Market & Legal Update

JUNE 2023 REVIEW

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

MARKET UPDATE | Where is the Recession?

June was an unexpectedly positive month for both the market and the economy, which concluded a surprisingly strong first half of 2023. Global equity markets rose during the first six months of 2023 which was a welcome reprieve from the losses experienced in 2022. The Dow Jones Industrial Average rose 4.7% and the S&P 500 and NASDAQ both jumped 6.6%. Foreign stocks also rose in June as the MSCI EAFE Index gained 4.6%, while the MSCI Emerging Market Index returned 3.8% for the month. The Bloomberg U.S. Aggregate Index dropped 0.4% as interest rates rose and bond prices fell, while high yield bonds, as measured by the Bloomberg High Yield Index, gained 1.7% as they tend to more correlated with equity markets. Therefore, these results suggest that the market believes the odds of a recession occurring later this year have receded.

Market Return Indexes	June 2023	YTD 2023	2022
Dow Jones Industrial Average	4.7%	4.9%	-6.9%
S&P 500	6.6%	16.9%	-18.1%
NASDAQ (price change)	6.6%	31.7%	-33.1%
MSCI Eur. Australasia Far East (EAFE)	4.6%	11.7%	-14.5%
MSCI Emerging Markets	3.8%	4.9%	-20.1%
Bloomberg High Yield	1.7%	5.4%	-11.2%
Bloomberg U.S. Aggregate Bond	-0.4%	2.1%	-13.0%
Yield Data	**June 2023**	**May 2023**	**April 2023**
U.S. 10-Year Treasury Yield	3.83%	3.64%	3.44%

June's positive economic developments were somewhat of a surprise given the dire forecasts of many economists earlier in the year, as many predicted a recession later in 2023 given the Fed's efforts to cool the economy over the last year. This unexpected strength included faster than expected economic growth, surprising tightness in labor markets and a growing optimism that the Fed will eventually succeed in controlling inflation without running the economy off a cliff (a.k.a., a "soft landing"). GDP growth in the first quarter of this year was revised upwards to 2.0% from 1.3% and Morningstar forecasts that the US economy could grow 2.0% in the second quarter. Additionally, the expectations for a softer landing were bolstered by the fact that May Headline CPI (Consumer Price Index), reported in June increased a seasonally adjusted 0.1% from the prior month, which was a drop from April's 0.4% increase. However, the Fed will have to remain vigilant. Core consumer prices rose 0.4% in May from the prior month, the same pace as in April and March. Moreover, Core Inflation for May (the Fed's preferred measure), rose 5.3% compared to the same period last year, which was down slightly from the prior month's increase of 5.5%.

The Fed must strike a delicate balance between full employment and price stability. Although the Federal Reserve left rates unchanged at its June meeting, these recent signs of economic health, coupled with "sticky" core inflation, are likely to encourage the Federal Reserve to hike rates two more times by year end to make additional progress on price stability. While the Fed's tightening is slowing price growth, it has been slower than some had expected or desired. Headline inflation (CPI) reported in May of 4.0% was well below its recent peak of 9.1% in June of last year and down from the 4.9% recorded in the previous month (April). So, despite slowing inflation, it remains well above the Fed's long-term target of 2.0%.

Better than expected economic strength has been underscored by stabilization in the financial system. The nation's largest banks recently passed the Federal Reserve's annual stress test, as the 23 largest US lenders showed they can withstand a severe global recession and turmoil in real estate markets. These encouraging results, which are closely monitored by industry experts, indicate that banking giants will be able to return billions of dollars to investors. However, many banks have warned they will hold off on this until there is more certainty on new capital requirements. The Fed is also weighing an overhaul of its supervision efforts. Notwithstanding new regulations, these results reflect a strong and well-capitalized banking industry.

The US consumer remains healthy, which is a good sign since approximately 70% of the US economy is driven by the consumer. In May, the consumer increased spending, especially within services. However, this increase was slower than in previous months, which reduces pressure on the Fed to raise rates. The Personal Consumption Expenditures Index rose 3.8% from the year ago period, the lowest level of price increase in two years.

Going forward, markets will continue to be focused on trade and the labor market indicators to be reported in July (e.g., trade balance and the Labor Department's jobs numbers). As a result of continued health in the economy, the 10-year Treasury yield has already risen another 20 basis points in the month of June to 3.83%. Increased optimism regarding economic growth, as well as continued pressure on the Fed to tame inflation, suggest there is now a lower probability of monetary relief coming from the Fed in the second half of 2023 in the form of interest rate reductions or other forms of monetary relief. In fact, further economic strength would render a July interest rate increase a distinct possibility.

LEGAL UPDATE | Roth and Catch-up Provisions

While the SECURE 2.0 Act of 2022 enacted by Congress in December 2022 provided retirement plan sponsors with many new potential design features, certain provisions related to Roth (after-tax) treatment have left employers and providers confused. This article will address the following three of those changes:

- Effective January 1, 2024, for participants with wages exceeding $145,000, the administrator must designate any catch-up deferrals as Roth catch-up deferrals.
- A plan sponsor also now may amend a retirement plan to permit participants to elect Roth treatment for fully-vested employer matching and nonelective (profit-sharing) contributions.
- SECURE 2.0 eliminates pre-death required minimum distributions from Roth accounts beginning with the 2024 distribution calendar year.

High-Wage Earners Must Designate Catch-Ups as Roth

Since 2002, a plan could include provisions permitting participants in an elective deferral arrangement (401(k) plan, 403(b) tax-deferred annuity plan or governmental 457(b) plan) who had attained age 50 or more to make limited "catch-up contributions" that exceeded the ordinary deferral limit. Currently and prior to 2024, catch-up eligible participants in plans that allow Roth contributions have the option to elect pre-tax or Roth (after-tax) treatment of all deferral contributions (including all catch-up contributions).

Beginning January 1, 2024, participants whose wages from the employer sponsoring the plan exceeded ***$145,000*** in the prior year ***must*** make any catch-up deferral contributions to such a plan as ***Roth*** catch-up deferral contributions.

- For this purpose, SECURE 2.0 provides that the administrator take into account wages within the meaning of Code Section 3121(a), i.e., ***Social Security or FICA wages,*** from the employer sponsoring the plan. "Wages" likely will be different from a plan's definition of "compensation" for contribution purposes. The $145,000 limit will be adjusted after 2024 for changes in the cost of living.
- SECURE 2.0 also provides that a plan permitting any employees to make Roth catch-up deferral contributions must permit ***all catch-up eligible participants*** to make such contributions. One cannot draft a plan to limit Roth treatment only to the catch-up deferrals of those with prior year wages exceeding $145,000 (as adjusted in future years).

In the absence of formal guidance from the Internal Revenue Service, this change has raised a host of unanswered questions and operational challenges, including the following:

- May a plan be amended to exclude from catch-up eligibility participants with prior year FICA wages in excess of $145,000 (as adjusted)?
- If a sponsor has a plan that have never offered Roth contributions, may such a plan provide that only catch-up deferrals can be Roth?
- How logistically will this characterization be implemented once the initial deferral limit is exceeded (especially when the deferrals initially were funded as pre-tax or when pre-tax deferrals are recharacterized as catch-up deferrals after ADP test failure)?

To further add to the confusion, while establishing these new Roth catch-up rules, Congress unintentionally deleted Code Section 402(g)(1)(C), thereby eliminating all catch-up deferrals effective January 1, 2024. While this was an obvious mistake, it is possible that Congress will not get it corrected prior to year-end. Due to the corrections that are needed and the unanswered questions, practitioners have petitioned Congress and the Internal Revenue Service to delay the effective date of this Roth catch-up contribution requirement.

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Roth Match and Profit-Sharing

Prior to SECURE 2.0, plan sponsors contributed employer matching contributions and nonelective contributions (e.g., profit-sharing contributions) on a tax-deferred basis only. The law did permit plan sponsors of retirement plans accepting Roth rollovers to adopt provisions for In-Plan Roth Rollovers. This In-Plan Roth Rollover feature allows participants to convert pre-tax contributions to Roth by allowing them to elect to roll non-Roth vested account balances, including employer matching and nonelective contribution, into a designated Roth account under a plan. An electing participant would include the taxable portion of the In-Plan Roth Rollover in the participant's gross income for the taxable year of the election.

SECURE 2.0 permits plan sponsors to amend such plans (any time after enactment) to permit participants to elect to designate employer matching contributions and nonelective contributions as Roth contributions when the contribution is made. This also would include any matching contributions attributable to student loan repayments. Electing Roth treatment, however, only is available if the involved matching contribution or nonelective contributions are ***one hundred percent (100%) vested*** when contributed to a plan. A Roth electing participant would include in gross income for income tax purposes the amount of the matching contributions or nonelective contributions in the year made. (Limiting Roth treatment to fully-vested employer contributions prevents a participant from paying income tax on a contribution subject to potential forfeiture.) At this point, plan sponsors considering this new feature await guidance from the Internal Revenue Service on the payroll changes needed to withhold income tax on employer contributions characterized as Roth. As an alternative, plan sponsors can offer the same result by permitting In-Plan Roth Rollovers without involving payroll.

Pre-Death RMD From Roth Accounts Eliminated

Current law had exempted Roth individual retirement accounts (but not Roth accounts in employer retirement plans) from the pre-death Required Minimum Distributions (RMD) requirements.

Beginning with the 2024 distribution calendar year, participants at or after their required beginning date no longer must receive RMDs from Roth account balances in employer retirement plans. SECURE 2.0 also raised the required minimum distribution age (from 72, to 73, and eventually to 75). For participants who attain 73 in 2024, their required beginning date will be April 1, 2025 – but not with respect to any Roth account balances.

Many questions remain about these new provisions of SECURE 2.0. Plan sponsors and plan providers must wonder whether Congress will act in time to prevent the elimination of catch-up deferrals (or whether the Department of Treasury or the Internal Revenue Service unilaterally will address this statutory mistake). The benefits community also waits for much needed guidance from the Internal Revenue Service regarding the implementation and administration of the mandatory Roth catch-up requirement for higher-FICA wage earners. Many plan sponsors and participants may have an interest in electing the Roth treatment of fully-vested employer contributions but may face reluctance to include these optional features in the absence of formal guidance. SECURE 2.0 helpfully eliminated a disparity between the treatment of Roth individual retirement accounts and Roth amounts in employer-sponsored retirement plans.

How USI Consulting Group (USICG) Can Assist

The USICG team can help answer any questions that you have regarding SECURE 2.0. Both the IRS and the DOL are expected to issue additional guidance regarding the SECURE 2.0 provisions and when additional information becomes available, we will provide updates to inform you about such guidance and its impact on plan compliance and administration. The USICG team is always available to help plan sponsors with documents, compliance, and other matters, including those discussed here. Please contact your local USICG representative, email information@usicg.com or visit usicg.com.

Retirement Resources for You

The USICG team 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.

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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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