form 5329: Additional Taxes on Qualified Plans. This form is used to "come clean" with the IRS when you have made a mistake and the deadline has passed for correcting the error (normally October 31st after the year of the error. If you made an excess contribution to your IRA (greater than the annual maximum—perhaps because you changed custodians—and a 6% penalty) or missed a Required Minimum Distribution (50% penalty) you can file the Form 5329 to correct it. You start the statute of limitations and the IRS can only come back to you for a few years but not forever. If you don't file the Form 5329, the clock doesn't start! This also is a stand alone tax form so you can file for previous years without having to amend the full Form 1040.

LOSS AVERSION

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CLOSING THOUGHT

"Some people regard private enterprise as a predatory tiger to be shot. Others look on it as a cow they can milk. Not enough people see it as a healthy horse, pulling a sturdy wagon."

— ***Winston Churchill***

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