August 2023 Monthly Commentary

Sept. 1, 2023

Stock Market & Portfolio Performance

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August, 2023: After five months of gains, U.S. stocks fell modestly in August. International stocks also fell, while bonds prices slipped as the rate on the 10-year Treasury continued to rise.

	Aug 2023	YTD 2023	Description:
Without Dividends:			
S&P 500	-1.8%	17.4%	500 Largest Public U.S. Companies
Russell 2000	-5.1%	7.9%	2000 of the smallest U.S. stocks
MSCI EAFE	-3.7%	8.9%	international stock index
U.S. Aggr Bond	-0.6%	1.6%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-1.2%	8.6%	non-very conservative MAM portfolios
MAM Consrv	-0.7%	5.5%	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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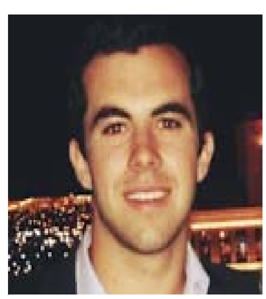

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Interest Rates: Higher for Longer?

Higher for Longer? Despite the Federal Reserve raising interest rates to a 22-year high, the economy remains surprisingly resilient, with estimates now putting third-quarter growth on pace to easily exceed its 2% trend. This is one of the factors leading some economists to question whether rates will ever return to the lower levels that prevailed before 2020, even if inflation returns to the Fed's 2% target over the next few years.

Surprising Strength in the U.S. Economy: As has been the case repeatedly over the past year, a steady stream of better-than-expected data has left analysts scrambling to lift their forecasts. New orders for manufacturing firms reached their highest level in nine months in July. Retail sales were also strong in July, with consumers splurging on everything from restaurant meals to online shopping. The construction industry has also been buoyant, supported by a rebound in homebuilding. Underpinning all this is the labor market, which has remained hot, making it relatively easy for people to find work at decent wages. The total number of jobs in America has been growing faster than the working-age population, helping to keep the unemployment rate at 3.5%, just shy of a five-decade low.

Recent Rise in Bond Yields: Bond yields, which move in the opposite direction of bond prices, turned sharply higher starting midway through July. Most notably, the yield on the U.S. Treasury 10-year note, which serves as an important benchmark for home mortgages, rose to its highest level since late 2007. The 10-year note reached 4.3% on August 18th, up from 3.8% on July 18th. As a result, the overall bond market has recently suffered losses.

This recent spike in interest rates may come as a surprise, as lately there has been continued good news on inflation. The July Consumer Price Index report marked a continued decline in the rate of inflation with prices rising a mild 0.2% for the month, the same as in June. On an annual basis, inflation rose 3.2% in July, down from a peak of 9%, and the lowest annual level since March 2021. Furthermore, core inflation, which strips out volatile food and energy costs, has also risen at its slowest pace in more than two years.

The Neutral Rate of Interest: The "neutral rate of interest" may be an issue. This is the rate at which the demand and supply of savings is in equilibrium, leading to stable economic growth and inflation. With inflation now falling but economic activity still firm, estimates of the neutral rate could take on greater importance in coming months. If the neutral rate has gone up, that could call for higher short-term interest rates, or delay interest rate cuts as inflation falls. It could also keep long-term bond yields, which determine rates on mortgages and corporate debt, higher for longer.

Analysts see three broad reasons why the neutral rate may be higher than it was before 2020:

1. Economic growth is now running well above Fed estimates of its long run "potential" rate of around 2%, suggesting interest rates at their current level of 5.25% to 5.5% simply aren't restrictive enough.

2. Swelling government deficits could increase the demand for savings, pushing the rate higher. See P. 3 for our article discussing our concern over the dramatic increase in the level of U.S. debt.

3. As the U.S. population ages (see P.4), retirees who had been saving for retirement, might now be spending those savings. With less being saved, this puts upward pressure on interest rates.

Case for Short-Term Bonds: With the Fed having raised interest rates by more than 5% since March 2022, bond yields have soared. Short-term bond yields have climbed even faster than the yield on longer-term bonds. As a result, the yield curve has been inverted since mid-2022, with that trend more pronounced through the first half of 2023. This means that currently, short-term bond funds are yielding more than longer-dated bond funds, without the additional interest-rate risk. This has benefited MAM portfolios with the J.P. Morgan Ultra-Short-Income ETF (symbol JPST) having the largest weighting in most MAM portfolios.

Interest Rates: Higher for Longer?- Con't

MAM Comments: If interest rates remain elevated for longer, we will position MAM portfolios to take advantage of these relatively high rates. Bond investments benefit from high rates. This is because higher yields increase the odds of higher total return for bonds. Bondholders also can benefit from potential price appreciation when rates eventually drop. For instance, the Bloomberg Intermediate Treasury Index returned just 1.7% when interest rates were low, but it jumped to 5.3% when they were moderate and exploded to 12.1% when rates were high.

History shows that the U.S. economy goes through cycles. Eventually, the economy will weaken, and the Fed would likely start to cut interest rates. At that time, it will make sense to shift at least part of the ultra-short term bond allocation into long-term bonds. Longer-maturity bonds allow us to lock in an attractive yield for longer and offer the potential for price appreciation.

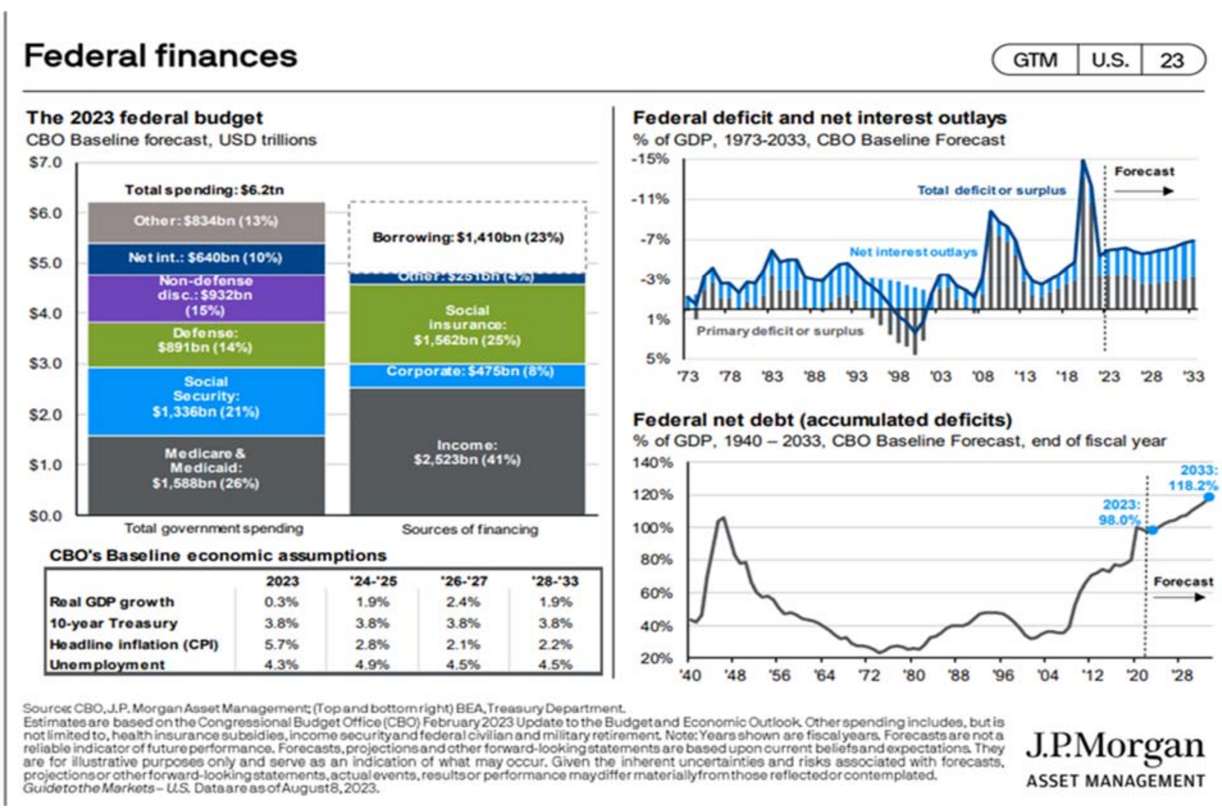
Will the U.S. Have a Debt Crisis?

On August 1st, credit rating agency Fitch Ratings downgraded U.S. Treasuries from AAA to AA+. Fitch's explanation for the downgrade was that it "reflects the expected fiscal deterioration over the next three years, a high and growing general government debt burden, and the erosion of governance relative to AA and AAA rated peers over the last two decades that has manifested in repeated debt-limit standoffs and last-minute resolutions."

Should we be worried about the credit worthiness of U.S. Treasury debt? No, I don't think there are any concerns there. What could become a problem, though, is the amount of debt the Federal government is accumulating. As the level of the debt increases, the cost of servicing that debt will continue to climb. Unfortunately, there is little talk in Congress to address rising deficits.

As Congress prepares to hash out spending for the next fiscal year, Republicans and Democrats aren't considering the policies that could meaningfully address the problem: raising taxes or cutting spending on major programs, such as Medicare or Social Security.

Long-Term Budget Outlook: In 2019, the federal debt was 78% of Gross Domestic Product (GDP). Large budget deficits, due in part to the economic costs of efforts to fight COVID, caused this debt to rise to 98% of GDP by 2023. As can be seen in the lower right of the chart below from J.P. Morgan, under current law, continued large budget deficits are projected to drive the federal debt to 118% of GDP by 2033:



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Factors that will continue to lead to large Federal deficits include:

- Net interest expense is expected to cost $640 billion for 2023. This is just over 10% of the 2023 federal budget of $6.2 trillion. Primarily due to higher interest rates, this interest is expected to increase by $123 billion compared to that of 2022. The Congressional Budget Office predicts net interest will reach $745 billion in the 2024 fiscal year—about three-quarters of all discretionary spending exclude defense.

- Social Security, Medicare, and Medicaid—which accounts for nearly half of all federal spending (47% as seen on the left of the chart above)—will also continue to get more expensive. Congress will have to act eventually. Social Security's trust fund is projected to be depleted by 2034. And Medicare's hospital-insurance trust fund is expected to be depleted even sooner in 2031.

- Aging U.S. Population: The U.S. population aged 65 and older has grown dramatically in recent years, rising from 40 million in 2009 to 57 million in 2022. It is projected to increase to more than 70 million by 2033. The 65+ population, which was just over 12% of the total population in 2000, is projected to rise to nearly 21% over the next decade, underscoring the growing burden of the aging population on federal spending.

Will this Become a Problem? We believe that high and growing government debt will eventually become a burden on economic growth. While not an immediate threat, eventually, large deficits could increase interest rates and crowd out borrowing by consumers and businesses.

What Can Be Done? Unfortunately, there are no easy answers. The policies that would be required to address the growing deficits are very difficult, if not politically impossible, at this point. Concerns about rising deficits and debt have been absent from the presidential campaign trail. While we don't view the rising deficits as a short-term risk, eventually (perhaps in 10 or 20 years), it could become more of a crisis. Probably only then will politicians act.

Implications for MAM Clients: Just to be clear, we don't see rising deficits as having a negative economic impact in the foreseeable future. Eventually, though, politicians will be forced to address the issue. Solutions could include raising income taxes and reducing Social Security and Medicare benefits through entitlement reform. Also, soaring government debt could motivate the Federal Reserve to increase the money supply, triggering higher inflation. Any of these steps may negatively impact the financial security of retirees, and therefore should be factored in when estimating the long-term rate of return for portfolios and the assumed rate of future inflation for retirement spending.

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

Please let us know if there are any topics you would like to have us cover or any questions answered in a future Monthly Commentary.