McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Financial Markets- What Is Going On?

Tuesday, September 16, 2008

Dear MAM Client,

Yesterday the stock market experienced its largest decline (the S & P 500 fell 4.7%) since September 17, 2001 (which was the first day of trading after 9/11). In this continuing bear market, stock markets all over the world are down sharply this year and news on the financial front has been shocking. Yesterday's sharp decline was in reaction to the news that Lehman Brothers is filing for bankruptcy, Merrill Lynch is being bought out by Bank of America and American International Group (AIG), the world's largest insurance company, is scrambling to raise additional capital.

What is going on? Based on a conference call today with PIMCO's Bill Gross (the world's largest bond manager), we are continuing to see the "deleveraging" process by financial firms to reduce their risk. As a result, stock market volatility and risk premiums have skyrocketed and the prices of almost all assets are dropping (real estate, commodities, stocks). Mr. Gross feels this process will continue until financial firms have raised sufficient capital for their operations.

I feel that the crux of the financial turmoil is the most severe correction in real estate prices since the Great Depression. As I have discussed previously, for a variety of reasons residential real estate were in a bubble from 2000 to July of 2006. During this 6 ½ years, real estate prices nearly doubled nationally, which is far greater appreciation than their long-term average. The painful correction is now reducing real estate prices to where they should be based on their long-term trend. Unfortunately, this corrective process has led to millions of foreclosures and massive problems at some major financial firms that have failed or are close to failing (Bear Sterns, Lehman Brothers, AIG, and Washington Mutual). While I don't know if it will be necessary for real estate prices to start to recover for the bear market in stocks to end, I think that at a minimum, we will need signs that the residential real estate market is starting to stabilize.

What is Being Done to Alleviate the Situation?

After bailing out Bear Sterns in March, recently the Federal government announced they will effectively bail out Fannie Mae and Freddie Mac. This latest move was to prevent the mortgage market from "freezing up". On Sunday the government made it clear that it would not provide assistance to Lehman Brothers. I feel that this was probably the right move. By not helping out Lehman Brothers, the government sent the message that investors need to be responsible for their decisions and not expect the government to rescue them when risky bets go bad. On the other hand, AIG is expected to receive Federal government support, as the ramifications of the world's largest insurer going bankrupt would have far-reaching implications.

In an effort to keep financial markets functioning, on Sunday the Federal Reserve announced they would accept a wider range of collateral, including equities, from investment banks seeking central bank loans. At the conclusion of its meeting today, the Fed announced that at this point it was not

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going to cut the Federal Funds rate. With interest rates higher in foreign markets, there is room for other central banks to act. Yesterday China's central bank cut interest rates for the first time in six years. This is expected to be the beginning of an easing cycle in China, which should be a positive for world equity markets. It remains to be seen whether other foreign central banks will also cut their interest rates.

Some Good News:

One of the factors afflicting the stock market has been skyrocketing energy costs. Since July 15th, oil prices have fallen nearly 40% since their mid-July high. Unfortunately, gasoline prices have not dropped as far as oil prices, in part due to damage to oil refineries from the recent hurricanes. Once gasoline prices catch up to the recent fall in oil prices, consumer spending should benefit. I find it interesting that while the sharp rise in oil prices was blamed as one of the causes of the current bear market, the recent drop in oil prices has not yet provided a boost to stock prices.

Additional good news is that the recent takeover by the Federal government of Fannie Mae and Freddie Mac has helped reduce mortgage rates. Rates on conforming loans have now dropped below 6%. Lower mortgage rates should help the residential real estate market to eventually turn around.

Should You React?

While I don't know when the stock market will hit bottom, I do have confidence that things will improve. During difficult times like now, I think it is important for investors to separate their emotions from their investment decisions. The natural inclination could be to get more conservative by selling equities now and wait for better times to reinvest. The problem is that almost by definition, this means selling when the market is low and buying back when it is higher. The average individual investor is susceptible to making these emotional decisions, and that is one reason why studies have shown the average individual investor dramatically underperforms the stock market averages.

What investors should really care about is where the stock market will be when they need to be withdrawing from their portfolios. Therefore, taking a long-term viewpoint is best. Fortunately, the volatility (and the risk of losses) of the stock market is greatly reduced in the long-run. For those retired clients who are currently withdrawing from their portfolios, as a general rule I keep two to three years of withdrawals in cash or cash equivalents. By doing this, we are not forced to sell equities to provide distributions. Rather I will wait for equity markets to improve before replenishing the cash accounts.

Do you want to talk?

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

Very truly yours,

Stephen P. McCarthy, CPA, CFP