CLIFFORD SWAN
INVESTMENT COUNSELORS

THE INVESTMENT COUNSELOR
MAY 2023

MARKET UPDATE: SHORT-TERM PESSIMISM, LONG-TERM OPTIMISM

Daniel J. Mintz
Principal, Equity Analyst

Around the time of the Global Financial Crisis (GFC), a guest comedian on *Late Night With Conan O'Brien* poked fun at airline passengers who complained about boarding difficulties and tarmac delays. The comedian pointed out that if these passengers would just focus on what happened next—participating in the "miracle of human flight"—they might appreciate that a coast-to-coast flight in six hours is an impressive outcome despite some inconveniences along the way. The anecdote came at a time when the world needed a dose of optimism.

There are parallels to today's investment backdrop. For more than a year, the mainstream media has been predicting that a recession is right around the corner. Results from the Bank of America Fund Manager Survey (FMS), which quantifies professional investors' perception of risks to financial stability due to the business cycle, the credit cycle, geopolitics, and several other factors, have looked similar to 2008-2009 levels for the past year. Pessimism is alive and well. However, as much as a slowing economy may lead to delays on the runway in the short term, there are several structural reasons why we could be in for a pleasant flight over the long run.

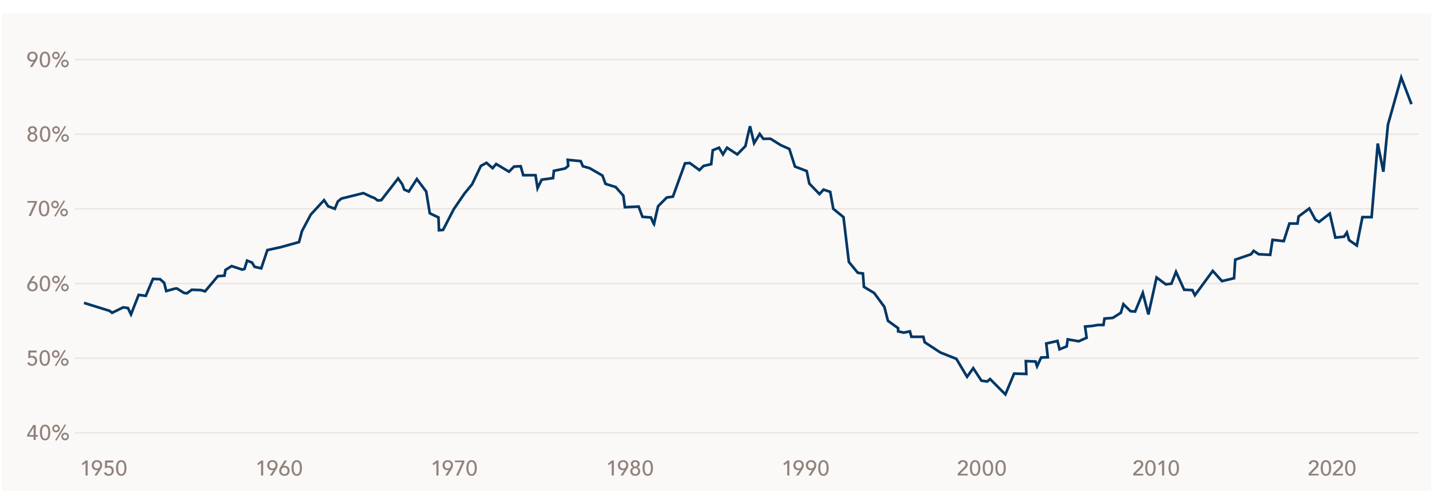
As of the spring of 2023, there's little doubt that we're starting to see some economic softness. Recent earnings from companies exposed to interest-rate-sensitive areas of the economy like construction point to early signs of a slowdown. The retail

"...there's little doubt that we're starting to see some economic softness."

Market Update: Short-Term Pessimism, Long-Term Optimism | Continued on page 2

U.S. HOUSEHOLDS STILL HAVE PENT-UP SAVINGS

U.S. HOUSEHOLD DEPOSITS AS A PERCENT OF PERSONAL DISPOSABLE INCOME



Note: Household and nonprofit organizations' checkable deposits, currency, and time and savings deposits as a percent of personal disposable income.
Source: BCA Research

Market Update: Short-Term Pessimism, Long-Term Optimism | Continued from page 1

and technology sectors have seen layoffs as customer demand has moderated. When it comes to the economy's financial engine, rising interest rates have weakened

"...the factors that brought us here—namely the pandemic and select stimulus initiatives—created some long-term structural tailwinds..."

the balance sheets of numerous banks, restricting their willingness and ability to lend. Granted, the country's largest banks still appear healthy. Loan-loss provisions are rising, but they're not yet near the levels seen during the Great Recession or the pandemic. Regardless, according to Citigroup CEO Jane Fraser: "It's now more likely that the U.S. will enter into a shallow recession later this year." That logic seems sound to us.

The resilient consumer could be a double-edged sword. Flush with cash from pandemic-driven stimulus (see the chart on the previous page), the average consumer may be able to withstand a sluggish economy for longer than usual. But there's a chance this dynamic could simply delay the decrease in demand and resulting job market cooling necessary for the Federal Reserve to make monetary policy more accommodative. Accordingly, the uncertainty around when the next leg of the economic cycle will arrive could persist for some time.

And so despite the current environment lending itself to "more pessimism for longer," the factors that brought us here—namely the pandemic and select stimulus initiatives—created some long-term structural tailwinds that we can look forward to as investors. Two of these in particular are the "re-shoring" of U.S. manufacturing production and the modernization of U.S. infrastructure. These themes stand to benefit the U.S. economy as a whole as their effects reverberate through multiple industries.

Re-shoring refers to U.S. businesses bringing production home, or at least preventing it from centralizing in regions with growing geopolitical risk. UBS Research compiled a list of 222 companies that have announced plans to expand their supply chains into the U.S. as of late last year, and it's a who's who of manufacturing leaders. Semiconductor titans Intel and Taiwan Semiconductor make the list. So do automobile manufacturers Toyota, Volkswagen, and Honda. Defense prime contractors Lockheed Martin, Northrup Grumman, and Raytheon Technologies are named. Perhaps the largest cohort is the general industrial companies that supply these firms, such as BASF, Panasonic, and Parker Hannifin. What began as a buzzword during the pandemic has evolved into what appears to be a sustainable trend.

While a case can be made that re-shoring may lead to higher manufacturing costs, negating any economic benefits, we've seen some recent arguments to the contrary. The International Economic Development Council found that as far back as 2010, the cost savings associated with off-shoring began to erode due to higher labor and transportation expenses as well as unforeseen costs in monitoring, quality control, and intellectual property protection. More recently, snarled supply chains disrupted the economy significantly toward the end of the pandemic. Re-shoring reduces the risk of that happening again. Further, advances in automation technology have reached the point where domestic manufacturing can be more cost-competitive with off-shore production despite the additional jobs domestic production will create. And finally, when it comes to those new jobs, there will likely be a multiplier effect across the economy. The Economic Policy Institute claims that for every manufacturing job brought back to the U.S., seven new jobs are

"...U.S. re-shoring and infrastructure re-development may boost the economy incrementally in the coming years..."

created in other industries. Although the economy has many moving parts and no one knows the second and third order effects of re-shoring with certainty, hundreds of companies are voting with their feet.

The problems with U.S. infrastructure (e.g., roads, bridges, waterways, electrical grids) have been well-known for years, but several legislative initiatives may mean the cavalry is on the way. The Infrastructure Investment and Jobs Act (IIJA), signed by

Market Update: Short-Term Pessimism, Long-Term Optimism | Continued on page 3

Market Update: Short-Term Pessimism, Long-Term Optimism | Continued from page 2

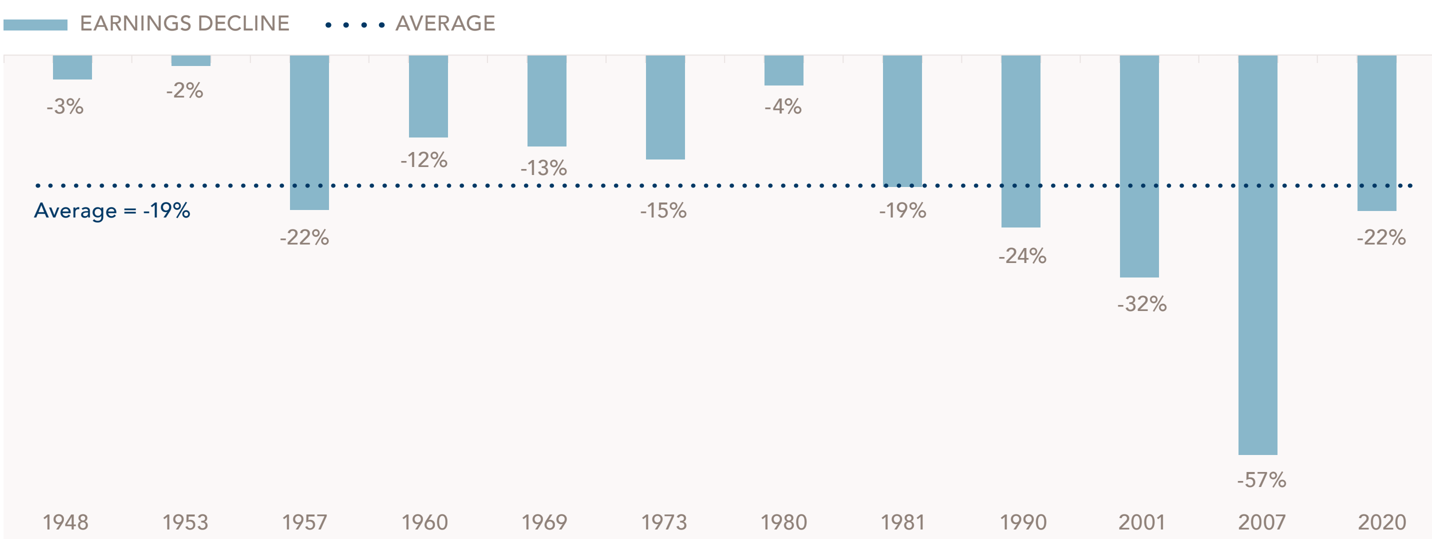
President Biden in November 2021, is finally beginning to work its way into state-level projects. The IIJA authorized $550 billion in incremental spending over five years, backloaded after 2026. California has reported $14 billion of transportation funding so far, on its way to a forecasted $42 billion. The Federal Highway Administration has allocated $60 billion in IIJA funds for roads and bridges across all 50 states this year. The CHIPS and Science Act, signed into law in August 2022, carves out $280 billion for domestic semiconductor manufacturing and R&D. Eight new semiconductor projects have already broken ground, largely in Arizona and Texas, totaling $100 billion in estimated total spend (though much of this will be funded privately). And the Inflation Reduction Act, also signed in August 2022, apportions $251 billion for energy infrastructure, $58 billion for manufacturing projects, and $23 billion for transportation and electric vehicle investments. From August through December of last year, over $40 billion of new grid-scale clean energy projects had been announced. Even though U.S. GDP measures in the trillions, these are large numbers when taken together. In addition to the jobs these initiatives may bring, suppliers into the industrial economy—many of them public companies—are eager to begin reaping the benefits.

Although U.S. re-shoring and infrastructure re-development may boost the economy incrementally in the coming years, it's still difficult to forecast the breadth and depth of the current slowdown. We note that the base case is that it won't be as severe as the GFC, or even the pandemic-driven recession. Looking purely at S&P 500 earnings declines around the past 12 downturns, the average drop is 19%, which can be compared to the 22% decline during Covid and the 57% plunge during the financial crisis (see the chart below). For those of us invested in the U.S. economy, an average recession seems palatable versus the recent past. Lengthening our analytical horizon to where we can visualize what may happen coming out of a downturn further lowers our heart rates.

> *"Lengthening our analytical horizon to where we can visualize what may happen coming out of a downturn further lowers our heart rates."*

Importantly, a backdrop characterized by near-term weakness followed by long-term strength creates opportunities to find attractive investments. Market participants that don't take a multi-year time horizon sometimes leave behind companies at attractive prices when viewed through the lens of long-term earnings potential. Our process at Clifford Swan is designed to take advantage of those opportunities on behalf of our clients.

S&P 500 EARNINGS DECLINES AROUND RECESSIONS



Source: Truist Advisory Services

OPPORTUNITIES FOR MAXIMIZING EDUCATION AND RETIREMENT ACCOUNTS

George E. Hasbun, CFP®
Principal, Investment Counselor

The cost of education has never been higher. According to the National Center for Education Statistics, the cost of education has increased by two times the inflation rate since 2000. Despite the increase in education costs, tax-advantaged 529 savings plans, which are the primary savings vehicle for education, have been underfunded by most Americans.

"...the cost of education has increased by two times the inflation rate since 2000."

Concerns about having leftover funds in an education account after paying for the cost of education are the primary reason for this shortfall.

Overfunding an education plan has historically been a risk because nonqualified withdrawals from a 529 plan are generally subject to income taxes and a 10% penalty on earnings. These potential penalties have led to families hesitating, delaying, or declining to fund 529s to the levels needed to pay for the rising cost of education. Families were worried about putting too much money into the plans. *What if my child gets a scholarship? What if they don't go to college? What if my sacrifice and savings get penalized if a non-education-related withdrawal is necessary?* Recent legislation helps to address these hesitations.

New Rules for 529 Plans

Secure Act 2.0 is not the sequel to last summer's blockbuster action movie. Rather, it's the recent law passed in December 2022 which specifically addresses the risks of overfunding a 529 plan. The law allows excess funds in 529 education plans to be rolled over into the beneficiary's Roth IRA.

"[Secure Act 2.0] specifically addresses the risks of overfunding a 529 plan."

Roth IRAs offer attractive qualities compared to traditional individual retirement accounts. Unlike traditional IRAs, contributions to a Roth IRA are made with after-tax dollars, meaning that you pay taxes on

Opportunities for Maximizing Education and Retirement Accounts |
Continued on page 5

COMPARING ROTH AND TRADITIONAL IRAS

	ROTH IRA	TRADITIONAL IRA
CONTRIBUTIONS	Contributions made with **after-tax dollars** Contributions **permitted** after age 70.5	Contributions made with **before-tax dollars** (if ***not*** covered by a work-sponsored retirement plan) Contributions **not permitted** after age 70.5
2023 MAXIMUM YEARLY CONTRIBUTION (Must have earned income)	$6,500 (plus an additional $1,000 if age 50 or over) Unlimited Roth conversion amounts	$6,500 (plus an additional $1,000 if age 50 or over)
TAXATION OF WITHDRAWALS	Non-taxable withdrawals if taken after age 59.5 and account is open 5 years. There are exceptions to the early withdrawal penalty, such as a first-time home purchase, college expenses, and birth or adoption expenses.	Withdrawals of contributions **and** earnings subject to federal/state income taxes
REQUIRED DISTRIBUTIONS	Distributions **not required** while owner is alive	Must withdraw **required minimum distribution (RMD)** starting at age 73 if you were born between 1951 and 1959, and age 75 if you were born in 1960 or after

Opportunities for Maximizing Education and Retirement Accounts |

Continued from page 4

the money you contribute to the account in the year that you earn those funds. However, the contributions and any earnings grow tax-free, and you can withdraw the money tax-free in the future, as long as you meet certain requirements. Tax-free growth and tax-free withdrawals in retirement can be a huge advantage, especially if you expect your tax rate to be higher in the future. Additionally, starting a Roth IRA early, like in the case of rolled over 529 plans, provides more time for the money to compound and allows the account owner to eventually withdraw funds without giving a portion of the withdrawal to the tax man.

"The new ability to move 529 assets to a Roth IRA without penalties provides families with interesting planning opportunities."

There are a few important restrictions to your ability to roll over funds from a 529 plan to a Roth IRA to consider:

- $35,000 lifetime cap on transfers.
- The 529 plan must have been open for 15 years or longer.
- The beneficiary must have earned income up to the amount you plan to convert to a Roth IRA.
- Rollovers can only be made to the beneficiary's Roth IRA (not to the account owner, who is typically the parent).
- The annual limit for how much can be rolled into a Roth is the current Roth annual contribution limit, which for 2023 is $6,500.

Strategies for 529 Plans

The new ability to move 529 assets to a Roth IRA without penalties provides families with interesting planning opportunities. For example, upon the birth of a new grandchild or child, you can open and begin funding a 529 plan. The maximum annual contribution in 2023 is the same as the gift tax exemption, which is $17,000. For families seeking to reduce their taxable estate (remember that estate and gift tax exemption levels are defined by law and can change), a technique called "super funding" whereby you contribute five years' of contributions at once ($85,000 in 2023) can be used to reduce the size of your estate and get money into an education plan while taking advantage of current gifting limits. Taking this a step further, as soon as the 529 plan beneficiary reaches 16 years old, you can begin rolling out the annual limit ($6,500 in 2023) into a Roth IRA for the beneficiary and begin the long runway of tax-free growth for the young beneficiary to draw from in retirement. The remaining funds can be allocated to education expenses. Thanks to the power of compounding over a long period, Roth IRAs can grow to significant amounts if properly invested, with the added benefit of withdrawals in retirement being tax-free.

Consider Roth Conversions Before 2025

Roth IRAs can also be a powerful tool for many of our clients that aren't funding education. As outlined above, the cost of admission for gaining entry to tax freedom is paying the tax now. The thought of paying tax now versus later runs counter to widely held financial guidance and human instinct. But, if paying tax now allows you to prosper later, then a Roth conversion should be considered. Your investment counselor can help advise you on the key decision point between a traditional and Roth IRA which is: *Will you be in a lower or higher tax rate in the future?* In your conversations with your investment counselor, you can project your current and future income to determine if a Roth conversion could be right for you.

"...the cost of admission for gaining entry to tax freedom is paying the tax now."

The tax breaks established by the Tax Cuts and Jobs Act of 2017 are set to expire in December 2025. These cuts lowered taxes for many taxpayers below long-term historical averages. It's impossible

Opportunities for Maximizing Education and Retirement Accounts |

Continued on page 6

Opportunities for Maximizing Education and Retirement Accounts |

Continued from page 5

to predict future tax rates, but with a budget deficit, a slowing economy, and higher interest rates, higher future tax rates are likely. Beginning a Roth conversion plan over the next couple of years

"It's impossible to predict future tax rates, but with a budget deficit, a slowing economy, and higher interest rates, higher future tax rates are likely."

can provide you with the tax diversification options you need in the future. Without a Roth account as an option, every distribution from your tax-deferred retirement account—whether an IRA, 401(k), 403(b), 457(b), or Thrift Savings Plan—is taxable. Having the Roth option at your disposal can provide several advantages in your future retirement planning.

Let Your Money Grow

Roth IRA conversions help avoid required minimum distributions (RMDs). RMDs are mandatory withdrawals from traditional IRAs that you must take starting at age 72. For those born between January 1, 1951 and December 31, 1959, the RMD age was recently extended to 73. For those born after January 1, 1960, the RMD age was extended to age 75. The extension of the RMD age allows tax-deferred accounts to continue to grow, but with that growth comes the consequence of larger required distributions which will entail higher taxes. These required withdrawals can be a burden for some people, especially if they don't need the money. With a Roth IRA, there are no RMDs, so you can let your money continue to grow tax-free for as long as you like.

Roth IRAs as an Estate Planning Tool

A Roth IRA conversion also offers estate planning benefits. When you pass away, your beneficiaries will inherit your Roth IRA tax-free. While they are still subject to the 10-year withdrawal rule introduced by the original Secure Act, the distributions will not be taxed. This can be a huge advantage, especially if your beneficiaries are in a higher tax bracket than you

"Beneficiaries are often in their prime earnings years, so not being faced with additional taxable income is a big benefit."

were. Beneficiaries are often in their prime earnings years, so not being faced with additional taxable income is a big benefit. With the elimination of the stretch IRA (a pre-Secure Act estate planning strategy that could extend the tax-deferral benefits of an inherited IRA for generations), converting funds to a Roth for your beneficiaries will help lower taxes and provide them with tax-free money when you are gone.

Your investment counselor can help you consider if a Roth conversion is appropriate for your financial situation.

CLIFFORD SWAN
INVESTMENT COUNSELORS

Officers

Peter J. Boyle, CFA
Chief Executive Officer

Kenneth H. Dike, Esq., CPA, CLPF
Executive Director of Planned Giving Services

Kathleen Gilmore, CFP®
President and Chair

Gretchen E. Lee
Chief Compliance Officer

David J Nelson
Chief Operating Officer

Investment Counseling Team

Kevin J. Cavanaugh
Austin H. Gewecke
Roger L. Gewecke, Jr., CFA
George E. Hasbun, CFP®
Murcy Huang, CFA
Anil Kapoor, CFA
David Y. Lin, CFA
Daniel J. Mintz
Maxwell R. Pray, CFA
Carlota B. Venegas, CFP®, CDFA®
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA, CAIA®

Contact

177 East Colorado Blvd., Suite 550
Pasadena, CA 91105
T: 626.792.2228 | F: 626.792.2670
www.cliffordswan.com