May 20, 2024

THOUGHTS TO START YOUR WEEK

Demise of 20% Long-Term Capital Gains Tax Rate?

Continuing our investigation of President Biden's 2024 Budget Proposals, we address the often under-appreciated, but incredibly useful, preferential long-term capital gains rate maxing at 20%.

- The Green Book proposes eliminating the preferred rate when income exceeds $1 million.
- Possible implementing legislation could include a "cliff" so that once the income is above $1 million, ALL income is taxed at the ordinary income tax rate, removing the favorable rate even on the first $1 million of income.
- The Green Book proposes raising the top income rate from 37% to 39.6% and raising the Medicare Tax from 3.8% to 5%, raising the combined effective rate to as high as 44.6%, almost double the current max of 23.8% on long-term capital gains.
- This change could impact certain taxpayers immensely:
  - Selling the family business or family farm would likely result in over $1 million gain in a given tax year.
    - This could be spread over an extended period, with annual installments of purchase price, or the transaction could be treated as an installment sale. Both of these possibilities inject additional risk in the seller's plans, however.
  - Hedge fund managers who have enjoyed the privilege of structuring their compensation in such a way as to use the preferred long-term capital gains rate, rather than the ordinary income rate that affects most wage earners, would be lost.
  - High net worth investors, who live off of dividends and realized long-term capital gains, will find the taxes much more intrusive.

Removal of preferential rates for long-term capital gains is one of the proposals getting less press coverage than some of the others, but we all remember the opening scene of the movie ***Jaws,*** and what happens to unsuspecting midnight swimmers or similarly unprepared investors liquidating highly appreciated assets ….

Weekly Economic Insights From Our Investment Managers

Last week, stocks soared to record highs as traders embraced cooler inflation data. The Dow Jones Industrial Average surged above 40,000 for the first time ever, while several other major indices posted fresh new highs as well. The week began quietly, but volatility increased with mixed reactions to the April PPI report and a midmorning speech by Fed Chair Powell. Tuesday, Reddit's famed "Roaring Kitty" came back, and the meme stocks jumped higher while Google announced

AI enhancements to its search function and the tech sector caught a bid. The rally continued Wednesday with in-line April CPI data showing declining inflation, further supporting expectations for Fed rate cuts. Walmart posted solid earnings on Thursday, keeping alive the idea that the consumer is strong and overshadowing a couple of weak economic data points, before a Fed speaker poured some cold water on the parade. Markets sold off Friday morning but were able to come back in a late day rally.

Key Takeaway:

Last Monday, I wrote the following:

"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's 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."

And last week we got exactly what the market wanted via a favorable mix of declining inflation, the Federal Reserve's assurance against further rate hikes, slowing economic growth data that pressured yields, and increased expectations for rate cuts, along with strong earnings and macroeconomic news. So, growth is positive but decelerating, the Fed is expected to cut rates soon, inflation is high but decreasing, and earnings remain robust. The keyword on CNBC this morning is "Goldilocks" and for good reason!

The Week Ahead:

This week's key report is Thursday's May flash PMI, as it's the first national economic indicator for the month. While markets would favor soft data due to its positive implications for Fed rate cut expectations, a major decline in activity is undesirable. An in-line or slightly lower-than-expected PMI will be well received.

Other notable reports include Wednesday's FOMC minutes and Friday's Durable Goods and University of Michigan Inflation Expectations. The minutes should offer no surprises. Durable Goods offer insights into business spending and markets will once again favor slightly soft figures in the short term while the weaker the inflation expectations can come in, the better for markets.

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 further boost last week, showing investor optimism is strong and Greed is prevailing.*

Intermarket Trends:

- *The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) all posted new highs last week, signifying a positive trend.*
- *Bond investors have accepted the recently soft data as potentially impactful, and rates have retreated recently.*
- 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 have raced higher 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:

A plethora of short term economic "growth" data have come up short of expectations lately and deserve our close attention. It's one of those strange times where bad data is perceived as good data, as it begets lower interest rates from the Federal Reserve in the future amidst decelerating inflationary environment, but we must be careful what we wish for…Valuations are high as we sit squarely in the middle of the "Goldilocks" environment we were anticipating, yet markets only discount the same information once, and the path forward could have some surprises.

Markets have experienced a broadening effect, which is a good thing, but it's noteworthy that some of the more defensive sectors have been leading the charge. These sectors have been out of favor for a while and likely deserve a little attention, but it's hard to not consider this type of activity could also spell conservative repositioning ahead of a potentially choppy environment.

For now, this is all "to be watched," as the positives (full employment, declining inflation, economic growth, strong earnings, etc.) far outweigh the negatives and until those change, conditions are favorable for risk assets. Environments like this have best been navigated in the past by making certain one's overall portfolio is in line with their risk tolerance and focused on achieving long term goals.

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

John Slayton, CFP®
Managing Director
First Carolina Wealth