July 8, 2024

THOUGHTS TO START YOUR WEEK

IRA Fundamentals

Last time, we examined the breadth and depth of today's IRA marketplace. Today, let us look at the fundamentals of IRAs, both from a practical and tax planning focus.

There are two main versions of IRAs, each with its own variant (Numbers are for tax year 2024).

- **Traditional Deductible IRA**
    - $7,000 contribution, plus $1,000 catch-up if over 50, is excluded from 2024 income.
        - If both spouses are covered by an employer plan, contributions are excluded for joint Adjusted Gross Incomes (AGIs) over $143,000.
        - If only one spouse is covered by an employer plan, the other can contribute up to a Joint AGI of $240,000.
    - Contributions grow in the IRA tax-free until they are distributed, when they are taxed as ordinary income at then-current tax rates.
    - Complex rules regarding hardship withdrawals, inherited IRAs, Required Minimum Distributions (RMDs), and many more prickly issues will be discussed during future submissions, STAY TUNED!
- **Traditional Non-Deductible IRA**
    - Same contribution limits.
    - No up-front tax reduction, but earnings on the after-tax contribution compound tax-free until they are withdrawn, when they are taxed as ordinary income.
    - We will discuss why taxpayers establish IRAs with after-tax dollars below.
- **Roth IRA**
    - Same contribution amounts permitted until Joint AGI is over $240,000.
    - No up-front tax reduction, but earnings compound tax-free **and are distributed tax-free.**
    - No RMDs by funder of Roth IRA but may be for inheritors.
    - Because after-tax dollars are used to fund a Roth IRA, it is a much better estate planning tool than a traditional IRA, as it involves less income tax to the beneficiaries. The Roth IRA funder pays the taxes.
- **Roth IRA Conversion**
    - Fortunate taxpayers whose AGIs exceed the IRA contribution limitations discussed above can still fund a non-deductible IRA and then convert it to a Roth IRA in the cleverly named **Backdoor Roth IRA**.
    - The catch is if you have large sums in Traditional IRAs (not 401(k) Plans) with pre-tax dollars, the pro rata rule requires that the post-tax non-deductible IRA be

combined with the much larger pre-tax IRAs, and tax is due based on the proportion that the pre-tax dollars are to the total IRAs. This increases the amount of tax.

- Nevertheless, taxpayers who can pay the income tax on conversion from non-IRA funds benefit from the Roth IRA due to greater tax-free yields.
- Taxpayers converting to Roth IRAs during life reduce their overall estate, lowering the impact of higher estate tax rates.
- We will discuss the tax-bracket planning involved in Roth IRA conversions in a later submission.

Remember that these weekly pieces are saved to the **Wise Wealth** section of our website: www.firstcarolinawealth.com. If you lose track of points made in earlier submissions, just visit **Wise Wealth** and refresh your recollection. Please refer these pieces to anyone you know who could use the advice.

Weekly Economic Insights from Our Investment Managers

The S&P 500 extended its rally to new highs last week, gaining 1.08% when the closing bell rang on Friday afternoon. Disappointing economic reports once again increased expectations for Fed rate cuts, which seems to be the market's primary concern at this point in time. A Goldilocks ISM Manufacturing print, aheadline misses in the June ISM Services Index, a softer-than-anticipated June jobs report, and dovish commentary from Fed Chair Powell all boosted sentiment in the holiday-shortened week with low volumes. The rally was also supported by easing European political worries as the political extremist failed to gain the traction people were expecting in the French elections.

The dollar and Treasury yields both dropped last week, presumably as a result of soft economic data and rising Fed rate cut expectations. Treasuries were volatile, initially rising due to political concerns in Europe, but later declining due to rate cut expectations. The 10-year yield closed down 12 basis points, just above 4.30%.

Key Takeaway:

Last week's growth data revealed a notable slowdown in economic expansion. The ISM Services purchasing managers' index (PMI) unexpectedly fell to 48.8, marking the second time in three months it dipped below 50. The ISM Manufacturing PMI also decreased to 48.5. Sustained sub-50 readings in both PMIs often indicate an impending economic slowdown. Friday's jobs report presented a mixed picture, with job additions slightly surpassing estimates, but an increase in the unemployment rate to 4.1%, which was a near-three-year high. Other employment indicators also pointed to a weakening labor market. Overall, last week's data suggests that the economy, though not yet weak, is showing signs of cooling off.

The Week Ahead:

The key data point this week is Thursday's Consumer Price Index (CPI) report, which is anticipated to show a continued decline in inflation. Before that, we will hear from Fed Chair Powell at his semiannual testimony to Congress, but nobody is expecting any surprises there. Continuing this week's inflation data theme, we will get a look at Producer Price Inflation on Friday along with the University of Michigan's Preliminary Consumer Sentiment report.

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 collapsed last week to their lowest levels since March of this year*
- Very narrow market participation driven primarily by mega cap tech and AI-related companies

Current Tailwinds:

- Optimism surrounding Artificial Intelligence (AI)
- Fed potentially cutting in the future
- Strong labor market
- Solid economic growth
- Continued earnings growth (the pace of which may be slowing)
- Momentum

Sentiment:

- Credit spreads remain tight, hitting their lowest levels since peaking in 2022, signaling the bond market (aka "smart money") is not worried about a recession in the near future.
- The VIX (CBOE Volatility Index) is back to the lower levels of the complacency zone.
- The CNN FEAR & Greed Index ticked back into Neutral territory two weeks ago.

Intermarket Trends:

- The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) recently posted new highs, signifying a positive trend.
- Interest rates have been volatile lately but appear to be retreating at the present time.
- 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 has been consolidating near record highs.

- Industrial metals, which raced higher recently, have consolidated gains and are largely trading sideways.
- Oil futures are in the middle of their one-year trading band but have "perked up" lately and are gaining momentum.

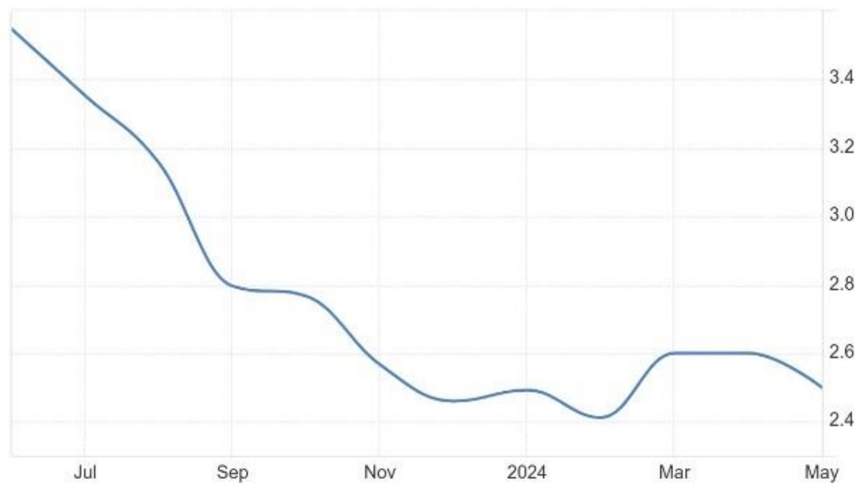
Tying it all together:

Four main factors have seemingly been supporting the markets: strong growth, falling inflation, expectations of Fed rate cuts, and AI enthusiasm. These drivers remain intact; however, some key economic data points are flashing warning signals at the present time. While the economy is not weak, some of the data suggests a weakening trend, and this is a concern given the markets are not acknowledging the possibility of any sort of economic contraction. Current valuations have certain equities priced for perfection, so it would be fair to say that any type of growth scare could result in rather extreme volatility in the short run.

I like to keep an eye on the two charts below, as they are the Fed's primary focus: full employment and stable prices. Watching the unemployment rate tick up is a concern but was a necessary evil in the Fed's inflation battle, which they appear to be winning if you look at the bottom chart. According to the CME FedWatch tool, there is now a 72% probability that our first rate cut here in the US will come in September, and I would have to say that appears to be just in time, as we are now seeing some "cracks" developing in the economic growth data.

Source: tradingeconomics.com | U.S. Bureau of Labor Statistics

US CPI Core Core - percent



Source: tradingeconomics.com | U.S. Bureau of Labor Statistics

In the long term, economic growth is the primary driver, and while growth remains robust, we must remain vigilant for signs of a slowdown, as this could end the current bull market we are all enjoying. For now, the positives meaningfully outweigh the negatives, and as long as these conditions persist, the environment remains favorable for risk assets.

Historically, the best approach in such environments is to ensure that one's overall portfolio aligns with their risk tolerance and long-term goals.

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