USI CONSULTING GROUP

Market & Legal Update

JULY 2024 REVIEW

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

MARKET UPDATE | Rate Cuts Seemingly on the Horizon

U.S. stocks experienced a rollercoaster of a month in July following an encouraging inflation reading, a tech sector selloff, cooling labor market data, and another Federal Open Market Committee ("FOMC") meeting. The volatility resulted in mixed returns for the month with the Dow Jones Industrial Average gaining 4.5% and the S&P 500 rising 1.2%, while the tech-heavy NASDAQ lost -0.8%. Foreign stocks rose during the month as the MSCI EAFE Index gained 2.9% and the MSCI Emerging Market Index returned 0.3%. Bond yields fell during the month as incoming economic data supported the case for a September interest rate cut, and as result the Bloomberg U.S. Aggregate gained 2.3%.

Market Return Indexes	July 2024	YTD 2024	2023
Dow Jones Industrial Average	4.5%	9.5%	16.2%
S&P 500	1.2%	16.7%	26.3%
NASDAQ (price change)	-0.8%	17.2%	43.4%
MSCI Eur. Australasia Far East (EAFE)	2.9%	8.4%	18.2%
MSCI Emerging Markets	0.3%	7.8%	9.8%
Bloomberg High Yield	1.9%	4.6%	13.4%
Bloomberg U.S. Aggregate Bond	2.3%	1.6%	5.5%
Yield Data	**July 2024**	**June 2024**	**May 2024**
U.S. 10-Year Treasury Yield	4.09%	4.36%	4.51%

Headline Consumer Price Index ("CPI") fell 0.1% in June, marking the first month-on-month decline since May 2020. On an annual basis, CPI increased 3.0% in June, down from 3.3% in May. Core CPI, which excludes the volatile food and energy components, rose 0.1% from May, its slowest pace since August 2021. Core CPI increased 3.3% in June on an annual basis, down from 3.4% in May, and marking a fresh three-year low. Falling gas prices helped the overall CPI print, while a drop in new and used car prices assisted both headline and core readings. In addition, the historically stubborn shelter index rose just 0.2% during June, the slowest monthly increase in three years. The Fed's preferred measure of inflation, the PersonalConsumption Expenditures (PCE) price index, increased 2.5% on an annual basis compared to 2.6% in May, while Core PCE (excluding food and energy) remained unchanged from the prior month at 2.6%.

The cooling inflation reading released in the middle of the month was followed by a divergence of domestic equity returns. Specifically, mid- and small-cap stocks experienced a meaningful rally after lagging significantly behind large cap stocks for over a decade. The inflation reading increased the market's confidence that rate cuts are on the horizon, which will benefit smaller companies that tend to rely more on borrowing than their cash-rich large cap peers. As a result of the sector rotation, the Russell 2000 Index, a small-cap U.S. stock market index, soared 10.2% during July. Meanwhile, the seemingly unstoppable mega-cap tech stocks experienced a significant market correction during the month after AI enthusiasm helped the tech giants reach new records during the first half of 2024. Skepticism began to set in for some investors of the potential long-term payoffs of AI, as well as the capital required to achieve them. The elevated valuations and growing investor skepticism was compounded with a few disappointing earnings readings within the sector, which resulted in the Magnificent Seven losing a collective $768 billion in a single trading day. Tech stocks ended the month with a rebound centered around the message delivered by the Federal Reserve following their July meeting.

The **Russell 2000 Index**, a small-cap U.S. stock market index, **soared 10.2% during July**

On the last day of the month, the Fed held a press conference to report the results of the July FOMC meeting. Although the Committee held the federal funds rate steady at the 5.25%-5.50% range as expected,

Fed Chair Powell provided some highly anticipated insight into the potential rate cuts that the market is expecting for September's meeting. While Powell noted that the Committee had not made any decisions regarding the next meeting, his language changed dramatically from previous meetings, even noting that a rate cut is "on the table" (provided continued progress on the inflation front). Powell commented that the "broad sense of the Committee is that the economy is moving closer to the point at which it will be appropriate to reduce our policy rate." Powell mentioned that the current disinflationary progress is of higher quality than what we saw in 2023, as there is finally disinflation across all categories of Core PCE, compared to last year which was mostly centered around the disinflation of goods. The Fed will continue to assess incoming inflation data, employment data, and balance the risks of elevated interest rates before finalizing their decision to change the policy rate. However, Powell's remarks were enough for the market to price in a 100% chance that the Fed will cut rates in September according to the CME Group's FedWatch tool.

Regarding employment data, Powell noted that the cooling labor market has broadly returned to its pre-pandemic levels. The preliminary reading of job openings in June revealed another modest decline, as job openings fell 46,000 to 8.2 million. June's level is a 705,000 decrease from the end of 2023, and over a 4 million decline since the peak of 12.2 million openings in March of 2022. Meanwhile, the unemployment rate has continued to slowly trend upward, reaching 4.1% in June, up from 3.7% at the start of the year, however, still well below the 50-year average of 6.2%. As the labor market cools, wage growth has also come down, alleviating upward pressure on inflation. The Fed will continue to watch the labor market for prolonged signs of cooling as they address their dual mandate goals of maximum employment and stable prices.

The **unemployment rate** has continued to slowly trend upward, reaching **4.1% in June**

While the Fed has given investors hope that rate cuts are on the horizon, they will need to assess an abundance of incoming economic data before their September meeting. The Fed will need to digest two inflation readings, a revised second quarter GDP release, and multiple employment reports before making its final decision on the trajectory of interest rates. While markets ended the month trading positively on the speculation, they have proven that they are sensitive to the constantly developing inflationary, economic, and geopolitical environments.

LEGAL UPDATE

Recent Litigation Regarding 401(k) Plan Forfeitures

Background

Over the past year, there have been a number of class action lawsuits that have been brought against 401(k) plan sponsors, in their capacity as plan fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA"), regarding the discretionary use of 401(k) plan forfeitures. In particular, plan participants allege the fiduciaries have breached their duties by using forfeitures to offset all or a portion of the employer contributions rather than by applying such forfeitures towards the payment of the plan's administrative expenses.

Forfeitures arise under a 401(k) plan where a plan participant terminates employment before working a sufficient amount of time to become 100% vested in the employer contributions. Under well-established administrative practices, plan sponsors have historically applied 401(k) plan forfeitures, on a discretionary basis, either to fund employer contributions being made under the plan or to pay plan administrative expenses. In early 2023, the Internal Revenue Service ("IRS") issued proposed regulations confirming its long held view and position that plan sponsors have discretion to use plan forfeitures in various ways, including offsetting employer contributions being made under the plan, paying plan administrative expenses, or providing additional benefits to plan participants, provided that such forfeitures are applied no later than the last day of the Plan Year immediately following the Plan Year in which such forfeitures occurred. However, the U.S. Department of Labor ("DOL"), which has concurrent jurisdiction with the IRS in this area under the Employee Retirement Income Security Act of 1974, has never issued any definitive guidance regarding the discretionary use of plan forfeitures.

Status of Pending Litigation

The main argument being made by the class action plaintiffs in these lawsuits is that, where the administrative expenses incident to operating a 401(k) plan are being charged to plan participants rather than paid by the plan sponsor directly, a plan sponsor who exercises discretion to apply plan forfeitures to offset its own employer contributions under the plan rather than towards the payment of administrative expenses has breached their fiduciary duties of loyalty and prudence regarding plan participants under ERISA. This novel position is premised on the contention that, despite the fact that plan sponsors are generally understood to have the discretion to design and determine the benefit provisions of their respective plans, the exercise of such discretion to use plan forfeitures to fund plan benefits rather than to offset the administrative expenses paid by plan participants, is a fiduciary act of self-dealing under ERISA, which gives rise to a prohibited transaction.

The various class action lawsuits concerning the application of plan forfeitures are all in the early stages of litigation, and thus there are no binding precedents regarding the merits of the respective plaintiffs' claims. However, recently there were conflicting preliminary decisions made by two different U.S. District Courts in California, based on similar sets facts, that have caused some confusion and concern regarding this issue. Both cases involve plans that charge administrative expenses to plan participants, provide their respective plan sponsors with the discretion to choose whether to use forfeitures to offset employer contributions or to pay administrative expenses, and involve plan sponsors who chose to apply forfeitures against employer contributions.

In the first case, *Perez-Cruet v. Qualcomm Inc.*, the court denied the defendant's motion to dismiss the case against them on the grounds that the exercise of discretion granted in the plan document allowing the plan sponsor to choose whether to use plan forfeitures to defray employer contributions or to pay administrative expenses could potentially give rise to a fiduciary claim under ERISA. The court reached this conclusion, despite long standing acceptance of such discretion by the IRS, arguing that the recent proposed IRS regulations and other applicable prior guidance was insufficiently persuasive to convince the court that plaintiffs were not entitled to relief, particularly in light of the absence of any similar definitive guidance from the DOL.

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Conversely, in another case, *Hutchins v. HP Inc.*, the court granted a similar motion to dismiss made by the defendants, citing the same long standing acceptance of such discretion by the IRS and other applicable guidance, including the congressional Conference Report of the Tax Reform Act of 1986, that the court in the *Perez* case chose not to follow. The court in *Hutchins* determined the plaintiff's theories would infringe upon the "settlor" authority of plan sponsors under ERISA to determine the benefit provisions of their respective plans and further argued that the plaintiff's claims would effectively and improperly extend the provisions of ERISA beyond the statutory scope and create additional plan benefits, which was clearly not the intent of ERISA.

Thoughts & Observations

At this point, having diametrically opposed views of the two courts has led to some confusion. However, it should be noted that these are only preliminary trial court decisions, and thus not binding precedent on any other court. Litigation in this area is still at an early stage and thus likely to continue for at least several more years.

It should also be noted that the recent litigation affects only 401(k) plans that charge administrative expenses to plan participants and does not affect plans where the plan sponsor pays most or all of such expenses. With respect to plans that pass along such costs to plan participants, one way that has been suggested to potentially address the issues raised in the forfeiture class action lawsuits is for plan sponsors to amend their respective plan documents to specifically provide that forfeitures be used only to offset employer contributions.

USICG will continue to monitor these issues and keep you apprised of any further developments regarding this litigation. USICG is also available to help answer any questions you may have regarding this topic.

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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.

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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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