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ISSUE 11 | VOLUME 12 | MAY 2024

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FOCUSED ON WHAT MATTERS MOST.

The Treasury Bond Conundrum

By Casey Clarke

When it comes to making long-range calls on investment categories, probably the single most important factor is current price. There's no question that unknowable developments will influence price direction in some way, but these future variables will be either assisting or fighting against the gravitational pull of fair value. And so, when it comes to asset price bubbles driven primarily by speculative fervor rather than fundamentals, the only question relating to the eventual trip back to normal is when. The same is often true for those categories, as we discussed last month, that are usually ignored and left for dead as the mob chases more interesting things. Eventually, circumstances change that initiates a price increase back toward normal.

Long-term investing gets more difficult when there is no clear long-term tail or headwind with respect to valuation while at the same time, major fundamental changes are taking place that could have significant impacts on price in either direction. In these situations, timing and risk management become very important. This is precisely the setup with U.S. government bonds at the moment.

The Factors That Affect Bonds

In many ways, bonds can be more difficult to invest in than stocks in that a rising economic tide doesn't always lift all boats. To keep things focused, here are the main considerations when evaluating bonds as an investment:

- Current Interest Rate – If stocks are working well, and investors believe they will continue to, then they will typically find bonds less attractive if interest rates are too low. This will hurt demand for bonds (which is synonymous with lending), which in turn, assuming there is demand for borrowing, exerts upward pressure on rates. In free functioning markets, these supply and demand forces act to keep rates and prices from getting too far out of whack for too long. This is all to say that if there's a better investment opportunity for investors and lenders, then there won't be a whole lot of demand for bonds or lending.

- Inflation – Rising consumer prices are anathema to bonds. When there's high price inflation,

it behooves people to borrow money at a fixed rate as they will have more money over time to pay that loan back with. At the same time, when there's systemic inflation, lenders don't necessarily want to lend at rates that are too low, as the interest they collect will be worth less and less over time. Hence, when inflation runs high, demand for borrowing rises while availability of loans (supply) falls. This leads to higher interest rates, which is bad for bond prices.

- Creditworthiness – If the borrower is at risk of defaulting on the loan, interest rates will need to be much higher in order to compensate the investor or lender for that risk. U.S. government bonds have traditionally been known as being "risk-free", as the Federal Reserve can always print money (in essence) with which to buy bonds issued by the Treasury. However, with the public debt now exceeding $34 trillion and interest payments on that debt now totaling over $1 trillion, up from ~$500 billion in 2020, that risk-free status is being called into question. If investors on balance fear a U.S. default on interest and bond payments at maturity, then interest rates could rise substantially.

- Economic Growth – When all is well in the early stages of an economic expansion, default risks of borrowers tend to be low, the supply of money ample, and thus rates fairly low. However, toward the tail-end of that expansion, default risk climbs as borrowers now have more debt, borrowing demand for capital rises, all while lenders become more discerning and seek opportunities elsewhere. This upward drift in rates toward the end of an economic cycle (which also tends to correlate with rising consumer prices) puts downward pressure on bond prices. However, it's important to keep in mind that however neat this model appears, things aren't always this simple. Other factors like the timing of the inflation cycle, market manipulation via Federal Reserve asset purchases, and the proliferation of automated 401(k) and other retirement plan flows muddy the waters quite a bit. Although stocks and bonds can move in opposite directions through acute phases of the business cycle, they tend to move together over longer cycles.

The Bearish Case for Bonds

All of the factors above have the potential to drive bond prices down, but it's a combination of them that paints the gloomiest picture. The two that are most relevant currently are inflation and creditworthiness, with both being issues that have been front and center in peoples minds over the last couple years at least. The rapid rise in consumer prices post Covid-reaction-stimulus has re-wired investor mindsets around both the possibility of meaningful inflation and the destructive force of it, while it's clear to almost everyone that U.S. government spending is like a bullet train with no brakes. These two factors at any point have the potential to drive interest rates higher should investors en masse decide they are intractable problems.

Investors over the last couple decades have become accustomed to rescues; bailouts – and for the most part, they've worked in keeping financial market prices propped up. The challenge now becomes the unsustainable nature of this scenario. Stocks and other financial assets can't remain in a bubble forever. Gravity is exerting its pull every day that goes by. The same is true with inflation. It has come down over the last 18 months, helped along by higher interest rates, but is now showing signs of reaccelerating. It turns out that when the government spends $2 trillion a year more than it's bringing in to keep the economy afloat, price inflation happens. The point is, when valuations and too-high inflation eventually take stocks down, as happened in the 1970s, the government will feel compelled to spend even more money at precisely the time it has even less of it to spend. This has the potential to further aggravate the inflation problem, especially if the stability of the dollar gets called into question by the rest of the world. This scenario would be terribly bad for bonds.

The Bullish Case for Bonds

There are two plausible scenarios in our opinion that are favorable for bond prices. The first pertains to the stock market bubble breaking somewhat dramatically causing capital to flow out of equities and into something deemed safer. Government bonds historically have met that criteria for short-term safety. It's reasonable to assume however, that if too-high inflation is what catalyzes the stock market panic, bonds may not be viewed as a viable alternative even in the short term. This seemed the case in the 1970s.

The second complimentary scenario for bonds is one where the government steps in to forcibly suppress higher interest rates, like happened from 1942 to 1951 in an effort to keep borrowing costs for WWII and the recovery thereafter low. Given the rapidly rising debt levels and associated servicing costs mentioned above, especially when considering that government deficits always rise subsequent to collapsing stock markets and economic contractions, it's reasonable to expect that monetary authorities will feel compelled to dust off the old yield curve control playbook of the 1940s. Although it would delay the bearish bond outcome, in the end it would only serve to exacerbate already present inflationary pressures. In 1947, inflation reached 17%, and in 1951, over 20%, in large part due to rates being set too low for the economic conditions present at the time. Ultimately, monetary policy-makers were forced to remove interest rate pegs in phases, first on the short end of the duration curve, then the long, as middle class and poverty-challenged Americans were getting crushed by rising consumer prices. In the end, where interest rates go, and by inverse, bond prices, is largely dictated by inflation. If we can't get inflation under control through fiscal and monetary restraint and discipline, bonds, as well as all financial assets, have problems. So, in either the flight to quality case or yield curve control case, the supportive effect on bond prices would likely be temporary.

Where That Leaves Us

In short, there's a reasonable chance bonds could do well in the short term while suffering greatly over longer periods. I am of the opinion that the vast majority of people in positions of power struggle to think long term and selflessly. It's also my contention that said people have difficulty relating to and empathizing with the other 99.9% of Americans who pay bills in the real world. This helps to explain how we got to where we are, just as it helps to explain how most developed societies ultimately got to where they did. Through a combination of empty promises to assure re-election, flocking together with other powerful birds of feather, lobby influence, manipulating the monetary system (interest rates) to favor institutions and the wealthy, spending recklessly to appease the entrenched and perpetuate the status quo, we find ourself as a country in the sticky situation of having made too many promises and not enough money with which to keep them – the inevitable outcome of promising "stuff" instead of structure. The unfortunate reality is that the only way to pay back the debt our government has accumulated is with the help of inflation, and the higher it is, the faster the national debt gets paid back – talk about a conflict of interest between the government ruling class and the people. Solving this problem will come down to leadership and the ability to make hard decisions that benefit all Americans over time.

Thus, inertia as well as the track records of the leaders currently in the mix will lead to a continuation of current government spending and reactionary trends. Fiscal restraint will not be coming and short-term solutions like bailouts and yield curve control to maintain the status quo are probable. This means higher than accustomed inflation is a very likely outcome in the months and years ahead. For this reason, we're not optimistic on the longer-run outlook for bonds. That said however, bonds have let a record-breaking amount of air out of their balloon over the last couple years already, while the stock market hasn't yet grappled with its oversized reality. When that happens, sending capital flows into safe-haven assets, treasury bonds could receive some of those flows, especially given the amount of institutional money that needs to be working and earning interest for investors. Sitting in cash for too long simply isn't an option for large pools of money. In addition, should inflation

reemerge, it's very possible we see a yield suppression campaign by monetary authorities, which would serve to limit downside risk to bond prices. We view that as fairly short-lived though, as inflation has already demonstrated its ability to rise uncomfortably fast. It may buy us months or even a couple years, but it's hard to envision it holding the line for much longer than that.

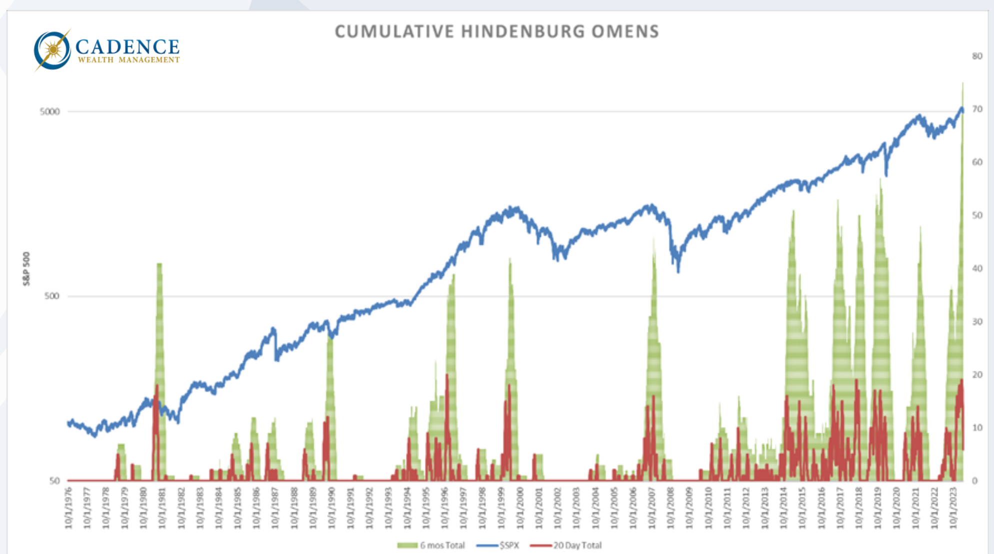
For now, the highest quality U.S. government bonds have a place in our portfolios. If the economy slows and stocks crack, that should pay off. From day to day, it offers diversification against our other commodities and natural resource-oriented positions which we do very much like over both the short and longer term. It will be a bit of a race between inflation and those aforementioned bullish factors. If inflation picks up meaningfully as the economy and stock market continue to tread water, then bonds will likely suffer. If we see economic and stock market weakness however, then inflation should get a reprieve and bonds could do well for a period of time. Bubble bursts are inherently deflationary, so that bond-friendly, safe-haven effect could be somewhat durable up until monetary authorities react sufficiently to rekindle the inflationary flame. When that happens, and it most likely will given the nature of weak leaders, bonds would be at the top of our list of things not to own. It's tricky; a bit of a conundrum. For now, we see the benefit of holding high quality bonds; but we consider them akin to an unpredictable dog with rapidly progressive distemper that we're keeping on a very short leash. Over the next few months, we should benefit from walking it. A year or two from now, probably not.

Market Topping Conditions

By Casey Clarke

One of the data points we follow to help us gain insight into the current condition of the stock market is called the Hindenburg Omen count. Originally created by James Miekka, its primary criteria is for at least 2.2% of stocks trading in the stock market to be both making new highs and new lows on the same days. Those days are tallied and looked at cumulatively to identify periods of divergence within a particular stock market index. The idea is that when you get disagreement within the stock market, it could mark a potential turning point. Below, is our version of Mikka's indicator where we use a 1.75% threshold for those new highs and lows during a stock market uptrend. What we can see fairly clearly is that we had a large number of Hindenburg Omen days cluster around major historical market turning points. The last few months marks the largest argument that's ever taken place within the Nasdaq index between stocks making new highs and those making new lows. Very interesting. We can also see that there were a number of false signals where we had those clusters without the markets subsequently turning meaningfully lower.

The takeaway here is to look at signals like this as a condition. It's often required for major market breakages, but not sufficient in itself to cause or predict them. This is why we look at a number of market indicators to form a singularity of message with respect to the inherent risk in markets. I'll add that a fair number of those indicators are singing the same tune at the moment. Not a good time to chase yesterday's performance.



Is There a "Best" Retirement Account?

By Steve DeBoth

There are a number of different kinds of accounts from which to choose when saving for retirement. 401(k)s, 403 (b)s, 457s, SEPs, SIMPLES, IRAs, regular brokerage accounts, etc. The amount you can save into an account as well as how any contributions and distributions are eventually taxed are two of the main determinants when it comes to where you should put your savings. In general, you either pay taxes upfront as well as while you go, or you pay taxes up front and never again, or you defer all taxes to a later date, depending on the type of account. With so many options from which to choose, is there a best account to use?

Most people who have been employed by larger companies or organizations are familiar with traditional 401(k) and/or 403(b) accounts. **Pre-tax** money goes into the accounts, there is usually an employer match, and then when money is withdrawn in the future almost every single dollar is taxed at current income tax rates. More and more 401(k) and 403(b) plans are offering Roth options. Similar to the Roth IRA, **post-tax** money goes into the accounts, there is also usually an employer match, and then when money is withdrawn in the future no income taxes are paid from the employee contributions as they were paid "up front". Until January 1, 2023, employer matches on employee Roth 401(k) contributions could only be made as pre-tax contributions into a traditional 401(k) account in the same plan, so that would mean in the future the 401(k) account would have a basket of money that comes out tax free, and another basket of money that does not. However, since January 1, 2023, employer matching contributions can also go into the Roth 401(k) account, but there's a catch: the employee has to pay the income taxes on the employer contribution before it goes into the Roth account. Because of this, most employer matching contributions will still go into a traditional 401(k) account for the employees.

Which saving and investing account would work out best for any given person is dependent on a number of different factors. Additionally, a person could completely forgo saving into an employer plan and instead invest in their own brokerage account which I will illustrate along with the others to show how these accounts grow and are taxed over time. Also, from here on out I will refer to 401(k) accounts to mean both 401(k) and 403(b) accounts as they are identical in most ways.

Account Characteristics

Characteristics of a traditional 401(k) Plan:

- Money goes in pre-tax
- Employer matches to some degree
- Investments grow tax-free
- Money comes out fully taxable

Characteristics of a Roth 401(k) Plan:

- Money goes in post-tax
- Employer matches to some degree
    - Match goes in pre-tax, or
    - Match goes in post-tax, and employee pays the tax on that match

- ➲ Investments grow tax-free
- ➲ Employee contributed money comes out relatively tax-free
    - Employer match comes out fully taxable, or
    - Employer match comes out relatively tax-free if employee paid taxes on the employer matching contributions

Characteristics of a brokerage account:

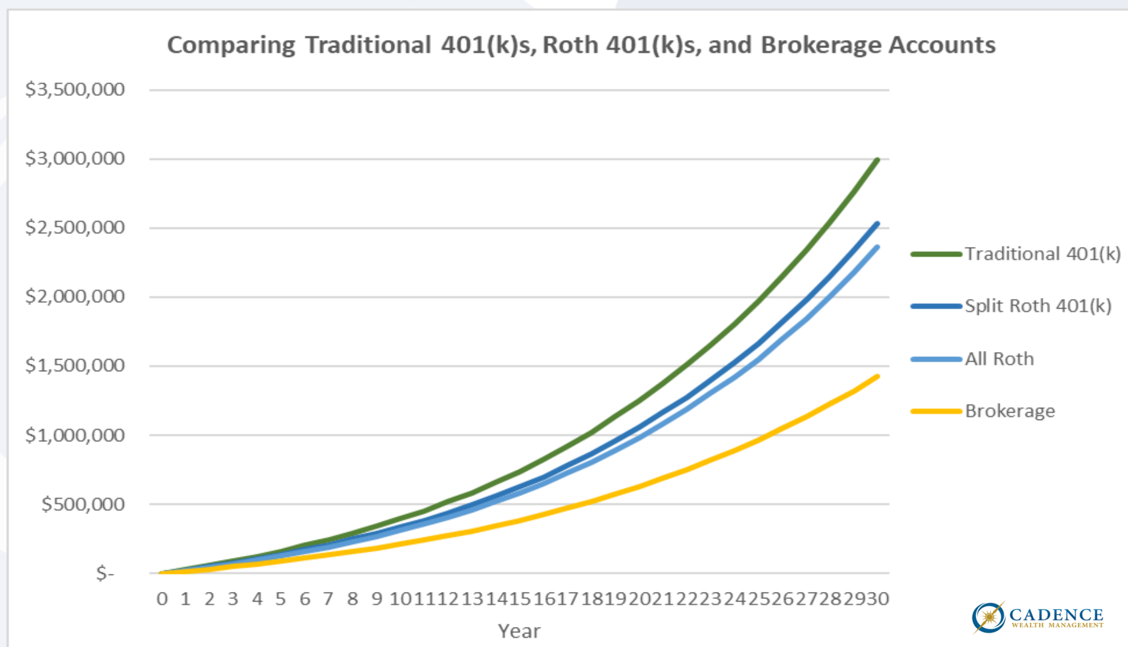
- ➲ Money goes in post-tax
- ➲ No employer match
- ➲ Investments taxed along the way
- ➲ Money comes out relatively tax-free

How Do They Compare?

For illustrative purposes, we are going to assume:

1) The combined federal and state income tax rates are 37% during the saving years;
2) Taxes paid on brokerage account gains are 15% per year;
3) The blended future tax rate on withdrawals is 20%;
4) Investments earn 7% per year over the 30-year period;
5) One Roth 401(k) has employer matching contributions going into a traditional 401(k) account (called "Split Roth"), and one has employer matching contributions going into the Roth 401(k) account after the employee pays taxes on those matching funds (called "All Roth"); and,
6) All taxes are paid out of the accounts themselves.

Assuming a starting pre-tax saving amount of $23,000 per year, which account yields the most post-tax dollars at the end?



Given the assumptions we used, saving into the traditional 401(k) yields the most post-tax dollars long-term. Both the traditional and the Roth accounts beat not using an employer plan and saving in a regular brokerage account instead mostly because there's no employer match on a non-employer sponsored brokerage account. Between the two Roth 401(k) accounts, the one that has the matching contributions going into the pre-tax part of the 401(k) appears superior to the Roth 401(k) account where the employee pays the taxes on the employer contributions and then it all comes out tax-free later.

There is one specific instance, though, where saving into the Roth 401(k) may result in more post-tax dollars long-term, and that is if the future tax rates during retirement are higher than the tax rates during the saving years. This instance would not be experienced for most people simply because the vast majority of people have reduced taxable income during their retired years, which means the tax rate saved in the early years is greater than the tax rate paid in the later years. Saving into a Roth 401(k) and having the matching contributions also go into the Roth 401(k) would outperform splitting the employee and employer Roth contributions between the Roth account and the traditional account in this situation. In general, though, despite all the positive press Roth 401(k)s have been getting over time, most employees will make out better in the long-term using a traditional 401(k) account.

All this being said, or written in this case, there are reasons to consider not putting all your savings into a traditional 401(k).

Reasons Not to Put Everything in Traditional 401(k)s

Roth and brokerage accounts do not have required minimum distributions (RMDs) like traditional 401(k)s and IRAs. The larger the total amount a person has in traditional 401(k)s and IRAs, the larger a person's required minimum distributions will be. Every dollar of a person's required minimum distribution is taxable income, and there are expensive knock-on effects to this:

Social Security Taxability

Along with being fully taxable, RMDs can also pull more of your social security into your taxable income. For example, retirees with $72,000 in social security income and $18,000 in 401(k)/IRA withdrawals have an adjusted gross income in 2024 of $32,500. By adding $10,000 more to the 401(k)/IRA withdrawals, the adjusted gross income **goes up by $18,500**. In this case, the extra $10,000 in 401(k)/IRA pulls in $8,500 more from social security to be taxed. You should only pay about $1,000 in federal taxes on that extra $10,000 RMD, but instead you're paying closer to $1,900, and it just gets worse the higher your RMDs go. Having money in accounts without RMDs helps this.

Medicare Part B Payments

Most Medicare recipients pay around $175 per month for Medicare Part B premiums. How much you pay is based on your adjusted gross income from two years ago. With a high enough RMD pushing your gross income higher, you could instead pay from $245 per month all the way up to $594 per month. For people with millions in traditional 401(k)s and IRAs, they run the real risk of having this happen. Even people with less may still get their Part B premiums raised, depending on the make-up and income reported on their 1040 in a given year. Having money in accounts without RMDs also helps this.

Big Purchases and/or Expenses

If the bulk of your money is in traditional 401(k)s or IRAs and you need money for a major purchase like a car or a home, or you have to take big chunks out for expenses like long-term health care payments, your income may be pushed into high enough tax brackets where it didn't in the end make sense for you to save so much in these accounts. Earlier I said the Roth 401(k) was superior if your tax rate in retirement is higher than your tax rate during your working years. Having to take hundreds of thousands of dollars out to pay for long-term care is one of those situations where this could come true. All the more reason to have long-term care insurance, or not to save everything in an account that will have fully taxable future withdrawals.

You may need some of the money before retirement

One area where saving into a regular old brokerage account does win is if you want to have maximum flexibility for what you can use the money for and when you can use it. Generally, taking money out of 401(k)s and IRAs early results in not just taxes but also penalties, and if you decide to take a loan out against a 401(k) instead (you can't take loans from IRAs), then that creates its own potential problems and expenses. If you have multiple potential uses for some amount of your savings, then the flexibility of a brokerage account may in the end be worth the other disadvantages.

These are four reasons not to use 401(k)s or similar pre-tax, tax deferral, fully taxable upon distribution type accounts. How much you should save in any account depends very much on your income, the plans available to you, your potential income during retirement, and a whole host of other considerations. In general, though, saving into traditional 401(k)s works well enough over time to be in most cases better than saving instead into a Roth 401(k), regardless if the Roth 401(k) employer match gets added to the Roth account or the traditional account. This is definitely one area to consult your Cadence advisor, as there are quite a few different variables to consider when deciding how much to save where, especially as there may be advantages to not having ALL your savings in a traditional 401(k).

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