

McCarthy Asset Management, Inc.

Registered Investment Advisor

August 3, 2009

Monthly Investment Commentary- July 2009

Stock Market Performance for July: After recovering from a 5% slump at the beginning of the month, the stock market continued its 5-month surge. The stock market (as represented by the S & P 500) posted its fourth consecutive month of gains in July and has now risen 46.0% since its March 9th low. My feeling is that momentum is building and the stock market rally will probably continue for at least a few more months.

Unadjusted for dividends, for the month of July the S & P 500 rose 7.4%, the NASDAQ climbed 7.8%, the Russell 2000 rose 9.6%, and the international equity index MSCI EAFE jumped 9.1%. Corporate bonds rose for the month as they continued to perform well this year.

MAM July Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite rise of 5.6% (after all fees), versus a rise of 7.6% 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 the bonds funds and Hussman fund posted positive returns, they rose significantly less than the S & P 500.

Year-To-Date Performance: For the first seven months of 2009, unadjusted for dividends, the S & P 500 rose 9.3%, the NASDAQ jumped 25.5%, the Russell 2000 rose 11.5%, and the international equity index MSCI EAFE climbed 15.2%. MAM portfolios out performed the S & P 500 for these seven months with a rise of 12.1% (after all fees) versus a rise of 11.0% for the Vanguard Index 500 fund with dividends reinvested.

The out performance of MAM portfolios over the S & P 500 for the first seven months of 2009 was due to good mutual fund selection (most U.S. equity funds used by MAM outperformed the S & P 500) and strong performance from all the international equity funds used by MAM. While the bond funds have performed very well so far this year, with the exception of Loomis Sayles Bond fund, they have underperformed the S & P 500.

The remainder of this Monthly Commentary addresses the following:

1. *Economic Update*
2. *Stock Market Outlook- The "New Normal"*
3. *Net Worth Analysis*

Economic Update

In the strongest signal so far that the longest and deepest recession since the Great Depression appears to be ending, last Friday the Commerce Department reported that the economy sank at a pace of just 1 percent in the second quarter of 2009. This initial estimate of Gross Domestic Product (GDP) was a sharp improvement from the 6.4% drop for the prior quarter. Less drastic

spending cuts by businesses, a resumption of spending by federal and local governments and an improved trade picture were key forces behind the better performance for the most recent quarter. The following are factors that are expected to help the economy resume growth as early as this quarter:

1. **Rebuilding of Inventories:** During the second quarter, businesses continued to reduce inventories and the cumulative liquidation over the past nine months could set the stage for a considerably stronger set of GDP numbers than currently forecast as inventories are rebuilt. With inventories at rock-bottom, businesses are expected to ramp up production in this third quarter to satisfy customer demand. This is expected to provide a significant boost to the economy.
2. **Auto Sales:** The inventory-related rebound will be helped by auto output, as General Motors and Chrysler gear up. Their shutdowns and cutbacks lead to a record drop in cars on dealer lots. Over the past year sales of U.S.-made vehicles have fallen 28% but production has plunged 55%. The “cash for clunkers” program will help spur output as the \$1 billion program appears to have become fully spent within one week with over 200,000 cars being sold. There are now efforts in Congress to allocate an additional \$2 billion to extend the life of the “cash for clunkers” program.
3. **Homebuilding:** As with auto production, homebuilding has been close to depression-like levels and has contributed to huge job losses. The homebuilding industry by itself is running 75% below its peak levels and 66% below natural demand. The economy has lost more than 1.5 million construction jobs from its peak (versus 6 million jobs for the whole economy). Benefiting from sharply reduced prices, low mortgage rates and the first-time homebuyer tax credit, homebuilding appears to have hit bottom and may start benefiting the economy. Even a partial rebound in construction could add back nearly a million direct and indirect jobs to the economy.

There are signs that real estate and homebuilding may be close to turning around. Home sales have turned up in recent months, which have reduced the inventory of unsold homes from 11.3 months one year ago to 9.4 months in June. Furthermore, last week the Case-Shiller Home Price index for May was released. The result was the first monthly sequential increase in real estate prices in 31 months (though the number was still down 17.1% from the prior year). This report could begin to turn sentiment of potential homebuyers who have been slow to purchase because of fear that housing prices would erode even further.

4. **Exports:** I expect for the economy to benefit from the growth of U.S. exports. While imports have plummeted for ten months in a row, exports rose by \$1.9 billion in May, the first uptick since July 2008. Foreign countries, especially the fast-growing emerging markets of Asia and Latin American, are buying more of our goods and services. Now that America’s consumption binge has tapered off, exports will figure increasingly in the nation’s growth.
4. **Employment:** While unemployment is expected to continue to climb until at least early next year, signs have emerged recently that the worst of the job losses are probably behind us.
5. **Consumer Spending:** Consumer spending has a huge impact on the economy as in recent years it has accounted for 70% of Gross Domestic Product (GDP). While I expect Americans new fondness for frugality will reduce this percentage going forward, recently consumer confidence and spending have shown signs of stabilization.

The consensus from economists is for the economy to grow at an annual rate of about 2% in the second half of this year with further growth in 2010. A risk is that, without a pickup in consumer spending, any inventory-led bounce in growth could stall in 2010. For consumer spending to significantly increase, the labor markets will probably need to stabilize so that U.S. households obtain a sustainable source of income growth. *The bottom line is that while it appears the recession is ending, it is not clear how strong the recovery will be.*

Stock Market Outlook:

Is this the start of a new multi-year bull market based on a quick and steep economic recovery? Or are we faced with a more drawn out economic recovery process that may take many quarters or even years to complete? Clearly the stock market has regained a lot of momentum. While there is a good chance the market will continue to recover in the short run, it is difficult to predict how far and fast this will go as the recovery in stock prices is moving well ahead of the recovery in the economy. This is not surprising as stock prices are influenced by how the economy is expected to be performing in four to six months.

My longer-term assessment is that *we have entered a "new normal" where the fundamental rules of the game have changed*, a phrase and concept coined by Mohamed El-Erian, co-CEO of PIMCO. After years of credit and leverage-induced economic growth, the "new normal" will incorporate slower economic growth, lower profit growth, reduced consumption, and a difficult employment market. *The historical pace of economic growth will face many headwinds, including excessive regulation, higher taxation, ballooning deficits, higher interest rates, and a depreciating U.S. dollar.* The upshot of this is my belief that at this time investors should not take on undue risk and should remain flexible to adjust their portfolio(s) in light of changing market conditions.

This is consistent with the current asset allocation of MAM portfolios. With the portfolio repositioning that was completed last month, most MAM portfolios have an asset allocation such that they should experience 60% to 75% of the volatility of the S & P 500. While this means that MAM portfolios are likely to lag the stock market should stocks continue to rally strongly, I feel it is prudent to maintain significant downside protection given the risks and unknowns in the current environment.

Net Worth Analysis:

If it has been more than 12 months since we updated your Net Worth Analysis (NWA) (or if we haven't prepared one for you), I encourage you to request a questionnaire from us. Last year's brutal stock market (the worst since 1932) took a toll on clients' invested assets. As a result, I know some of you have been hesitant to update your NWA. While the rebound so far this year will help improve the numbers, whether the news is good or bad, I feel it is important for clients to at least annually track their progress toward a financially comfortable retirement. Please let me know if we should send you a questionnaire.

Please contact me if you would like to discuss any of this further.

Sincerely,

Stephen P. McCarthy, CPA, CFP