EAGLE RIDGE
INVESTMENT MANAGEMENT, LLC

Investment Commentary

March 31, 2024

HIGHLIGHTS

- The market had a strong start to the year with the S&P 500 up 10.6%. Macro data has been a mixed bag but indicates a growing economy. This makes it more and more likely that we will avoid a recession despite last year's Federal Reserve rate hikes.
- The Information Technology sector is the largest sector, accounting for about 30% of the S&P 500. However, its constituents are more homogeneous than the Communications Services sector.
- Most financial planning software assumes that state and local tax rates will remain stagnant. In certain cases, this assumption is valid. However, in most circumstances, it would be more prudent to analyze trends in your own area and then adjust appropriately.

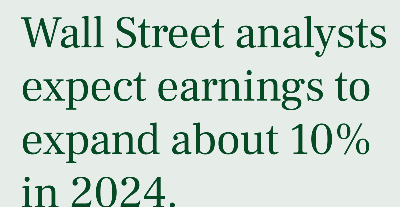
Mixed Macro, Strong Market

The market had a strong start to the year with the S&P 500 up 10.6%. Macro data has been a mixed bag but indicates a growing economy. This makes it more and more likely that we will avoid a recession despite last year's Federal Reserve rate hikes. The jobs market continued to chug along, adding more jobs than expected. Consumer spending was up and down while the savings rate started to fall. Inflation continues to be above the long-term target of 2%. Core inflation trended in the right direction during the 2nd half of 2023 but has been higher to start 2024. It's still well off the highs of 2022 and early 2023.

Earnings growth should return in 2024 after declining approximately 1% in 2023. Wall Street analysts expect earnings to expand about 10% in 2024. This offsets the mixed macro-economic data and provides ammo for market bulls. On the other hand, long-term interest rates have risen. The 10-year Treasury ended 2023 yielding 3.9% and closed the 1st quarter of 2024 at 4.2%. This increase is good for fixed income investors but a headwind for equity investors. Higher interest rates mean future cash flows are discounted more, which should decrease equity valuations.

The S&P 500 started the year with a price to earnings ratio of about 21.5 and closed the 1st quarter at 23.5. This multiple expansion accounts for most of the S&P's return in the 1st quarter. However, if we use forward earnings estimates, as opposed to trailing, the multiple decreased from 22.1 to 21.7. This reflects the increasing earnings expectations for 2024, adjusting from an expectation of flat growth to an expectation of 10% earnings growth. The expectations for earning growth are what drove the market higher, offsetting the mixed macro data, higher interest rates and stubborn inflation.

Now for the hard part - earnings must grow to meet these expectations. Over the last 25 years, earnings have grown, on average, 7% to 8% per year. Earnings growth can exceed that level and reach 10% for a few reasons. Unemployment is still near record lows, allowing the consumer to continue to spend. Inflation, while above long-term targets, is still lower than it's been over the last couple of years. This should allow companies to pass along costs to consumers and maintain or improve their margins, driving up earnings. Finally, short-term interest rates will come down once the Federal Reserve starts cutting rates (expected in June at the earliest). This allows businesses and consumers to borrow at lower rates, increasing investment and spending. As always, confidence in earnings growth is paramount.

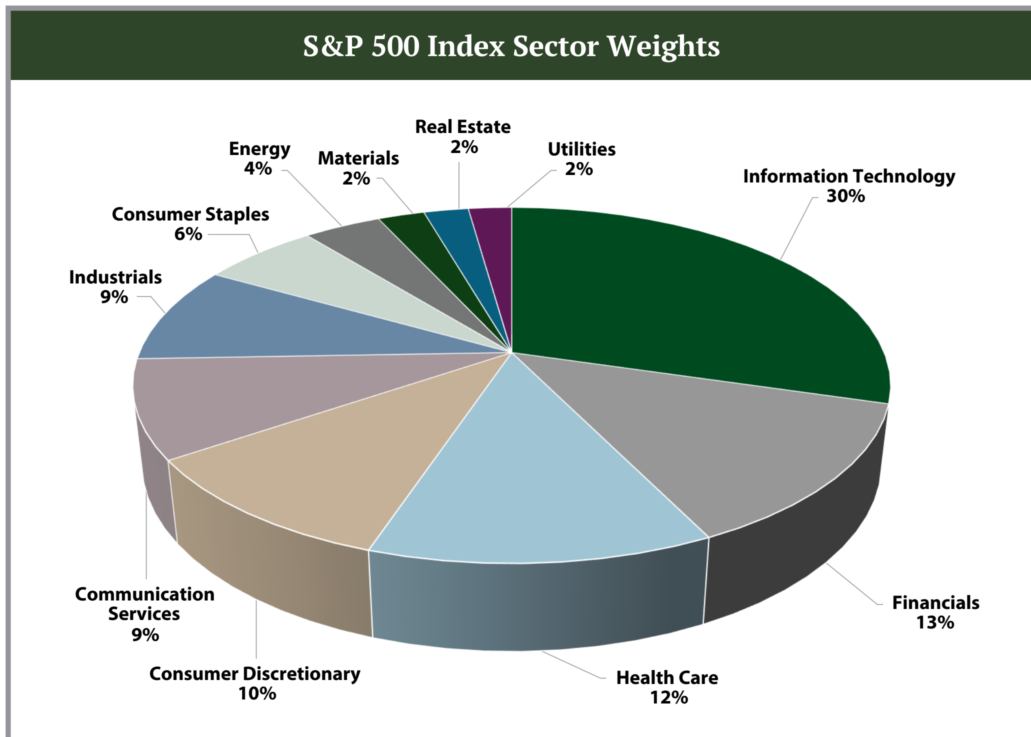


Diversify by Name, not Sector

The S&P 500 is made up of about 500 companies. These companies are commonly categorized into 11 sectors: Communication Services, Consumer Discretionary, Consumer Staples, Energy, Financial, Health Care, Industrial, Information Technology, Materials, Real Estate, and Utilities. Each sector theoretically contains similar companies that will have similar equity performance. Historically, a fully diversified investor would have a balance of holdings across each sector. This diversification may not matter as much now.

The goal should be to have a balance of holdings that respond differently to different economic conditions regardless of sector. The Communication Services sector lumps telecommunication companies like Verizon with technology companies like Alphabet and consumer companies like Electronic Arts. Each of these companies will respond differently to different economic conditions. Verizon, given its high dividend, is much more interest rate sensitive and is more correlated to a utility than Alphabet or Electronic Arts.

The Information Technology sector is the largest sector, accounting for about 30% of the S&P 500. However, its constituents are more homogeneous than the Communications Services sector. The technology companies are software companies (Microsoft) or the companies that power those companies (Broadcom). Owning all technology stocks may represent a large chunk of the S&P 500 but would not provide needed diversification.



Three sectors are about 2% each- Materials, Real Estate and Utilities. The sectors make up so little of the index that adding positions to check the sector boxes is not necessary for a properly diversified portfolio. An investor should be sector aware, but not sector driven. As stated, the goal should be to have a balance of holdings that respond differently to different economic conditions.

State & Local Taxes – Forecasts Vary Widely

Most people focus their attention on Federal taxes; however, state and local taxes are often very significant expenses. These taxes are also more difficult to estimate going forward since state and local finances receive much less media attention than Federal budgets and deficits. The soundness of public financing also varies incredibly across the country. Certain states and municipalities are very prudent regarding their financing while other regions are more profligate and could subject their residents to service disruptions and/or markedly higher tax rates.

For many investors, state income taxes are their second largest expense after Federal income taxes in their budgets. State income taxes vary from nothing in Florida, Texas etc. to 14-15% in California and New York City (10.9% top state rate plus 3.8% NY City tax). State tax rates often change over time due to funding priorities, structural expenses and/or electoral politics within the state. Certain states, especially in the South and Rocky Mountain area, have decreased income tax rates recently. For instance, Kentucky decreased its top tax rate to 4% this year from 4.5% last year. This follows a trend where Kentucky's rates were 6% in 2016. Other states have recently increased income tax rates including California from 13.3% to 14.4%, and Michigan from 4.05% to 4.25%.

One of the larger factors influencing the path of state income tax rates is benefits promised to state employees. States typically spend about 4-5% of their budgets on retirement benefits. An outlier, Illinois, however, spends 25% of its budget on retirement benefits and the associated debt service. Illinois also has a $140 billion shortfall to fully fund its pensions which represents over 3X its total annual budget. On the other end of the spectrum, Tennessee has 105% of the funding necessary to meet its pension obligations. Given the above, Illinois residents should expect that their income taxes will increase to meet their funding shortfalls while those in Tennessee can expect the status quo.

Property taxes are also a large line item for many homeowners. These taxes are typically assessed by approximating the market value of the real estate and applying a tax that usually corresponds to 1-3% of the value of that property. Property taxes typically pay for schools, certain roads, first responders and other services provided by local governments. Politics also determine whose taxes increase at what rate depending on situations within towns.

Municipalities with more services and/or higher-paid public employees are more likely to face higher property taxes. Towns within the NY metropolitan area historically have the highest property tax rates in the country. California capped property tax rates on existing homeowners in the 1970s so that those taxes can be extremely low; however, new buyers there pay higher rates when they acquire property. Most homeowners know intuitively if they will face higher taxes in the future. However, it is important to consider compounding since single-digit increases can grow rapidly over time. For example, if property taxes increased at 7% per year, total taxes paid would double every 10 years.

State Effective Property Tax Rates

Highest		Lowest	
State	**Rate**	**State**	**Rate**
Illinois	1.88%	Hawaii	0.31%
New Jersey	1.64%	Arizona	0.41%
Connecticut	1.54%	Alabama	0.42%
New York	1.46%	Delaware	0.43%
Nebraska	1.46%	Tennessee	0.44%

A complicating factor in this analysis involves the impact that these State and Local Taxes (SALT) have on one's Federal income tax liability. Historically, state and local taxes were deductible against Federal income taxes. However, the tax act of 2017 limited total SALT deductions to $10,000. If this law sunsets as legislated in 2026, then there will be no limitation on SALT deductions as in the past. Unfortunately, it is impossible to determine if the current law will persist given the competing interests at play.

Most financial planning software assumes that state and local tax rates will remain stagnant. In certain cases, this assumption is valid. However, in most circumstances, it would be more prudent to analyze trends in your own area and then adjust appropriately.

Planning Strategies for Higher Taxes

What opportunities are available to explore in the face of potential tax rate hikes and evolving policy changes?

Consider these ten income and estate tax planning ideas for the coming year:

1. Roth Funding Channels: More employer sponsored retirement plans (401k, 403b, etc.) are offering Roth salary deferral options so many participants would benefit from these Roth options compared to traditional pre-tax savings. High-income earners barred from direct Roth IRA contributions should explore avenues like backdoor Roth conversions. However, careful attention to tax regulations, particularly the "pro rata" and "IRA Aggregation" rules, is crucial to avoid adverse tax consequences.

2. Roth IRA Conversions: Thoughtfully converting traditional IRAs to Roth IRAs can serve as a proactive measure against anticipated tax increases post-2025. Lower current tax rates may offer a window of opportunity for cost-effective conversions tailored to individual financial circumstances. Roths can offer valuable tax-diversification, especially if income tax rates are higher in the future.

3. Inherited IRA Regulations: The Secure Act 2.0 imposed a 10-year liquidation rule on inherited IRAs for beneficiaries. Strategies like directing retirement assets to heirs in lower tax brackets and Roth conversions can mitigate the tax impact on beneficiaries.

4. Estate Planning Strategies: Take advantage of the annual gift tax exclusion amount which currently sits at $18,000 per individual ($36K for married couples). Power of attorney, healthcare directives, and probate avoidance strategies merit careful consideration irrespective of wealth thresholds.

5. State-specific Death Taxes: Beyond federal estate tax implications, some individuals must navigate state-specific estate or inheritance taxes. Comprehensive estate plans should account for the liquidity needs of the estate. Generally, estates subject to federal and state tax liabilities have 9 months from the date of death to file the returns and pay any taxes due.

6. Stepped-up Cost Basis: Prudent management of low-cost basis assets ensures the preservation of stepped-up cost basis upon transfer at death. This requires careful planning for those who wish to incorporate lifetime gifting to family in their estate plan.

7. 529 Plans: Leveraging 529 college savings plans for education funding offers compelling tax advantages, including tax-free earnings growth and favorable gift tax treatment. Distributions for qualified education expenses are tax-free. Many States also offer income tax deductions on contributions up to certain amounts.

8. Qualified Charitable Distributions (QCD): Retirees, unable to realize tax benefits from itemizing deductions, can capitalize on tax-free charitable gifts from IRAs. The QCD option is available to individuals aged 70.5 and higher and presents a tax-efficient strategy for directing retirement funds to qualified charities.

9. Donor Advised Funds: The Tax Cuts and Jobs Act of 2017 expanded the standard deduction and curtailed itemized deductions. There may be opportunities to maximize itemized deductions in certain years by claiming the standard deduction in other years. Donor Advised funds can be used to aggregate charitable contribution deductions into a single tax year while preserving the donor's flexibility to donate to several charities over multiple years.

10. Qualified Business Income (QBI) Deduction: Entrepreneurs and business owners can leverage this deduction to offset taxes on up to 20% of qualified business income. QBI is a business's net profit that results in "pass-through income" - business income reported on a personal tax return. Common pass-through entities are sole proprietorships, partnerships, S-Corps, and LLCs. Consultation with tax professionals is recommended to optimize eligibility and maximize tax savings.

Eagle Ridge regularly collaborates with our clients and their tax professionals to help ensure comprehensive and effective tax planning.

Justin Sabanski Joins Eagle Ridge

If you've called the office recently, you may have noticed a new voice answering the phone. Justin Sabanski joined Eagle Ridge in March as an Operations Associate. He brings a broad background in client service to all Eagle Ridge clients.

Prior to joining Eagle Ridge, Justin worked as a Trust Department Operations Assistant at First County Bank. Justin received his bachelor's degree in Business Management from Manhattanville College.

Outside of the office, Justin enjoys fishing, boating and cooking outdoors.

About Eagle Ridge

Eagle Ridge Investment Management is an independently owned, SEC-registered investment advisory firm. Our goal is to provide superior investment performance and a high level of service to a select group of clients, unencumbered by the need to sell products or meet corporate goals. We strive to help our clients meet their needs and compound their wealth through a disciplined investment process.

For more information, please contact Mike Oliver at **m.oliver@eagleridgeinvestment.com** or **203-227-4515**.