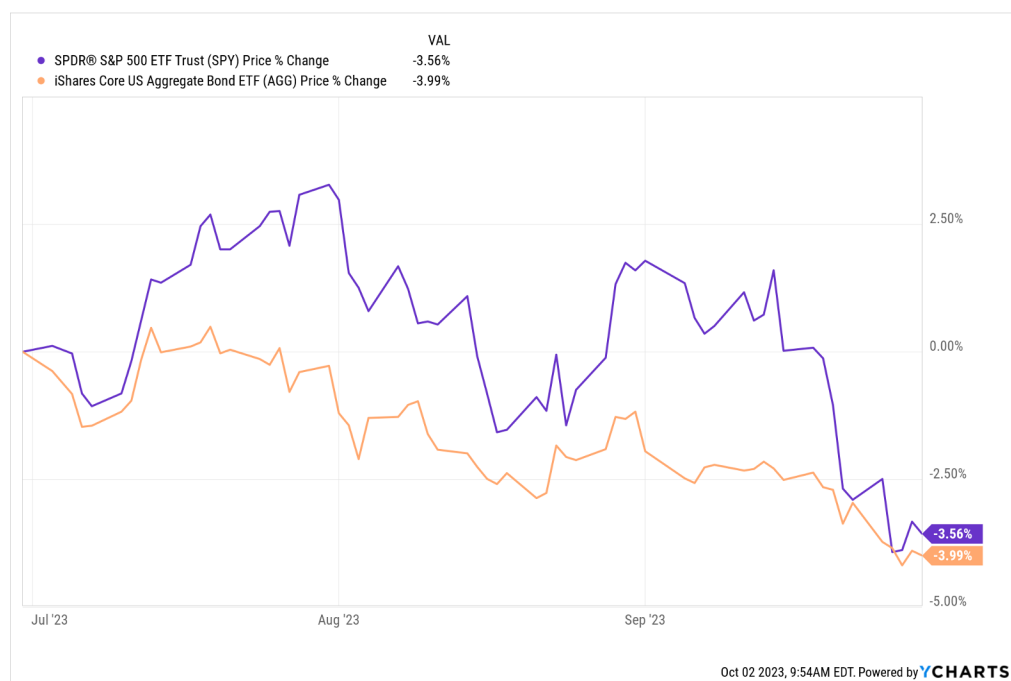




It's Still All About Rates by Robert Sokolowski

The third quarter came in like a lamb and went out like a lion. Stocks had the winds of stronger than expected earnings and stable interest rates at their backs for most of the month of July. As earnings season started to wind down, investors' attention turned squarely to interest rates, which began to rise sharply.

The benchmark 10-year treasury yield rose from 3.86% to 4.57% during the quarter- with virtually all the increase coming in August and September. That might not sound like much, but it is an 18.4% increase in just three months- in a market that is known for stable prices and slow rates of change. This increase in rates caused both bonds and stocks to sell off during the quarter (bond prices move inversely to their yields). As you can see in the chart below, the S&P 500 and the aggregate bond index have been highly correlated over the last three months.



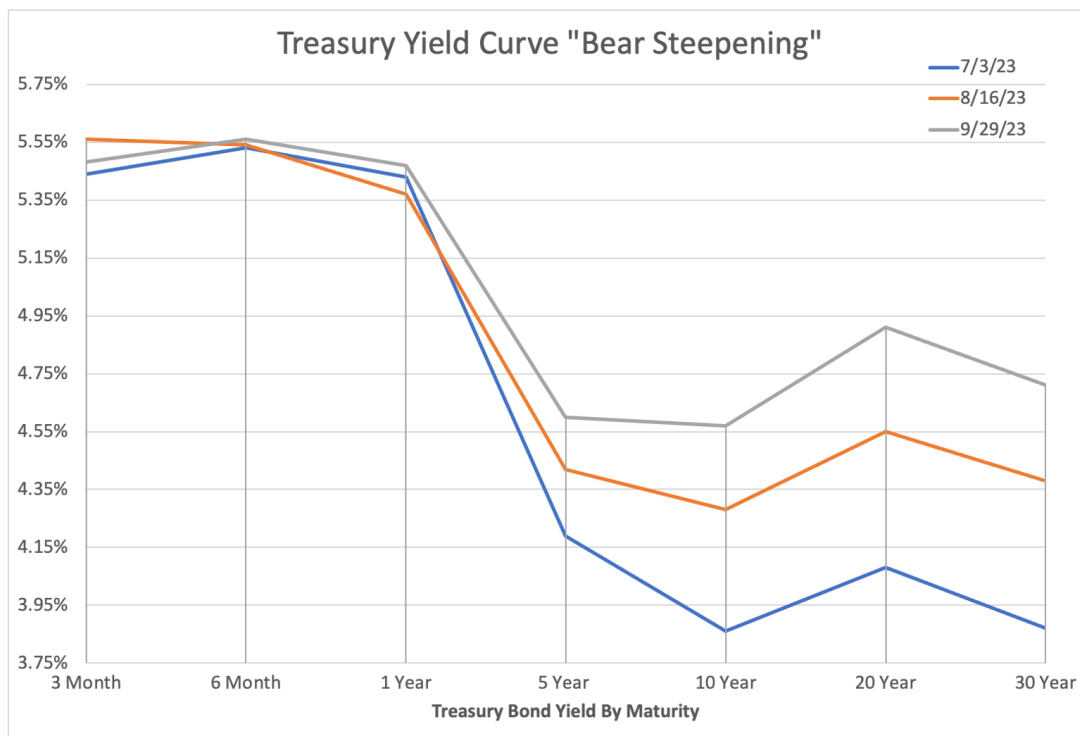
Taking a more technical look at rates, we have been witnessing a “bear steepening” in the yield curve. This means that interest rates have risen in general and long-dated bonds have seen a more pronounced move than short-dated bonds. The graph below shows the treasury yield curve on the first, middle, and last trading days of the quarter. While the yield curve was and still is inverted (short term rates are higher than long term rates), you can see the dramatic difference in the amount long term rates have moved compared to short term rates.

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SPECIAL POINTS OF INTEREST

- We are traveling 10/18-10/20. We will still be checking e-mail and returning phone calls. Please don't hesitate to contact us if needed!
- It's almost RMD season. Jenn will begin contacting clients in late October who need to take RMDs. Please let us know if you would like to change your tax withholding amounts or the distribution method.



There are a few possible causes for these huge moves in the bond market:

- The economy has proven to be much more resilient than most investors and economists anticipated. Part of the reason for the deep inversion in the yield curve was an anticipation of near-term economic weakness that has not yet materialized.
- Economic growth has been propped up by deficit spending by the government (estimated at 5.8% of GDP in 2023) and investors are rightly worried that even during a relatively strong economy we continue to spend beyond our means. They are likely demanding a higher level of interest because they are growing more concerned about our government's ability to repay its debt.
- While inflation is down significantly from its peak in June 2022, it has started to level out and there is a sense among investors that the last mile of the inflation fight might be the toughest. This would mean higher interest rates for longer- hence a rise in the long end of the curve.
- The Federal Reserve's balance sheet runoff is well underway and may be accelerating. The Fed has now pulled nearly \$1 Trillion of cash out of the economy through quantitative tightening and last week's runoff was the largest since the Fed began tightening.

Market Index	Q3 Total Return	YTD Total Return	1 Year Total Return
S&P 500	-3.3%	13.1%	21.6%
DJIA	-2.3%	2.2%	18.4%
Nasdaq Comp	-3.9%	27.1%	26.1%
MSCI EAFE	-4.7%	6.4%	25.2%
Russell 2000	-5.1%	2.5%	8.9%
US Aggregate Bond	-3.2%	-1.0%	0.5%

Talk Is Cheap

When I talk to people (and when they respond to surveys), they are much more pessimistic than their behavior suggests. Consumer confidence surveys have been lackluster, but consumer spending keeps marching higher. People perceive the economy to be weak, but international travel (for example) has been going gangbusters. I think there are a few issues at play here:

1. The economy still just doesn't feel "normal" compared to pre-COVID times to most people.
2. People really hate inflation. Even though inflation (the rate of change in prices) is moderating, the absolute level of prices is substantially higher than a few years ago. Gas prices, in particular, are a huge pain point and you can see the impact of higher gas prices in the survey data.
3. Regardless of which side of the aisle you fall on, the government feels pretty dysfunctional. This is nothing new and indeed our government was designed to be a bit of a quagmire, but we have had several high-profile bouts of dysfunction lately.

Fortunately, we don't have to rely on the soft data of how people feel, we can look at what they're doing. On a macro level, the US economy continues to chug along. The Atlanta Fed's GDPNow model, which has been more accurate than economists at predicting US GDP lately, is forecasting 4.9% annualized GDP growth for the third quarter. Likewise, the tightness in the labor market has continued. Initial unemployment claims, which have been at very low levels since late 2021, have actually been trending lower since June. Labor force participation in general has been rising and prime age labor force participation, which measures the percentage of people ages 24-54 who are in the workforce, currently sits at a 21-year high.

Looking Forward

As we have written before, August and September are seasonally weak months, and this seasonal weakness is pronounced in pre-election years. There isn't a great logical explanation for this phenomenon, but the effect was on full display again this year. Furthermore, the stock market averages more than three pullbacks of 5% or more each year and prior to September, we hadn't seen a 5% pullback in six months. All things considered, it's not hugely surprising that we got a correction late this summer.

I certainly did not expect to see interest rates move as far or as quickly as they have. I also don't think you can overstate the extent to which the action in the stock market was caused by the moves in the bond market- especially after earnings season ended. If this rapid rise in bond yields continues unabated, I would anticipate stock market volatility to continue. That being said, at the current juncture the absolute level of interest rates is not overly concerning. We have certainly seen very strong stock market performance with interest rates at these levels in the past.

In general, we have been pleased with the performance we are seeing in client accounts. We maintained our slightly defensive position throughout the quarter, and we trimmed back tech stock positions (again) in the middle of August. As bonds are maturing, we are reinvesting the proceeds into much higher-yielding bonds- this will begin to provide a nice performance tailwind at some point. We are nearly through a seasonally weak period and the end of the year tends to be stronger. We will continue to keep a close eye on changes in interest rates and the economy and we will adjust as necessary.



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In December 2019 the SECURE Act was signed into law. This brought about changes to retirement savings and one of the most impactful changes applied to non-spousal beneficiaries of IRAs. There are many possible types of non-spousal beneficiaries for IRAs, but the most common example is an adult child inheriting their parent's IRA.

Before the passage of the SECURE Act, a non-spousal beneficiary of an IRA had to take annual Required Minimum Distributions (RMDs) that were based on their own life expectancy and there were no rules requiring the account to be fully distributed by any point. This meant that the younger the beneficiary was, the less they had to withdraw from the IRA every year, and the longer the account could continue to grow tax-free. Taking only the required minimum amount helped beneficiaries reduce their tax bill annually- especially if they did not need the money for living expenses. Passing IRAs down to children was a popular estate planning tool and set up younger generations to build wealth.

The SECURE Act changed this. If you inherit an IRA from someone who is not your spouse in 2020 or later, the funds in the IRA must be completely distributed within 10 years. When this law was changed there were a lot of unanswered questions. It was unclear if you had to take distributions every year and if there was a minimum you had to take. The IRS responded by further complicating inherited IRAs for beneficiaries. Now you must consider if the decedent died before or after their Required Beginning Date which is when IRA owners must begin taking RMDs.

For folks who inherited their parent's IRA before their mom or dad began taking RMDs, all you must do is completely distribute the inherited IRA within 10 years. It does not matter how this is done according to the law, but there are of course better options than others when considering your own tax situation. If the decedent had begun taking RMDs, the beneficiary will need to take RMDs annually based on the beneficiary's life expectancy and then empty whatever is left after 9 years of RMDs. A beneficiary may want to consider taking more than their RMD amount to smooth out the income (and taxes) over 10 years, but this strategy does not make sense in every situation.

Examples:

Tom's mom Tammy died in 2022 at the age of 65. Tom inherited her IRA which had \$500,000 in it when she passed. Tammy had not reached her Required Beginning Date yet which means that Tom is not required to take anything from the IRA annually. However, he is required to completely drain the IRA by 2032.

Jane's mom also died in 2022, but she was 80. Since Jane's mom had begun to take her annual RMDs, Jane will also need to take an RMD every year for 9 years. Jane's RMD amount is based on her own life expectancy, so it will be smaller than what her mom would have had to take. Additionally, whatever is left in the account in 2032 will have to be distributed. Again, this can cause some lumpy tax years if not planned for accordingly.

Since there was no clear indication if anyone was required to take distributions from these recently inherited IRAs some folks have not made any withdrawals from these accounts. In July the IRS released a notice stating that the RMDs from these accounts are waived for 2021-2023. This is good news for anyone who did not take their RMD in 2021 or 2022 and for anyone who would like to skip 2023 as well, we now know that is an option.

This new law has the potential to make a big impact on an IRA inheritor's taxable income for 10 years and there are many different options and strategies that could be used. It is important to talk to a CPA or Financial Planner before making distribution decisions.