Setting Sail
Second Quarter 2023

Still Waiting on the Recession that is always six months away

The conclusion of the first quarter of our new year is a good time to recall what has happened from an economic and market perspective. After all, looking back at what has happened is always easier than guessing what will happen in the future. Most of the developments have been positive. The economic indicator on everyone's minds is inflation and the progress has been good. After reaching its peak in June of 2022 at an annual rate of 9.1%, the Consumer Price Index (CPI) has been working its way downward and came in at 5.0% in March of 2023. A large contributor to the decrease in overall inflation is the sharp decline in energy prices which have been volatile historically. If energy prices increase, the overall inflation rate will increase too.

Two main forces are working together to bring down inflation. First, the Federal Reserve has moved quickly in the last year to raise interest rates. The Fed Funds rate has gone from 0% to 5% in just over a year, and many other interest rates have followed. Also, for the first time since the 1980s the supply of money (M2 if you remember your economics class) has been shrinking and taking inflation down with it. So far, the Fed's plan has worked the way they hoped it would.

While short-term rates have risen substantially, intermediate-term rates have fallen slightly this past quarter. The 5-year US Treasury bond rate fell from 4.0% at the end of 2022 to 3.6% on March 31st, and the 10-year rate fell from 3.9% to 3.5% over the same period. The scenario we find ourselves in, where short-term rates are higher than longer-term rates, is called an inverted yield curve and has been a good, but not perfect, predictor of recessions. Of course, it has been inverted for over a year now, and the impending recession always seems to be six months away.

While we have been waiting, we have seen some reasonably good results in the equities markets. Stocks have risen from the stock market low set on October 12, 2022, and it remains the low point six months later. Stock market volatility is at its lowest point since 2021.

Setting Sail is written by **Alan S. Campbell, MBA, CFP®** and published quarterly by **Spinnaker Financial Advisors, LLC,** a Registered Investment Adviser. The firm provides ***fee-only*** wealth management services, including investment advisory and management services and comprehensive financial planning and consulting.

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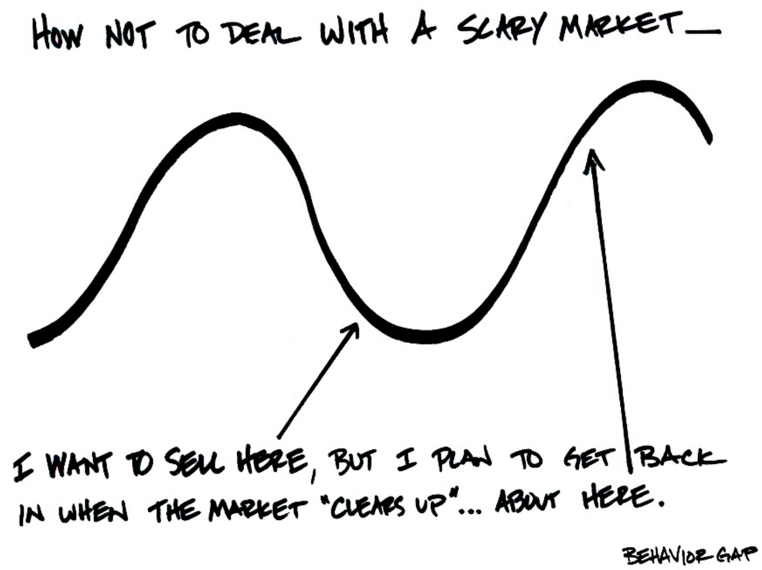
The S&P 500 companies paid dividends in 2022 that were 11% higher than their dividends in 2021. This would seem to indicate that they were still profitable even as the investing public discounted the earnings potential of America's great companies.

So how do we explain the relatively solid market performance so far this year when every economist is predicting that a recession is inevitable? Furthermore, what should we do if we know (or think we know) that a recession is coming? What matters in the short to intermediate term is (a) how deep the recession goes in terms of driving down GDP, (b) how long it lasts, and (c) how significantly corporate earnings take a hit as a result of the recession. Unfortunately, even if we knew that a recession was coming, knowing the details of when, how long, and how deep are supremely unknowable.



What we can know is that, like all recessions, even if it does come it will be temporary. And we can be sure that secular growth (and marvelous compounding) of the great companies of America and the world is something we can't miss out on even if participating in the miracle of compounding means holding on during downturns that we think we see coming.

Another thing we can know right now is that even if we don't know if a market selloff will occur, how long or deep it will last, we know that if it does happen, we will tell ourselves that we saw it coming and we didn't do anything about it. Then we will beat ourselves up for "knowing" and not avoiding it. As time moves forward and turns our tomorrows into yesterdays, the cloudy future becomes the certain past. It will be very easy to tell ourselves, now that we know what happened, that we knew before it happened. But we don't know the future now, and after it all plays out, we still didn't know until we knew.

If we do want to know what the future holds, the most reliable way to make predictions is over the long term. Markets have ups and downs and various catastrophes of the month, but they tend to balance out over time. In the thirty years ending in 2022, the cost of living increased 2.2 times while the S&P 500 cash dividend increased 5.3 times, and the index increased nine times. You can pick any 30-year time period and the results will be reasonably close. The problem that most investors are trying to solve for, keeping up with inflation so that they can continue to provide for their needs as costs rise, has a solution and the solution is that equities beat inflation over time.

The best way to have completely missed this opportunity was (and is) fixating on the short to intermediate term randomness of equity prices. Many investors overreact to the equity market's random and historically temporary price declines. They sell their long-term equity holdings at panic prices and end up buying them back (if at all) at much higher prices when the panic subsides.

We may be going into a time of turbulence, or we may not be. If it is turbulent, we won't know how bad or how long it will be. But we do know that it will be temporary.

Recent Changes to Retirement Tax Law

The last few months and even the last few years have been busy for retirement planners as retirement-focused tax law changes have been made. This is a summary of the most important changes and how they may affect you.

End of the Stretch IRA for IRA Beneficiaries

In December 2019, Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act. This act made several changes to the retirement planning landscape, the largest of which was new rules for Inherited IRAs. Inherited IRAs (or Beneficiary IRAs) are IRA accounts inherited by a beneficiary after the death of the account owner. Under the previous law, beneficiaries of Inherited IRAs were allowed to stretch out the distributions over their lifetimes, which allowed them to minimize the tax impact of the distributions. Under the SECURE Act, beneficiaries of Inherited IRAs must distribute the entire balance of the IRA by the 10th year after the death of the IRA owner if the owner died after 2019.

In February 2022, the IRS issued proposed regulations interpreting the new RMD rules changed by the SECURE Act of 2019. Specifically, they addressed the new 10-year rule for non-spouse beneficiaries of IRAs for those who passed away in 2020 or later. Many IRA owners assumed that this rule simply indicates that the entire IRA must be distributed by the tax year that includes the 10-year anniversary of the death of the original IRA owner. In that case, an IRA beneficiary could skip making distributions in some or even all of the first nine years and distribute all the funds in the tenth year. However, the new IRS regulations stipulate that IRA beneficiaries must take RMDs each tax year and that the entire remaining balance must be withdrawn in year 10.

This potentially creates a problem for IRA beneficiaries who have not made annual RMDs, as the guidance wasn't released at that time. In October 2022, the IRS published a notice stating there would be no penalty for missing Beneficiary IRA RMDs in 2021 and 2022. Now that the word is out, though, the new rules apply in 2023 and thereafter. To be clear, if you are the beneficiary of an IRA and the original owner died before 2020 or was your spouse, the 10-year distribution rule does not apply.

SECURE Act 2.0

Three years to the day after the SECURE Act was passed, Congress followed up with more changes in December 2022 to retirement planning known as Secure Act 2.0

Increased Age for Required Minimum Distributions (RMD)

The change with the largest impact is the adjustment of the age of Required Minimum Distributions (RMD) for IRA and qualified retirement account owners from age 72 to age 73. Investors born in 1960 or later will not be required to start RMDs until age 75. For context, the original RMD age of 70 ½ was established in 1986 and had remained that age until the first SECURE Act in 2019. This is good news for taxpayers who have extra time to make Roth conversions or other tax-planning moves before they are required to take funds from their tax-deferred accounts.

Reduction of the 50% RMD Penalty

Starting with the 2023 tax year, the penalty for not meeting the Required Minimum Distribution has been reduced from 50% to 25% of the shortfall. In addition, the penalty can be reduced to 10% if the shortfall is rectified before the IRS sends a notice of deficiency or assesses a tax.

Qualified Charitable Distributions (QCD) Age Requirement
Sometimes the biggest news in a new bill are the provisions that stay the same. When the original SECURE Act of 2019 was passed, it changed the RMD age from 70 ½ to 72, but did not change the age of eligibility to make Qualified Charitable Distributions (QCD). These are IRA distributions that are made directly to a charity. Amounts donated to charity in this way are excluded from taxable income and provide relief for taxpayers who take the standard deduction and do not itemize their deductions. In addition, having a lower income can affect how much Social Security is taxable or even how much Medicare recipients are charged for Part B insurance.

With this new SECURE 2.0 bill extending the RMD age to 73 or 75, the QCD age remains the same at 70 ½. This is welcome news for IRA owners who can start making their charitable donations from their IRA accounts before their RMD age. It should be noted that Qualified Charitable Donations are only eligible once an IRA owner reaches their age 70 ½ instead of the calendar year in which this age is met.

In the last few years, a confluence of tax law changes has made the QCD an excellent strategy. In 2017, the standard deduction was doubled so fewer people are choosing to itemize their deductions. In 2019, the SECURE Act changed the stretching of IRA distributions for non-spouse beneficiaries of IRA accounts from over their remaining life expectancy to just ten years. In other words, sometime between now and ten years after your life and your spouse's life, all of the funds in your Traditional IRA, Traditional 401(k), and other tax-deferred accounts will be taxed to you or your heirs. The QCD represents a unique opportunity to remove funds from Traditional IRAs without being taxed. If you are aged 70 ½ or older, have an IRA account, and regularly make charitable donations, making these donations from your IRA makes a lot of sense, even if you are younger than your RMD age.

529 College Savings transfers to Roth IRAs
Another interesting provision in the SECURE 2.0 Act is the ability to make limited transfers from 529 college savings accounts to a Roth IRA. This feature will become available in 2024 and has a number of conditions. To be eligible, the Roth IRA receiving the transfer must be in the name of the beneficiary of the 529 plan. The 529 plan must have been maintained for 15 years or longer. Contributions made to the plan in the last five years are ineligible. Any funds moved from the 529 plan to the Roth IRA will reduce the amount the Roth IRA owner can contribute to their Roth or Traditional IRAs. Finally, the maximum amount that can be transferred in a lifetime is $35,000.

This provision provides a solution to the long-asked question of what to do with 529 plan funds if the beneficiary didn't use all the funds for their education. This has stopped a number of people from opening and funding 529 plans and should help drive more dollars into these investment vehicles.

I think the beautiful part about it is everyone experiences different pains, everyone experiences different agonies of life, but you decide if you want to learn from it. You decide if you want that to be a teachable moment. I know I do.

--Jalen Hurts (1998-)
American football quarterback for the Philadelphia Eagles