

# ***McCarthy Asset Management, Inc.***

Registered Investment Advisor

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## **Monthly Investment Commentary- April 2009**

**Stock Market Performance for April:** After experiencing the worst drop on record for the first two months of a year, the S & P 500 for March-April 2009 has now had the best two-month gain (18.7%) in thirty-four years. The stock market has almost fully recovered its losses for 2009. Of course, there is still quite a ways to go for 2008 losses to be recovered.

Unadjusted for dividends, for the month of April the S & P 500 rose 9.4%, the NASDAQ climbed 12.3%, the Russell 2000 jumped 15.4%, and the international equity index MSCI EAFE climbed 12.3%. Bonds rose modestly for the month as they continued their recovery which started in late November of 2008.

**MAM April Performance:** For the month, MAM portfolios underperformed the S & P 500, with a composite rise of 6.9% (after all fees), versus a rise of 9.6% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The under performance of MAM portfolios relative to the S & P 500 was due to the bond and Hussman fund allocation. While these conservative funds rose modestly for the month, they rose less than the S & P 500.

**Year-To-Date Performance:** For the first four months of 2009, unadjusted for dividends, the S & P 500 fell 3.4%, the NASDAQ rose 8.9%, the Russell 2000 dropped 2.4%, and the international equity index MSCI EAFE dropped 4.2%. MAM portfolios out performed the S & P 500 for these four months with a rise of 0.3% (after all fees) versus a loss of 2.5% for the Vanguard Index 500 fund with dividends reinvested.

The remainder of this Monthly Commentary addresses the following:

1. *Economic Update*
2. *Stabilization of Housing Market?*
3. *Portfolio Adjustments- None for Now*
4. *Stock Market Outlook*
5. *Swine Flu*

**Economic Update:** On Wednesday the Commerce Department released its initial estimate of 1<sup>st</sup> quarter 2009 GDP, reporting that economic output contracted at a 6.1% annual rate. Combined with the 6.3% contraction for the 4<sup>th</sup> quarter of 2008, this represents the worst six-month performance for the U.S. economy since 1958. Despite the sharp drop, there was positive news in the first quarter report. The 6.3% drop for the 4<sup>th</sup> quarter of 2008 was partly a consumer-driven pullback as credit froze in the months after September's financial shock. Consumer spending, which accounts for about 70% of economic activity, has bounced back since then. It rose 2.2% in the first quarter, offering modest hope that consumers' hesitance to buy major products may be wearing off.

Almost half of the 6.1% annual rate of decline in the first-quarter GDP was due to businesses paring inventories. While the inventory adjustment is expected to carry into the current quarter, the correction should put the economy in a better position to stabilize by the third quarter. This is because the inventory purge sets up a natural snapback for the economy. As depleted inventories come into better balance with sales, companies start ordering again, setting the stage for renewed growth.

Excluding the drop in inventories, ultimate demand in the economy fell at a 3.4% annual rate for the 1<sup>st</sup> quarter, compared to 6.2% in the fourth quarter. The latest forecasts see the economy slipping in the second quarter at a 2% to 3.5% rate, and finally flattening out or even turning moderately up in the second half of 2009. Growth is expected to be positive but subdued for 2010. Employers continue to slash jobs at a rapid pace, and economists expect severe job losses to continue at least into summer. The government's fiscal stimulus package is boosting incomes modestly, however, and by the fourth quarter is expected to provide support for other sectors of the economy. The \$787 billion stimulus, which passed in February, is expected to deliver huge infusions to local and state governments for infrastructure and other major projects.

**Stabilization of Housing Market?:** There have been signs that real estate prices are close to bottoming out in the most hard-hit markets of the U.S. The sharp drop in mortgage rates (which was engineered by the Federal Reserve's aggressive buying of mortgage-back securities that began in March) has been a very positive factor. During the first quarter of 2009, the Affordability Index reached the highest level since the National Association of Realtors began collecting this data in 1971. The March reading of 166.7 for this index means that a family earning the median income has 166.7% of the income needed to qualify for a mortgage on a median-priced home. The Fed's continued efforts to keep mortgage rates low may help stabilize the housing market. This should help boost the entire economy, as the national plunge in real estate prices is what started the credit crisis two years ago.

**Portfolio Adjustments-None for Now:** For the vast majority of the MAM-managed portfolios, I have made no changes since early February, when the allocation to Hussman Strategic Growth Fund was increased. I estimate that the average MAM portfolio has an asset allocation that should provide approximately 65% of the volatility of the S & P 500. At this point, I have no immediate plans for making new portfolio adjustments. I believe it is prudent to maintain the downside protection of the bond funds until I am more confident that the stock market is undergoing a sustainable rally. When I do decide to reposition portfolios, one step that I am considering is to increase small-cap equity exposure. Historically, small-cap stocks have significantly outperformed large caps coming out of a recession.

For portfolios with excess cash, I recently started investing that cash on a monthly basis in some of the funds in the "Very Conservative Portfolio" that was introduced in the March 31, 2009 quarterly report. I feel that these conservative funds, which are primarily bond and conservative balanced funds, provide an attractive option to low-yielding money market accounts.

**Stock Market Outlook:** Since the March 9<sup>th</sup> low to the April 30<sup>th</sup> close, the S & P 500 has risen 29.0%. I imagine that this rise occurred at a time when it was least expected by investors as most of the economic reports in February and early March were fairly dire. This is a trait of the stock market as it often does what is least expected. It makes successful timing of the market incredibly difficult. While six weeks ago it probably felt emotionally like a good time to get more conservative, it was probably a great time to get more aggressive. Since I think it is too difficult to try to time these market lows, I think it is critical to provide enough downside

protection to allow investors to “hang in there” during the market downturns. For those investors who have found it very difficult to endure this bear market, my recommendation for them is to be less aggressive in their asset allocation.

Given the strong stock market of the last seven weeks, a temporary pullback may be healthy. A rise that is “too sharp and too fast” can leave stocks vulnerable to a sharp correction. As the financial crisis continues to subside and the economy shows signs of improvement, I am cautiously optimistic that the general trend will be up for stocks. What gives me more reason for hope is the tremendous amount of cash parked in CDs, savings accounts, and money markets earning very little. Over time, I expect that a significant portion of this money will eventually be invested in the stock market.

**Swine Flu:** Last weekend an international swine flu (H1N1) outbreak emerged as the U.S. has declared a “public health emergency” and the World Health Organization (WHO) said the virus threatened to become a global epidemic and raised its alert level to Phase 5, the second-highest level. This is a health story that potentially could have a significant impact on investing and financial planning. While it’s still premature to draw significant conclusions or take action, I will continue to monitor these events.

A pandemic is defined as an epidemic occurring over a very wide area, crossing international boundaries, and usually affecting a large number of people. Since 1900, three pandemics and several “pandemic threats” have taken place. In the twentieth century, three flu outbreaks—in 1918, 1957, and 1968—were labeled as pandemics. Three further flu outbreaks threatened to become pandemics but did not become global. These took place in 1976 (swine flu), 1977 (Russian flu), and 1997 (avian flu). Controls such as quarantine, inoculation, and limits on travel helped to keep these outbreaks from spreading.

What are the investment implications if this swine flu were to become a major pandemic? I would expect a weakened stock market and another flight to safety in U.S. Treasuries. In general terms, I would seek high quality bonds funds and flexible funds such as Hussman Strategic Growth, which can adjust exposure to stocks.

At this point I feel investment adjustments would be premature. In the coming days and weeks, I will be watching such key factors as infection rates, incubation periods, mortality rates, and the effectiveness of anti-viral and pneumonia medications. Hopefully the swine flu outbreak will subside before any significant health risks spread globally.

Sincerely,

Stephen P. McCarthy, CPA, CFP