August 20, 2024

THOUGHTS TO START YOUR WEEK

To Roth or Not to Roth, That is the Question!

Whether 'tis nobler in the mind to suffer

The slings and arrows of outrageous up-front taxes,

Or to take arms against a sea of interest and penalties,

And by opposing, minimize them? To retire, to work

No more; and by retiring to say we end

The heart ache and the thousand natural shocks

That the workplace is heir to; 'tis a consummation

Devoutly to be wished. To retire, to live;

To live: perchance to outlive our money: ay, there's the rub;

For in that long life, what financial needs may come

When we have shuffled off this mortal workplace,

Must give us pause: there's the respect

That makes calamity of so long a life inadequately funded…

[Adapted from William Shakespeare, ***Hamlet, Act III, Scene I***].

When confronted with life's quandaries, such as whether to fund a Traditional or a Roth IRA, I find it useful to consult the Bard for guidance. Unfortunately, in this case, Hamlet has identified the question but is a little light on answers. Fortunately, we have recent IRS regulations and various interpretations to plumb for wisdom. We will delve into the nuances between Traditional and Roth IRAs in future issues, but today, we address the fundamental decision points.

- At the bottom line, Traditional IRAs or any Defined Contribution Plan (such as a 401(k) plan) offers the participant the opportunity to defer income into a qualified plan without paying income tax currently on the deferrals.
    - The deposits grow income tax-free until they are withdrawn during retirement taxable as ordinary income.
    - The general belief is that your tax rates will be lower in retirement because you will no longer earn a regular salary, only social security. Of course, if you have an extensive investment portfolio that funds your living expenses, that may not be the case.

  - The counterargument is that tax rates today are generally at an historically low rate and are likely to be higher in retirement, putting more tax on a similar income.
- Roth accounts are funded with after-tax deferrals and grow tax-free, but distributions are also tax-free five years after the Roth is initially funded.
  - Roth IRAs can be funded so long as joint income with your spouse is below $123,000, if at least one of you participates in an employer plan, and up to $230,000 if neither of you participate.
  - Roth 401(k) plans are offered by many employers and can be funded to the same extent as Traditional 401 (k)s, but they are after-tax dollars and come out tax-free.
  - You can also convert Traditional IRAs to Roth IRAs and pay the tax today.
  - Roth accounts offer the government up-front taxes to fund operations and swaps that for not receiving taxes on retirement distributions. This evens off the Traditional IRA's tax deferral, delivering a less volatile cash flow.

Next time, we will venture deeper into the world of Roth IRAs.

Weekly Economic Insights From Our Investment Managers

From the recent correction lows on August 5, 2024, to last week's close, the Dow has gained over 5.50%, the S&P 500 is up 8.50%, and the NASDAQ has surged 12.24%. Small and Mid-Cap stock indices have also risen more than 7% during this period.

Weaker-than-expected employment data a few weeks ago initially rekindled recession fears while the Bank of Japan sparked an unwinding of the yen carry trade just as investors were rotating out of big tech, and the markets tumbled as a result. Those concerns have seemingly been dismissed, as the markets have staged an impressive rebound based on last week's Goldilocks inflation data combined with a very strong Retail Sales report, while earnings continued to surprise to the upside.

Treasuries were rather quiet, as the data really offered nothing new with regards to forward rate cut expectations. The 10-year Treasury yield closed 2 basis points lower on the week, near 3.9%. The dollar fell less than 1% and surprisingly, given the positive economic data, commoditi es were close to flat for the week, as Oil was essentially unchanged. Industrial metals posted gains for the second week in a row, and Gold surged to all-time highs once again.

SYMBOL	NAME	5D PERF	YTD PERF	1Y PERF
$COMPQ	$COMPQ - Nasdaq Composite	+5.29%	+17.46%	+30.85%
$SPX	$SPX - S&P 500 Large Cap Index	+3.93%	+16.45%	+26.11%
EFA	EFA - iShares MSCI EAFE ETF	+3.83%	+8.48%	+17.67%
GLD	GLD - SPDR Gold Shares	+3.31%	+21.35%	+32.14%
$INDU	$INDU - Dow Jones Industrial Average	+2.94%	+7.88%	+16.95%
$MID	$MID - S&P 400 Mid Cap Index	+2.58%	+8.26%	+15.63%
$SML	$SML - S&P 600 Small Cap Index	+2.55%	+3.96%	+13.42%
DBB	DBB - Invesco DB Base Metals Fund	+2.36%	+4.21%	+16.02%
AGG	AGG - iShares Core U.S. Aggregate Bond ETF	+0.57%	+3.05%	+8.61%
$GNX	$GNX - S&P GSCI Commodity Index - Spot Price	-0.37%	+0.83%	-5.84%
$USD	$USD - US Dollar - Cash Settle	-0.79%	+1.11%	-1.09%

Source: www.stockcharts.com

Key Takeaway:

Stocks rallied sharply last week, seemingly driven by improved economic data and short-term momentum/short covering. This bounce retraced much of the recent decline, which was fueled by concerns over slowing economic growth, the Bank of Japan's interest rate policy, and the AI-related sector unwinding. While these factors have temporarily eased, it's important to note that underlying economic challenges persist.

The Week Ahead:

According to statistics derived from the options market, this week's "Expected Move" (EM) for the S&P 500 is +/- 105 points, 36 points less than last week's EM, but still large at nearly 2%. Last week the S&P 500 exceeded the expected move by nearly 65 points—this was the first time since last November that such a move occurred and highlights just how extreme volatility is presently.

This week, two key events could significantly impact the markets: the August Flash PMIs on Thursday and Fed Chair Powell's Jackson Hole speech on Friday. For the rally to persist, investors are looking for stable economic data and clear indications from Powell of a rate cut in September. The August PMIs will need to show stability to prevent growing concerns about a weakening U.S. economy and Powell needs to further signal a September rate cut and keep a relatively dovish tone, or markets may not respond favorably.

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)
- 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 have widened significantly in recent weeks, as bond investors are requiring higher risk premium for holding the debt of less creditworthy companies.*
- 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 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 stabilized.*
- 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 not:, 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. 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 remains robust, we now see 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 the below paragraphs from my prior reports, as they really sum up expectations and what is currently taking place:

"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.

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."

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.

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

John Slayton, CFP®
Managing Director
First Carolina Wealth