McCarthy Asset Management, Inc.
Personalized Wealth Management

June 2022 Monthly Commentary/ Q2 2022 Quarterly Letter

July 1, 2022

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Stock Market & Portfolio Performance

Second Quarter 2022: U.S. and international stocks fell due to concerns about the high rate of inflation and aggressive actions by the Federal Reserve to raise interest rates. Bonds experienced another difficult quarter also due to rising interest rates.

	2nd Qtr 2022	YTD 2022	Description:
Without Dividends:			
S&P 500	-16.4%	-20.6%	500 Largest Public U.S. Companies
Russell 2000	-17.5%	-23.9%	2000 of the smallest U.S. stocks
MSCI EAFE	-15.4%	-21.0%	international stock index
U.S. Aggr Bond	-4.6%	-10.3%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-11.6%	-16.3%	non-very conservative MAM portfolios
MAM Consrv	-8.6%	-12.7%	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.

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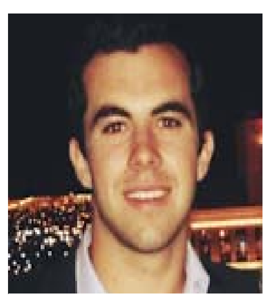

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The 2022 Bear Market; Recession on the Way?

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. The S&P 500 then fell further into bear market territory during June. The driving forces behind the selloff are the high rate of inflation, and fears about the health of the U.S. economy, as the Federal Reserve aggressively raises interest rates to curtail inflation.

Disappointing May Inflation Report: On June 10th, the Labor Department said the consumer-prices increased 1% last month from April, above expectations at 0.7%. As a result, the consumer price index was up 8.6% in May from the same month a year ago, marking the fastest pace since December of 1981. This was above expectations of 8.3%. Much of the increase had to do with the sharp rises in the prices for energy, which rose 34.6% from a year earlier, and groceries, which jumped 11.9% on the year. The sharp rise in energy prices is primarily due to Russia's war against Ukraine.

Prices excluding food and energy items, the so-called core rate of inflation, rose a smaller 0.6% for the month. That put core prices up 6% from a year earlier, which was moderately down from April's 6.2% increase and March's 6.5% rise. The Federal Reserve focuses more on the core rate of inflation rather than the consumer price index, as the latter is so heavily influenced by volatile energy prices.

Separately, the preliminary results from the June University of Michigan survey of consumers' five-year inflation expectations rose to 3.3%, up from 3.0% in May. This was the first increase since January and the highest level since 2008. The measure is important to Fed officials because they believe such expectations can be self-fulfilling. This preliminary results for May were subsequently revised on June 24th to an increase of 3.1%, which eased investors worries about the magnitude of future rate increases, helping to spur a short-term rally in stocks.

Federal Reserve's 0.75% Increase in the Discount Rate: The Fed announced on June 15th a 0.75% increase to the federal-funds rate to a range of between 1.5% and 1.75%. This was the largest increase since 1994. Furthermore, the Fed signaled it would continue lifting rates this year at the most rapid pace in decades to combat inflation that is running at a 40-year high.

New projections showed all 18 officials who participated in the June Fed meeting expect the Fed to raise rates to at least 3% by December 2022 and 3.75% by December 2023 (up from the 2.75% rate that Fed officials projected in March). "We're not trying to induce a recession now. Let's be clear about that," said Fed Chairman Jerome Powell at a news conference. But he said it was becoming more difficult to achieve a so-called "soft landing," in which the economy slows enough to bring inflation down while avoiding a recession. At the same time, Mr. Powell said he saw no signs of a broader slowdown in the economy. "You're seeing continuing shifts in consumption…but overall spending is very strong," he said.

Will We Have a Recession? As we wrote last month, recessions are not a matter of "if" but simply a matter of "when." They are a natural part of the economic cycle. While the risks of a recession starting in the next year have significantly risen the past couple of months, it is not certain to occur this soon. Clearly, though, the U.S. economy is starting to slow under the combined weight of soaring inflation and climbing interest rates. Mortgage rates have nearly doubled, increasing from 3% at the beginning of 2022 to almost 6%. This will have a negative impact on the housing market. In fact, U.S. home construction fell sharply in May, the Commerce Department recently reported. And Americans broadly cut spending at retailers in May, for the first time this year.

On the other hand, the U.S. economy is still reporting strong employment growth. The Labor Department reported employers have added an average of 488,000 jobs a month in the first five months of 2022, far above the historical average. The unemployment rate held at a 3.6% in May, close to the half-century low level it reached in 2020 before the pandemic sent the economy into a deep but short recession. Furthermore, household and corporate balance sheets are healthy, income trends are strong, and the corporate profit outlook is one of slowing but still positive growth.

When Will Inflation Drop and How Quickly? Probably the most important factor right now for a recovery in stock prices are signs to emerge that the Fed is starting to get a handle on inflation. Once this starts to occur, the Fed could signal a slowdown or even pause in its interest rate increases. That in turn, could impact if and when the U.S. economy slips into the next recession.

MAM Comments: While we think it is nearly impossible to predict where and when the stock market will bottom out, much will depend on when the inflation news starts to improve. We feel that it is likely the bulk of the drop has already happened and, at this point, it doesn't make sense to sell stocks. It is likely some panic selling is driving part of this market downturn. Typically, when the stock market turns back up, it does so very quickly. For those who sell near the bottom, they miss out on the early gains, which tend to be substantial.

How U.S. Officials Got Inflation Wrong

Why is the current rate of inflation at a 40-year high? In part, it is due to supply bottlenecks caused by Covid-19 and soaring energy and food prices attributed to Russia's invasion of Ukraine. It is also the result of strong U.S. economic growth, fueled by ultra-low interest rates and government stimulus to counter the Covid-19 pandemic's impact. In hindsight, these were policy errors.

In recent weeks, top officials in the Biden administration and Federal Reserve have publicly conceded that they made mistakes in their handling of inflation. Behind their errors was a misreading of the economy. They were worried the Covid-19 pandemic and related restrictions would bring similar consequences to the 2007-09 financial crisis: weak demand, slow growth, long periods of high unemployment and too-low inflation. In response, they applied the last playbook to the new crisis. The Fed redeployed low-interest-rate policies and the federal government decided to spend more aggressively this time, starting with President Trump and capped off with President Biden's $1.9 trillion stimulus in March of 2021.

But the pandemic economy turned out to be fundamentally different. While the financial crisis primarily suppressed demand by businesses and consumers, the pandemic undercut supply, resulting in persistent shortages of raw materials, container ships, workers, computer chips and more. Unemployment fell and inflation rebounded more quickly than policy makers expected. Yet the Federal Reserve and Administration stuck with the old playbook saying the spike in inflation was transitory. That exacerbated the supply-and-demand mismatches and helped drive inflation up, reaching 8.6% in May.

Private forecasters and non-partisan congressional scorekeepers similarly failed to anticipate the magnitude and duration of higher inflation. In July 2021, private forecasters surveyed by The Wall Street Journal projected inflation would recede to 2.4% by the end of 2022. They now project 4.8% by year-end.

As discussed in the previous article, the Fed is now slamming on the brakes by aggressively raising interest rates in a bid to slow economic growth and curb the high rate of inflation. Hopefully, they are not overdoing it, as inflation is likely to gradually fall as supply bottlenecks clear up and the eventual end of the Ukraine war lowers energy prices.

Outlook for Balanced Portfolios

It's been a very tough year so far for portfolios comprised of stocks and bonds ("balanced portfolios"). Using the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index ("Agg") to represent stocks and bonds, a 70% equity/30% bond portfolio was down 17.1% for the first six months of 2022.

Bonds typically provide downside protection to a portfolio when stock prices are falling. But not this year. Starting in March, the Federal Reserve announced a much more aggressive plan to raise the federal funds rate to combat inflation, which caused bond prices to drop over 11%.

There's a silver lining in the declines this year. Recent stock and bonds losses have dramatically improved valuations for balanced portfolios, based on a combination of the price-to-earnings ratio for the S&P 500 and the yield for bonds. While valuations aren't an effective market timing mechanism, they are an important consideration for longer-term return expectations, and that picture has improved quite a bit:

- The S&P 500 opened 2022 at a near record-high value of 4766. The forward P/E ratio at that time was 21.4. By June 17th, the S&P 500 fell 22.9%, which the forward 12-month EPS estimate increased by 6.1%. As a result, the forward P/E ratio for the S&P 500 had recently fallen to 15.6. This was 7.5% lower than the 20-year longer-term average.

- Bond valuations have improved dramatically too. The yield on the 10-year U.S. Treasury at the beginning of 2022 was 1.5%. As of June 17th, it was 3.2%. Historically, 90% of the return from bonds comes from their yield. The doubling of the yield on the 10-year Treasury has dramatically increased the expected returns from bonds.

Outlook for Balanced Portfolios– Con't

According to LPL Research, the average bear market takes about 19 months to recover all of their losses, but shallower bears—those when the S&P 500 falls less than 25%--bounce back faster, an average of 7 months. To be conservative, let's say it takes 36 months for the S&P 500 to recover. What could a 70% equity, 30% bond portfolio return annually for the next 3 years from the recent low on June 16th?

- Assuming it takes 3 years for the S&P 500 to fully recover this year's losses, the S&P 500 will provide a 30.2% return over these 3 years. This works out to a compounded annualized return of 9.2% over these 3 years.

- The current dividend yield on the S&P 500 is 1.6%. Adding this 1.6% dividend yield to the 9.2% annualized return, results in a total annualized return of 10.8% for the equity portion of the portfolio.

- The current yield on the AGG bond index is approximate 3.5%. Assuming interest rates in 3 years are the same as current rates, the AGG should return 3.5% per year.

- Adding it all together, the 70% equity allocation would return 10.8% * 70% or 7.6% and the 30% bond allocation would return 3.5% * 30% or 1.0%. **Adding these together, the portfolio would return 8.6% annually for the next three years, assuming the S&P 500 recovers to its 12/31/21 level by then and interest rates stay the same level as they are now.** This is well above our modest longer-term expectations for balanced portfolios to provide average annual returns of 5% to 7%.

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

*Are you on course for a financially-comfortable retirement? A **Retirement Analysis** can be very helpful in answering that. Please let us know if you would like to have us prepare one for you.*