McCarthy Asset Management, Inc.
Personalized Wealth Management

May 2021 Monthly Commentary

June 1, 2021

Stock Market & Portfolio Performance

May 2021: Stocks and bonds posted modest gains for the month. For the first five months of 2021, stocks posted solid gains, while bonds posted small losses.

	May 2021	YTD 2021	Description:
Without Dividends:			
S&P 500	0.6%	11.9%	500 Largest Public U.S. Companies
Russell 2000	0.1%	14.9%	2000 of the smallest U.S. stocks
MSCI EAFE	2.5%	8.3%	international stock index
U.S. Aggr Bond	0.3%	-2.3%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	0.7%	7.8%	non-very conservative MAM portfolios
MAM Conserv	0.8%	5.9%	portfolios with 50%+ bond allocation

The returns showed above are unaudited. Past performance is not indicative of future results. Returns for McCarthy Asset Management Portfolios ("MAM Portfolios") are net of management fees and transaction costs, and reflect the reinvestment of dividends. Results represent a composite of clients using a similar investment strategy, individual results will vary.

Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for the indices would be lower if these costs were reflected.

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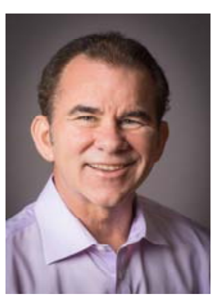

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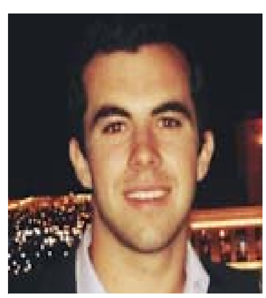

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Is Inflation Heating Up and Should You Be Concerned?

Stock market investors were rattled last month when it was reported that consumer prices surged in April by the most since 2008. In the report, the Labor Department said that its consumer-price-index jumped 4.2% in April compared to one year earlier. The increase was driven partly by sharp rises in prices for used cars, gasoline and airline fares. The news sent the S&P 500 to its steepest three-day decline in nearly seven months.

We were not surprised to see an uptick in inflation. It is estimated that Americans have hoarded $1.5 trillion of cash from the government's first two stimulus checks and reduced spending during the pandemic. Adding in a third stimulus payment of up to $1,400 per person, consumers have plenty of cash to spend. As the economy continues to open up, pent-up consumer demand will likely result in much of this cash being spent.

The key question for financial markets is whether this upswing in prices will prove to be temporary. The Federal Reserve has said it believes so. After the release of the April consumer price report, a top Fed official said the central bank would need to see more data before changing course on monetary policy. Previously, it has said it would hold short-term rates near zero until the central bank's preferred inflation measure is averaging 2% and full employment has been achieved. A persistent, significant increase in inflation could prompt the Fed to tighten its easy-money policies earlier than planned, or to react more aggressively later.

The combination of unprecedented peacetime monetary and fiscal policy support and the rollout of highly effective vaccines are supporting the prospects for the strongest year of growth in real (inflation-adjusted) gross domestic product (GDP) since the early 1980s. Some worry that this will result in a turbo-charged economy that sees demand outstripping supply, generating shortages and boosting prices. Sustained inflationary pressures, though, have historically come from a severe tightening in the labor market. Until the unemployment rate drops down to the low levels reached in 2019, there should be enough slack in the labor market to keep a lid on inflation.

For investors concerned about inflation, how can their portfolios be protected against rising inflation and rising interest rates? Here are some alternatives:

- Real estate and commodities are considered classic hedges against inflation. Most MAM clients own their own home, so they have some inflation-protection with that. We don't currently have a commodity position in most portfolios. We may establish a position if we feel that we are likely to experience a sustained increase in inflation.
- Treasury Inflation-Protected Securities (TIPS) can provide inflation protection because their coupons and repayments at maturity are directly tied to consumer prices. Unfortunately, currently TIPS are expensive, with 10-year TIPS paying 0.9% below inflation. That is, the current rate on a 10-year TIPS is negative 0.9%. Therefore, we don't view TIPS as a viable alternative.
- Short-Term Bonds: Bonds prices fall as interest rates rise, so rising inflation is a negative for bonds. But this not true for all bonds. Short-term and ultra-short-term bonds, which have a maturity of two years or less, are much less impacted by rising interest rates This is in contrast to longer-term bonds, which are much more susceptible to rising rates. Most of the bond allocation in MAM portfolios is invested in short and intermediate bonds, which are less impacted by rising inflation.
- Dividend-Paying Stocks: Stocks which have a history of increasing their dividends, tend to do better in inflationary environments. On the other hand, growth stocks, which promise larger profits far in the future, are less attractive in an inflationary environment.

<u>Impact of Rising Interest Rates/Inflation on Stock Prices:</u> The impact of rising inflation on stock prices depends on the level of inflation. When inflation is low, a stronger economy pushes up inflation, which is good for stocks. The Federal Reserve is also happy to ignore rising inflation at this point, because they want inflation to not be below 2%. As inflation rises further, though, there's a tipping point where gains from the economy are offset by the threat from the Fed to raise interest rates. This seems to be around 4%.

As discussed in a May 19th article in the Wall Street Journal, "The 4% logic isn't written in stone, but has reasonable historic support. Since the S&P 500 was created in 1947, U.S. inflation has risen above 4% nine times, and in eight of those cases, stocks were lower three months later. The exception, in 2005, saw inflation fall back below 4% again almost immediately, calming investors." At this point, we are not too concerned as we are still quite a way from inflation reaching 4% on a sustainable basis.

Biden Seeking to Increase Funding for the IRS

There has been a sharp reduction in IRS audits over the last ten years. If President Biden has his way, that will be changing with his proposed $80 billion funding boost for the IRS over the next decade. This would result in a major expansion of the tax agency that would double its enforcement staffing and give it new tools to combat tax dodging.

The proposal would provide a steady funding source to the IRS, after years of flat or declining budgets forced steep cuts in the number of employees conducting audits and collecting taxes. Agency officials have said they need a multi-year commitment from Congress so they can hire and train enforcement staff and ramp up audits with less risk of lawmakers stopping such an initiative midway through.

The actual funding levels will be set by Congress. A significant budget increase is likely to happen, though, as both Democrats and Republicans in recent years have signaled support for replenishing the agency's resources after nearly a decade of budget cuts that resulted in the loss of more than 20,000 employees.

Under the plan, banks and other payment providers would be required to tell the IRS how much money came into and out of individuals' and businesses' accounts each year, going far beyond the existing reporting of interest income. Business owners trying to hide income could still attempt to use cash or cryptocurrency. But the change to the information-reporting rules would give the IRS much more information about business income as it decides whom to audit.

Audit rates of individuals have hit 40-year lows, and the agency has 15% fewer employees than it did in 2010. The IRS said it devotes 30% less funding and staff to enforcement than it did in 2010. The agency estimates that for tax years 2011 through 2013, about $381 billion annually in legally owed taxes went uncollected—in what is known as the tax gap. After inflation and budget cuts, that number is now likely much higher, perhaps $1 trillion annually.

The Biden administration's focus of enforcement is supposed to be on wealthy taxpayers and corporations, but what does that mean exactly? Who should be on notice? Most at risk are taxpayers whose earnings aren't reported to the IRS by an outside source like an employer or brokerage firm. Studies show that when there's third-party reporting, compliance rates are around 90%, but when there isn't, the rate drops to 50%.

One area that is likely to receive greater scrutiny is crypto investors. IRS Commissioner Chuck Rettig said at a recent congressional hearing that the $1 trillion tax gap could be narrowed by more stringent cryptocurrency reporting requirements. No third party currently tracks and reports sales or trades of digital currencies, in contrast to stock and bond activity sent to the IRS by brokerage firms. The agency has created a team it calls "Operation Hidden Treasure," which is dedicated to ferreting out unreported gains. It has also included a new question prominently located on the 2020 tax form asking about crypto holdings.

Business owners could also be a target of the increase in audits. We have found in our tax practice, the most likely taxpayers to be audited have been those with small businesses.

In summary, it is likely the IRS will be receiving increased funding, allowing them to expand its ability to conduct taxpayer audits. We want clients to be aware that they may be at greater risk of an audit, particularly for business owners and rental property owners. If you are audited, the best protection for a positive outcome is to keep good records of expense deductions.

Sincerely,

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.

Financial Planning Services:

- The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.
- "Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.
- Social Security Planning is an analysis of the best strategy for when and how to start claiming Social Security benefits.

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- Tax Return Preparation
- Income Tax Projections
- Tax Minimization Ideas
- Tax Authority Representation

Other Services: MAM has retained outside experts, whose services are available at no cost to our clients:

- Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.
- Medicare Advisory Program (MAP) - Eileen Hamm

Reminders/Updates

- Estimated Tax Payments: Second quarter of 2021 estimated payments are due on June 15th.
- MAM Portal: Please let us know if you have any questions regarding accessing your MAM Portal.