CLIFFORD SWAN
INVESTMENT COUNSELORS

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STAYING THE COURSE

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Financial markets can catch investors off guard. This year has been a case study of how market rallies can occur in the face of seemingly bad news. Domestic equities roared higher in the first seven months of 2023, with the S&P 500 up more than 19% from the start of the year, while the tech–heavy NASDAQ rose an incredible 44% through the end of July. Given an increasingly challenging macroeconomic backdrop, this impressive performance was far from expected.

This disconnect is unsettling. While investing can be an emotional ride, keeping calm and sticking to an investment strategy that supports your financial plan is the key to success. Even when price actions in markets don't make sense, a thoughtful plan should provide the flexibility needed to weather any environment.

> *"...a thoughtful plan should provide the flexibility needed to weather any environment."*

Entering the year, several factors contributed to the uncertain backdrop, many of which persist today.

Rate Hikes and Inverted Yield Curve

As recently as the first quarter of 2022, the U.S. Federal Reserve was holding the federal funds rate at around zero and buying billions of dollars of bonds every month to boost the economy. When the central bank decided to change course and respond to inflation that was registering 40-year highs, it did so forcefully. Over the past 16 months, the Fed has raised the federal funds rate by over five percentage points. Theoretically, increasing interest rates helps to stabilize prices by putting the brakes on the economy.

As short-term interest rates rose quickly, they surpassed the level of long-term rates—a phenomenon known as an inverted yield curve. Historically, an inverted yield curve indicates that a recession is on the horizon. The chart below shows each time a yield curve inversion has occurred since 1975. Every

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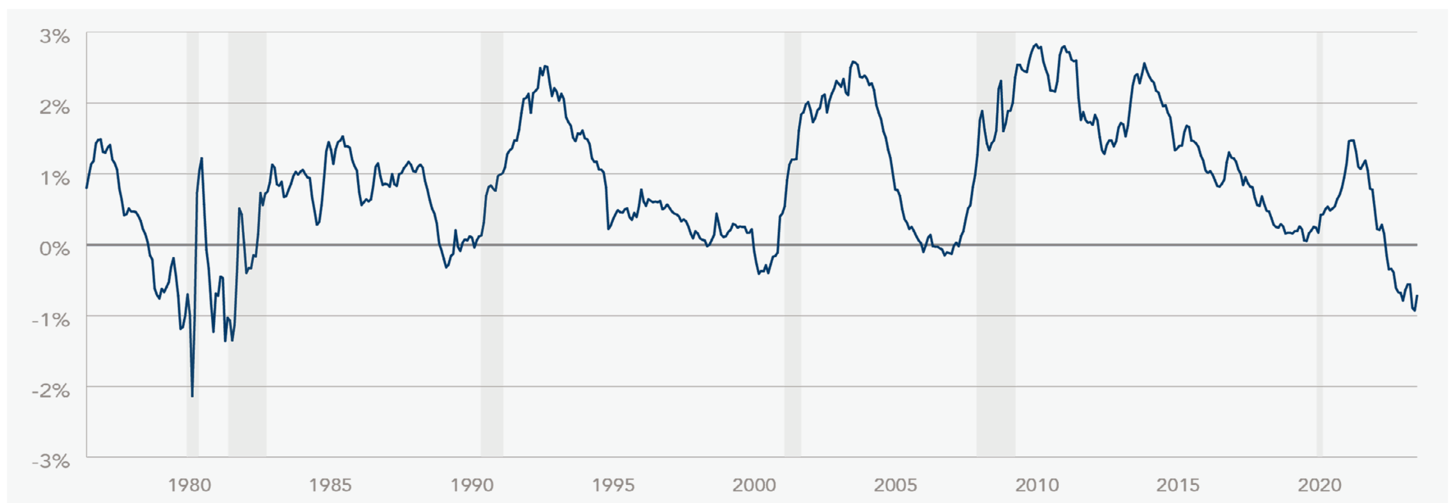
U.S. RECESSIONS USUALLY FOLLOW YIELD CURVE INVERSIONS

10-YEAR TREASURY CONSTANT MATURITY MINUS 2-YEAR TREASURY CONSTANT MATURITY



Note: Shaded areas indicate U.S. recessions.
Source: Federal Reserve Bank of St. Louis

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single time, without fail, after the difference between 10-year and 2-year U.S. Treasuries has turned negative, there has ultimately been a recession, represented by the gray bars. This time around, a recession has not yet occurred.

Bank Failures

The Fed's rate hikes contributed to the collapse of Silicon Valley Bank and other regional banks in March of this year. These banks held U.S. Treasury bonds that decreased in value as interest rates rose (a bond's price and yield are inversely related). Depositors got scared and withdrew their funds en masse, causing an old-fashioned run on the bank. The failure of these banks caused fear of contagion within the banking sector and the broader economy.

Tech Slowdown

Technology sector valuations decreased forcefully toward the end of 2022. Many market analysts expected the multiple compression to continue. Almost all the mega capitalization technology companies such as Google and Meta enacted mass layoffs. The technology sector serves as a bellwether for the economy, and these layoffs validated negative consumer sentiment. All economic signals were flashing red from tech executives.

"The technology sector serves as a bellwether for the economy, and these layoffs validated negative consumer sentiment."

China Tensions

The U.S. and China are engaged in an economic war over semiconductor chip manufacturing and technology. On the geopolitical scene, China-Taiwan relations are fragile as China threatens to take over control of Taiwan, where most of the world's advanced chips are manufactured. From computers to cars, analysts fear a takeover would cause global disruption in the production of the myriad of goods containing chips.

China's economic conditions are also uncertain. Expectations for a robust recovery to China's economy were high after Beijing lifted strict Covid lockdowns at the end of 2022. This has not materialized. In fact, July data shows China is facing deflation. In the short term, lower prices in China can be good for the global economy, with China essentially "exporting" low prices abroad. Ultimately, however, stable China relations and economic vitality are essential to the health of the global economy.

War in Ukraine

Over one year since Russia invaded Ukraine, the war's threats to the global economy are still a concern. This region is important for commodities such as wheat and oil. Potential disruptions in these markets had many investors unnerved. Some effects have been mitigated by targeted policy measures and initiatives. However, if Russia truly played hardball, commodity prices could increase meaningfully, depriving the world of valuable inputs. Indeed, Moscow's recent bombing of Ukraine's grain export routes could renew pressures on bread and other food prices.

Market Concentration

The market rally that started in October 2022 has pushed stock valuations to extended levels. In the first half of 2023, participation in the rally was limited, with much of the march upwards carried by the "Magnificent Seven" technology firms: Apple, Nvidia, Microsoft, Tesla, Meta, Alphabet, and Amazon. Historically, this sort of narrowness usually reverses —indeed, there are early signs that the market is becoming more evenly distributed. Investors may remember a similar time in 2000, when just a small number of companies dominated the market. Ultimately, those firms' stock prices declined by 70% to 90%.

"...there are early signs that the market is becoming more evenly distributed."

Where do we go from here? At this juncture, it is difficult to hold a strong opinion on the direction of interest rates, inflation, corporate profits, or even stock valuations. While the worst of inflation appears to be behind us, inflationary pressures could reemerge. Historically, there has been a lag after interest rate increases and before the economy slows down. The evidence for a coming recession has been building for some time.

Psychology rules stock prices over the short term—think of momentum investing or trading in response to the news cycle. Corporate earnings growth drives

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stock prices higher over the long term. We expect a more challenging backdrop for stocks in the second half of 2023 or early 2024, as higher borrowing costs (interest rates) and input costs (raw goods, labor) put downward pressure on corporate margins. Management teams have been guiding analysts for a more difficult second half for corporate profits.

> *"Corporate earnings growth drives stock prices higher over the long term."*

When a negative outlook for the market builds, it can be tempting to get out of the stock market to avoid a reversal of capital gains. However, market timing is inherently difficult. The chart below shows that missing just the ten best days of the market over the last 20 years would have cost investors a little over 4% per year. Not participating in the top 40 days would have lowered one's annualized total return by almost 11%! No matter how much we want to try avoiding market declines, jumping in and out of the market is simply too risky.

Record low interest rates over the past 20 years have made asset allocation decisions difficult, with investors forced to look to riskier assets for returns. Now that yields on high-quality bonds have become competitive with stock returns, portfolio managers have more tools to meet investment objectives and, accordingly, smart allocation decisions can add value.

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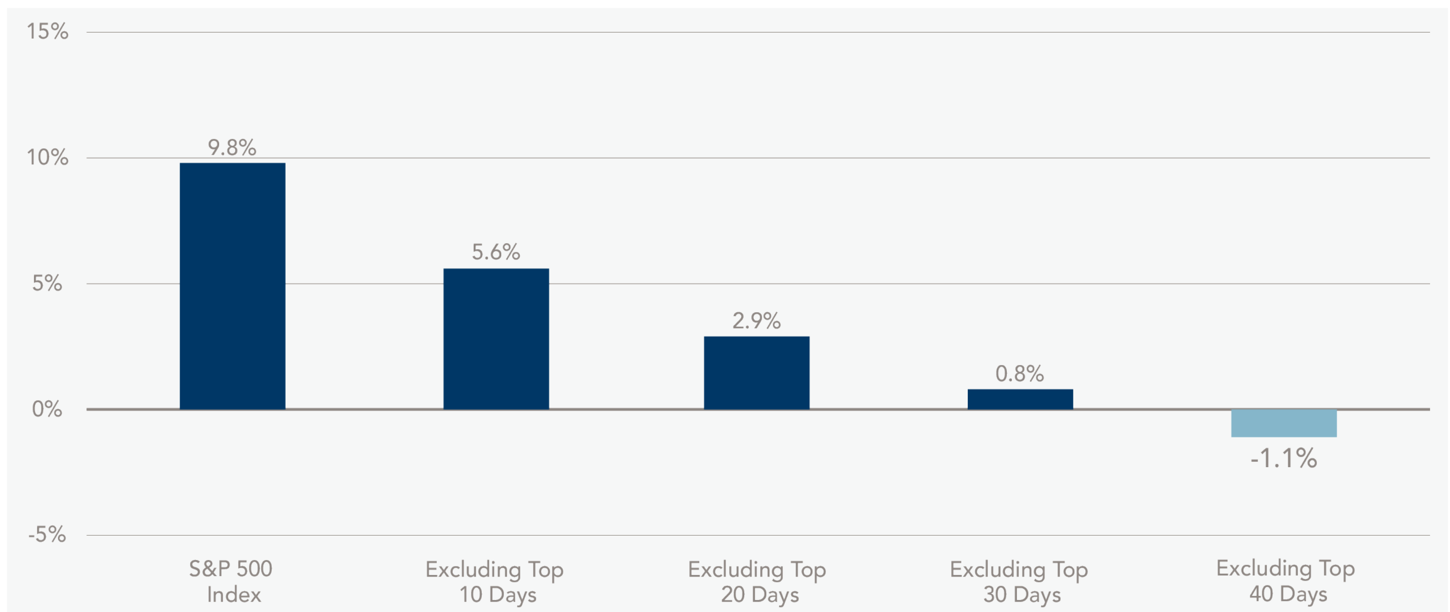
We advise a cautious approach that plans for an economic slowdown. This includes maintaining a conservative exposure to stocks and having an appropriate level of liquid reserves in place to meet short-term financial needs. At Clifford Swan, instead of attempting to time the market, we seek to identify high-quality companies that can emerge from various economic conditions with solid growth prospects—and to buy those companies at attractive prices. History shows that to meet long-term investment objectives, investors must be patient to let the attractive business characteristics of excellent companies accrue over time. Even under bearish scenarios, our clients' portfolios should meet financial objectives if we stay the course.



Source: Schwab, Bloomberg. Returns assume reinvestment of dividends and interest.

TAX BENEFITS OF "BUNCHING" CHARITABLE GIFTING

Maxwell R. Pray, CFA
Principal, Investment Counselor

Every year, income taxpayers need to decide between taking the standard deduction or itemizing. For those that itemize deductions, a strategy to combine two years' worth of charitable giving into one year has been a financial planning consideration for years. The Tax Cuts and Jobs Act (TCJA) of 2017 made this strategy even more relevant. While many TCJA tax changes are set to expire at the end of 2025, calendar-based gifting management may make sense for 2023 through 2025.

The Tax Cuts and Jobs Act enacted some of the most significant tax changes in the last 30 years. One of the most notable changes was to raise the standard deduction for those who don't itemize from $12,700 to $24,000 for married couples filing jointly (and from $6,350 to $12,000 for individuals). Coinciding with this were reductions in certain itemized deductions—but not charitable contributions.

> *"One of the most notable [tax law] changes was to raise the standard deduction for those who don't itemize from $12,700 to $24,000 for married couples..."*

Based on inflation metrics, the standard deduction for spouses filing jointly for 2023 has increased to $27,700. To illustrate the tax impact of concentrating charitable contributions, we will use Mike and Mary as an example. Mary and Mike typically gift $15,000 each year to charities and their non-philanthropic deductions total $10,000 per year. The two scenarios below show the two-year total deduction impact of bunching their giving. As you can see, if Mike and Mary give their desired amount of $15,000, they can have the same charitable impact but a more attractive tax situation by bunching two years of gifting ($30,000) into one year. Depending on their other deductions, this could benefit them with an additional $12,300 in deductions. This would be worth $4,305 of cash benefits at a 35% tax level.

The same tax-smart approach can be applied to elective (planned) medical costs. Medical

Tax Benefits of "Bunching" Charitable Gifting | Continued on page 5

CASE STUDY: TWO-YEAR DEDUCTION IMPACT OF BUNCHING CHARITABLE GIVING

	Scenario 1: Take the Standard Deduction		**Scenario 2:** Bunch Charitable Giving	
Tax Year	2023	2024	2023	2024
Charitable Giving	$15,000	$15,000	$30,000	$0
Other Deductions	$10,000	$10,000	$10,000	$10,000
TOTAL	**$25,000**	**$25,000**	**$40,000**	**$10,000**
Deduction Type	Standard Deduction	Standard Deduction	Itemized Deduction	Standard Deduction
Deduction Amount	$27,700	$27,700 est.	$40,000	$27,700 est.
TOTAL TWO-YEAR DEDUCTION	**$55,400**		**$67,700**	

Note: This is a hypothetical example and only exists for illustrative purposes. Clifford Swan does not provide tax advice, so please consult your legal or tax advisor about your particular circumstances.

Tax Benefits of "Bunching" Charitable Gifting | Continued from page 4

expenses that are not reimbursed and are above 7.5% of adjusted gross income can be itemized. Of course, medical procedures require more scheduling considerations than tax implications. If scheduling large medical procedures in the same calendar year is logistically realistic, concentrating medical expenses along with charitable deductions in one year and taking the standard deduction in the "off year" could result in an optimal two-year tax situation.

> *"The same tax-smart approach can be applied to elective (planned) medical costs."*

1 Beyond the timing of charitable giving, gifting appreciated stock is almost always a better strategy than gifting cash (subject to certain limitations) and should be reviewed with a qualified tax professional.

STILL WAITING FOR FINAL RMD REGULATIONS FOR INHERITED IRAS

The Internal Revenue Service has again postponed releasing final rules on required minimum distributions for inherited individual retirement accounts. Because of the delay, some beneficiaries of IRAs inherited after 2019 won't be penalized for not taking required minimum distributions in 2023.

Background

There have been many important legislative changes for retirement accounts over the past few years. Notably, in 2019, the SECURE Act eliminated the "stretch-IRA" which had allowed most inheritors of individual retirement accounts to take distributions over their lifetimes. In its place, the new law introduced the 10-year withdrawal rule, requiring many beneficiaries who inherited IRAs on or after January 1, 2020 to empty the retirement account within ten years of the original account owner's death.

The 10-year rule applies to most non-spouse beneficiaries of traditional IRAs. Surviving spouses, children of the account owner until age 21, disabled and chronically ill individuals, and individuals no more than 10 years younger than the original IRA owner can follow the old rules and empty the funds over their lifetimes. Different withdrawal rules apply when the beneficiary is an estate or a charity.

Even the IRS had trouble interpreting the new rules for retirement accounts. An important question was whether inheritors needed to take annual withdrawals over the 10-year period or if they could wait until the tenth year to empty the account. The timing of when the funds are taken out can have significant tax implications. Because withdrawals from inherited retirement accounts are treated as income by the IRS, the ability to time withdrawals with lower income years would be advantageous. Additionally, leaving money in an IRA for longer allows more tax-deferred growth of the account.

> *"The timing of when the funds are taken out can have significant tax implications."*

Evolving Distribution Regulations

In February 2022, the IRS proposed rules requiring inheritors to make annual withdrawals during the 10-year window in cases where the original owner was already taking RMDs. Withdrawals are not required in years one through nine if the original owner had not started taking distributions before death, but the account must still be completely emptied within ten years.

As we've reported before, in recognition of the confusion around the rules, the IRS issued a notice in October 2022 retroactively waiving RMDs for inherited IRAs for the 2021 and 2022 tax years.

In July 2023, the IRS said it would continue to delay enforcement of the new rules. Like the October 2022 guidance, the new release doesn't specifically waive RMDs but instead provides relief from penalties for missed distributions.

While we have clarity for the 2023 tax year, we will need to continue to wait for the IRS to finalize regulations on retirement accounts that need to be emptied within ten years.

SUMMER INTERNSHIP PROGRAM SUCCESSFULLY COMPLETES 8TH YEAR

Cyrus Gaylord and Sophia Wilson

Rising college juniors Cyrus Gaylord and Sophia Wilson participated in the firm's eighth summer internship program. Over the course of six weeks, they completed several projects and learned about portfolio management, securities analysis and research, trading and execution, client service, compliance, marketing, and operations.

Sophia majors in Economics and Dance at Scripps College, where she serves on the board of the Student Investment Fund and is a member of Claremont Women in Business. Cyrus is an Economics major at Claremont McKenna College. On campus, he is a springboard diver and a member of the Student Investment Fund as well as the Claremont Marketing Group.

Gretchen Lee, Jennifer Maqueda, and Dan Mintz conducted the interviews and selected the successful candidates. Jennifer also structured the curriculum, coordinated projects, and met with Cyrus and Sophia weekly.

Cyrus' favorite project was working with Chief Operating Officer David Nelson to streamline data templates, which helped him gain insight into the internal, employee-facing operations side of the firm. Sophia enjoyed stock research, looking deeply into what a company does, its competitors, and financial standing, and sharing her analysis and investment recommendation in a research meeting.

Sophia shared that she gained "practical understanding of not only how an investment counseling firm works, but also how an office and professional job works. It is incredibly valuable to me to understand exactly what each person in the office does—both high-level and day-to-day—and how they contribute to the overall flow and operation of the firm." Cyrus appreciated the welcoming environment and joining team meetings on client service, equity research, and investment counseling.

Clifford Swan is grateful to Sophia and Cyrus for seamlessly becoming part of the team and working hard to achieve an enriching experience for both them and the firm!

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