First Carolina Wealth

August 5, 2024

THOUGHTS TO START YOUR WEEK

Should I Put An Annuity Into My IRA?

Today, we consider an easy question with a complex answer. There has always been a split opinion between brokers—who apply a suitability standard—and registered investment advisors/trust officers—who apply a fiduciary standard requiring all recommendations be in the client's best interests. Brokers typically have never met an annuity that they do not recommend; the more riders with guarantees, bells and whistles, the better, Fiduciaries, who are not compensated on sales of products, but rather on asset-based fees, have always argued that holding a tax preferred annuity instrument inside of a tax preferred IRA is layering of tax deferrals, not worth the stiff commissions typically adhering to annuities and their numerous riders.

Part of the difference in opinion derives from the numerous varieties of annuities available in the marketplace. Variable annuities are basically mutual funds wrapped in an insurance product, with riders guaranteeing return of basis, guaranteed lifetime income, and any other add-on the clever product developers can add to collect rider fees. Many of these riders are unlikely to ever be used, but brokers find them very attractive to purchasers. I want to discuss the traditional annuity product, a straight contract between the insurance company and the annuitant to make regular payments, for a term of years or for a lifetime, in exchange for a lump sum investment. These annuities bear very low fees. They can be payable immediately or deferred for a period of time and then pay out. In order to receive repayment at death of amounts not returned from the original purchase, additional riders are added for additional fees. I propose use of a stripped-down annuity that is a basic life insurance bet. If you buy an annuity and get killed by an auto later that day, the insurance company wins; If you survive your life expectancy by 20 years, you win. Regardless, unless the insurance company folds and the state insurance guarantees fail, you will receive the agreed upon payment for the rest of your life or the term of the annuity.

I have accepted the fact that I missed the golden era of Defined Benefit pensions where, in exchange for your working for a company for 30 years, that company supported you during your retirement, no matter how long. Rather, I encountered the Defined Contribution era of 401(k) plans, where the financial obligation was thrust on to the individual to defer contributions into an employer plan, after which most companies would match a portion of the deferrals, subject to vesting over a period of time. The financial liability for retirement contributions was transferred from the companies' balance sheets to those of the employees, much to the joy of the shareholders of the companies relieved from the pension liability.

My concept of placing a bare-bones annuity into your IRA is akin to a do-it-yourself pension. You decide what portion of your retirement assets can be used to purchase a monthly annuity stream, which, when added to your social security payment, will provide you the monthly minimum "nut" needed to survive for the rest of your life. This would allow you to take more risk with your other retirement assets, knowing that, regardless of a future Armageddon in the stock market, you will still have enough to survive. You have replaced the monthly pension payment with other guaranteed payments.

The tax code has specific provisions regarding use of annuities in IRAs, including their impact on Required Minimum Distributions, so please consult your tax professional to stay in compliance.

This approach is particularly attractive today, given the recent interest rate hikes delivering significantly higher fixed annuity pay-outs than two or three years ago. It might be the best time in recent history to consider annuities.

Weekly Economic Insights From Our Investment Managers

The “frothy valuation scenario” we’ve been talking about in these reports for some time now finally materialized last week, as investors were forced to recognize that the economic backdrop—while still good—isn’t perfect. The selloff was initially triggered by the weak ISM Manufacturing PMI report on Thursday, but the jobs report Friday morning sealed the deal, with the unemployment rate unexpectedly jumping to 4.3%. This triggered the extremely reliable—100% accuracy in predicting recessions since 1959—Sahm Rule Recession Indicator warning, which occurs when the three-month moving average of the national unemployment rate exceeds the lowest three-month moving average unemployment rate from the previous year by 0.5% or more. Volatility actually began to pick up earlier in the week, when the Bank of Japan (BOJ) announced it was anticipating a .25% rate hike, which has major implications with regards to the carry trade, but this was rather muted by a round of solid earnings reports.

All of this resulted in a sharp drop in equities and a collapse in Treasury yields to nearly six-month lows, sending bond prices higher and the US dollar towards its YTD lows. In the wake of the “growth scare,” commodities, in general, traded with a heavy tone, while gold soared to new records highs.

SYMBOL	NAME	5D PERF	YTD PERF	1Y PERF
AGG	AGG - iShares Core U.S. Aggregate Bond ETF	+2.36%	+3.26%	+7.67%
GLD	GLD - SPDR Gold Shares	+2.14%	+17.88%	+25.47%
DBB	DBB - Invesco DB Base Metals Fund	+0.16%	+1.75%	+7.56%
$USD	$USD - US Dollar - Cash Settle	-1.88%	+1.31%	+0.51%
$SPX	$SPX - S&P 500 Large Cap Index	-2.06%	+12.09%	+18.46%
$INDU	$INDU - Dow Jones Industrial Average	-2.10%	+5.43%	+12.63%
$GNX	$GNX - S&P GSCI Commodity Index - Spot Price	-2.95%	-0.48%	-8.20%
EFA	EFA - iShares MSCI EAFE ETF	-3.05%	+3.96%	+9.92%
$COMPQ	$COMPQ - Nasdaq Composite	-3.35%	+11.76%	+20.06%
$MID	$MID - S&P 400 Mid Cap Index	-4.13%	+5.98%	+9.53%
$SML	$SML - S&P 600 Small Cap Index	-5.53%	+2.43%	+6.76%

Source: www.stockcharts.com

Key Takeaway:

The actual data last week wasn't that bad. Despite the softer labor readings, jobs are still on the rise per the JOLTS (Job Openings and Labor Turnover) report; the unemployment rate is historically low; GDP continues to beat expectations; and corporate earnings and sales are trending higher. To me, this doesn't necessarily foreshadow a recession.

The Yen carry trade is a very popular institutional trading strategy whereby investors borrow money in a country with low interest rates and a weaker currency (i.e., Japan) and then reinvest the money in assets of another country with a higher rate of return (i.e., USA). When the BOJ announced a rate increase just as the US Federal Reserve all but signaled a rate cut is coming, one can only imagine the scramble taking place to unwind these carry trade positions. Couple this with high valuations and the first talks of a "Growth Scare," and you have the recipe for a swift sell off.

As painful and scary as these events can be, history tells us they are very common—occurring a few times a year on average—and often provide great opportunities to put capital to work at lower prices and enhancing one's overall returns throughout the market cycle.

The Week Ahead:

We get a reprieve this week from the intense data flows with only one key report, the ISM Services PMI, due out Monday morning. This is an important report in light of the recent weakening trend in economic activity, and we will want to see the numbers back above 50—signaling economic expansion—or investors are going to start recognizing the data is becoming a negative 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
- Very narrow market participation, apparently driven primarily by mega cap tech and AI-related companies, has dominated the indices; however, over the last couple of weeks, we have witnessed a significant broadening effect with "the rest of the market" showing stronger returns

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
- 10-year Treasury yields continue to hover near their lowest levels since March of this year

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) has leapt higher, suggesting fear among investors at the present time.*
- *The CNN Fear & Greed Index has moved to Extreme Fear.*

Intermarket Trends:

- *The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) recently posted new highs, signifying a positive trend; however, in the short term, they are trending downward.*
- *Interest rates have been volatile lately and are trending lower.*
- *The US Dollar has reversed course and is now trending near YTD lows.*
- *Gold recently broke out of its trading range to record highs.*
- Industrial metals, which raced higher recently, have retraced all recent gains and are back in the middle of the large consolidation zone of the last year.
- Oil futures are in the middle of their one-year trading band and appear to be stuck in a trading range.

Tying it all together:

In the long term, economic growth is the primary driver, and, while growth remains robust, we are now seeing signs of moderation. This does not mean everything is falling apart; in fact, this was the Federal Reserve Board's intention. They have held interest rates high for a long time to combat inflation, and the expected result of such policies is economic moderation and a cooling of the labor market. The Fed is shooting for a soft landing, a scenario whereby inflation returns towards their 2% target without destroying economic growth, and so far, that scenario appears most likely.

I'm keeping this paragraph below from my prior reports as it really sums up expectations and what is currently taking place:

"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, like rising unemployment, 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 equity 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 will reiterate that the best approach in these environments is to ensure that one's overall portfolio aligns with their risk tolerance and long-term goals and add to this the importance of keeping emotions at bay. Markets tend to overreact to both positive and negative data, and keeping a calm perspective has always proven prudent.

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

John Slayton, CFP®
Managing Director
First Carolina Wealth