CLIFFORD SWAN
INVESTMENT COUNSELORS

THE INVESTMENT COUNSELOR
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RATE CUTS AND YOUR BOND PORTFOLIO

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After several years of low interest rates, bond yields have been attractive for the past few years. While a recent turning point in central bank policy has slightly lowered yields, today's bond market offers a unique combination of capital preservation and income in an increasingly complex economic landscape.

Our current fixed income investment strategy is focused on *positioning on the yield curve* and *locking in current yields* as opportunities arise. The yield curve, which plots bond yields across various maturities, normally slopes upward, with longer-term bonds offering higher yields than shorter-term bonds. We can position bond portfolios to take advantage of our expectations on the level, slope, or shape of the yield curve.

In anticipation of further rate cuts, we are purchasing bonds with short- to intermediate-term maturities (approximately one to seven years) that can benefit from a "roll-down" investment strategy where we buy and then sell a bond at a higher price than purchased before it reaches its maturity date to potentially earn a higher overall return. This technique allows us to take advantage of the yield curve's shape normalizing from a downward slope. Additionally, we are looking for attractive opportunities to extend maturities slightly to lock in current yields.

As investors, let's review the economic backdrop that drives our strategy.

Economic Backdrop

As we approach the end of 2024, the economic landscape is defined by easing inflation and a softening labor market, providing the backdrop for the Federal Reserve's recently initiated rate-cutting cycle. With inflation approaching the Fed's 2% target, the Fed cut rates by 0.50% at its September meeting—a move not seen since the start of the pandemic in March 2020. In November, mixed labor market data prompted the Fed to lower short-term interest rates by another 0.25% to a range between 4.50% and 4.75%. The shift from rate hikes to cuts aims to prevent the rate increases of the prior 2½ years from weakening the labor market as inflation eases.

Given a recent uptick in several economic indicators, long-term interest rates have risen notably since the Fed's September and November rate cuts, with the 10-year U.S. Treasury yield climbing from 3.80% to 4.30% as of mid-November. This rise reflects scaled-back expectations for future rate cuts. We expect short-term rates to stabilize around 3.50% by late 2026.

The data-dependent Fed faces mixed economic signals. While the economy is still growing, signs of weakness may support additional cuts. For example, consumer savings rates are at historic lows while consumer debt continues to climb, and persistent geopolitical risks are elevated in the Middle East and Eastern Europe. Furthermore, the ballooning national deficit is a growing concern. With the government's debt-service costs surpassing $1 trillion annually, the size of the deficit is expanding, potentially impacting long-term U.S. economic growth. Finally, it's too early to say, but election-driven policy shifts could lead to significant changes in fiscal priorities, potentially increasing market volatility and reducing investor confidence.

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Let's examine how different components of the bond market are performing against this backdrop:

U.S. Money Market Funds

With interest rates elevated, short-term, relatively high-yielding money market funds have seen increased inflows as investors seek flexible, low-risk options amid economic uncertainty. This suggests that, despite the recent rate cuts,

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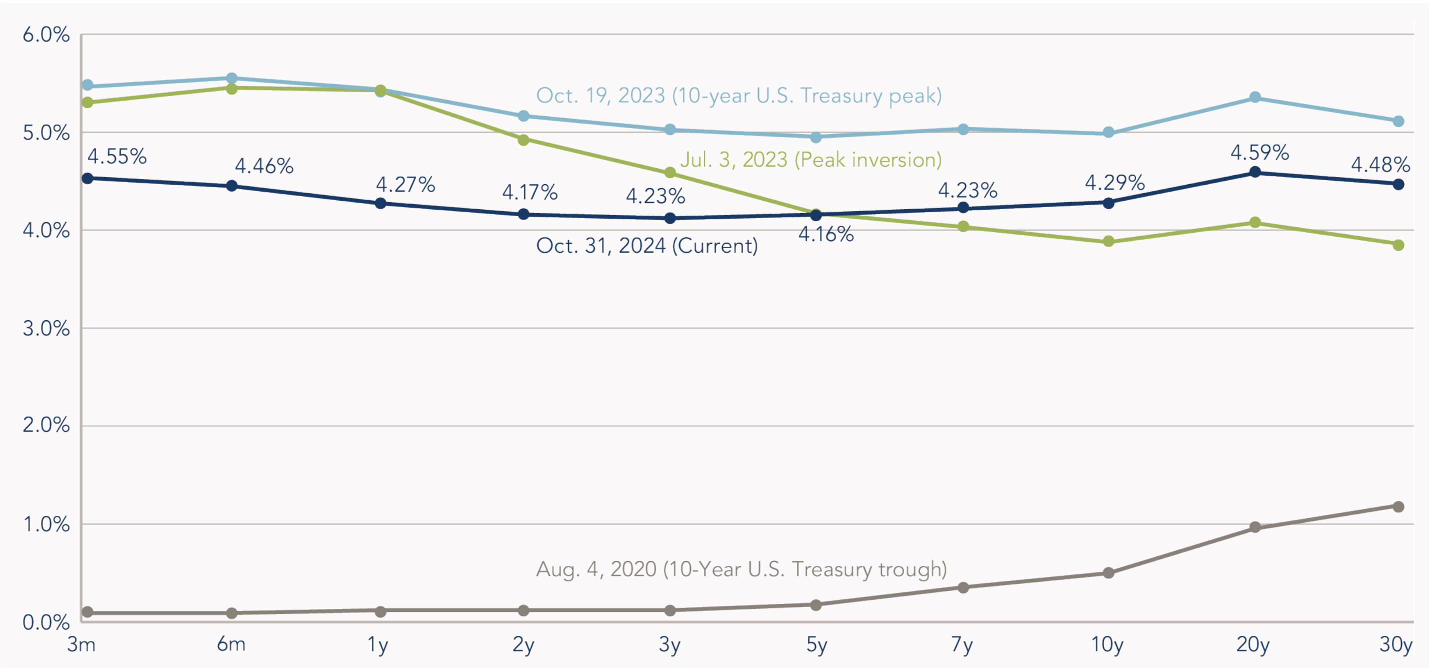
THE YIELD CURVE IS BEGINNING TO NORMALIZE

U.S. TREASURY YIELD CURVE



Source: Bloomberg

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investors prioritize safety and liquidity over riskier assets. This cautious behavior likely stems from market uncertainties that include concerns about potential recessions domestically and abroad, inflation, or geopolitical risks. Money market funds offer investors relatively attractive yields compared to bank deposits.

U.S. Treasury Securities

After being inverted for over two years, the 2/10 yield curve—the difference between the 10-year and 2-year U.S. Treasury yields—finally turned positive in September 2024, signaling a potential positive shift in the economic outlook. The yield curve is inverted when the 2-year U.S. Treasury yield is higher than the 10-year yield. This unusual relationship between short and long-term rates, with investors being paid lower yields for lending money over a longer period, traditionally indicates slowing economic growth. Conversely, today's steepening curve (positive difference) points to stronger future growth and stabilizing inflation.

U.S. Agency Mortgage-Backed Securities (MBS)

Mortgage-backed securities (MBS) are debt obligations that represent claims to the cash flows (both interest and principal payments) from pools of home mortgage loans. With the end of the Federal Reserve's quantitative easing program, wherein the Fed purchased large amounts of government bonds and securities to lower long-term interest rates and stimulate the economy, the agency and mortgage-backed fixed income markets face significantly reduced buying interest from the Fed and banks. With the Fed and banks no longer in the market for MBS securities, investment opportunities have emerged as new home loan origination rates are significantly higher than those on existing mortgages. The rise in mortgage rates affects how quickly borrowers pay off their loans early through refinancing or selling their homes. While old, lower-rate mortgages are being paid off slowly, we expect new, higher-rate mortgages to be paid off more quickly or refinanced as interest rates decline. This shifting trend could influence MBS bond performance and potentially offer investment opportunities in the agency space.

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Corporate Bonds

Compared to Treasuries with similar maturities, corporate credit spreads (which represent what investors demand to be paid to take on additional credit risk) remain tight, and corporate earnings have been resilient throughout 2024. This strong performance signals potential risk, as we believe many current credit spreads do not fully compensate investors for taking on credit exposure in an uncertain economic environment.

Municipal Bonds

With larger issuance volumes in 2024, municipal bond yields have been slower to drop compared to the taxable bond market. This is particularly true for longer-dated callable bonds, which typically compensate investors more than a traditional bond because the issuer has the option to redeem the bond before it reaches maturity. Investors are rewarded for the uncertainty of when the bond will be called. California leads in municipal bond issuance, with $380 billion raised in 2024 through September—a 35% increase over 2023. This surge is driven by infrastructure, education, and capital projects, benefiting from tax-exempt bond advantages in high-tax states like California.

Where We See Opportunities:

Mortgage-Backed Securities: We are targeting mortgage-backed securities with an intermediate term average life to balance stability and performance, positioning some portfolios to capture yield with AAA-rated government credit.

Corporate Bonds: Our corporate bond selections emphasize high-quality, investment-grade issuers, particularly within the financial sector, with short or intermediate maturities. Rather than relying solely on third-party credit ratings, we also perform a thorough analysis of each company's financial position. By doing our own work, we can uncover attractive bonds in a tight-spread market.

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Municipal Bonds: Depending on each client's state of residence, our focus is on tax-exempt, investment-grade municipal bonds. We are specifically interested in those with longer maturities (for example, 10 years) and shorter callable dates (for example, four years). Additionally, we're identifying opportunities in zero-coupon bonds to enhance yield potential while maintaining favorable tax treatment. For municipal issuers, we conduct an in-depth analysis of the municipality's financial statements, debt levels, and economic fundamentals. This deep understanding enables us to confidently assess the ability of each issuer to meet its obligations to bondholders.

Today's higher interest rate environment offers compelling fixed income investment opportunities to consider within a well-diversified portfolio. As always, speak with your investment counselor to determine whether these strategies align with your financial goals.

WRAP UP 2024 ON A HIGH NOTE: YEAR-END CHECKLIST TO BOOST YOUR WEALTH AND LOWER YOUR TAX BILL

Carlota B. Venegas, CFP®, CDFA®
Investment Counselor

As the year winds down, it's the perfect time to pause and take a close look at your financial goals. Even if you've reached some big milestones, there still could be a few valuable moves you can make before year-end. With IRS deadlines approaching, now's the moment to make some proactive choices that could leave you with a lighter tax bill and a stronger financial foundation going into the new year. Let's walk through a few approachable actions to wrap up the year on a high note!

1. Max Out Your Retirement Contributions

One of the most impactful year-end moves? Maxing out your retirement accounts. These

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accounts, like your 401(k) or IRA, offer a double win—building your future and potentially reducing your 2024 taxable income. If you're able to contribute more before the year ends, it's a smart way to cut down on taxes while you're at it.

This year's contribution limits are $23,000 for 401(k) plans (with an extra $7,500 if you're over 50) and $7,000 for IRAs ($8,000 if you're 50+). Check with your employer or investment provider to see how close you are to these limits and consider bumping up your final contributions to reach them.

Tip: Sit down with your investment counselor for a quick strategy session on where to allocate extra contributions, especially if you're expecting a year-end bonus. She or he can help you align your retirement savings with your overall financial game plan!

2. Don't Miss Your Required Minimum Distributions (RMDs)

If you're over 73, it's essential to take your required minimum distributions (RMDs) from accounts like traditional IRAs and 401(k)s by year-end. Missing this step can mean steep IRS penalties. And if 2024 is your first time taking RMDs, you have until April 1, 2025, but remember—you'll have to take two in one year if you wait until 2025, which could bump up your tax bracket.

> *"...if you're already planning on donating, consider how charitable gifts can also give you a tax break."*

Your counselor can help decide the best way to handle your RMDs, whether it's spreading them out or exploring qualified charitable distributions (QCDs) if you're charitably inclined. This way, you can meet your RMD requirement and potentially reduce your taxable income.

3. Make Charitable Gifts or Qualified Charitable Distributions

The holiday season is a time of giving, and if you're already planning on donating, consider how charitable gifts can also give you a tax break. Contributions made by December 31 can lower your 2024 taxable income if you itemize deductions.

If you're over 70½, a QCD from your IRA can let you donate directly to a charity—up to $105,000 without it impacting your taxable income. Not only can this help fulfill your RMD, but it's also a way to give back while saving on taxes.

You also have the option to make a one-time distribution of up to $53,000 to fund a charitable gift annuity (CGA) or charitable remainder trust (CRT), providing you both an income stream and a tax-free withdrawal which can go towards meeting your RMD.

Chat with your investment counselor to ensure your donations make the most impact for you and the causes you care about. He or she can guide you on structuring these gifts to benefit both you and your favorite organizations.

4. Make Gifts to Family Members

One effective way to reduce the size of your estate is through gifting to family members. The IRS allows for an annual gift tax exclusion—currently up to $18,000 per individual in 2024—that you can give to as many people as you wish without incurring federal gift taxes. By making annual gifts to family members, you not only transfer wealth but also reduce the potential estate tax your heirs may face later.

These gifts don't require recipients to pay taxes on what they receive, and by gifting incrementally each year, you can significantly reduce your estate over time without impacting your lifetime gift and estate tax exemption.

Speak with your investment counselor to ensure your gifting strategy aligns with your overall financial goals. Your counselor can help you structure these gifts to maximize tax efficiency and ensure you're staying within the allowable limits.

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5. Consider a Roth Conversion, Backdoor Roth IRA, or 529-to-Roth Transfer

If you're anticipating a lower tax bracket this year—maybe due to a career shift or life change—a Roth conversion might make sense. This involves moving funds from a traditional IRA to a Roth IRA, where future growth is tax-free. You pay taxes now but potentially avoid higher taxes in the future.

For high earners, a backdoor Roth IRA (where you contribute to a traditional IRA and then convert to a Roth) could be a good workaround for Roth contribution limits. Just be mindful of the tax

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implications—your counselor can walk you through it to see if it's the right fit.

As of January 1, 2024, you can use up to $35,000 of unused funds in a 529 college savings account to make tax and penalty-free rollovers to a Roth IRA. This transfer has an annual contribution limit tied to regular IRA contribution limits, allowing for a gradual rollover while still enabling those funds to benefit from tax-free growth. It's a valuable new flexibility for repurposing leftover 529 savings if education expenses were less than anticipated.

6. Harvest Gains and Losses from Your Investments

If you have underperforming investments, tax-loss harvesting might help balance out gains from other areas, lowering your tax bill. On the flip side, if this has been a year with lower income, it might be smart to use tax-gain harvesting and realize gains while in a lower tax bracket.

Your investment counselor can help you evaluate which strategy best fits your overall financial picture and execute any necessary transactions.

7. Make Use of Your FSA Funds

Do you have a Flexible Spending Account (FSA)? These accounts are usually "use-it-or-lose-it," so if you have remaining funds, now's the time to use them. Some plans have a grace period but double-check the rules specific to yours.

"It's a valuable new flexibility for repurposing leftover 529 savings if education expenses were less than anticipated."

Consider using these funds on health supplies, medical expenses, or dependent care. If you're not sure what's eligible, your counselor can help clarify and plan a quick spending strategy for you.

8. Reflect on Your Financial Goals and Schedule a Year-End Review

Taking a moment to look back at the progress you've made this year can be empowering. Are there areas where you met or exceeded your goals, and others where you'd like to make a fresh start? Reviewing your goals—whether it's planning for retirement, a big purchase, or an education fund—keeps your financial life aligned with where you are today.

This time of year, sitting down with your investment counselor to discuss your goals and any new strategies is a proactive step that can keep you on track as life changes and set you up to enter the new year feeling confident and prepared. A quick check-in can help ensure your tax strategy, investments, and goals align for a successful start to 2025.

For Clifford Swan clients, please also refer to your year-end reminders for more details on these strategies and other tasks for closing out the year.

PROTECT YOUR ASSETS FROM PHISHERS

We've written before about protecting yourself from financial fraud and encourage you to keep this threat in mind. As technological advances have improved our lives in many ways, an unfortunate side effect is technology's role in helping cybercriminals construct more sophisticated financial scams.

Recently, some of our clients have experienced more advanced phishing attempts that use the names of their custodians. Phishing is a cybercrime that involves sending fake communications that appear to come from a trusted source to trick people into revealing sensitive information.

While Clifford Swan and third-party providers like Charles Schwab and Fidelity have mechanisms in place to help safeguard your data and accounts, there are practical steps you can take to protect your identity and assets:

- Do not click on links or attachments in emails and text messages if you doubt the authenticity of the sender. Instead, type the web address in your browser.
- Hover your mouse over links to reveal the site's full URL.
- Check the sender's domain name in the email address to see if it matches what you would expect to see.
- Call us immediately if you suspect a breach or fraud.

Please talk with us to learn about more prevention strategies. You can also read the article we published this past May on protecting against AI-driven financial fraud.

MESSAGE FROM THE CEO

Peter J. Boyle, CFA
Chief Executive Officer

The holidays have come early at Clifford Swan, as we've received the gift of new team members. Given our people are a key component of what makes Clifford Swan strong, we are excited to share a few team updates.

Bolstering Operations

Early in 2024, we identified a need to expand our operations team to free up capacity for high-impact technology projects and deliver the best possible operational support to our client-facing teams. We've fulfilled this need through the promotion of Diane Riveros and the addition of Jesse Cortes as Operations Specialists.

Diane joined us nearly two years ago as a receptionist and quickly made her mark. Her new duties include assisting with the firm's ongoing corporate accounting responsibilities, front-line user support for our client database software, and various compliance items. Jesse brings direct experience with the software we use to manage client portfolios, proficiency in managing datasets, and accounting expertise for private real estate investments. His focus includes reconciling transactional data and serving as the point of contact for our portfolio accounting software and as a backup trader.

With Diane's promotion, Janelle Vidal has joined as our new receptionist. We've all appreciated her positivity, attention to detail, and willingness to go above and beyond for others.

Research Team

We recently had the opportunity to add Daniel Cheng to our research team. He has a strong institutional investment background, including 11 years at Sands Capital Management in Virginia, where he helped lead investments in healthcare companies across the U.S., Europe, and Asia. With his unique skillset, Daniel will support various areas of our investment offering including stock research, manager research, and asset allocation.

Daniel is working with us on a part-time basis ahead of a cross-country move in early 2025 with his wife Becca and their two young children.

A New Chapter

After nearly 30 years at Clifford Swan, Ken Dike is stepping back from the day-to-day responsibilities of managing our planned giving program. Moving into 2025, Ken will transition to a consulting role, allowing us and our clients access to Ken's knowledge while allowing him the personal flexibility of retirement. We wish Ken a wonderful retirement with his wife Melissa.

We are very grateful to Ken for three decades of dedication to building our planned giving offering. He has been integral to our success in this area and leaves us in a good place to carry on without his daily involvement.