CLIFFORD SWAN
THE Investment Counselor
AUGUST 2022
WISDOM *for* GENERATIONS

HOW TO INVEST IN A CHANGING FIXED INCOME ENVIRONMENT

By Murcy Huang
CFA

In last quarter's newsletter, equity analyst Dan Mintz considered equity investment in an inflationary environment. Today, we will discuss how the fixed income landscape is changing and share our resultant investment strategy.

INFLATION, RECESSION, AND YIELD CURVE SIGNALS

With prices for everyday purchases like food and gas remaining high, inflation continues to be top-of-mind for both consumers and investors. However, following the Consumer Price Index (CPI) peaking in June 2022 when it rose 9.1% compared to the previous year, we are starting to see signs of a slowdown in inflation. Noticeably at the gas pump, average gasoline prices are steadily going down after half a year of gains that culminated in record-high prices in mid-June. Other commodities such as wheat and copper are also on a downward price trend. Declining commodity prices may indicate that inflation is finally reducing consumer and industrial demand for goods.

Weaker demand for commodities could also be a sign of slowing economic growth. Indeed, investors have become increasingly concerned with the risk of recession. The U.S. Federal Reserve is raising interest rates to combat price inflation, intentionally slowing consumer spending and business investment to achieve this goal. The Fed faces a delicate balancing act to achieve a "soft landing" wherein they slow inflation (and economic activity) without tipping the nation into a recession.

> "The Fed faces a delicate balancing act to achieve a 'soft landing' wherein they slow inflation (and economic activity) without tipping the nation into a recession."

The U.S. economy has shrunk the past two quarters, with gross domestic product (GDP) declining -1.6% in the first quarter of the year and -0.9% in the second. Many economists define a recession as two consecutive decreases in economic output. We saw another sign of a downturn when the S&P 500 Index recently entered a bear market (traditionally defined by a 20% fall from the high). While these technical indicators are concerning, formally the National Bureau of Economic Research (NBER) is responsible for identifying a recession. The criteria they use is a "significant decline in economic activity that is spread across the economy and that lasts more than a few months." With consumer spending recently picking up and historically low unemployment, among other factors, they do not yet see evidence of a recession.

> "With consumer spending recently picking up and historically low unemployment, among other factors, [the National Bureau of Economic Research] do not yet see evidence of a recession."

The U.S. Treasury Curve, a graph of the relationship between Treasury yields and time to maturity, also has a track record for foreshadowing recessions when it inverts. An inversion occurs when shorter maturity yields move above longer maturity yields. Although yield curve inversion is a potential recession signal, it does not always translate

HOW TO INVEST IN A CHANGING FIXED INCOME ENVIRONMENT | Continued on page 2

HOW TO INVEST IN A CHANGING FIXED INCOME ENVIRONMENT | Continued from page 1

into a recession. For example, in 2019 the yield curve inverted due to concerns that the Federal Reserve's increase in interest rates would weigh on consumer spending and business activity. While the U.S. did experience a slight recession in 2020, that economic slowdown was due to a global pandemic rather than

> "Although yield curve inversion is a potential recession signal, it does not always translate into a recession."

regular economic activity. The following chart demonstrates the historic relationship between yield curve inversion and recession. Inversions occur when a spread drops below zero, entering high recession risk territory. The shaded areas indicate recessions that followed inversions. Today, one indicator, 10-year/2-year spreads (represented

> "While the economy has contracted, we do not anticipate a pervasive downturn."

by the grey line) has already reached the high recession risk zone threshold. As the red line shows, we have not yet seen the 3-month yield rise above the 10-year yield (some academics view this particular inversion as the most reliable recession predictor).

While the economy has contracted, we do not anticipate a pervasive downturn. That being said, going into 2023, we are mindful of the economic uncertainty ahead of us. Our fixed income investment strategy is based on today's macroeconomic and market environments, as well as our outlook. As always, we will adjust our strategy as appropriate.

TAX-FREE BOND MARKET

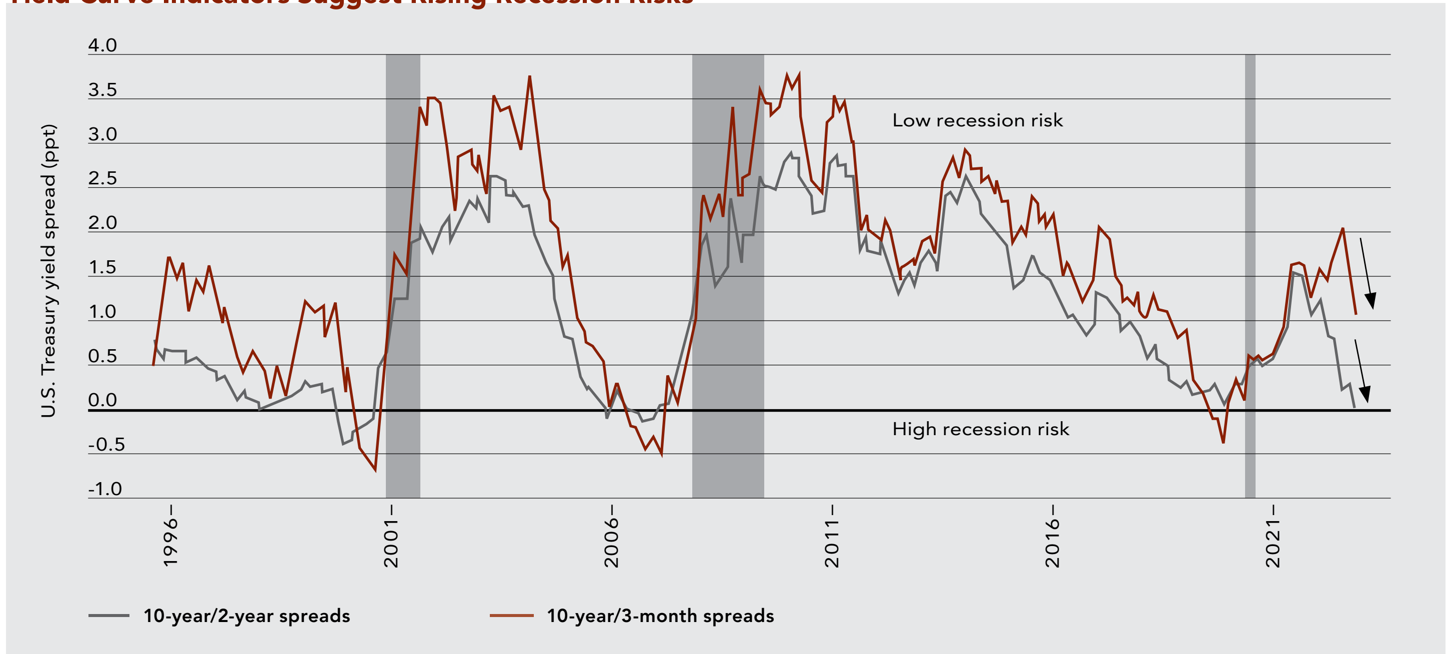
Many factors drove the fixed income sell-off in the first half of 2022, including supply chain issues, a change in monetary policy, war in Ukraine, and inflation fears. Rapid changes in market sentiment drove the largest outflow cycle ever recorded for the municipal bond market. As of the end of June 2022, municipal bond funds experienced an outflow of $86.6 billion year-to-date, which surpasses the prior largest outflow cycle during the mid-2010s. This has pushed municipal yields to near multiyear highs, especially in very short maturities like 2-year bonds.

Despite this year's selloff, we are seeing improving credit fundamentals across state and local governments after receiving sizable federal aid as part of the American Rescue Plan Act of 2021. Moreover, home prices appreciated significantly during the pandemic,

> "Rapid changes in market sentiment drove the largest outflow cycle ever recorded for the municipal bond market."

HOW TO INVEST IN A CHANGING FIXED INCOME ENVIRONMENT | Continued on page 3

Yield Curve Indicators Suggest Rising Recession Risks



As of 07/06/2022. Shaded area represents recession.

Source: RBC Global Asset Management

HOW TO INVEST IN A CHANGING FIXED INCOME ENVIRONMENT | Continued from page 2

and in turn have provided increased property tax revenues, which will be a tailwind for local government credit in the years ahead. For example, California has a record budget surplus and Illinois' credit rating was upgraded for the first time in 25 years. With strong tax collection and federal government aid, the need to issue state and local government bonds could be reduced. Specifically, California has already announced that the state will fund projects with their excess cash, rather than issuing new debt. As a result, we expect a lower supply of municipal bonds. Additionally, existing issuances may be poised to rally over the second half of the year.

> "With strong tax collection and federal government aid, the need to issue state and local government bonds could be reduced."

TAX-FREE INVESTMENT STRATEGY

In the first half of the year, it was attractive to position portfolios with shorter maturing fixed income securities as we saw buying opportunities in the higher interest rate environment. Now we will consider longer maturities as we are seeing interest rates peaking and inflation showing signs of abating. Municipal bonds continue to offer investors a good source of tax-free income.

> "Now we will consider longer maturities as we are seeing interest rates peaking and inflation showing signs of abating."

> "In addition to the Federal Reserve's interest rate hikes this year, the reduction in the Fed's holdings of government securities also contributed to higher yields in the taxable market."

TAXABLE BOND MARKET

The taxable fixed income market also faced some selling pressure in early 2022 as interest rates rose across the yield curve. In addition to the Federal Reserve's interest rate hikes this year, the reduction in the Fed's holdings of government securities also contributed to higher yields in the taxable market. Currently, the Fed has a capped runoff of $47.5 billion ($30 billion for Treasuries and $17.5 billion for mortgage-backed securities) per month until September, when the cap will increase to $95 billion. The Fed's path towards tightening will provide opportunities in the taxable market that include Treasuries, agency debt, corporate bonds, and securities backed by residential mortgages (mortgage-backed securities, called MBS).

Since the beginning of the year, we saw Treasury yields increase significantly across the yield curve. For example, in July the yield for the 2-year Treasury increased from 0.20% the previous year to 2.89%. Corporate spreads, the difference between yields on a U.S. Treasury note and corporate bonds, has also widened. The runoff of mortgage-backed securities on the Fed's balance sheet was expected, but what has also caught our attention is the weakening demand from institutions for these MBS investments. Depository institutions commonly purchase government backed securities for diversification and have been a large purchaser in the MBS market during the pandemic. However, the lack of deposit growth has subdued their purchasing power.

TAXABLE INVESTMENT STRATEGY

For the first half of the year, we strategically stayed with short maturities in anticipation of a higher interest rate environment and widening credit spreads. We also increased our Treasury purchases as yields became increasingly attractive. Now in the second half of the year, we plan to continue to take advantage of widening spreads in the corporate market and focus on relatively more stable and predictable businesses, such as food and utilities companies, which tend to be more defensive in a recessionary environment. In our view, economic fundamentals will likely dictate where the credit market trades in the second half of the year.

For investors, a changing landscape presents both challenges and opportunities. In today's environment of high inflation, increasing interest rates, and slowing economic growth, we believe our longstanding discipline in selecting high quality securities—whether stocks or bonds—and carefully evaluating risk will serve our clients well. As always, part of our risk assessment is to understand the economy and markets and position portfolios appropriately. ◆

> "...we plan to continue to take advantage of widening spreads in the corporate market and focus on relatively more stable and predictable businesses, such as food and utilities companies..."

GIFT ANNUITY PAYOUT RATES ARE INCREASING

By Lloyd K. Wong
CFA

There are many ways to support charitable causes financially. There are outright cash donations, bequests in an estate, different types of charitable trusts, as well as charitable gift annuities. Today, we will focus on the latter.

Charitable gift annuities, or CGAs for short, are a popular planned giving vehicle and a mutually beneficial way to support a charity. It's a win-win for both the charity and the donor. At its core, a charitable gift annuity is a contractual promise by a charity to provide secure fixed payments to a donor or income beneficiary for life in exchange for a gift of cash or securities. The promise of a reliable income stream is often attractive to donors.

> "The promise of a reliable income stream is often attractive to donors."

Before establishing a charitable gift annuity, it is important to consider both the potential risks and benefits to the donor:

CGA RISKS TO THE DONOR

Mortality risk and purchasing power risk are likely the most important potential concerns for a donor to assess. The first occurs when the donor dies before his or her actuarially expected age and is therefore unable to benefit from the full income stream accounted for when the annuity contract was written. Purchasing power risk is the possibility that the annuity payout rate may not keep up with inflation. While exceptionally rare, default risk, wherein the charity is unable to pay the lifetime income stream, can happen if the charity's financial resources are insufficient or mismanaged. Following the American Council on Gift Annuities' payout guidelines (discussed below) is an important best practice charities can adhere to—and most do—for a sustainable gift annuity program. Finally, these are irrevocable gifts, meaning you can't take it back—a donor must be comfortable with this commitment.

> "Mortality risk and purchasing power risk are likely the most important potential concerns for a donor to assess."

CGA BENEFITS TO THE DONOR

In addition to fulfilling a desire to support a charity, the donor receives an immediate income tax deduction and fixed, stable income for his or her lifetime. Also, the donor can avoid capital gains tax if he or she gives appreciated stock. If the donor dies before the actuarially expected year, his or her estate can apply the unrecovered investment in contract (missed payments due to shorter-than-expected life) as an itemized deduction on the donor's final income tax return.

Beyond these evergreen qualities, payout rates for CGAs are increasing in today's rising interest rate environment, making this planned giving vehicle more attractive to donors.

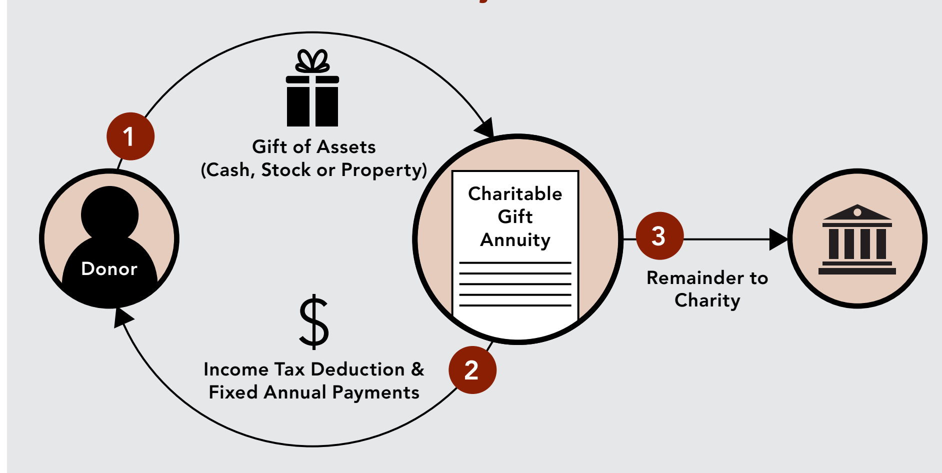
UNDERSTANDING CGA PAYOUT RATES

The American Council on Gift Annuities (ACGA) suggests maximum charitable gift annuity rates that are used by most charitable institutions when issuing gift annuities. Since 1955, the ACGA has targeted a residuum (the amount remaining for the charity at the termination of the annuity) of 50% of the original contribution for the gift annuity. Importantly, this makes it very likely that the annuitant will reliably receive distributions and that the donor's charitable intent is realized at the conclusion of the annuity.

In addition to this target residuum, other major assumptions behind ACGA-recommended annuity payout rates include mortality assumptions, investment return assumptions, expense assump-

GIFT ANNUITY PAYOUT RATES ARE INCREASING | Continued on page 5

Mechanics of a Charitable Gift Annuity



GIFT ANNUITY PAYOUT RATES ARE INCREASING | Continued from page 4

tions for investment and administration, and annual payments made in quarterly installments at the end of each period.

The largest component of the ACGA expected return calculation is based on the 10-year U.S. Treasury bond yield. Increases in yield can lead to an increased investment return assumption for fixed income in the ACGA model, resulting in a higher overall investment return assumption.

ACGA investment return assumptions ranged from 6.00% to 6.75% between 1999 and 2006. Due to the Great Financial Crisis and the impact of the Federal Reserve's accommodative stance on interest rates, the ACGA investment return assumptions declined to 4.25% by January 2012. The ACGA last raised its investment return assumption in July 2018 from 4.25% to 4.75%, only to decrease its investment return assumption 18 months later (January 2020) back down to 4.25% from 4.75%. Six months later (July 2020), the ACGA further lowered the investment return assumption to 3.75%, presumably due to the unpredictability surrounding the COVID pandemic lockdown and more interest rate accommodations by the Federal Reserve.

Most recently, the ACGA Board announced that the investment return assumption would increase from 3.75% to 4.50% (an increase of 0.75%), effective July 1, 2022. As a result of this increase, most recent payout rates will increase anywhere from 0.4% to 0.6% depending on the age of the annuitant. The chart below shows how the payout has changed over the last 20 years or so for a single life 79-year-old, relative to the ACGA gross investment return assumption and the 10-year U.S. Treasury.

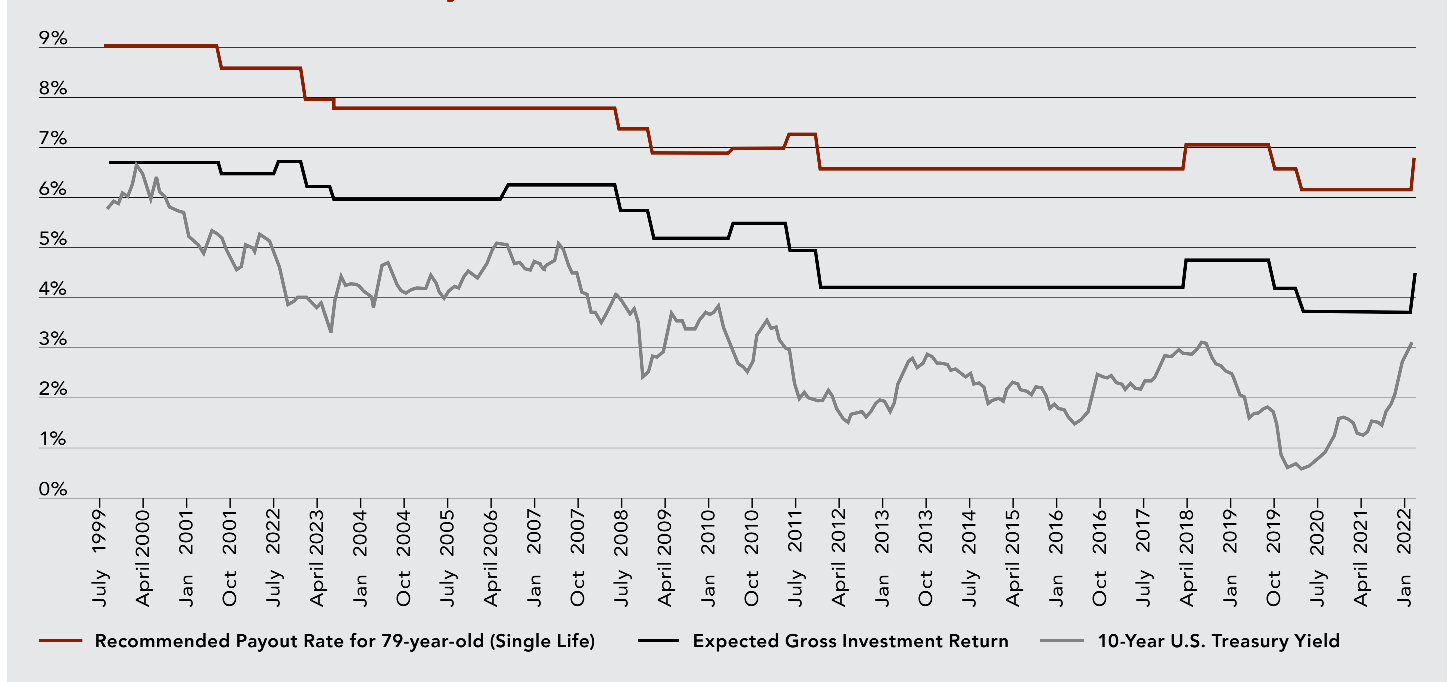
Since donations to charitable gift annuities don't require as large an outlay as, say, a charitable trust, you can assist your favorite philanthropy in a small but meaningful way and also receive a steady income stream. The table above shows the increases in annuity payments before and after the July 1, 2022 ACGA recommendations for varying gift annuity amounts.

With payout rates increasing, now might be a good time to establish a charitable gift annuity, if this approach to giving interests you. You can also consider laddering CGAs in a rising interest rate environment since the minimum amount to fund a gift is relatively low. Your investment counselor can help you evaluate charitable gift annuities within the context of your overarching philanthropic strategy and financial goals. ◆

ACGA Recommended Annual Annuity Payment (Single-Life 79-Year-Old)

Gift Annuity Amount	1/1/2020 to 6/30/2022	After 7/1/2022
$ 15,000	$ 930	$ 1,020
$ 25,000	$ 1,550	$ 1,700
$ 50,000	$ 3,100	$ 3,400
$ 100,000	$ 6,200	$ 6,800
$ 125,000	$ 7,750	$ 8,500
$ 150,000	$ 9,300	$ 10,200
$ 200,000	$ 12,400	$ 13,600

Historical ACGA Recommended Payout Rates



Note: Historical ACGA Payout rates for a single life 79-year-old.

Sources: American Council on Gift Annuities, The Federal Reserve Bank of St. Louis

SUMMER INTERNSHIP PROGRAM SUCCESSFULLY COMPLETES SEVENTH YEAR

Sean Hall and Mihika Desouza

Clifford Swan's summer internship program has successfully—and happily—been reinstated following a two-year hiatus during the pandemic. The internship provides undergraduate students considering a career in investment and wealth management a fundamental educational experience and opportunity to develop skills in multiple components of an investment advisory firm, while at the same time providing Clifford Swan with an opportunity to use the interns' skills to better serve our clients.

The internship program was led by Jennifer Maqueda, who, along with Gretchen Lee and Dan Mintz, conducted the interviews and selected Sean Hall and Mihika Desouza from a competitive pool of applicants. Sean is a Pasadena native and rising sophomore at the University of Southern California where he is majoring in Physics. Mihika is originally from Berkeley, California and is a rising junior at Scripps College majoring in Economics-Accounting. She is on the board of the student investment fund and a member of the Claremont College's investment banking club.

Over the course of six weeks, Sean and Mihika completed several projects and learned about key aspects of the firm, including portfolio management, securities analysis and research, trading and execution, client service, compliance, marketing, and operations. The interns worked directly with Clifford Swan colleagues who served as their teachers and mentors.

Alongside new research and technical skills, Mihika valued the financial education she received, saying, "Every curriculum portion and conversation with firm members opened my eyes to a new complexity of managing money." Sean shared that his favorite project was working with the CEO, Peter Boyle, to outline the structure of trust documents to understand the flow of money and mitigation of taxes. His second favorite project was conducting credit analyses for municipal and corporate bonds. Mihika's favorite project was researching and pitching a stock internally, saying she enjoyed becoming a mini expert on the company and consolidating her findings into a succinct presentation.

When asked what advice they have for those that follow them, Mihika decisively answered, "I highly encourage future interns to get lunch with everyone!" Sean and Mihika set this goal for themselves on their first day and found that these meals enriched their experience by helping them get to know the team better on a personal level and professionally.

Looking back on the seventh year of the internship program, Clifford Swan is confident that both the structure and curriculum of the program have been refined to provide an enriching experience to both the firm and the interns. It is a program our firm looks forward to each summer! We are grateful to Sean and Mihika for contributing so meaningfully to the firm, both practically and culturally. ◆

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
George E. Hasbun, CFP®
Anil Kapoor, CFA
Gretchen E. Lee
David Y. Lin, CFA
Jennifer I. Maqueda
Daniel J. Mintz
Murcy Huang, CFA
Maxwell R. Pray, CFA
Carlota B. Venegas, CFP®, CDFA®
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

OFFICES
Pasadena
177 E. Colorado Blvd., Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX

Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX

cliffordswan.com

Both this and past editions of *The Investment Counselor* are available on our website.

The information contained in this publication is for educational purposes and should not be considered a recommendation or investment advice. If you have any questions, please contact your investment counselor.

WISDOM *for* GENERATIONS