First Carolina Wealth

September 10, 2024

THOUGHTS TO START YOUR WEEK

The Mysterious Backdoor Roth IRA

We undertook last time to delve more into the nuances of Roth IRAs. Backdoor Roths are fairly nuanced. Initially, let us dispatch any confusion between a Backdoor Roth and Alfred Hitchcock's 1954 cinematic masterpiece ***Rear Window.*** Our pursuits pale in the face of amateur sleuths Grace Kelly and Jimmy Stuart, but we persevere, nevertheless.

In 2024, if you file taxes Married Filing Jointly ("MFJ"), you cannot contribute directly into a Roth IRA if you make over $240,000 ($161,000 if filing single).

- Many taxpayers earning over these amounts perform tax analyses and are interested in maximizing the balances in their Roth IRAs for income or estate tax rationales.
- If you cannot reach the Roth IRA through the front door, an alternative approach has developed through use of the Backdoor.
- While deferrals into a traditional deduction IRA are unavailable if you make over $143,000 MFJ ($87,000 single), or by one spouse if the other spouse is covered by an employer plan, it is capped at the same $240,000 MFJ.
- Fortunately, there are no caps on making non-deductible IRA contributions, nor (since 2010) are there any income caps on converting regular deductible IRAs to Roth IRAs (but you have to pay income tax on the conversions).
- The high-income taxpayer makes a non-deductible IRA contribution, and then converts it to a Roth IRA, using the Backdoor to get his/her Roth IRA.
- A potential drawback to this approach arises if you have large traditional rollover assets that have never been taxed.
    - The "pro rata" rule allows the IRS to count all assets you hold in traditional IRAs when determining how much tax you owe on the conversion. If 95% of your traditional IRAs have never been taxed, 95% of the Roth conversion amount will be taxed as ordinary income.
    - A small conversion could result in a large tax bill.
- A potential "workaround" if you participate in an employer 401(k) plan is to move the traditional IRA assets into the 401(k) plan (if permitted by the Plan) and then convert. Assets in 401(k) Plans are not counted in the pro rata rule.
    - Be sure the employer plan permits it and that it is actually an attractive Plan from an investment viewpoint before you move large sums into it, however.
    - My mentor in the tax planning business always quipped, *"Never let the Tax tail wag the Investment Dog."*

Perhaps you recall the tech-bubble of the late 1990s, when cocktail party (or bowling league night) conversations inevitably lapsed into the home run you just scored in your ownership of Cisco, Oracle or Global Crossing, allowing you to retire early and move to Monaco (just like Grace

Kelly). You now will be able to drop Backdoor Roths into your story line, to the enjoyment, awe, and envy of your friends.

Weekly Economic Insights From Our Investment Managers

Last week's holiday-shortened trading was full of disappointing economic data, and risk assets such as stocks and commodities traded with a heavier tone. The S&P 500 was down -4.25% when the final bell rang, while the NASDAQ shed more than -5.5% of its value, led by a massive double-digit selloff in the semiconductor space. Nine of the 11 sectors were in the red, with only real estate and consumer staples posting a gain for the week.

A soft Chinese manufacturing report, weak European PMI data, and a disappointing US ISM manufacturing release set the tone on Tuesday. A weaker-than-anticipated Job Openings and Labor Turnover (JOLTS) report and comments from Dollar Tree CFO regarding weak consumer spending trends on Wednesday kept investor sentiment low, but the real blow came out Thursday morning when the ADP Employment Change report showed only 99,000 new workers, about one third less than expected! If this wasn't enough, the ISM Services report showed a weak employment index and rising prices, while the big event of the week, Friday's August Employment Report, disappointed with weaker-than-expected job growth and higher-than-expected wage inflation.

Treasury bonds rallied with the 10-year yield, dropping -20bps (.20%) for the week and closing at its lowest level since July of 2023. The 10's-2's yield curve (the difference between the 10-year treasury rate and the 2-year treasury rate) un-inverted, with shorter-term rates falling faster than their longer-term counterpart as the entire yield curve sank. Commodities sold off hard on the growth concerns, with oil down close to -6.5% and industrial metals off by nearly 5%. Gold was the commodities star last week, only giving up roughly -.30% for the week. The US dollar, normally a safe haven in times of volatility, also shed a few basis points, as softer than expected foreign data provided a backstop despite the 2% rise in the Yen.

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Ticker	Name	Last	WTD Return	YTD Return	1 Year Return
Major Indices & Factors					
SPLV	Invesco S&P 500 Low Volatility ETF	70.17	-1.31%	11.99%	16.50%
DJI	Dow Jones Industrial Average	40,345.41	-2.93%	7.05%	17.14%
VTV	Vanguard Group, Inc. - Vanguard Value ETF	167.42	-3.14%	11.99%	17.71%
EEM	iShares MSCI Emerging Markets ETF	41.98	-3.67%	3.90%	6.88%
EFA	iShares MSCI EAFE Index Fund ETF	79.80	-3.83%	5.91%	12.84%
SPX	S&P 500 Index	5,408.42	-4.25%	13.39%	21.12%
VTI	Vanguard Total Stock Market ETF	268.20	-4.29%	12.32%	20.05%
HEFA	iShares Currency Hedged MSCI EAFE ETF	33.90	-4.53%	7.58%	11.48%
SPMD	SPDR Portfolio S&P 400 Mid Cap ETF	51.80	-4.78%	5.99%	13.12%
VUG	Vanguard Growth ETF	356.23	-5.14%	14.59%	24.14%
SPSM	SPDR Portfolio Small Cap ETF	42.94	-5.15%	1.80%	11.76%
ONEQ	Fidelity Nasdaq Composite Index Tracking Stock ETF	65.88	-5.71%	11.21%	20.57%
QQQ	Invesco QQQ Trust	451.71	-5.79%	9.56%	19.73%
SPHB	Invesco S&P 500 High Beta ETF	79.81	-6.94%	-3.14%	5.89%
Sectors & Industries					
XLP	SPDR Consumer Staples Select Sector Fund ETF	82.99	0.58%	15.22%	16.17%
XLRE	SPDR Real Estate Select Sector Fund ETF	43.93	0.18%	8.91%	19.34%
XLU	SPDR Utilities Select Sector Fund ETF	76.11	-0.50%	19.86%	22.79%
XLV	SPDR Health Care Select Sector Fund ETF	154.02	-2.07%	12.88%	17.10%
XLY	SPDR Consumer Discretionary Select Sector Fund ETF	182.40	-2.52%	2.01%	8.39%
IYT	iShares U.S. Transportation ETF	65.34	-2.87%	-0.41%	7.57%
XLF	SPDR Financial Select Sector Fund ETF	44.55	-3.17%	17.79%	29.05%
XLC	SPDR Communication Services Select Sector ETF	84.19	-4.07%	15.29%	25.25%
XLI	SPDR Industrial Select Sector Fund ETF	126.54	-4.24%	10.44%	18.20%
XLB	SPDR Materials Select Sector Fund ETF	89.89	-4.66%	5.09%	9.50%
XLE	SPDR Energy Select Sector Fund ETF	86.61	-5.77%	2.59%	-5.75%
XLK	SPDR Technology Select Sector Fund ETF	205.62	-7.45%	5.94%	16.55%
SMH	VanEck ETF Trust - VanEck Semiconductor ETF	217.10	-11.69%	22.95%	38.92%
Bond Proxies					
IEF	iShares 7-10 Year Treasury Bond ETF	98.12	1.33%	2.04%	5.57%
LQD	iShares iBoxx $ Investment Grade Corporate Bond ETF	112.33	1.01%	1.51%	7.82%
AGG	iShares Core U.S. Aggregate Bond ETF	101.05	0.94%	1.95%	6.04%
SHY	iShares 1-3 Year Treasury Bond ETF	82.93	0.19%	1.12%	2.67%
EMB	iShares JP Morgan USD Emerging Markets Bond ETF	91.92	-0.20%	3.21%	9.18%
JNK	SPDR Series Trust - SPDR Bloomberg High Yield Bond ETF	96.49	-0.34%	1.86%	5.66%
Commodities & Currencies					
GLD	SPDR Gold Shares ETF	231.05	-0.29%	20.64%	29.69%
UUP	Invesco DB US Dollar Index Trust - Invesco DB US Dollar Inde:	28.30	-0.32%	4.02%	-3.59%
CPER	United States Copper ETF	25.81	-3.42%	5.26%	8.87%
DBC	Invesco DB Commodity Index Tracking ETF	21.27	-3.80%	-3.49%	-15.12%
DBB	Invesco DB Base Metals Fund	18.69	-4.89%	2.13%	1.52%
DBO	Invesco DB Oil Fund ETF	13.73	-6.47%	-1.29%	-20.68%
GBTC	Grayscale Investments LLC - Grayscale Bitcoin Trust	43.95	-8.88%	23.05%	129.03%

Key Takeaway:

September has a reputation on Wall Street for being volatile, and this year is looking to validate that thesis with a few weak economic datapoints. While last week's data is certainly concerning, it's important to recognize that is does not constitute a trend at this point, and the underlying backdrop (solid GDP growth, historically low unemployment, moderating inflation, and a Federal Reserve Board signaling lower rates to come) is still favorable.

The recently mentioned repositioning into defensive sectors and lower volatility has taken hold. Looking at the first graphic above, one can see the defensive sectors leading last week, while SPLV (Low Volatility ETF) was at the top of the leader board and SPHB (Invesco S&P 500 High Beta ETF) was at the bottom. This defensive rotation in equities, coupled with a decline in the commodity space and strength in bonds, is clearly signaling a risk off tone with respect to intermarket dynamics. Whether or not this is just a mild growth scare or something more lasting heading our way, it deserves close attention with valuations at their current lofty levels.

The Week Ahead:

According to statistics derived from the options market, this week's "Expected Move" (EM) for the S&P 500 is a massive +/- 158 points. Last week's selloff blew through the expected range by over 100 points, setting the tone for further volatility ahead as traders and investors reposition assets.

This week's economic reports will be centered around inflation with CPI on Wednesday and the relatively lesser important PPI Thursday. Investors will be trying to gain further insight on whether the Fed will cut rates by .25% or .50%, and these two reports provide some further clues.

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" participating in returns

Current Tailwinds:

- *Optimism surrounding Artificial Intelligence (AI), though it is recently waning*
- *The Federal Reserve signaled that rate cuts are upon us*
- Strong labor market (signs of rising unemployment are showing up, yet jobs are available)
- Solid economic growth
- Continued earnings growth (the pace of which may be slowing)

- Momentum
- 10-year Treasury yields continuing to trade lower to new annual lows

Sentiment:

- *Credit spreads have returned to historically low levels following a recent spike due to the growth scare in August.*
- *The VIX (CBOE Volatility Index) has moved significantly higher, typically signaling fear among investors.*
- *The CNN Fear & Greed Index has moved back to "FEAR," signaling waning investor optimism.*

Intermarket Trends:

- *The major indices (Dow Jones Industrial Average, S&P 500, and NASDAQ) are trading at or near all-time highs, signifying a positive trend.*
- Interest rates have been volatile lately and are trending lower.
- The US Dollar has broken its upward trend line over the past several weeks and is beginning to trend downward.
- Gold recently broke out of its trading range to record highs.
- *Industrial metals, which have been trending lower lately, have reversed course and have been gaining traction.*
- 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:

Despite the recent rally, we maintain a cautious outlook on the market, as some of the recent factors which caused the pullback don't just disappear overnight. The Bank of Japan's divergent monetary policy and the ongoing slowdown in the US economy pose some significant risks to markets going forward. Also of note, at the present time, it appears investors may be potentially factoring in a more aggressive interest rate easing cycle than the Fed might deliver, while several historically relevant "warning signals" have been fired off recently—namely, the Sahm Rule (where 3-month average unemployment rises by more than 0.5% above is annual low) and the 10s-2s yield curve un-inverting. These realities, coupled with late-stage business cycle dynamics, have historically created a more challenging environment for stocks in the intermediate term.

In the long term, economic growth is the primary driver and, while growth currently remains robust, we are now seeing signs of moderation. This does not mean everything is falling apart; in fact, this was arguably 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 the below paragraphs from my prior reports, as they 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 want to 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.

“Tactically, we recommend maintaining long-term investment exposure to equities focusing on lower volatility sectors and value factors at the present time. We also encourage a fair amount of duration and high quality, investment grade bonds in an effort to mitigate portfolio risk.”

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