

McCarthy Asset Management, Inc.

Registered Investment Advisor

September 2, 2008

Monthly Investment Commentary- August 2008 (With Corrected Performance)

Stock Market Performance for August: After reaching a 9-month low on July 15th, the market continued its mini rally through August as oil prices fell sharply and the U.S. dollar rose dramatically. For the month, unadjusted for dividends, the S & P 500 rose 1.3%, the NASDAQ climbed 1.8%, and the Russell 2000 jumped 3.5%. Foreign equities fell as the U.S. dollar recovered, bonds were mixed, and commodities fell sharply.

MAM Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite loss of 0.7% (after all fees), versus a rise of 1.5% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for August were FMI Large Cap (up 3.9%), iShares Russell 1000 Growth Index (up 2.7%), Selected American (up 2.6%), Oakmark Equity Income (up 1.8%), and Pioneer Cullen Value (up 1.5%).

The five worst performing MAM investments for August were PIMCO Commodity (down 6.5%), American New World (down 5.7%), Artisan International Small Cap (down 5.2%), PIMCO Developing Local (foreign bonds) (down 3.9%), and Dodge & Cox International Stock (down 2.6%).

For the month, the performance of MAM portfolios relative to the S & P 500 was hurt primarily by weakness in international funds due to a 7% rise in the U.S. dollar. Additionally, the drop in commodity prices and the relatively flat performance of bonds also hurt. Please see the discussion below regarding my outlook for the U.S. dollar, international equities, and commodities.

Year-To-Date Performance: For the first eight months of 2008, unadjusted for dividends, the S & P 500 fell 12.6%, the Nasdaq dropped 10.7%, and the Russell 2000 fell 3.4%. MAM portfolios out performed the S & P 500 so far for 2008 with a composite loss of 11.1% (after all fees), versus a loss of 11.4% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

U.S. Economy: The U.S. economy has been resilient despite tighter credit, soaring energy prices, a tumbling housing sector and consumer gloom. In fact the economy shifted to a higher gear in the spring, growing at its fastest pace in nearly a year as foreign buyers snapped up U.S. exports and tax rebates spurred shoppers at home. The Commerce Department reported last Thursday that Gross Domestic Product (GDP) increased at a 3.3% annual rate for the second quarter of 2008. The revised reading was much better than the government's initial estimate of a 1.9% pace. The rebound comes after two dismal quarters. The economy actually shrank in the final three months of 2007 and limped into the first quarter at a feeble 0.9% annual growth rate.

The recent growth pickup is not likely an indicator that the fragile economy is back on solid ground. Federal Reserve Chairman Ben Bernanke recently warned the economy will be weak through the rest of this year. A number of economists fear that the U.S. will hit another economic pothole in the fourth quarter as the stimulus from the Federal rebate checks fades and U.S. exports could slip as foreign economies slow down. Furthermore, seven consecutive months of negative employment growth does not portray a growing economy.

My Outlook

The remainder of this Monthly Commentary provides my outlook for various economic issues:

U.S. Dollar: Since the middle of July the U.S. dollar has risen 8% versus the euro and 5% against the Japanese yen. What triggered the rise and will it continue? Historically, major changes in the dollar's direction take time to unfold and rarely are smooth. In each case, the dollar reached a point of extreme weakness or strength before heading in the other direction. The current slide seems to follow that pattern: from its peak in 2001 until its July low, the dollar lost nearly half of its value versus the euro, reaching a level that currency experts say was about 30% too cheap based on economic fundamentals.

The two biggest factors behind the dollar's recent rise have been the collapse in oil prices and recent data that confirmed the European and Japanese economies are weakening. While I expect the U.S. dollar will continue to recover in the short run, I don't think a long-term recovery is likely. The recent rally is driven more by slowing foreign economies rather than a coming U.S. economic boom. Furthermore, the weakening foreign economies do not bode well for the continued growth in U.S. exports. In the long run, I feel that the dollar is vulnerable to further weakness due to structural problems with the U.S. economy. In particular, we have an aging population with projected massive Social Security and Medicare deficits that could lead to huge U.S. government deficits.

Foreign Stocks: The sharp rise in the U.S. dollar in August resulted in the very poor performance of foreign mutual funds. Because I feel that the U.S. dollar is likely to continue to recover in the short-run (at least relative to the euro), I am considering reducing the high foreign stock exposure in MAM portfolios. This will be a tough decision, though, as long-term I favor foreign stocks over U.S. stocks for the following reasons:

- Foreign economic growth will exceed U.S. economic growth. In fact, Baring Asset Management of Boston predicts that the proportion of total market capitalization represented by the emerging world will increase from 13% currently to over 30% by 2018. The rising middle class in China, India and other emerging markets will enable the economic growth in these countries to dwarf that of the U.S.
- Foreign stocks are cheap relative to U.S. stocks. Emerging markets are currently trading at an 8.2 times price-earnings ratio, developed Europe is trading at 8.9 times earnings, Asian at 11.6 times earnings, and the U.S. is trading at roughly at 12.5 times earnings. Similarly, emerging regions of the world rank highest in expected earnings growth, trailed by the developed markets of Europe and the United States.
- Foreign stocks have much more attractive yields than U.S. stocks. A leading index of big cap stocks in the developed overseas markets recently yielded 3.7% versus a 2.4% rate for similar U.S. stocks.

Oil Prices: After a further drop today, U.S. oil prices have plunged nearly \$40 per barrel from their peak in mid-July. The drop is attributed to slower global economic growth combined with consumers' conservation measures to reduce gasoline consumption. Some experts predict that moderating demand will allow oil prices to trade in the range of \$90 to \$125 per barrel during the next 18 months.

While we may enjoy a one to two-year reprieve from high oil prices, I believe it is only a matter of time before oil prices reach new highs. The reason is simple: the long-term outlook for new oil supplies will be insufficient to satisfy the projected growth in long-term demand. The rise of the middle class in emerging markets will lead to a steadily increasing demand for oil. For example, one energy expert recently said that the decrease in demand that would occur if all Americans switched to hybrid vehicles would not be enough to offset the projected increase in oil demand from China for the next two years. While I hope that next year's new Administration will help the U.S. will finally get serious about developing a long-term energy policy to reduce or eliminate our need for foreign oil, realistically the development of significant sources of alternative energy will take decades.

Inflation: "Inflation Rate Hit's 17-year High", was the title of an article two weeks ago that reported that consumer prices shot up 0.8% in July, twice the expected rate, pushed higher by surging energy and food costs. Rising inflation would be a real problem for consumers and retirees in making ends meet and for the Federal Reserve to prop up the economy (as Fed actions to strengthen the economy could further exasperate inflation). I believe that inflation fears are now yesterday's news. The recent plunge in oil prices and other commodities will reduce the pressures that have led to the recent upsurge in inflation. Furthermore, the depressed employment market will keep wage inflation pressure from developing, which is what led to the high inflation that we experienced in the 1970's.

Real Estate Prices: The U.S. is experiencing the greatest decrease in real estate prices since the Great Depression. I see few signs that would indicate a recovery is near. I expect that the bottom is still at least 1 year away, with any recovery not starting until at least 2010.

The Stock Market: Short-term I am cautious in my outlook for the stock market. A weakening economy and further troubles with financial institutions could stifle stocks. When will the current bear market end? Predicting the turnaround in stock prices is difficult (if not impossible) in part because historically the stock market recovers before the economy does.

One way I try to gauge the future direction of stock prices is to follow the analysis of technical analysts such as Lowry's. As I have written before, Lowry's has provided its stock market timing service for the last seventy years by analyzing investor Demand and Supply for stocks. Unlike Bob Brinker (who I also follow), Lowry's has been consistently bearish for the last 12 months. According to Lowry's, historically bear markets end with a one or more selling climaxes in which a severe decline occurs on very large volume (a "90% Down Day"), followed shortly by a reversal of a very large up day on large volume (a "90% Up Day"). The 90% Down Days serve to reduce the supply of stock being offered for sale (Selling Pressure), while the 90% Up Day indicates renewed investor Demand (Buying Power) has become broad and strong.

Based on its historical analysis, Lowry's feels that the mid-July stock market low did not conform to the patterns of Supply and Demand typically found at major bottoms. In particular, while there were two 90% Down Days in June, there were none during the last three weeks of the decline to the mid-July market low. This suggests that the last 3 weeks of decline occurred on mild selling, and that the sellers had not been exhausted. Furthermore, the subsequent rally has not had the characteristics of a new bull market as a 90% Up Day has yet to occur.

In Summary: I expect that the U.S. economy will slow during the next few quarters, with a possible recession occurring late this year or early next year. This should be accompanied by falling oil and commodity prices, falling inflation and a rising U.S. dollar. It is very possible that the stock market will reach new lows during the next couple of months (as historically many of the significant stock market declines have occurred in September and October). In the longer run, I expect rising oil and commodity prices, renewed weakness in the U.S. dollar, and a strengthening economy led by a recovering stock market.

Please call or email me if you have any questions regarding any of this or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP