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# Market & Legal Update

JANUARY 2024 REVIEW

Stay on top of the latest market developments and legal and regulatory updates that may affect your business.

## MARKET UPDATE | To Cut, or Not to Cut, That is the Question

After a whopping seven rate hikes in 2022 followed by another four hikes in 2023, the widely held expectation is that the Fed would begin cutting rates in 2024. While the median projection from all Federal Reserve officials is for three rate cuts in 2024, that is far more conservative than investors, who expect six rate cuts starting in March. When, and how many times, the Fed will reduce rates is certainly up for debate, and whether the Fed will cut, or not cut, in March is weighing heavily on investors' minds, ultimately driving markets up or down depending on the news. So, on January 31st, when Federal Reserve Chairman Powell announced that they were holding rates steady and hinted that they would not begin cutting rates in March, markets tumbled to end the month. That day alone, the tech heavy Nasdaq dropped 2.2%, the S&P fell 1.6% and the Dow Jones lost 0.8%. Fortunately, for the month, all three indices were positive. However, as rates crept up in January, fixed income did not have the same outcome. The Bloomberg U.S. Aggregate Bond Index fell 0.3% while the Bloomberg High Yield Index was flat.

| Market Return Indexes | Jan 2024 | YTD 2024 | 2023 |
|---|---|---|---|
| Dow Jones Industrial Average | 1.3% | 1.3% | 16.2% |
| S&P 500 | 1.7% | 1.7% | 26.3% |
| NASDAQ (price change) | 1.0% | 1.0% | 43.4% |
| MSCI Eur. Australasia Far East *(EAFE)* | 0.6% | 0.6% | 18.2% |
| MSCI Emerging Markets | -4.6% | -4.6% | 9.8% |
| Bloomberg High Yield | 0.0% | 0.0% | 13.4% |
| Bloomberg U.S. Aggregate Bond | -0.3% | -0.3% | 5.5% |
| **Yield Data** | **Jan 2024** | **Dec 2023** | **Nov 2023** |
| U.S. 10-Year Treasury Yield | 3.99% | 3.88% | 4.37% |

As markets ponder the question as to "will they or won't they" cut rates in March, most of the focus zeroes in on the various measures of inflation data. Unfortunately, December's data was a bit mixed and may leave investors with more questions than answers. The Consumer Price Index (CPI) data showed that U.S. consumer prices increased more than expected in December, rising 0.3% for the month, with Americans paying more for shelter and healthcare.

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Shelter, which includes rents, hotel and motel stays as well as school housing, accounted for more than half of the increase in the CPI. The December data showed that both headline CPI and core CPI, which excludes the volatile food and energy components, clocked in above estimates, at an annual 3.4% and 3.9%, respectively. Economists had expected slightly lower or 3.2% and 3.8%, respectively. This data would suggest that it was probably too early for the Federal Reserve to start cutting interest rates in March. However, just a week later, the Fed's preferred inflation measure, the Personal Consumption Expenditures (PCE) index was released. The Fed prefers the PCE data because it is sourced from businesses & suppliers and feeds directly into GDP. By comparison, CPI data is sourced from consumers (urban households). PCE is also a broader reading, as it measures all goods and services bought by US households & non-profits, and includes expenditures not paid directly like medical care paid for by employer provided insurance. Headline PCE came in at 2.6% while core PCE, which excludes volatile food and energy prices, came in at 2.9%. Both readings were below estimates, but more importantly this was the first time the core PCE fell below 3% since March 2021. Even more promising was the fact that the core PCE fell to 1.5% on a three-month annualized basis, its lowest since late 2020, while on a six-month basis it was 1.9% for the second month in a row. Both of those data points are below the Fed's 2% target. How the Fed responds to the CPI and PCE readings will surely be a driver of markets in the coming weeks and months.

# MARKET UPDATE *continued*

As markets pondered the inflation data, employment data released in the month somewhat tempered expectations for a rate cut in March. The December jobs report showed that the economy added a higher than expected 216,000 jobs in December. Economists polled by Reuters had forecast payrolls rising by 170,000 jobs so this number was significantly higher. Moreover, annual wage growth picked up as well, with average hourly earnings rising 0.4% in December, in line with November's gain. That raised the year-on-year increase in wages to 4.1% from 4.0% in November. As such, wage growth is well above the 3-3.5% range that most policymakers view as consistent with the Fed's 2% inflation target. The fact that U.S. employers hired more workers than expected in December and continued to raise wages caused markets to further question whether the Federal Reserve would start cutting interest rates in March.

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And finally, strong retail sales and better-than-expected GDP growth also tempered expectations for a March rate cut. U.S. retail sales rose more than expected in December, rising 0.6% last month after an unrevised 0.3% gain in November, per the Commerce Department. For reference, economists polled by Reuters had forecast retail sales would gain 0.4%. Moreover, fourth quarter GDP came in hot, growing at an annualized 3.3%, far above the consensus forecast of 2% from the Bureau of Economic Analysis. While solid growth and strong retail spending are certainly positive, both data points could support an argument for pushing any cuts beyond March.

It will likely be difficult for the Fed to ignore the data discussed above and, from Jerome Powell's comments on January 31st, it appears that data is front and center when it comes to the Fed's decisions. Moreover, according to the CME Fedwatch tool, it appears interest rate traders cannot ignore the data and Fed comments either, as they are now expecting the Federal Reserve will keep interest rates on hold in March, with the first rate cut coming in May. There's a long way to go until the March meeting so while expectations may be that the Fed will hold rates steady in their March meeting, new data may change those expectations rather quickly.

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# IRS Guidance Provides Some Clarity Around Key SECURE 2.0 Provisions

When SECURE 2.0 was enacted at the end of 2022 it was hailed as one of the most significant pieces of retirement legislation in almost 20 years, and indeed it was just that. But many provisions of the new law left plan sponsors and retirement industry professionals with more questions than answers about how some of the changes in the law would work. In December the IRS issued long awaited guidance in the form of IRS Notice 2024-2 *("Notice")*, which provides some clarity to specific provisions of this new law. Unless otherwise noted in this article the provisions discussed herein are effective now *(as of January 2024)*. **Here are some highlights from this new guidance:**

## Optional Provision to Permit Employees to Designate Employer Contributions as Roth

SECURE 2.0 provides that a plan can be amended to permit employees to elect to treat employer matching or non-elective contributions as Roth contributions. Although this provision was effective immediately upon passage of the law, very few plans have moved forward to implement this optional change because of unanswered questions. Here are some clarifications that the Notice provides:

- This new plan provision is optional at the employer's discretion.
- An employee must be fully vested in their matching of non-elective contribution to make the Roth election.
- These contributions are subject to income taxes when they allocated to the participant's Roth account, but they are not subject to federal income tax withholding, FICA, or other payroll taxes.
- The contributions are reported on a 1099-R, not on the participant's W-2.
- The contributions are not considered to be compensation under Code Section 415.

## Terminal Illness Exception to the 10% Early Distribution Tax

SECURE 2.0 added a new terminal illness exception to the 10% additional tax on early distributions imposed by Code Section 72(t), the Notice clarifies that:

- This change provides tax relief, but does not add a new 401(k) or 403(b) distribution option. For a participant to take advantage of this provision, the participant must otherwise be eligible for a distribution or in-service withdrawal from the plan. *(Note, there appears to be language in a proposed technical corrections bill that would indeed create a new type of qualified distribution option for this situation)*.
- The plan sponsor cannot rely on a participant's self-certification; the terminal illness must be certified by a physician before the plan can issue a 1099-R with a code that designates the distribution as excepted from the 10% penalty tax. *(The proposed technical corrections bill would permit self-certification)*.
- Plans are not required to recognize and report the terminal illness distributions. Even if the plan sponsor does not report a distribution as being made pursuant to a terminal illness the participant can still claim the exception on the participant's Form 1040.

## De Minimis Financial Incentives for Participation

SECURE 2.0 created an exception to the contingent benefit rule which historically has prohibited plan sponsors from offering a benefit *(other than matching contributions)* as an incentive to participate in a 401(k) or 403(b) plan. The Notice provides:

- The de minimis incentive is capped at $250.
- It can only be offered to employees that have not yet made a deferral election.
- It can be spread over multiple years *(i.e. as an incentive for continued participation in the plan)* but cannot exceed $250 in total.



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- The incentive cannot be treated as a match or any other type of plan contribution.
- The incentive is treated as taxable wages.

## Self-Correction of Automatic Contribution Errors

The Notice provides some clarification on the SECURE 2.0 provision that made self-correction of certain errors in the administration of automatic enrollment and escalation provisions permanent. The IRS had previously modified the Employee Plan Compliance Resolution System *(EPCRS)* to provide a safe harbor correction when these types of errors arose, but the safe harbor was offered on a trial basis, and SECURE 2.0 made it permanent. The Notice clarifications include:

- Generally following the previously issued EPCRS guidelines, the Notice provides details explaining the types of errors that can be corrected with the safe harbor, and the correction method that should be used.
- The relief can apply to active and terminated employees.
- The time when contributions must be made was specified.

## Cash Balance Plans Accrual Rule

SECURE 2.0 modified the rules for testing to make it easier for a cash balance plan with a design that increases pay credits based upon a participant's age and service to comply with anti-backloading rules found in 411(b)(1) of the Code. The Notice explains how a plan can be amended without running afoul of Section 411(b)(6) anti-cutback rules:

- A cash balance plan can be amended prospectively and receive anti-cutback relief, if the plan is being amended to make changes permitted in Section 348 of the SECURE 2.0 Act, specifically this covers an amendment to eliminate the fixed minimum interest rate if the plan is, or will be, providing for principal credits that increase with a participant's age or service.
- The amendment must be done by the amendment deadline provided in the Notice *(see below)*.
- The Notice does not impact statutory hybrid plans that are not cash balance plans.
- The amendment cannot take away any interest credits that have already been accrued.

## Mandatory Automatic Enrollment for Plans – *Effective for Plan Years Beginning after 12/31/24.*

One of the more well publicized changes made by SECURE 2.0 is Section 101 that makes automatic enrollment mandatory for 401(k) plans established after the date of enactment, December 29, 2022. That seemed straightforward enough, but there were a lot of questions about how this rule would operate when applying it to plans that were created pre-enactment and are going through mergers or divestitures. The Notice clarifies the following:

- If the plan terms providing for 401(k) deferrals are initially adopted on or after December 29, 2022, the mandatory automatic enrollment rules will apply.
- If a 403(b) plan has an effective date on or after December 29, 2022, the mandatory automatic enrollment rules will apply.
- If you have two plans in effect before December 29, 2022, that are merged, the resulting plan is not subject to the mandatory automatic enrollment rules even if the merger happens after December 29, 2022.
- If a plan subject to the mandatory automatic enrollment rules is merged with a plan that was established before December 29, 2022, the ongoing plan will generally be subject to the mandatory automatic enrollment rules, unless the merger meets specific exception requirements, the most significant of which is that merger must be completed within the Section 410(b)(6)(C) transition period.

- A plan spin-off is generally not going to impact whether the resultant plan is subject to mandatory automatic enrollment rules. If the plan was not subject to the mandate before the spin-off, then the spun-off plan will retain its character.

## Provisions Applicable to Small Plan Sponsors

The guidance provides details about several SECURE 2.0 provisions that only apply to small plan sponsors, including the following:

- How to claim small employer start-up costs tax credits.
- How to claim small employer military spouse tax credits.
- Who is eligible and how to elect increased contribution limits for SIMPLE plans.
- How to terminate a SIMPLE IRA and replace it with a safe harbor 401(k).
- How to add Roth contributions to SIMPLE IRAs and SEPs.

## Amendment Deadline Extension

The Notice extends the deadline for executing plan amendments relating to applicable provisions of the SECURE, CARES and SECURE 2.0 Act and any related regulations:

- The general deadline is now **December 31, 2026.**
- Collectively bargained plans have until **December 31, 2028.**
- Governmental plans have until **December 31, 2029.**

## More SECURE 2.0 Guidance To Come

Although Notice 2024-02 provides guidance on many of the SECURE 2.0 provisions, there remain several provisions of this massive new retirement legislation of which more guidance is needed. IRS comments have made it clear that they are continuing to analyze this legislation and expect to issue additional guidance this year. Additionally, the House and Senate tax writing committees have released a draft of the technical corrections bill for SECURE 2.0 which promises to fix some drafting errors and provide additional clarity around the bill.

This is a brief overview of the key provisions of Notice 2024-2. Please contact your consultant at USI Consulting Group to assist you with how these provisions specifically affect your plan and next steps.



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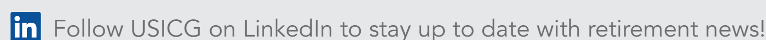
## Retirement Resources for You

USI Consulting Group's team of experts is happy to assist employers with all retirement plan compliance matters and changes in the market, including those discussed here, to help you mitigate risk and financial impact to your organization.

To learn more, please contact your local USICG representative, visit our Contact Us page or reach out to us at information@usicg.com.

Find the address and telephone number of your local USI Consulting Group office here.

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*An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.*

*The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.*

*The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.*

*The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S. based securities listed on the NASDAQ Stock Market.*

*Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.*

*The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.*

*The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.*

*The Barclays Capital U.S. Corporate High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below.*

*The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.*

*The 10 Year Treasury Yield is the interest rate the U.S. government pays to borrow money for a 10-year period. In addition to influencing how much the government pays to borrow over this time-frame, the 10-year Treasury Yields also determines how much investors earn by investing in this debt and it is a good indicator of investor sentiment.*

*The higher the yield, the better the economic outlook.*

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