McCarthy Asset Management, Inc.
Personalized Wealth Management

October 2018 Monthly Commentary

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Stock Market & Portfolio Performance

October 2018: The stock market experienced a scary correction in October, eliminating most of the gains earned earlier in the year. See the article on P.2-3 to get our thoughts about whether this marks the end of the bull market. Bonds served their purpose by cushioning portfolio losses, although they experienced small declines for the month.

	Oct 2018	YTD 2018	Description:
Without Dividends:			
S&P 500	-6.9%	1.4%	500 Largest Public U.S. Companies
Russell 2000	-11.0%	-1.6%	2000 of the smallest U.S. stocks
MSCI EAFE	-8.0%	-11.5%	international stock index
U.S. Aggr Bond	-0.8%	-2.4%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-5.8%	-1.0%	non-very conservative MAM portfolios
MAM Conserv	-4.2%	-1.8%	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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Is This the End of the Bull Market?

On October 10th, global equity markets tumbled, led by the U.S., with the S&P 500 declining 3.3%. The S&P 500 fell another 1.9% the next day. For the seven trading days from October 3rd through October 11th, the S&P 500 had a cumulative drop of 7.5%. This raises at least two questions:

What caused the sharp drop? While we can only speculate what triggered the fall, the primary culprit was likely a spike in interest rates. Continued robust U.S. economic data, combined with the Federal Reserve's ongoing tightening strategy, has caused U.S. interest rates to rapidly rise. The yield on the benchmark 10-year U.S. note, the backbone of borrowing costs for consumers, corporations and governments, rose to 3.23% on October 8th, up from 2.85% on August 31st.

A strong economy is generally good for stocks. But if yields continue to climb higher, investors may start to pull back from riskier assets since they are being better compensated for holding risk-free ones. Higher borrowing costs also could cool the pace of the economic expansion. The challenge for stock investors is gauging the point at which higher yields could trigger a bear market. During previous cycles of interest-rate increases, a 5% yield on the 10-year Treasury was usually the point that rate increases caused stock prices to fall, according to Credit Suisse data analyzing stock-market returns over the past 54 years.

Could this time be different? Until the Fed started consistently raising rates in 2017, the economy and stocks benefited from almost a decade of near-zero interest rates and other easy-money policies. Is it possible that a yield of 3.5% to 4.0% on the 10-year Treasury could be where the stock market experiences more significant weakness? This is something that we will focus on in the coming months.

Is this the start of a bear market where stock prices decline 20% or more? We believe probably not. Most bear markets start just prior to a U.S. recession. Due to the continued strength in the U.S. economy, the likelihood of the U.S. economy slipping into a recession in the next year is quite low.

Attached to this Monthly Commentary is a timely October 8th article, "An End Has a Start: Keeping an Eye on Recession Indicators," from Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co. Here are some points from the article (with her comments in "quotes" and the page numbers references to the article):

- **P.1:** "… I believe the runway between now and the next recession is reasonably long; it perhaps looks a bit like the runway at LaGuardia—long enough to land the plane, but fraught with potholes and construction obstacles."

- **2nd Longest Expansion (P.1):** "The current recovery/expansion is now the second longest in history, but also the shallowest."

- **Yield Curve Not Yet Flashing Red (P. 2):** "The Treasury yield curve is known as one of the most consistent recession indicators…Not only has the curve steepened a bit recently, due to the back-up in yields, it's not close to inverting, which tends to precede recessions." The recent steepening of the yield curve has been due to a spike in the 10-year Treasury rate. This can be viewed as bullish, as it indicates investors are confident the U.S. economy will continue to perform well. An inversion of the yield curve occurs when longer-term rates such as the 10-year Treasury dip below short-term rates, indicating that investors fear an economic slowdown.

Is This the End of the Bull Market? – cont'd

- **Recession Probability Up, But Still Low (P. 3):** "The Federal Reserve Bank of New York keeps a recession probability model…You can see it's been steadily rising and is approaching 15%. Obviously that's a low probability, but at its highest reading since 2008."

- **Leading Indicators Not Yet Flashing Red (P. 4):** "Most readers likely know I also focus a lot on the leading economic index (LEI) put out by The Conference Board on a monthly basis…I call it the "heads up" indicator given that it's never failed to roll over in advance of a recession starting." Rather than dropping, the LEI continues to reach new highs.

- **Consumer Confidence Spiking Higher (P. 5 & 6):** "…You can see that peaks in consumer confidence have been warning signs of recessions unfolding; and the latest reading has only been surpassed twice—in 2000 and the late 1960's." This is a bearish signal.

- **Consumers Highly Confident in Labor Market (P. 6):** Like the Consumer Confidence Index, consumers being highly confident in the health of the labor market is an indicator of pending risk to the economy.

- **Wage Pressure Slowly Rising (P. 7):** "This is one area where it's clear there remains some length in the runway based on historical trends, given that the past three recessions come following moves up to the 4% level." Currently, wages are rising less than 3% annually.

- **Unemployment Rate Plumbing Historical Lows (P. 7 & 8):** "…The unemployment rate has always been near its low point when recessions began and near its high point when recessions end". This is probably not bearish as it is likely that the unemployment rate will continue to fall through at least 2019.

- **Stocks Suffered Most Immediately Before Recessions (P. 8):** "The stock market, as a leading indicator, tends to display its greatest weakness in the (0 to 6) months immediately prior to the start of recessions." This is why we are so focused on when the next recession is likely to start.

- **Recessions Came After Fed Was Finished (P. 9):** "Recessions have generally come after the Fed has finished hiking rates in a cycle—not while they're in the process of raising rates." It is expected that the Fed will continue to raise rates at least through next June, which is bullish for the short-term outlook for the stock market.

In Summary: Most indicators show a low likelihood of a recession starting in the next year. Given that the worst stock market performance historically has occurred 0 to 6 months prior to the start of a recession, we will continue to pay close attention to when the next one is likely to start.

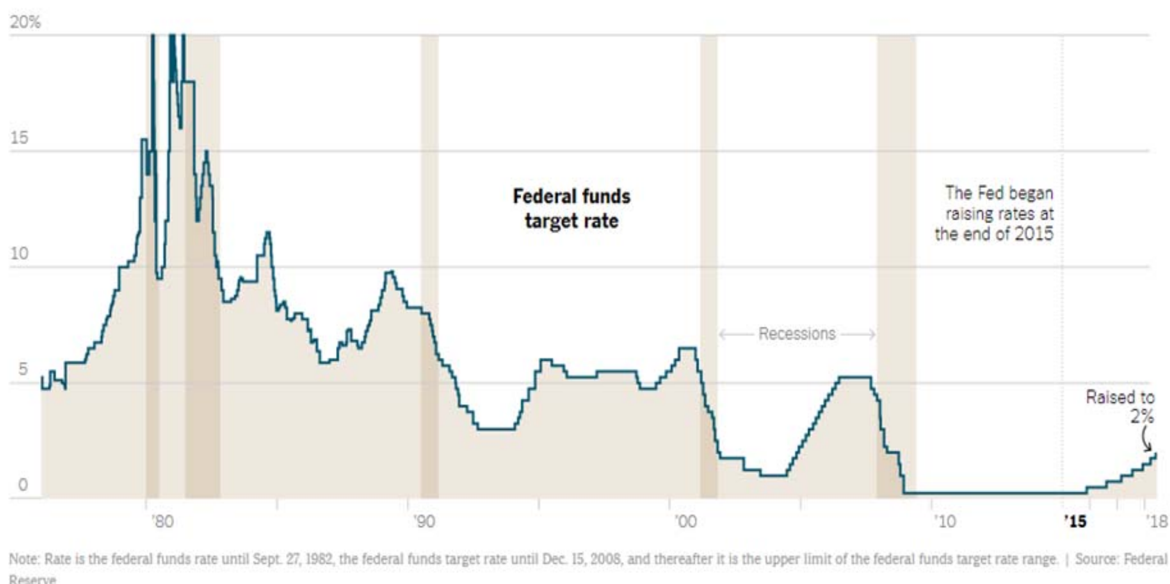
Impact of Rising Rates

Interest rates have risen this year, resulting in bonds posting small losses. Furthermore a recent spike in the 10-year Treasury rate was the likely cause of the drop in stock prices last month (see the previous article). The purpose of this article is to explain why we see the recent rise in rates as a positive.

Federal Funds Rate: The Federal Reserve controls the federal funds (fed funds) rate, which is the rate banks charge each other to lend Federal Reserve funds overnight. The Fed uses the fed funds rate as a tool to control U.S. economic growth, while banks use it to set other short-term interest rates, including the prime rate. Therefore, the fed funds rate is one of the most important interest rates in the world.

In response to the Financial Crisis of 2008, the Fed reduced the fed funds rate from 5.25% starting in September of 2007. By December of 2008, the rate was reduced to a historic low of 0.00% to 0.25%. The rate stayed near 0% until December of 2015, when the Fed raised it 0.25% in response to a growing economy. Since then, one more 0.25% increase was made in 2016, three more in 2017, and three so far in 2018. The most recent 0.25% increase in September of 2018 raised the fed funds rate to 2.25%. The Fed is expected to continue to raise rates in 0.25% increments three more times through June of 2019.

Here is a chart that shows the fed funds rate since the 1970's:



Note: Rate is the federal funds rate until Sept. 27, 1982, the federal funds target rate until Dec. 15, 2008, and thereafter it is the upper limit of the federal funds target rate range. | Source: Federal Reserve

Are Rising Interest Rates a Good or Bad Thing? As long as the increases in rates are due to a strong economy rather than fears of rising inflation, then we think the increases are good. This is the case currently as the economy continues to perform well while inflation remains subdued. We see the following benefits of the Fed's interest rate increases:

1) **Higher rates increase future bond returns.** While the Fed only directly controls short-term interest rates, they do indirectly impact longer-term rates, such as the 10-year Treasury. So far this year, the yield on the 10-year Treasury has increased from 2.46% at the beginning of 2018 to a recent rate of 3.16%. The best indicator of the return on a 10-year bond is its current yield. If an investor purchased a 10-year Treasury bond at the beginning of 2018, he/she would earn 2.46% per year if they held it for 10 years until maturity. Purchasing that same bond at the end of September would now earn 3.16% per year over the ten years. Higher rates will therefore increase the future return on owning bonds. This is a good thing because having a bond allocation in a diversified portfolio is very important to protect against downturns in the stock market.

Impact of Rising Rates– cont'd

2) **Provides a Tool for the Fed to Combat the Next Recession:** Probably the best tool that the Fed uses to stimulate the U.S. economy is to cut the fed funds rate. The higher the Fed raises the rate prior to the next recession, the greater it can reduce it to stimulate the economy. As can be seen in the chart above, the Fed dramatically cut the fed funds rate in 2000 in response to the dot.com bust, as well as in 2007-2008 due to the financial crisis.

3) **Impact on Stock Prices:** According to Vanguard, periods of rising rates almost always coincide with stock market gains, albeit the stock gains are typically modest. Vanguard looked at data covering the past 50 years, which included 11 periods where the Fed raised rates. The market rose in 10 of the 11 periods. As discussed in the previous article, historically, the worst period for stock market performance is after the Fed has completed its series of fed funds increases.

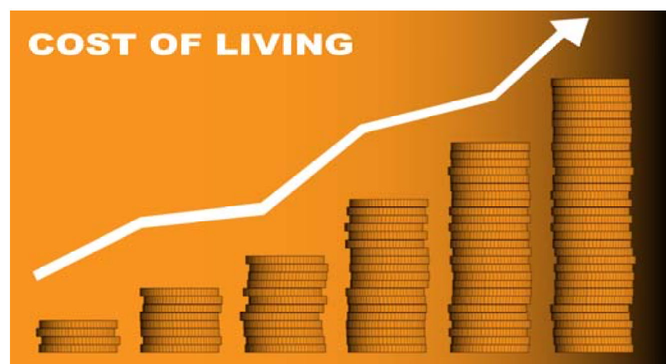
4) **Reason for Fed Rate Increases:** How stocks perform relative to Fed rate increases depend in part upon the reason for the increases. If it is due to a strong economy, as is the current case, then it is positive. On the other hand, if it is in response to excessive inflation, then it is a negative.

Rising Interest Rates Are a Negative for Real Estate: It is clear, though, that rising interest rates are a negative for real estate. This is because rising rates cause mortgage rates to rise. Given that mortgage interest is the most significant component in the cost of a home, higher mortgage rates could depress real estate prices. Recently, the rate on a 30-year fixed rate mortgage climbed to 5%, a 7-year high.

Social Security Benefits Will Increase 2.8% for 2019

The Social Security Administration announced last month that 63 million beneficiaries, including retirees and disabled workers and their eligible dependents, will receive a 2.8% increase in benefits next year, the largest annual cost-of-living (COLA) adjustment since 2012. The 2.8% COLA for 2019 follows a 2% increase this year. Previously, Social Security benefits increased a meager 0.3% in 2017. There was no increase in benefits in 2016.

The 2.8% rise will increase the maximum benefit for someone who retires at full retirement age by about $73, to a total of $2,861 per month in 2019. This maximum benefit does not include delayed retirement credits. Social Security recipients who delay claiming benefits beyond full retirement age earn an additional 8% per year for every year they postpone benefits up to age 70. Those who retire before full retirement age receive reduced benefits for the rest of their lives.



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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

Year-End Tax Planning: For those of you who are tax clients, please let us know if you would like to have us do any tax planning, such as determining the amount of 4th quarter estimated payments.

Discover the difference with a Registered Investment Advisor.