KEMP Financial Management, LLC

July 2021: Fireworks and Inflation

KFM Update

We hope you had a wonderful Independence Day Celebration with family and friends! It certainly was a nice change of pace to see military plane flyovers along with the sights and sounds of fireworks along with “oohs and aahs” from the viewers. What a fantastic improvement from last year!

Another great sight oddly enough is the travel lines at National airports. No doubt the longest we’ve seen in quite some time. Projections of increased road traffic was true over the fourth of July despite the increased cost of gasoline. It almost has the look and feel of a normal summer.

It’s wonderful to hear clients talk about travel plans for later this year along with current domestic travel to see family and friends whom they have not seen for quite some time. We are delighted for everyone to renew relationships face to face instead of virtually.

At KFM, we have experienced an uptick in personal meetings in Fullerton. It's been great to sit down in the same room to be with one another face to face. We are so fortunate to have plenty of space within the office to be socially distant as we continue to get back to a more normalized work environment.

Your KFM Team is back in the office as well with occasional work from home days as our schedule allows. Next time you pay us a visit, the snack bar and coffee maker is back in business in the KFM family room. Make sure you let Kate know your favorite snacks before you arrive.

KFM has crested $200m under advisement this past quarter. We thank you for the continued recommendations that have allowed us to create new relationships and friendships for years to come. More importantly, we thank you for your friendship, continued trust, support and confidence.

We are greatly looking forward to our Virtual Experience Charcuterie Event on July 15th. We will have over 40 participants and we look forward to creating an unbeatable charcuterie tray together to be used with friends and family during upcoming events with family and friends.

Capital Markets Update

We mentioned last quarter that you would be happy with the results. So if you were happy last quarter, you’ll be even happier this quarter. (Not that your happiness comes from performance.) Once again, the capital markets continue to add value towards your individualized personal desires, and we are grateful for the continued progress.

Where do the capital markets go from here? The dreaded crystal ball question. Our honest answer never wavers, “We don’t know”. However, if the year were to be over now and we finished where we are today, we do not believe anybody would be unhappy. Given what we have gone through in the last 15 plus months, there is no question we are on the road to recovery. It took a very long time to get here, but no doubt, we are here.

Given we are still in recovery, the question most often asked is: "How long will it last?" Yet another crystal ball question. While we do not advocate listening to the financial media for investment information, much of the media is mixed on the length of time for recovery, but they are unified in the fact that the economy is growing nicely. Some predict a return to the roaring 1920s, while others seem to believe that it will be 1 to 2 years before growth stabilizes. If we land somewhere in the middle, the outlook still appears bright.

As mentioned earlier, the quarter was very good to all of our client portfolios. While that is great, we are most hopeful that you continue your quest to pursue what matters most in your lives. We've been highlighting those areas in our Client Corners over the past 12 months, and we look forward to celebrating many more life achievements in the years to come. Enjoy the reopening! We look forward to connecting in person or virtually soon!

Legislative Update

Surprisingly, there is not much to discuss since last quarter. It appeared eminent that we would be discussing potential changes in taxes. But as of this writing, nothing has changed. There is continued speculation on the following:

- Potential increase in the Corporate Tax Rate
- Potential decrease in the estate tax exemption (2021 is set at $11.7m per person)
- Potential increase in estate tax rates
- Potential elimination of the Step-Up in basis rules for assets that are inherited
- Increasing the Capital Gains tax rate for top income tax bracket (2021 top income tax bracket for Single / Head of Household $523k income or more / Married Filing Joint $628k income or more)

We share them once again, strictly to let you know we are continuing to monitor the situation as well as be ready to discuss the impact for each of our clients. As you know, at Kemp Financial Management, we have always maintained the phrase: "Never let the tax tail wag the dog." It's too early to make any adjustments in your tax plans until we have more information relating to each potential tax change.

Inflation 101

Surprisingly, we have only had a few in depth conversations relating to inflation. With the increased costs during the recovery, one would have suspected more conversations around inflation and the potential impact on future desires.

At KFM, for pre-retirees our accumulation assumption has always included a 4% compounded rate of inflation until retirement. With inflation running less than 2% for the past 15 years, running models with a 4% inflation rate seemed too high. However, the practical application of using a higher expected inflation rate has been accumulating more assets than necessary to generate the needed cash flow throughout retirement.

For retirees, we have also included the ability of increasing cash flow each and every year by 4% to account for inflation. Practically speaking, retirees have not needed to increase their income in the last 15 years due to actual costs being stable. That said, one of the beauties of our clients is that most of them would opt to spend less rather than increase during market declines like we have experienced in the last twenty years. It's simply just how they are wired. Regardless, the great news is we've got you covered relating to inflation.

For those that would like more inflation information, read on. Others can feel comfortable stopping here.

Inflation can be defined differently for certain events and/or sustained periods of time. Let's start by defining the various types of inflation:

• Inflation – Inflation generally occurs all the time, except during certain recessions. It is common for the price of goods and services to rise a few percentage points each year. That is why it is important to account for inflation in financial planning.

• Hyperinflation – Very high, often accelerating inflation.

• Disinflation – It is still inflation but declining. One-year inflation is 5%, the next 4%, for example.

• Stagflation – Characterized by slow economic growth and relatively high unemployment, or economic stagnation, which is at the same time accompanied by rising prices (i.e., inflation). This normally occurs in a unique situation, such as when inflation is confined to one critical resource, like oil.

• Deflation – When prices go down and trend lower. Sounds awesome. It really is not.

• Transitory Inflation – This refers to inflation that is real, but temporary. Some recent examples include: a container ship that clogs the Suez Canal, blocking 10% of energy flows; a Russian hacker who takes down the Colonial Pipeline, disrupting flows to Eastern Seaboard; and a Texas freeze that takes 20% of U.S. energy production off-line. In these cases, the price spikes were drastic, but temporary.

Long-Term Implications

What is the bottom line? We are currently experiencing higher inflation than normal. Some of this is transitory inflation. The supply chain will work itself out, supply will meet demand, part of the excess demand will subside, and the flood of money will eventually be absorbed back into the economy. This scenario makes hyperinflation unlikely, but inflation will likely persist. The Federal Reserve has a strong incentive to make sure that it does.

Over the long term, it will take significant effort to fight off deflation. The reality is that technology is driving down the cost of everything from TVs to laptops, and globalization is enabling corporations to find low-cost labor all over the world. These powerful economic forces are hard to overcome and will likely keep inflation in check.

In short, we now have high inflation, but part of that is transitory inflation, which will eventually ease and give way to disinflation (declining inflation), but likely not deflation. Phew!

So, what is an investor to do? The asset classes that perform the best in inflationary environments are stocks and real estate. Think of it this way: If every ingredient in a Chipotle burrito costs more, then Chipotle will charge more for the burrito. Ultimately, the stock price will reflect this increase. The same goes for a candy bar, a box of cereal, a car or a ticket to Disneyland. Higher prices for consumers are ultimately reflected in the stock price.

The same goes for real estate. If the materials that go into building a home cost more, then a new home will cost more to buy. That makes all other homes worth more as well. This translates quickly into commercial real estate as well – higher costs result in higher rents which result in higher prices.

What does poorly?

Cash. Put simply, earning nothing on your cash while everything goes up in price means you are losing real purchasing power every year. Sometimes bonds do not do well in this type of environment either. If you collect

3.5% on a bond, and inflation is the same or higher, you are, at best, only treading water. Even worse, you may be losing ground.

The savvy investor holds stocks for the long run and bonds for the short run. Stocks will do their part to stay with or ahead of inflation, but bonds should be included to cover whatever income an investor may need over the next five to seven years.

Why bother with bonds if everyone is expecting inflation?

There are two primary reasons:

1. "Everyone" is wrong all the time, so it is always wise to be diversified.

2. Stuff happens. If we've learned anything since the beginning of 2020 it should be the importance of planning for the unexpected. If there is another pandemic, a major cyberattack, a terrorist attack or anything else that shuts the country down and causes us all to go back to cocooning, bonds will once again be king, and you will have to suffer through another article by yours truly on this topic (but with an emphasis on deflation).

Bonds give us a place to go, regardless of what is happening in the short term, and stocks give us a way to increase the probability that our money stays ahead of inflation over the long term.

The investments in your portfolio should match your needs. While the Federal Reserve's top priority is to ensure some inflation, at Kemp Financial, our top priority is simple – To ensure you are never, ever at the mercy of the markets and that you never run out of money over your lifetime. Your investments, now and always, should match your timeline and your needs, ensuring you are covered in the short term, regardless of what the world throws at us.

So hopefully, in your discussions with your advisors at KFM, you will recall we have always considered inflation into your personal financial plan. Whether it be during accumulation or during retirement, we've considered inflation as part of the planning process. While our practical experience has shown inflation has not been a material risk to our clients, it is still and will always be considered for planning purposes.

We look forward to incorporating additional education materials into your Legacy Action Plan should you desire additional conversation around Inflation. Thanks for reading this far and thank you to Creative Planning and Liz Ann Sonders for input around the inflation discussion.

We look forward to seeing you in Fullerton or Virtually in the near future. Thanks again for your friendship, trust, confidence and continued recommendations to KFM.

This commentary on inflation is provided for general information purposes only and should not be construed as investment, tax or legal advice. Past performance of any market results is no assurance of future performance. The information contained herein has been obtained from sources deemed reliable but is not guaranteed.