Trust Company of Vermont

Quarterly Update

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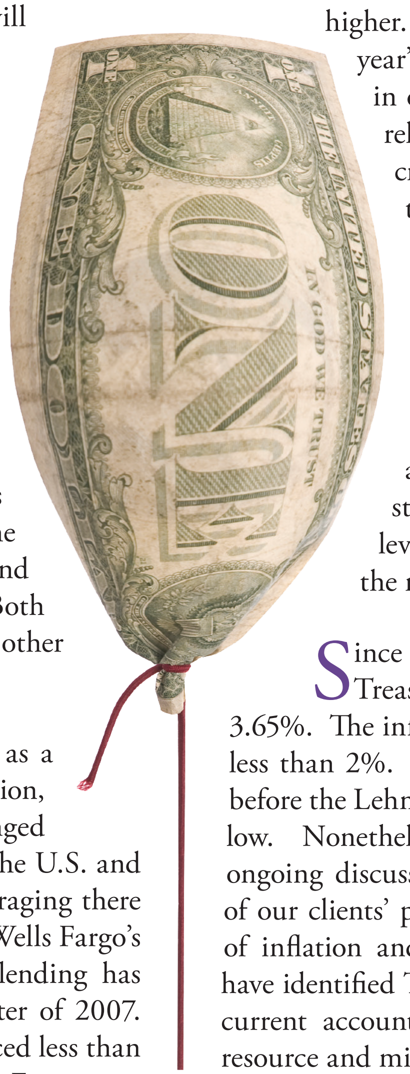
Brattleboro ◆ Burlington ◆ Rutland ◆ Manchester ◆ St. Albans ◆ Stowe

Inflation Ahead?

Gregory M. McConahey, Trust Investment Committee

In the face of $1.8 trillion U. S. budget deficits in the current year and projected $1 trillion budget deficits for each of the following two years, investors are expecting inflation to return after nearly 30 years in hibernation. The timing of this return is open to debate and will depend on many factors.

There are similarities to the 1970s and now. Both periods experienced government intervention into the free market economy. In 1971 the Nixon Administration instituted a 90 day freeze on wages and prices to counter inflation. This attempt was unsuccessful and both wages and prices continued to accelerate for the remainder of the decade. Today, the Obama Administration has intervened in the financial and auto industries and has plans to overhaul the health care industry, as well as energy through climate change legislation. The outcomes of these efforts, both intended and unintended, will not be known for years. Both periods also experienced spikes in energy and other commodity prices.



While the 1970s can best be described as a period of stagflation, the current recession, which began in late 2007, has been prolonged by the massive deleveraging taking place in the U.S. and global economy. As a result of this deleveraging there is "slack", unused capacity, in the economy. Wells Fargo's Senior Economist calculates that non-Fed lending has dropped by $6 trillion since the third quarter of 2007. The various Fed lending programs have replaced less than 20% of this amount. BMO Capital Markets Economics Research calculates the amount of inflation absorbing slack in the economy should hit its highest level since the late 1940s. These observations and other economic data suggest there are still more deflationary aspects to our current economy.

The greater risk for inflation comes from the commodities that are traded in U.S. dollars. A continued depreciation in the U.S. dollar relative to other foreign currencies could drive energy and other commodity prices higher. Currently, crude prices are well below last year's highs and gold has not set a new high in over a year partly due to the U.S. dollar's relative strength during the global financial crisis. There are several reasons to believe the U.S. dollar will depreciate further, including ongoing budget deficits, foreign diversification away from Treasuries, competition from other foreign currencies as a reserve, and ongoing Federal Reserve decisions regarding monetary policy. Of these variables, the Fed's ability to execute a timely exit strategy from their historic stimulus efforts will greatly influence the level of the U.S. dollar and have bearing on the magnitude of future inflation.

Since the end of 2008, yields on the 10 year Treasury have increased from just over 2% to 3.65%. The inflation expectation on the 10 year TIPS is less than 2%. These rates have recovered to levels seen before the Lehman failure last fall but are still historically low. Nonetheless, our investment committee has had ongoing discussions on how we might invest a portion of our clients' portfolios to protect against the prospects of inflation and a declining U.S. dollar. Initially, we have identified TIPS, and emerging markets with surplus current accounts, such as those from Asia or natural resource and mining companies, as investments that offer some protection from increasing inflation down the road.

As always we would welcome the opportunity to speak to you about this concept or any aspect of your portfolio.

Vermont Estate Tax Alert!

Jack Davidson

"IMMEDIATE ACTION REQUIRED"

We all get those promotions in the mail with the above notice. Well, this one may be real.

If your estate, or combined estate for married couples, is reasonably under 2 million, or you do not reside in Vermont, read no further. You will not be affected by recent changes in Vermont's estate tax. Otherwise, read on.

Effective January 1, 2009, Vermont has decoupled from the Federal estate tax, thus freezing the Vermont exemption at 2 million. Most estate plans designed for larger estates utilize a tax strategy for married couples that employs an exemption trust calculated on the Federal exemption, which is currently $3,500,000. And here lies the problem which I will simply illustrate by an example.

Let's say the combined estate for a married couple is $2,300,000 and that the first spouse to die has all the assets in his or her name. Federal Tax: $0. State Tax: $122,800.

How do you avoid this tax? It's very easy. Go to your attorney and he or she will make a slight change to your trust language to save much or all of this tax. For combined estates up to $4 million you can avoid the tax completely, thus saving as much as $379,200 in State and Federal taxes, with a minor adjustment to the trust language. In fact, you can save the tax without even modifying your trusts if the spouses simply split their assets so that each spouse does not have more than 2 million in their name. But we don't recommend this as the principal strategy. Over time, due to changes in market value or other events, couples often find it cumbersome to effectively monitor how much each spouse owns. There is too much at stake not to modify your trust documents.

What if you are single? You may want to consider gifting now rather than later. Say your estate is worth $2,100,000. If you gift $100,000, you will save $45,000 in Vermont estate taxes. Will the gift be subject to gift taxes? Probably not. The Federal exemption is one million and, oddly enough, Vermont does not have a gift tax.

Whether you make gifts now, or alter estate planning trusts, I think you will find that it is well worth your effort to contact your attorney today. Or call us. "Immediate action required." There could be significant dollars at stake.

Note: These illustrations assume no asset growth and that taxpayers are domiciled in Vermont. Disclaimer trusts will probably not need modification. For combined estates above $4,000,000, the trust modifications can be quite complex. Lastly, and curiously, Vermont did not decouple from the Federal generation tax exemption of $3,500,000.

A variety of legislative changes were enacted in Vermont recently that could affect our clients. The estate tax threshold we discuss above. Future newsletters will address the Vermont Trust Code, capital gains tax changes, Probate Court reform and an update of the default statute on descent and distribution to encompass blended families.