First Carolina Wealth

May 13, 2024

THOUGHTS TO START YOUR WEEK

Step-up In Basis at Death and Carryover Basis at Gifting

Continuing our discussion of tax changes contained in President Biden's new Budget Proposal.

- Under current law, there is carryover basis for gifts and a basis step-up for transfers at death. By holding appreciated property until death, taxpayers can generally avoid capital gains tax on the appreciation. This is a foundational tactic for elder tax planning.
- Proposed realization events:
    - Treating death as a realization event ensures that appreciation will be taxed.
    - Treating gifts as a realization event prevents endlessly deferring the tax to younger generations.
    - Marking assets held in a trust to market periodically prevents tax deferral using trusts and partnerships.
- Various exceptions/exemptions enable administration:
    - Deferral for transfers between spouses.
    - Exemption for transfers to charity.
    - Limited exclusion for gain on sale of principal residence.
    - The Section 1202 exclusion for qualified small business stock.
    - **A $5 million per person exclusion. [**This handles up to middle class taxpayers.]
- Deferral for family owned and operated business interests and a 15-year payment period for illiquid assets would also temper the pain of these proposed changes.
- This has been proposed for the last 3 years but remains unadopted.

Weekly Economic Insights From Our Investment Managers

Stocks continued their upward trajectory last week, extending gains for May and edging closer to record highs, with the S&P now less than 1% away from the high-water mark. Helping to fuel this surge over the past few weeks has been a robust earnings season, surpassing expectations and seemingly signaling ongoing profit expansion despite a growing list of short-term economic indicators that appear to be losing some momentum.

With approximately 90% of S&P 500 companies having disclosed their first-quarter earnings, profits may be poised to expand by as much as 10% this year, barring no unexpected events. If so, this would far exceed analysts' (and many corporate executives') expectations and reiterates the fact that there is more to the markets narrative than meets the eye. In this era where every piece of data is seemingly scrutinized for its potential impact on Federal Reserve policy, corporate profits tend to get overlooked, but not in the past couple of weeks…

Key Takeaway:

No real surprises last week…From a purely technical perspective, markets got overheated, retreated to a potential support zone, earnings came in better than expected, and investors "bought the dip" provided the sound economic backdrop. We are now within a stone's throw of all-time highs and once again facing the valuation wall of worry with equities trading around 21x forward earnings. That is a pretty high multiple historically and demands a Goldilocks economic scenario to continue, making this week's data uber-important to keep this rally alive.

The Week Ahead:

The focal point of this week lies in Wednesday's Consumer Price Index (CPI) report. Market expectations anticipate a notable decrease in the annual inflation rate from last month's 3.5%. Any failure to meet this expectation could fuel worries about entrenched inflation and prolonged higher interest rates, potentially reversing recent market gains. Notably, we will see the release of the Producer Price Index (PPI) on Tuesday, which may cause brief market volatility but should be overshadowed by the significance of Wednesday's CPI data.

Additionally, investors' attention will be on Wednesday's Retail Sales report, as it provides insights into consumer spending trends crucial for sustaining economic growth, while Thursday's weekly jobless claims data will be scrutinized to gauge whether last week's spike to six-month-plus highs was an anomaly or becoming a sustained trend.

Tidbits & Technicals: (New developments will be denoted in *italics*)

Current Headwinds:

- Valuations seem frothy given the current rate environment, leaving the markets subject to a potential swift pullback
- "Higher for Longer" – Risk that the Federal Reserve waits too long to begin lowering rates and threatens economic growth
- *10-year Treasury yields recently broke out to new highs for the year, signaling that bond investors may be beginning to believe in the "Higher for Longer" thesis, but have retreated more than 25 basis points (.25%) in May*

Current Tailwinds:

- Optimism surrounding Artificial Intelligence (AI)
- Fed pivoting from raising rates to potentially cutting in the future
- Strong labor market
- Solid economic growth
- Continued earnings growth (the pace of which may be slowing)
- Momentum
- Participation is broadening with cyclicals taking a leadership role while the tech-trade begins to fade

Sentiment:

- *Credit spreads remain tight, hitting their lowest levels since peaking in 2022, signaling the bond market (aka "smart money") is not worries about a recession in the near future.*
- *The VIX (CBOE Volatility Index) has completely reversed its tone and is back to the lower levels of the complacency zone.*
- *The CNN FEAR & Greed Index got a boost, showing investor optimism has returned to Neutral from its prior Fear state.*

Intermarket Trends:

- The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) all posted new highs in the past few weeks, signifying a positive trend.
- *Bond investors have accepted the recently soft data as potentially impactful, and rates have retreated.*
- The US Dollar is trading near the upper end of this year's trading range due to foreign central banks being the first to cut rates and others taking further rate hikes off the table while the Fed continues its campaign of tough rhetoric.
- Gold continues to set record highs.
- Industrial metals caught a bid recently, and copper recently broke out of a multi-month trading range.
- Oil futures have pulled back from recent highs and are trading in the middle of their one-year trading band.

Tying it all together:

Following the unexpected surge in March's CPI report that rekindled talks of inflation sticking around longer than anticipated, many recent economic indicators suggest a loss of momentum in the economy. Both the ISM Manufacturing and Services PMIs have dipped below 50, a relatively rare occurrence that signals contraction, while durable goods, often viewed as a gauge for business investment, have remained stagnant for over a year. The unemployment rate remains relatively low, yet there is a looming possibility of it surpassing 4% for the first time in years. While these metrics do not indicate economic growth has halted, they do suggest a slowing momentum which is something both the equity and bond markets have not currently priced in.

Folks are beginning to bring up "stagflation," which rekindles thoughts of the 1970's when economic growth halted (Stag) and inflation soared into the mid-teens (Flation). Words like these get people on edge, but I will add that any conditions we could possibly face in the near future must be looked at through the lens of our current situation. In my opinion, our biggest risk at the present time is the lofty valuations present in pockets of the stock market. Should the economy slow, or interest rates remain higher for longer, these valuations seem unreasonable from a historical perspective. Please keep in mind all of this recent data is short term in nature and in no way signifies an imminent collapse, but rather a situation that requires our attention and close

monitoring. Also keep in mind that corporate profits do not tend to surpass expectations when things are turning for the worse!

When assessing the current situation, one must also consider the underlying strength of the U.S. economy, which is being supported by robust consumer demand and a healthy job market, along with signs of stabilization in global economic growth and the fact that inflation is trending downward despite the recent deceleration. These are the variables that will shape future market dynamics and should play a far more vital role in shaping one's allocation decisions. Very recent data has been soft and warrants our attention, however, we must gather more clues and not attempt to make any rash predictions based off a few weak data points. We will follow all future developments closely and report our findings to you here.

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