MONTHLY
NEWSLETTER

The Advisor

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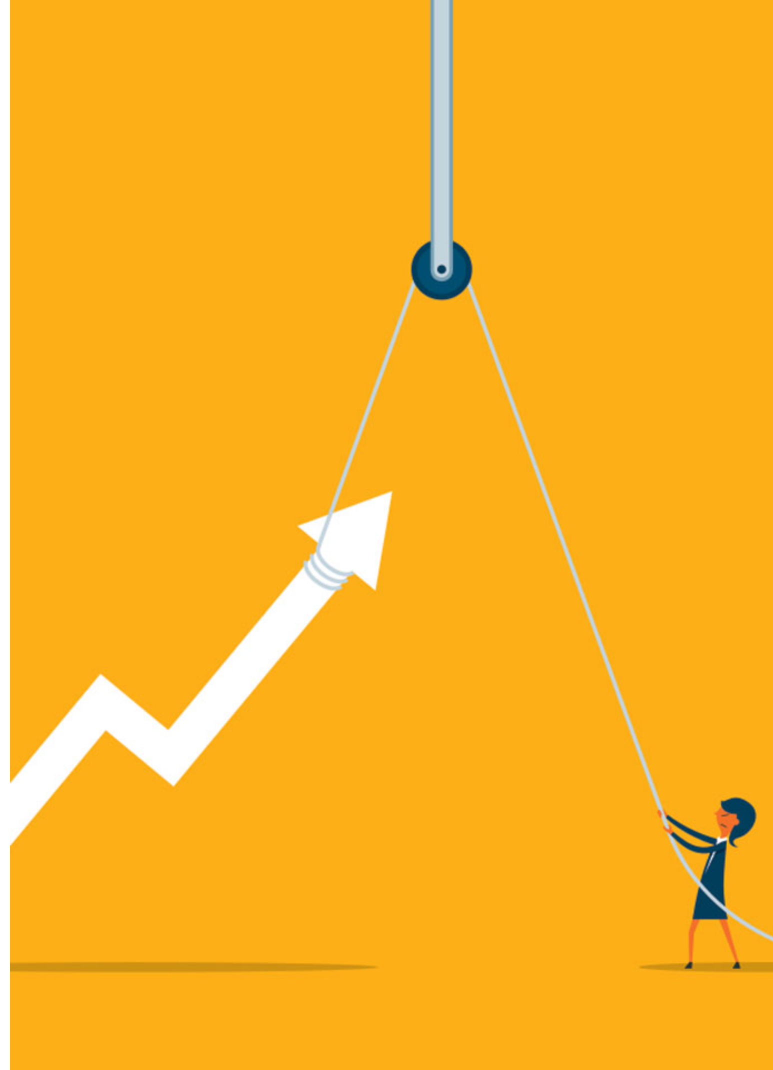
I am happy to present this month's market commentary from our Investment Team. The goal is to give our clients and friends a simple way to see everything they need to know about the financial markets on a weekly basis, in 5 minutes or less. After all, investing should be simple, not complicated.

NEW FED RATE HIKE; MARKET REACTION?



The past couple of years witnessed more speculation about interest rate hikes by the Federal Reserve than what was the reality. Many of the pundits were convinced we would see four increases during 2016 and they were wrong. The thinking has shifted in 2017 as some of the precursors that the Fed considers are starting a align and justify action on their part. A growing economy and real growth in the job market, with the accompanying uptick in inflation, is just the formula the Fed needs to raise rates; really.

On March 15, 2017, the Federal Open Market Committee (FOMC) raised the federal funds rate again by a quarter point; the second such move in three months. They had raised the benchmark rate this past December as well. The two increases are expected to have some effect on short term lending rates.

This has been a reversal of Fed policy, since the general direction of rates, except for December of 2015, has been down for a decade. In June of 1981, the federal funds rate stood at 19.10 percent. The rate had languished near zero for several years and now is in a range of 0.75 percent to 1 percent.

The Fed's decision was based on improving economic indicators and "reflects the economy's continued progress toward the employment and price stability objectives assigned to us by law," said Federal Reserve Chair Janet Yellen.

Those who are institutional investors, who manage other people's money in mutual funds, pension funds, hedge funds or the unit trusts in annuities, have anticipated a rate increase for more than a year.

For this reason, the most recent two increases have not come as a surprise. These are major investors who can drive markets. Most watch the Federal Reserve very closely, as well as the economic factors that drive the Fed's decisions. The Fed's recent move has already been "factored in" by these money managers in their recent investment decisions.

After the Fed's most recent increase, the Dow Jones industrial average increased by 113 points. The other reactions were that long-term Treasury yields fell and the dollar weakened. The Fed's comments about their current outlook were mostly positive for investors; modest rate increases the rest of the year and good economic performance since last December.

Famous bond investor, Bill Gross, says that the Fed's approach is less "hawkish" and this is a good thing. He

says the market is expecting an "old usual economy," meaning more normal growth in GDP. He also says that money coming into U.S. treasuries is coming from Europe, the UK and Japan.

Alongside the Fed's positive remarks are projections of a more robust economy in 2018 or 2019 resulting from current tax and spending legislation proposals.

The Fed has forecast that they anticipate two additional increases during 2017. This is more likely than the forecasts for last year because economic indicators are in a better place. A strengthening labor market and increased business investment are two factors that have influenced their decision.

Some more recent drops in the market have been blamed on health care reform, bank stocks, financial stocks and retail stocks. The price of oil factors in as well. The Fed's actions have not had a major impact though.

TAX PREPARATION AND WHY IT'S IMPORTANT FOR RETIREMENT

Taxes are much like rust; once they are allowed to erode, they just keep on eroding. As a saver or investor, both fees and taxes can erode the potential future balance of a savings or retirement account. For this reason, strategies should always include tax considerations, especially for those in higher marginal tax brackets.

During a person's working years, if they used a defined contribution plan like a 401k, they realized a tax decrease as their contributions were not currently taxed. The effect this has was generally to reduce a workers taxes.

With the exception of Roth accounts, a retiree must start tapping those retirement savings, and when they do, they will pay taxes at their current tax rate. Their marginal tax rate will be higher in most cases than if they were simply paying long-term capital gains on investments.

One thing that holders of a 401k plan should avoid is rolling their money over, but having the check made out to themselves. It is far better to have the funds move directly between two custodians. If the check is made out to the account holder directly, the issuer will be required to withhold 20 percent of the amount for taxes. If the entire amount withdrawn isn't redeposited into an IRA within 60 days, then the account holder could be subject to taxes and a potential 10 percent tax penalty as well. The 20 percent amount would also have to be deposited or the entire amount could be viewed as a distribution.

Allowing a rollover to happen directly between two custodians can avoid a very unpleasant tax surprise.

The Money has to be for Retirement

Retirement plans do not let participants hold onto those funds perpetually until they can be handed off to heirs through the disbursement of an estate. When retirement plans, like 401k's and traditional IRA's, were first passed into law, there were requirements that the account holder would begin to take funds by age 70 1/2. That is the age when mandatory distributions must begin. A person can defer that first distribution until April first of the year after they turn 70 1/2, but then they have to take two distributions in that year.

Failure to take the amount that the IRS expects you to take can result in a stiff 50 percent penalty of the amount that should have been withdrawn. Conversely, you can take out more than the minimum requirement, keeping in mind that taxes will be due if you are withdrawing from a

traditional 401k or IRA. The custodian will withhold taxes at your request.

Holding company stock in your retirement plan can offer a tax strategy that is a twist on other holdings. If that stock has gone up in value substantially, you can take a lump-sum distribution of that stock and move it to a taxable account. The remainder of the account would have to be rolled to an IRA to remain tax-deferred. The benefit for the stock portion is that you pay ordinary income tax on the basis (your original cost for the stock) and the remaining unrealized appreciation or gain (NUA), will only be taxed when sold. When it is sold, that appreciated portion will only be taxed at the long-term capital gains rate. Contrast this with rolling over the entire amount and then paying ordinary income on all withdrawals later on.

Up to now, we have discussed traditional retirement plans. Roth 401ks and IRA's work differently. The IRS views contributions to Roth's on a FIFO (first-in, first-out) basis. This means that your contributions are withdrawn first. The rule with Roth's is that you need to be 59 1/2, and have participated in the Roth for at least five years, to take distributions tax free; but that applies to your earnings, not contributions.

The withdrawal of conversions from traditional IRAs work somewhat different and this is a good topic for a conversation with your financial professional. A little tax planning can go a long way to hold onto more of your money.

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About the Author

K Richard Douglas has worked in the financial services industry for 26 years, with an additional 10 writing about financial and economic topics. He’s a former series 9, 10, and 26 registered principal and series 6, 7, and 63 registered representative. Richard has held many financial service industry designations, especially in the retirement planning and compliance mechanism areas.