McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Bear Market of 2007-2008

Monday, July 14, 2008

Dear MAM Client,

On Wednesday, July 9th, the S & P 500 closed down 20.5% from its October 9, 2007 high, now officially qualifying this downturn as a Bear market. The $2.95 Trillion loss since the October high has been concentrated in the Financial sector, which has lost 45.9% since then, or $1.24 Trillion dollars. The last Bear market was in 2000-2002, when the S & P 500 lost 49.1% of its value, or $5.77 Trillion. The subsequent Bull market (10/9/02 – 10/9/07), saw a 101.5% gain, adding $6.64 Trillion to investors' hands.

What has caused this Bear market?

The stock market has dropped in response to the housing slump, tightening credit conditions, skyrocketing energy prices and rapidly rising food costs. The combinations of these shocks have taken a heavy toll on economic activity, depressing growth to a sluggish pace. Surprisingly, the economy has managed to sustain very moderate growth, due to government stimulus payments, Fed interest rate cuts, and solid growth abroad.

The Federal Reserve's unprecedented actions during the first quarter to shore up credit markets and create liquidity led many to hope we were past the worst of the financial crisis and that the stock market had hit bottom. It now appears that while the Fed's actions may have significantly reduced the risk of a financial meltdown, the losses from bad loans continue to be worse than expected.

How difficult are the conditions for our financial institutions?

Very difficult. On Friday, July 11th, IndyMac Bank's assets were seized by federal regulators after the mortgage lender succumbed to the pressures of tighter credit, tumbling home prices, and rising foreclosures. The bank was the second largest financial institution to close in U.S. history. Some financial analysts predict that certain local & regional banks with large mortgage exposure could be the next to fail. Even Fannie Mae & Freddie Mac, who either hold or back about 50% of the outstanding mortgages in the United States, are struggling. Because these institutions are too critical to fail, some type of government bailout may be needed if conditions worsen.

Is my money safe in a financial institutional?

It is hard to anticipate how much worse conditions could get for financial institutions. It depends upon when real estate prices stop falling and begin recovering. While I expect the largest banks are "secure", to be prudent, I recommend depositors keep no more at any one financial institution than the FDIC-insured maximum ($100,000 per account holder).

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What is the outlook for the U.S. Economy?

There's little doubt that the U.S. economy faces severe challenges in the near term. A period of sub-par growth is likely to persist as the effects of the 3 negatives—the housing, credit, and energy shocks—play out. In a recent report, economists at the Deutsche Bank Group predicted "we see the economy gradually clawing its way back toward trend growth in 2009, as housing bottoms, as credit markets heal, as energy prices at least level off, as the effects of easier monetary policy persist, and as domestic demand in the rest of the world holds on enough to support U.S. exports."

How much lower is the market likely to fall? What should be done now?

It is quite possible that the stock prices will fall further before they start to recover. Even without a bad recession, fear and pessimism can take hold of investor psychology and send the market down further than what would be justified by long-term economic fundamentals. In this type of environment, a sense of perspective, and a reliance on investment discipline help to avoid becoming panicked by short-term concerns and paralyzed by long-term uncertainty.

I do not believe now is the time to get more defensive by reducing equity exposure. While bad news dominates the daily headlines, I currently view stocks as priced to outperform bonds and cash in most scenarios over the next five years. Furthermore, portfolios have already become more conservative through the 5% shift of equities to bonds in January, the addition of a conservative balanced fund (Oakmark Equity) in May, and the impact of the 9-month decline in equity prices which reduced the portion of portfolios invested in equities. I estimate that the combination of these 3 factors has caused the cash and bond portion of the average MAM portfolio to increase from 21.5% last October to 29% currently.

Should equity exposure be increased?

Ideally, the equity exposure in portfolios will be increased just when the stock market hits bottom. Practically, it would be very difficult to time this low, and emotionally, it would be hard to increase equity exposure in a declining market. The benefit of properly timing the increase in equity exposure would be tremendous, because historically, the greatest appreciation in stock prices occurs just after the market hits bottom. According to research done by Lowry's, stock market bottoms are formed after a series of 90% Down Days (there have been 2 since early June) which exhaust investors' desire to sell, followed shortly by a 90% Up Day. While I look forward to the 90% Up Day, I will wait for clear signs that the bear market has ended before increasing equity exposure.

Stock investors have been through difficult times before, while the U.S. economy has proved resilient and long-term investors have been rewarded. I don't think this time will be any different.

Do you want to talk?

Please send me an email or call if you would like to discuss the current stock market or your personal portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP