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BONDS ARE BACK

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(Originally Published in June 2023 Monthly Commentary/ 2nd Quarter Letter)

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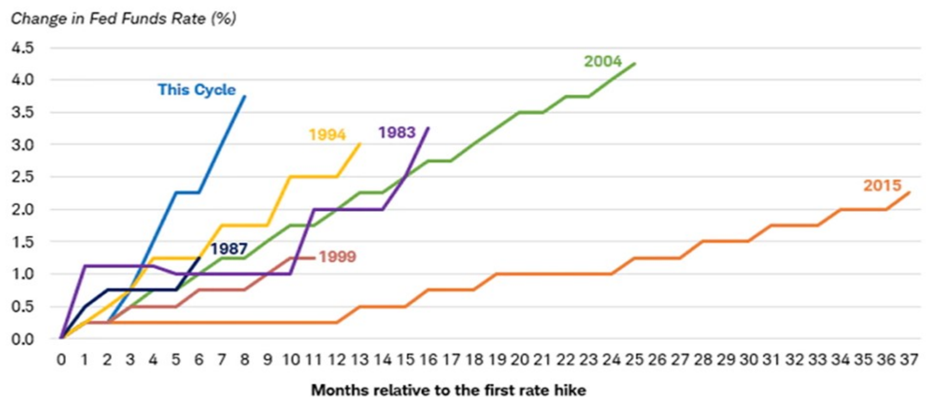
"After experiencing its worst year in decades last year, the outlook for the bond market is probably the best it has been in years. "This article discusses the main reasons why."

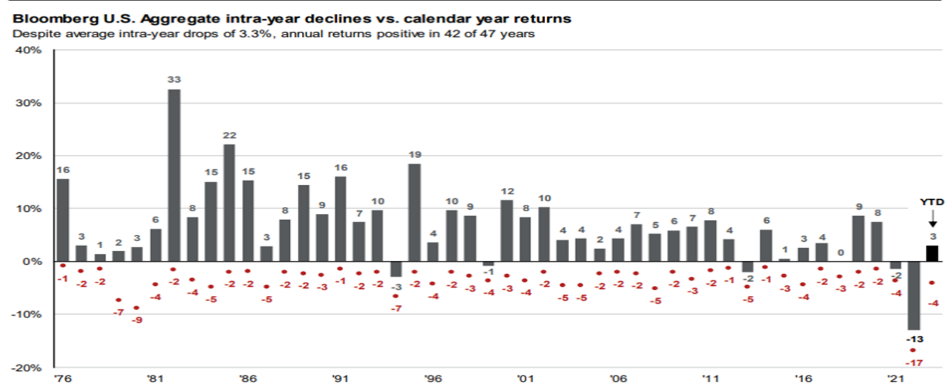
McCarthy Asset Management, Inc. is an independent, fee-only investment advisory firm that has been helping people invest wisely for over fifteen years. Our mission is to help you better understand and improve your financial situation. We specialize in Retirement Planning, Portfolio Management and Tax Planning.

The outlook for fixed-income investors is probably the best it has been for a number of years. This is after a disastrous 2022, which was a perfect storm for bond investors. Coming into 2022, short-term interest rates were still near the pandemic-era low of close to zero. The Federal Reserve began a gradual shift to tighter monetary policy with a 25-basis-point rate hike in March 2022 as economic growth recovered. Gradualism soon gave way to repaid tightening by summer, as inflation surged on the back of supply/demand imbalances, a resilient economy, and the spike in oil prices due to the war in Ukraine.

By the end of 2022, the Fed had raised the federal funds rate seven times, from 0% to 0.25% at the start of 2022, to 4.25% to 4.50% by the end of 2022. As shown in the Bloomberg chart below, the pace of rate hikes since March 2022 has been the most rapid in modern times:



As a result of these rapid rate hikes, 2022 was the worst year for bond performance since at least 1976. As can see in the J.P. Morgan chart below, the Bloomberg U.S. Aggregate bond index fell 13% for 2022. That's a huge loss for the bond market. Since 1976, the next worst year was a 3% drop in 1994. The full year performance for the bond market is indicated in the graph below by the dark grey numbers and bars.



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So far in 2023, the Fed has instituted three additional rate increases. The most recent increase, announced on May 3, raised the federal funds rate to 5.0% to 5.25%. While the Fed decided to keep rates flat at their June meeting, Chairmen Powell hinted that there could be two more 0.25% increases later this year.

For the following reasons, we feel that bonds are once again an appealing investment:

1) **Yields are Up:** After rising sharply last year, bonds yields are now the highest they have been in years. This is important because, starting yields historically have a strong correlation to future returns. Currently, portfolios of high-quality bonds, such as Treasuries and investment grade corporate bonds, are yielding 4% to 5%.

2) **Potential Appreciation:** Historically, the greatest appreciation in bond prices has occurred in the months leading up to and immediately after the last Fed hike of a cycle. While Fed Chairman Powell recently said the Fed may raise the federal funds rate twice more, it is likely we are getting close to the end of the Fed raising rates for this cycle. Furthermore, if the U.S. enters into a recession, the Fed will likely start reducing interest rates, which would cause bond prices to appreciate.

3) **Inflation Continues to Fall:** On June 13th, the Commerce Department reported the Consumer Price Index declined to 4.0% in May compared to the prior year. This is down sharply from the recent peak of 9.1% in June of 2022. While 4.0% is still well above the Fed's 2.0% target, a great deal of progress has already been made to bring down the rate of inflation. Further decreases in the rate of inflation are expected in the coming months.

4) **Good Years Normally Follow Bad Years:** As can be seen in the JP Morgan chart above, the bond market has experienced five years of losses since 1976. With the exception of 2021's loss of 2%, the other loss years were followed by strong returns in the following year. Specifically, the 3% loss in 1994 was followed by a 19% gain for 1995, the 1% loss for 1999 was followed by a 12% gain for 2000, and the 2% loss for 2013 was followed by a 6% gain for 2014.

5) **Normally, Bonds Provide Downside Protection When Stock Prices Decline:** While 2022 was an exception, in most years when the stock market declines, bonds provide good downside protection to a portfolio. With a heightened risk the U.S. economy may enter a recession within the next year, this downside protection would be welcomed.

In Summary: While we don't yet know how bonds will perform for full year 2023, for the first six months, the Bloomberg Bond Index was up 2.5%. Much of this year-to-date return is due to the attractive yields that bonds are once again paying. The icing on the cake is bonds will likely start appreciating in value once the Fed is done raising rates. If the Fed shifts to rate cuts next year due to a slowing economy, this appreciation could be very attractive.

Our Services

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.

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 several outside experts, whose services are available at no cost to our clients:
  - Medicare Planning– Eileen Hamm of Superior LTC Planning Services, Inc.
  - Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.

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