January 27, 2025

THOUGHTS TO START YOUR WEEK

New Tax Year Considerations

In 2024, we had no major income tax overhauls and relatively tame inflation, so the inflation adjustments for tax year 2025 were a minor +2.75% (compared to +7% in 2023 and +5.4% in 2024). All eyes are focused on what direction the new administration and Republican Congressional majorities will take in terms of the 2017 tax cuts sunsetting at year-end. Here are a few 2025 considerations in the meantime:

- Standard deduction for **Married Filing Jointly (MFJ)** increased by $800, to $30,000. Taxpayers over 65 or blind get an additional $1,600 each.
  - Many taxpayers who previously itemized deductions now take the standard amount.
  - Smart planning involves bunching of flexible deductions, such as medical expenses, charitable contributions, or state tax payments (within the $10,000 deductible threshold), in certain years, and taking the standard deduction in other years.
- Tax brackets adjusted up 2.75% also, minimizing bracket creep from inflation of taxable income without any real income increase. In 2025, a MFJ couple will be in the 24% rate up to $394,600 of income.
  - Now is the time to create a multi-year tax projection model to identify optimal years for Roth IRA conversions, income acceleration/deferral strategies, or capital gains harvesting.
- Planning opportunities also involve management of capital gains/losses.
  - For MFJ taxpayers, the 15% rate threshold is $96,700, and the 20% rate begins at $600,050.
  - Remember that estate and trust rates are very compressed, with the 15% rate beginning at just $3,250.
  - Coordinate capital gains with ordinary income to maximize tax savings.
  - Consider a capital gains harvesting schedule tie to your charitable giving strategies, utilizing direct gifting of appreciated securities for higher brackets and harvesting gains for those in the lower brackets.
- Estate and Gift Planning enjoy larger lifetime exclusions in 2025, with an exclusion increase of $380,000, to $13,610,000 per person.
  - The annual gift tax exclusion rose to $19,000 per recipient.
  - The IRS confirmed that there will be no "clawback" of gifts to the taxable estate if the 2017 law sunsets and the exclusion declines radically, so now is a good planning opportunity. It is likely, however, that the 2017 changes will be renewed or made permanent.
- The 20% Qualified Business Income (QBI) deduction for self-employed Schedule C filers and pass-through entities from the 2017 Act has saved many taxpayers many taxes.
  - Specified service business income is capped at certain income levels. In 2025, the cap increases by $10,700 to $394,600 for MFJ filers.

  - The increased thresholds create new planning opportunities for service business owners who had been limited by the phase-outs.
- The 3.85% Net Investment Income Tax (NIIT or Medicare Surtax) applies to MFJ taxpayers with Adjusted Gross Incomes (AGI) over $250,000 (no change).
  - NIIT applies to the lesser of investment income or AGI over the $250,000.
  - Investment income includes taxable interest, ordinary dividends, capital gains, rental and non-qualified annuity income, and passive business income.
  - We can assist you to implement an investment approach that strategically places tax-efficient investments in taxable accounts and income-generating assets in tax-advantaged accounts, such as IRAs. NIIT is minimized.
- Areas unchanged by inflation adjustments include:
  - The $10,000 State and Local Tax (SALT) deduction limitation for MFJ filers.
  - $500,000 capital gain exclusions for principal residence sales by MFJ filers.
  - The $3,000 limit on ordinary income that may be offset by capital losses.
- These inflation adjustments are another example of social legislation through tax legislation. Favored items are granted adjustments while others are not. The $3,000 capital loss ordinary income offset has not been increased in decades. It pays to take advantage of the favored items to the extent possible.

Weekly Economic Insights From Our Investment Managers

Stocks in the US continued advancing, with all three major indices up over 1.5% for the week after a round of strong earnings reports and President Trump's proposed policy changes, which would avoid tariffs on China and some of our EU trading partners. This change in tone was well received by investors, as it removed some fears of sparking another wave of inflation due to higher input costs. On the data front, growth in the manufacturing sector resumed after six months of contraction, while the services sector cooled off a tad. Despite elevated mortgage rates, existing home sales in the US rose to a 10-month high.

Optimism spread over to the bond market as well with longer term treasury yields holding steady despite year-ahead inflation expectations rising to an eight-month high, per the University of Michigan survey released on Friday. 10-year Treasury yields have come down ~0.2% since their recent highs, taking a little wind out of the sails that have been pushing the US dollar higher recently. The positive dynamics of steady growth, a weaker dollar, steady inflation, and rates ticking down a bit have no doubt given a boost to Gold prices, which are nearing all-time highs once again, but didn't seem to spill over to the Oil and Industrial Metals markets, which both traded down on the week.

SYMBOL	NAME	5D PERF	YTD PERF	1Y PERF
EFA	EFA - iShares MSCI EAFE ETF	+3.19%	+4.79%	+9.66%
GLD	GLD - SPDR Gold Shares	+2.56%	+5.58%	+37.15%
$INDU	$INDU - Dow Jones Industrial Average	+2.15%	+4.42%	+17.50%
$SPX	$SPX - S&P 500 Large Cap Index	+1.74%	+3.73%	+25.32%
$COMPQ	$COMPQ - Nasdaq Composite	+1.65%	+3.33%	+28.89%
$MID	$MID - S&P 400 Mid Cap Index	+1.11%	+4.96%	+19.37%
$SML	$SML - S&P 600 Small Cap Index	+0.92%	+3.35%	+13.82%
AGG	AGG - iShares Core U.S. Aggregate Bond ETF	+0.09%	+0.11%	+2.99%
$GNX	$GNX - S&P GSCI Commodity Index - Spot Price	-1.18%	+3.91%	+3.87%
DBB	DBB - Invesco DB Base Metals Fund	-1.40%	+1.22%	+12.92%
$USD	$USD - US Dollar - Cash Settle	-1.91%	-1.09%	+3.76%

Source: Stockcharts.com

Key Takeaway:

Markets have rebounded in the past two weeks, with the major indices testing all-time highs as investors begin to see how the new administration is working with tariffs; longer term yields have backed off a bit; and corporate earnings continue to come in strong. Investors are still grappling with the fact the Fed will likely pause their rate cutting campaign given the strength in the overall economy and AI optimism isn't quite as strong as it's been the past two years. The positive backdrop appears to be providing a tailwind for cyclical stocks as market breadth has expanded (read: more companies' stock prices are advancing), and investor optimism has returned.

The Week Ahead:

This week, traders will focus on President Trump's policy announcements, central bank decisions, and corporate earnings from mega cap tech giants including Microsoft, Meta, Tesla, and Apple. The Fed is expected to maintain rates on Tuesday, while the ECB and BoC may cut borrowing costs by an additional 0.25%. Key economic data releases include a peek at growth via GDP for the US and many key Eurozone countries along with a look at inflation via the Feds preferred measuring stick, Core PCE.

Current Observations (Updates denoted in *italics*)

Economic Growth: The economy appears to be growing at a moderate pace, not too hot. GDP expanded 2.7% year-on-year in the third quarter of 2024, slowing slightly from a 3% rise in the previous period and has averaged 3.16 percent from 1948 until 2024 (*Source: U.S. Bureau of Economic Analysis*).

Inflation: Inflation has been cooling over the past year but appears to be a little "sticky" in recent months. The annual inflation rate in the US rose for a third consecutive month to 2.9% in December 2024 from 2.7% in November, in line with expectations, yet concerning to the Fed's 2% target. This marks the third increase in inflation in seven months, while core consumer prices, which exclude volatile items such as food and energy, remained unchanged at 2.40 percent in December *(Source: U.S. Bureau of Labor Statistics).*

Employment: The jobs market remains robust despite the recent rise in unemployment from historically low levels. The US economy added 256K jobs in December 2024, the most in nine months, following a downwardly revised 212K in November, and once again beating market forecasts of 160K. The unemployment rate in the United States went down to 4.1% in December of 2024 from 4.2% in the previous month, below market expectations of 4.2% *(Source: U.S. Bureau of Labor Statistics).*

Monetary Policy: According to minutes from the December 2024 FOMC meeting, nearly all Federal Reserve officials concluded that the risks of higher inflation had risen, citing the potential effects of changes in trade and immigration policies with the new administration coming in. While participants expected inflation to continue progressing toward the 2% target, they acknowledged that the timeline for achieving this goal might be longer than previously anticipated. Several members voiced concerns that the disinflationary trend may have stalled temporarily or warned of the possibility of further delays. Additionally, officials indicated that the Fed was approaching a point where slowing the pace of policy easing would be appropriate. In December, the Fed implemented another 25-basis-point cut to the federal funds rate, bringing it to a range of 4.25%-4.5%, and signaled plans for just two additional rate cuts in 2025, totaling 50 basis points.

Sentiment: Investor optimism has been rising over the past couple of weeks. According to AAII, retail investors have recently flipped from bearish to bullish on the margin, while active money managers appear to have put money back to work in stocks as the NAAIM Exposure index has increased rapidly. The CNN Fear & Greed Index, which measures seven different aspects of market behavior to gauge the "mood" of the stock market, shows investors are who were recently fearful have returned to a more "Neutral" stance.

Volatility & Speculative Demand: The VIX (CBOE Volatility Index), which is known to be Wall Street's fear gauge, has fallen to "complacency" levels recently, and high-yield (or "junk") bond credit spreads have once again fallen to new cycle lows after recently showing signs of possible deterioration.

Stocks: The major Indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) are at or near all-time highs, signifying a positive trend. Outside of the US, Developed and Emerging Markets Indices, which peaked in late September, have spent the last month retreating with their currency-hedged counterparts holding up much better.

Bonds & Interest Rates: Bonds have had a relatively rough time since the Fed cut rates in September. A wave of overwhelmingly positive economic data and governmental policy concerns have rekindled inflation fears, causing investors to recalibrate their upcoming rate cut expectations. Longer-term yields recently peaked at their highest levels in nearly two years but have eased the past couple of weeks.

Commodities & Currencies: The weak Chinese economy (second largest in the world) and strong US dollar continue to weigh on commodities. Oil, the largest component in the commodities space, along with industrial metals (a key global growth gauge), have been under pressure while precious metals are trading near all-time highs. The US Federal Reserve is currently being viewed as the most "hawkish" (high rates) central bank in the world. This stance is keeping a bid under the US Dollar as it trades near cycle highs.

Breadth & Technicals: One of the major themes since the markets sold off in August has been expanding breadth. A lack of widespread support for the rally had recently appeared; however, the past couple of weeks are showing improvement as advancing stocks are once again outpacing decliners.

Tying it all together:

The stock market has shown remarkable strength historically, and for good reason. Inflation is steadily cooling, interest rate cuts are underway, economic growth remains solid, and the job market continues to demonstrate resilience, supported by strong corporate earnings projections.

Markets have responded favorably to the Federal Reserve's strategy of guiding the economy toward a "soft landing." This approach involves using monetary policy tools to slow economic activity just enough to curb inflation without triggering a recession. These tools primarily involve adjustments to short-term interest rates aimed at achieving full employment and price stability (i.e., low inflation). However, monetary policy changes often carry complex ripple effects, making it challenging for the Fed to anticipate all potential outcomes.

Prudent investors must analyze the Fed's decisions—along with other variables—and allocate capital based on their forecasts. When Wall Street's collective expectations align, clear price trends emerge.

Although recent trends in the stock market have been positive, overall valuations have reached historically elevated levels, suggesting the need for caution. It's worth noting that bull markets don't typically end due to stretched valuations alone (and sometimes valuations can surpass even the most optimistic projections). However, they often succumb to concerns over future monetary policy shifts and slowing economic growth. For this reason, it's critical to watch for warning signs in the later stages of a bull market to help manage risk effectively.

As always, we will continue monitoring the markets and economic trends closely, sharing our insights and analyses through these weekly briefings to help guide informed decision-making.

Edward J. Sabo
Chief Investment Officer
Capital Investment Advisory Services, LLC

John Slayton, CFP®
Managing Director
First Carolina Wealth