May 2022 Monthly Commentary

June 1, 2022

Inside this issue:

Stock Market & Portfolio Performance

May 2022: After a sharp drop early in the month, U.S. and international stocks recovered their losses to close down relatively flat for the month. Bonds prices posted a moderate recovery for May.

	May 2022	YTD 2022	Description:
Without Dividends:			
S&P 500	0.0%	-13.3%	500 Largest Public U.S. Companies
Russell 2000	-0.1%	-17.0%	2000 of the smallest U.S. stocks
MSCI EAFE	0.2%	-12.8%	international stock index
U.S. Aggr Bond	0.6%	-8.9%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	0.5%	-11.0%	non-very conservative MAM portfolios
MAM Consrv	0.4%	-9.0%	portfolios with 45%+ 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.

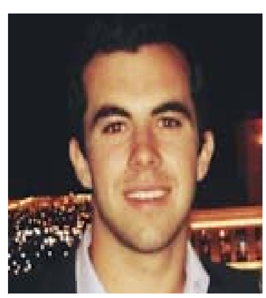
Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for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

Advisor Team

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

STEVE McCARTHY
CPA®, CFP®
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com



RYAN McCARTHY,
CPA®, CFP®
Financial Planner
650 610-9540
ryan@mamportfolios.com

MARILYN BLANCARTE, PACE
Executive Assistant
650 610-9540 x 305
marilyn@mamportfolios.com

A Bear Market? Likelihood of a Recession

During mid-day trading on May 20th, the S&P 500 briefly reached bear-market territory, with a decline of 20% from its January peak. By weeks-end, the S&P 500 and Nasdaq reached their longest streak of weekly losses since 2001, after the dot-com bubble burst. The driving force behind the selloff is growing fears about the health of the U.S. and global economy.

How is the Economy Doing? The U.S. economy contracted in the first quarter at a 1.4% annual rate, down from 6.9% growth the prior quarter. The drop was primarily due to a widening trade deficit. Imports to the U.S. surged and exports fell, reflecting pandemic-related supply chain constraints. Importantly, consumer spending, which makes up nearly 70% of the U.S. economy, grew at a 2.7% annual rate in the first quarter.

The Conference Board, which gathers data every month for the Index of Leading Economic Indicators (LEI), projects that the U.S. economy should resume expanding in the second quarter. Despite downgrades to its previous forecasts, The Conference Board still projects 2.3% year-over-year US GDP growth for full-year 2022.

The Index of Leading Economic Indicators (LEI) for the U.S. decreased in April, but the dip followed two consecutive months of gains. The LEI has been essentially flat in recent months, which is in line with a moderate growth outlook for the near-term. Historically, the LEI plunged before every recession in modern history except for the very short COVID recession. That's why the LEI is a very important forward indicator for the performance of the economy.

Is a Recession Imminent? Recessions are not a matter of "if" but simply a matter of "when". They are a natural part of the economic cycle. While the risk of a recession has clearly grown since the start of 2022, as we wrote in our email we sent out on May 9th, we still don't think the U.S. economy is on the verge of a recession. Our economic outlook is due to strong consumer and business spending and low unemployment. Odds still favor the next recession not starting any earlier than late 2023 or sometime in 2024. This is important because, historically, sustained stock market downturns have rarely occurred without a recession.

Of course, we don't know for sure. For example, currently, economists at Goldman Sachs estimate there is 15-20% probability of the U.S. economy entering a recession within the next 12 months, and a 35% probability within the next two years.

1st Quarter Corporate Earnings: With the latest reporting season wrapping up, analysts expect that profits from companies in the S&P 500 rose 9.1% in the first quarter from a year earlier, versus their forecasts for 5.9% growth on December 31st. Analysts project that corporate earnings will continue to grow in the high single-digits for the remainder of 2022 and low single-digits for 2023. These earnings gains, coupled with more reasonable valuations following the selloff, could propel a recovery in stock prices. Furthermore, rising corporate earnings is important because it is rare for a sustained bear market to develop when corporate earnings are increasing.

Inflation: The biggest risk to the stock market right now is the current high rate of inflation. The spike in inflation was brought about by the pandemic, which ushered in unprecedented fiscal and monetary easing, soaring demand for consumer goods, and a disrupted global supply chain. More recently, inflation has been further exacerbated by the indirect effects of the war in Ukraine, such as skyrocketing energy, food and materials prices.

A Bear Market? Likelihood of a Recession– Con't

The Federal Reserve has initiated a series of increases in the federal funds rate to temper inflation. If signs start to emerge that the Fed is getting a handle on inflation without triggering a recession, stock prices could stage a strong rebound. What is the likelihood for inflation to start to moderate?

The forces that drive inflation tend to move slowly, so the almost unprecedented surge since early 2021 means something anomalous is going on. Only twice since the late 1940's has inflation risen as much as it has in the past year and both were periods like the present, when supply shocks hit a strong economy (i.e., the Korean War in 1951 and the Arab oil embargo in 1973). Looking forward, the supply disruptions that have fueled so much of the rise in inflation are likely to get better:

- Gasoline prices aren't likely to rise much more since oil has stabilized around $110 per barrel.

- The queue of container ships waiting off the cost of California has shrunk by more than half, and freight rates have plummeted.

- Approximately three-quarters of China's top 100 cities have now either loosened restrictions to pre-Omicron levels or removed them entirely, according to Ernan Cui of the research firm Gavekal Dragonomics.

Economists are projecting the rate of inflation will decline from 8% currently to around 4% by year-end 2022. But then what? At that point, the Federal Reserve may still be targeting for inflation to fall back toward its 2% target. If inflation bottoms at around 4%, this opens the door for the Fed to raise rates in 2023 higher than what markets now expect. This could result in rates rising to a level that could induce an economic slowdown. We will be keeping an eye on this.

Comments and Actions from Favorite Investment Managers. In uncertain times, it can be helpful to see what respected investment managers are doing:

David Giroux, manager of the T. Rowe Price Capital Appreciation fund, our favorite fund, had this to say recently: "I think what's interesting is everybody is convinced we're going to have a recession. If you ask 100 investors, 99 would tell you we're going to have a recession, which is kind of interesting because six months ago, if you asked 100 investors, 99% would have said we are not going to have a recession. We go to extremes. You see companies like industrials, semiconductor companies trading at very, very depressed valuations today because everybody is pricing this in. And I think going through all the quarterly earnings so far, there is really no sign in orders, sales, backlog, cancelations that we're seeing that recessionary risk coming into the numbers, and, that's just across the board so far…We tend to take the other side of those extremes, which we're doing right now."

Actions speak louder than words. **Warren Buffett** was aggressive with Berkshire Hathaway's checkbook during the first quarter, scooping up equities at his fastest pace since the Great Financial Crisis. Berkshire Hathaway equity portfolio added a $41.5 billion in net stock purchases in the first quarter. That's the most cash Buffett has invested in equities in a quarter since 2008. Contrast this with last year, when Berkshire was a net seller of equities in all four quarters of 2021.

MAM Portfolios: As we wrote in last month's Commentary, we don't plan to make any portfolio adjustments at this time. We expect market volatility is likely to remain heightened until signs emerge that the rate of inflation is falling. Meanwhile, we are focused on monitoring the performance of the U.S. economy and corporate earnings. At this point, we expect another positive year for both.

Bond Performance and Portfolio Positioning

So far in 2022, both stock and bonds prices have fallen sharply. Short of investing in energy stocks and cash, there was “nowhere to hide.” Even cryptocurrencies, which we don’t invest in, didn’t provide a diversification benefit. In fact, bitcoin has declined over 30% since the start of 2022.

Bond Market Performance: This has been a frustrating period for balanced portfolios, as bond prices did not provide their expected downside protection when stocks slumped. Through May 6th, the Lehman Agg Bond Index (symbol AGG) was down 10.4%. From a historical perspective, since 1976, the U.S. Aggregate Bond Index has only had a negative return for 4 out of 47 years. Its worst one-year performance was -8.1%.

What happened? A gradual increase in interest rates has not been bad for bond investors, and that was the Fed’s game plan for 2022. As the start of 2022, the Fed was expected to initiate two short-term interest hikes, with more to follow in 2023. However, in March, with inflation data moving much higher than anticipated, Fed chairman Jerome Powell announced the Fed would be more hawkish (aggressive) by abruptly changing its game plan by increasing the pace of interest rate hikes.

The Federal Reserve: Currently, the federal funds rate is between 0.75% to 1.00%, up from 0% to 0.25% at the start of 2022. The current expectation is for the Fed to raise the rate in 0.50% increments in both June and July, and then in 0.25% increments for each of its last three meetings for 2022. This would result in a federal funds rate of 2.5% to 2.75% by year-end. Importantly, this would still be below a level that historically could trigger a recession. Of course, this is all subject to change if inflation remains elevated for longer than the Fed currently anticipates.

Bond Allocation in MAM Portfolios: Recently, there has been some good news for our bond allocation in portfolios:

- Between May 6th and the end of May, bond prices held steady. As a result, since May 6th, bonds have cushioned portfolios on days when stock prices fell.
- The bond allocation in MAM portfolios outperformed the Lehman Agg Bond Index as most of the bond allocation is in bonds with shorter maturities, which reduces their interest rate risk.
- Current bond yields are a good predictor of future returns. Over the long run, the total return of bonds depends far more on their income than on changes in price. Since 1976, just over 90% of the average annual return of the U.S. bond market has come from interest and reinvesting it, according to Loomis, Sayles & Co, an Investment manager.
- Thanks to the recent plunge in prices, the yield on the aggregate U.S. bond market, at about 3.0%, has nearly doubled since December 31st. This higher yield will increase the bond return in portfolios over time.

Equity Allocation in MAM Portfolios: Historically, stocks of companies with a track record of increasing their dividends can provide a measure of inflation protection. Furthermore, such companies are of higher-quality and lower volatility than the broad market. Three of the funds used in MAM portfolios, Schwab U.S. Dividend (SCHD), Schwab International Dividend (SCHY), and Vanguard Dividend Appreciation (VIG), focus their investing on stocks that have a history of increasing their dividends. SCHD and SCHY have held up particularly well this year.

Meanwhile, after a number of years of outperforming value stocks, growth stocks have dramatically underperformed this year. Historically, growth stocks underperform in a rising interest rate environment. Will this underperformance continue? J.P. Morgan’s Chief Economists, David Kelly, recently said in a webcast that in his opinion, growth stocks are still 14% overvalued relative to value stocks. While we have an allocation to both growth and value stocks in MAM portfolios, fortunately, during 2021 we shifted part of the growth allocation to value equities.

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

Phone: 650-610-9540
Fax: 610-9541
E-mail: Steve@mamportfolios.com

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 2022 estimated payments are due on June 15th.
- MAM Portal: Please let us know if you have any questions regarding accessing your MAM Portal.