SUMMER 2022

Wealth Management

WEALTH OF KNOWLEDGE

NEWSLETTER COVERING THE WEALTH CONTINUUM

Bonds, Interest Rates, and Inflation

2022 has certainly been an interesting and somewhat stressful year for investors, with high inflation and market volatility dominating the financial news daily. During all of this, even bonds—historically less risky than stocks—have decreased in value year to date. To understand why, you must first understand the nature of bonds and why interest rates and inflation can impact the prices.

There are two fundamental ways that you can profit from owning bonds: from the interest that bonds pay, and from any increase in the bond's price. Many people who invest in bonds because they want a steady stream of income are surprised to learn that bond prices can fluctuate, just as they do with any security traded in the secondary market.

Just as a bond's price can fluctuate, so can its yield—its overall percentage rate of return on your investment at any given time. A typical bond's coupon rate—the annual interest rate it pays—is fixed. However, the yield isn't, because the yield percentage depends not only on a bond's coupon rate but also on changes in its price.

Both bond prices and yields go up and down, but there's an important rule to remember about the relationship between the two: They move in opposite directions, much like a seesaw. When a bond's price goes up, its yield goes down, even though the coupon rate hasn't changed. The opposite is true as well: When a bond's price drops, its yield goes up. That's true not only for individual bonds but also for the bond market as a whole. When bond prices rise, yields in general fall, and vice versa.

In some cases, a bond's price is affected by something that is unique to its issuer—for example, a change in the bond's rating. However, other factors have an impact on all bonds. The twin factors that mainly affect a bond's price are inflation and changing interest rates. A rise in either interest rates or the inflation rate will tend to cause bond prices to drop. Inflation and interest rates behave similarly to bond yields, moving in the opposite direction from bond prices.

The reason has to do with the relative value of the interest that a specific bond pays. Rising prices over time reduce the purchasing power of each interest payment a bond makes. Let's say a five-year bond pays $400 every six months. Inflation means that $400 will buy less five years from now. When investors worry that a bond's yield won't keep up with the rising costs of inflation, the price of the bond drops because there is less investor demand for it.

Inflation also affects interest rates. This year has certainly been one where there is a lot of talk about the Federal Reserve Board trying to tame inflation by raising interest rates. However, the Fed's decisions on interest rates can also have an impact on the market value of your bonds. The Fed takes an active role in trying to prevent inflation from spiraling out of control. When the Fed gets concerned that the rate of inflation is rising, like this year, it may decide to raise interest rates which in turn can affect the economy.

When the Fed raises its target interest rate, other interest rates and bond yields typically rise as well. That's because bond issuers must pay a competitive interest rate to get people to buy their bonds. New bonds paying higher interest rates mean existing bonds with lower rates are less valuable. Prices of existing bonds fall. That's why bond prices can drop even though the economy may be growing. An overheated economy can lead to inflation, as we have seen this year, and investors begin to worry that the Fed may have to raise interest rates. Bond prices would be negatively impacted, while the yields (or income) on bonds would increase.

Just the opposite happens when interest rates are falling. When rates are dropping, bonds issued today will typically pay a lower interest rate than similar bonds issued when rates were higher. Those older bonds with higher yields become more valuable to investors, who are willing to pay a higher price to get that greater income stream. As a result, prices for existing bonds with higher interest rates tend to rise.

Bonds are an important asset class to have in an investor's portfolio. Though the ups and downs of the bond market are not usually as dramatic as the movements of the stock market, they can still have a significant impact on your overall return. If you're considering investing in bonds, either directly or through a mutual fund or exchange-traded fund, it's important to understand how bonds behave and what can affect your investment in them.

Your bond investments need to be tailored to your individual financial goals and integrate with your other investments. Our team at CNB Wealth Management may be able to help you design your financial plan to accommodate changing economic circumstances.

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Should You Convert Your Traditional IRA to a Roth IRA?

There are many reasons to consider having a Roth IRA as part of your retirement picture, and anyone can convert a traditional IRA to a Roth IRA in 2022. There are no income limits or restrictions based on your tax filing status. You generally must include the amount you convert in your gross income for the year of conversion, but the post-tax portion of any conversion won't be taxed when you convert.

The conversion rules can also be used to allow you to contribute to a Roth IRA in 2022 if you wouldn't otherwise be able to make regular annual contributions because of the income limits (sometimes called a "back door" Roth IRA). In 2022, you can't contribute to a Roth IRA if your adjusted gross income (AGI) is $214,000 or more and are married filing jointly or if you're single and earn $144,000 or more. You can contribute up to $6,000 to a traditional IRA in 2022, or $7,000 if you're 50 or older.

The "back door" Roth conversion works best if there are no other pre-tax IRAs. This is because you must aggregate all IRAs, then calculate the ratio of the pre-tax portion relative to the total conversion to determine the taxability of your conversion. If you don't have any other pre-tax IRAs, you can simply make a nondeductible 2022 contribution to a traditional IRA, and then convert that traditional IRA to a Roth IRA.

Converting is easy. Simply notify your IRA provider that you want to convert all or part of your existing traditional IRA to a Roth IRA, and they'll provide you with the necessary paperwork to complete. You can also transfer or roll your assets over to a new IRA provider.

Remember that you can also convert SEP IRAs, and SIMPLE IRAs that are at least two years old, to Roth IRAs. And, if you're eligible for a distribution from your employer retirement plan, you may be eligible to transfer or roll those distributions over to a Roth IRA as well.

Caution: If you've inherited a traditional IRA (or SEP/SIMPLE IRA) from someone other than your spouse, you cannot convert that traditional IRA to a Roth IRA.

Why now may be a good time to consider converting a traditional IRA to a Roth IRA.

1. Current low federal tax rates. The tax rates are scheduled to increase and revert back to pre-2018 rates starting January 1, 2026.
2. With the markets being down year to date, you can convert more assets which will likely experience market appreciation in the favorable Roth once the markets turn around.
3. Qualified distributions from Roth IRAs are tax free (and penalty free) if made at least five years after you first establish any Roth IRA, and if one of the following applies:
   - You have reached age 59½ at the time of the withdrawal
   - The withdrawal was made due to qualifying disability
   - The withdrawal was made to pay for first-time homebuyer expenses ($10,000 lifetime limit)
   - The withdrawal is made by your beneficiary or estate after your death. *Tip: The five-year holding period begins on January 1 of the tax year for which you make your first contribution to any Roth IRA. Each taxpayer has only one five-year holding period for this purpose.*
4. Roth IRAs are not subject to lifetime required minimum distribution (RMD) rules.
5. Qualified distributions from Roth IRAs are not included when determining the taxable portion of Social Security benefits. (Under current law)
6. It's beneficial to have different buckets of money with different tax consequences to draw on during retirement.
7. Roth IRA assets transfer to non-spouse beneficiaries in a more tax efficient manner than traditional IRAs.

There are some nuances not described here, but your Wealth Advisor or Tax Professional can provide further clarity on whether or not converting some or all of your IRA to a Roth could benefit your long-term retirement picture.

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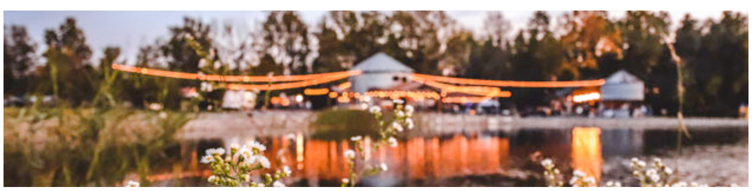

Join us for our Annual Picnic!

Wednesday, August 17
11:30 am – 1:00 pm

Lincoln Hills Farms
3792 NY-247, Canandaigua, NY

Now accepting early registration online!
Register today at CNBank.com/Picnic.

CNC Shareholder Corner

Current Value/Share: $343.42
Last average auction price as of 6/23/2022
sold - 4,335
High - $368.20
Low - $332.00

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