DIVERSIFIED PORTFOLIOS, INC.

Investment Insights

A Resource for Investors, Attorneys and CPAs

January 2023

at a glance

Market Update

The fourth quarter saw gains for global stock and bond investors

Inflation Update

We take a deep dive into the latest inflation readings, and what it means for markets

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DIVERSIFIED PORTFOLIOS, INC.

Market Update

January 2023

Asset Class	4th Quarter 2022 Return	2022 Return
Large U.S. Stocks: S&P 500 Index	7.60%	-18.10%
Small U.S. Stocks: Russell 2000 Index	6.20%	-20.40%
Developed International Stocks: MSCI EAFE Index	17.40%	-14.30%
Emerging Market Stocks: MSCI Emerging Markets Index	9.50%	-20.50%
Bonds: Bloomberg Barclays U.S. Aggregate Index	1.90%	-13.00%
Cash: FTSE 3-Month Treasury Bill Index	0.90%	1.40%

Source: Charles Schwab - Returns Calculator as of December 31, 2022

Investors saw some relief in the 4th quarter to close out a difficult year.

Investors were encouraged in the 4th quarter by some early signs that inflation may have peaked. While the current yearly inflation CPI number is still too high for anyone's comfort at 7.1%, the monthly rate has started to slow significantly to 0.1% month over month (annualized at 1.2%). At this point however, the headline CPI rate is expected to move significantly lower as we head through 2023.

The Fed has significant influence on broad financial markets in the short term. The Fed's general consensus to slow the pace of interest rate hikes allowed the U.S. Dollar to weaken for the first time all year in the 4th quarter. This can be seen in the strong outperformance of international stocks, as both developed international stocks and emerging market stocks outperformed in the 4th quarter, with a currency-related tailwind from a weaker dollar included in returns. In emerging markets, a more business friendly tone as well as an abandonment of COVID-Zero policies by the Chinese government assuaged investors.

Overall, the U.S. economy is still going through a transition period alongside the unusual post-pandemic era we are all living through, but early reads suggest economic activity in the U.S. picked up in the 4th quarter. Earnings from U.S. corporations grew year over year as of 9/30—with earnings reports in the 4th quarter coming in better than expected. While there is an awful lot of fear being sold by pundits and the financial media, the underlying economy has been resilient.

Finally, while interest rates do have some impact on equity performance, they are the primary driver of fixed income performance. The most commonly cited fixed income index is the Bloomberg Barclays U.S. Aggregate Index—which had a return of -13% for 2022. This is by far the worst year for the index, which dates back to 1976. Overall, it was the worst year for bond investors going back to 1842. The silver lining is that with interest rates at their highest level in over a decade, fixed income investors should enjoy low to mid single-digit returns over the medium to long-term due to the higher yields available today. This can be evidenced by the 4th quarter return for the Aggregate Index. Even though yields rose slightly in the 4th quarter, bonds were able to provide a positive return.

Deeper Dive: Inflation

January 2023

While the current yearly inflation CPI number is still too high for anyone's comfort at 6.5%, there are early signs that the inflation rate has already peaked for this cycle and moving back towards more normal levels.

Inflation, and the Federal Reserve's (Fed) reaction to the highest inflation rate in 40 years by raising interest rates, was the dominant story in financial markets throughout the year. When recapping market performance in 2022, the rapid increase in interest rates has been front and center as a main reason for struggling markets. While this is a short-term driver of volatility in equity markets, the Fed's action with interest rates is not a long-term driver of stock performance. The Fed has a dual mandate to minimize unemployment while keeping the inflation rate around 2%. Hence the Fed has been rapidly increasing interest rates at an unprecedented rate to slow down the economy and bring inflation back down towards 2%. After peaking at a rate of 9.1% this past summer, the current headline CPI number in the United States stands at 6.5%.

So, where do we go from here? Is the U.S. economy moving back to a more normalized inflation rate, and more importantly, would that allow the Fed to stop raising interest rates? To help evaluate where the inflation rate is headed, it is helpful to break inflation down into three categories:

1. Shelter: The largest component
2. Goods: The things we buy (cars, computers, food, furniture, appliances, sporting goods)
3. Services: Travel, transportation, recreation, restaurants, medical, personal services

Shelter is 33% of the CPI calculation, which is comprised of rent and home owners' equivalent rent. Shelter inflation is currently up 7.5% year-over-year. Essentially, when home prices are rising, mortgage payments for new buyers are rising and rents are rising, it will drive the overall CPI number higher. Those of us who spend time on Zillow or have a friend looking to move know that after a record ramp up in prices, things are beginning to cool.

U.S. Consumer Price Index (CPI) YoY: Investing.com, Jan 12, 2023 - https://www.investing.com/economic-calendar/cpi-733

Deeper Dive: Inflation

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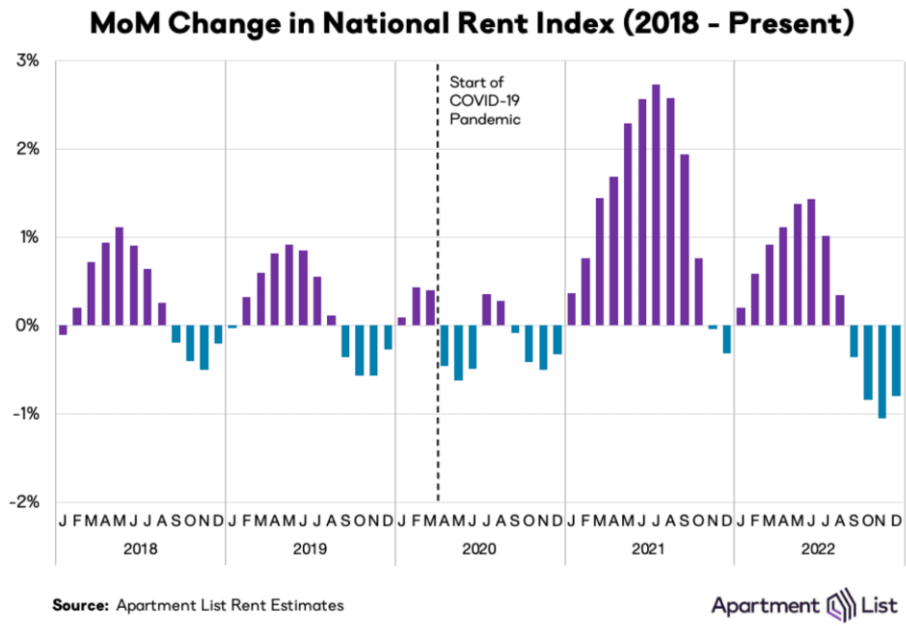
While Shelter and Goods CPI is moving in the right direction, CPI for services remains stubbornly high.

The market has confidence that the inflation in housing will begin to subside as we head into spring, as home prices begin to cool, and rent increases have slowed. We are also seeing a slowdown in household formation, which lowers the overall demand for housing. Essentially, higher rates have had a direct and meaningful impact in slowing down both the price and demand for housing.

Goods CPI is also decelerating at a rapid pace, led by plummeting prices for used cars and household furnishings.

As supply chains have normalized following the pandemic and consumer behaviors change, some retailers ended up with too much inventory as people switched from buying things to buying experiences (travel, going out to eat, etc.) after the pandemic. As of the end of the year, durable goods CPI was at 4.8% and trending lower.

The last piece of the puzzle, services, is the one area of the economy that is not showing signs of deceleration. Service CPI is up 7.2% year-over-year. This category is also directly correlated with wage growth and wage pressure. This is why the Fed is so focused on slowing the economy. In a counter-intuitive way, the Fed would like to see the unemployment rate rise somewhat in order to avoid a wage-price spiral in which wages have to rise to keep up with prices, and so prices rise even more. A slowdown in labor demand could keep a lid on wages and avoid this spiral. Recent data suggests that wages are not keeping up with inflation, yet the Fed is laser focused on this measure to ensure inflation



recedes to more normal levels. And if the Fed is focused on this area, markets are looking closely at all data points related to the labor market, as a lack of demand for labor, or an increase in labor through participation would likely let the Fed back off from even higher rates.

Putting it all together, two of three areas of the economy are showing meaningful deceleration in inflation, giving optimism to market participants. However, wages and a tight labor market is keeping the Fed on the brakes of the economy for now. We will be paying close attention to these figures given the stakes.

Rent Index: Apartment List via Marko Bjegovic, Jan 2022

Secure Act 2.0

At the end of the year, Congress passed a follow-up package to the SECURE Act of 2019, with many new retirement-related provisions. Notably, for all those about to turn 72 this year, or younger, the age for starting required minimum distributions (RMDs) from IRAs and employer plans was raised. Individuals born between 1951 and 1959 won't be required to take distributions until age 73 and those born in 1960 or later can wait until age 75. The law also adjusted the penalty for missing the deadline for RMDs to be less onerous.

Another provision, which on the surface seemed advantageous for our education-focused clients saving early for their children and grandchildren, turns out to have a very narrow application, but is still a potential backup option for those with leftover 529 funds. The provision allows for the account owner of the 529 plan to roll funds into a Roth IRA in the name of the account beneficiary. The rollovers are subject to the annual Roth IRA contribution limit ($6,500 in 2023). There is a $35,000 lifetime cap on transfers, and the account must have been open for 15 years, potentially without a change in beneficiary. The rollovers also can't be for funds contributed or investment earnings accrued in the last 5 years.

The bill also requires automatic 401k enrollment for employees of established businesses with more than 10 employees, created bigger "catch up" contributions for older retirement savers (see "2023 Reminders" to the right), broadened employer 401(k) match options for those making payments toward student loans, improved workers' access to emergency savings in retirement accounts, and created a federal matching contribution for lower-income retirement savers.

2023 Reminders

In 2023, participants in 401k, 403b, and other similar plans can contribute a maximum of $22,500 of employee contributions. Investors 50 and older can contribute an additional $7,500 for a total of $30,000. In 2023, IRA contribution limits have increased to $6,500, ($7,500 over the age of 50).

For those in profit sharing or defined benefit style plans, it is a good time to start thinking about how the 2022 calendar year is shaping up from a tax and business perspective and look to determine how much income can be contributed into these plans.

We're Here to Help

The team at Diversified Portfolios wishes everyone a great winter season as we work through the 1st quarter of the year. We are here to help on any investment or financial planning question.

Secure Act 2.0!: Kitces.com – December 28, 2022 https://www.kitces.com/blog/secure-act-2-omnibus-2022-hr-2954-rmd-75-529-roth-rollover-increase-qcd-student-loan-match/

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DIVERSIFIED PORTFOLIOS, INC.

39520 Woodward Avenue, Suite 200
Bloomfield Hills, MI 48304
248.644.3030