

McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- October 2008

Stock Market Performance for October: This past month was one of the most difficult and volatile months ever for the stock market. Performance for the full month was the worst since the 1987 crash, with the S & P 500 falling 16.9%, the NASDAQ dropping 17.3%, and the Russell 2000 falling 20.8%. Other asset classes also dropped sharply for the month. With the exception of U.S. government bonds, nearly all bond types fell dramatically, foreign equities fell more than U.S. equities, and the price of oil and other commodities plunged.

Things could have been much worse. The market hit an intra-day (non-closing) low on October 10th when the S & P 500 hit a low of -27.9% for the month-to-date (close to the -29.9% worst ever one-month performance which occurred in September of 1931). Subsequent to October 10th, the market bounced around quite a bit. The market hit a closing low on Monday, October 27th. To the relief of many investors, the market finished the month with the best weekly performance in 34 years (up 10.5% for the week). Volatility for October was enormous as 13 of the days the S & P 500 closed up or down at least 3%.

October MAM Performance: For the month, MAM portfolios out performed the S & P 500, with a composite loss of 15.8% (after all fees), versus a drop of 16.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The performance of MAM portfolios relative to the S & P 500 was helped by the downside protection provided by bond funds. Although bonds also slumped, they fell less than equities. MAM portfolios were hurt by weakness in international funds due to continued strength in the U.S. dollar. The MSCI EAFE international index fell 20.2% for the month. In addition, oil and other commodity prices fell sharply as indicated by the 29.1% drop in the PIMCO Commodity fund.

Year-To-Date Performance: For the first ten months of 2008, unadjusted for dividends, the S & P 500 fell 34.0%, the Nasdaq dropped 35.1%, the Russell 2000 fell 29.8%, and the MSCI EAFE international index plummeted 45.0%. MAM portfolios have slightly out performed the S & P 500 so far for 2008 with a composite loss of 32.5% (after all fees), versus a loss of 32.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

Problems and Possible Solutions:

Credit Crisis: As a result of a real estate bubble that developed in part due to extremely lax lending standards, we are experiencing the most severe downturn in real estate prices since the Great Depression. Millions of foreclosures have led to massive problems at major financial firms resulting in the failure of Bear Sterns, Fannie Mae, Freddie Mac, Lehman Brothers, AIG and Washington Mutual. This has led to a crisis of confidence where banks are hoarding cash and restricting lending to individuals, corporations and other banks.

Measures by the Federal Reserve to enhance liquidity have not been sufficient to impel banks to lend when their fear of default is so high. Recently authorities in the U.S. and abroad have been focusing on what they now believe is the core problem: the massive destruction of capital at lending institutions caused by markdowns of troubled assets. To that end, the U.S. Treasury has shifted its immediate attention toward investing up to \$250 billion in new capital into U.S. banks in return for temporary ownership stakes. This recapitalization may well mark the beginning of the end of the crisis, although progress will come slowly.

There are tentative signs of improving conditions. A key measure of the health of credit markets is the difference between the Libor rate (the overnight London Interbank rate used for banks lending to each other) and the U.S. federal funds rate. Historically, Libor has run fairly close to the federal funds rate (which the Fed reduced last week to 1%). Early last month the overnight Libor spiked to between 3% and 6%, an indication that banks perceive a great deal of risk. During the later part of October, however, the overnight Libor rate had dropped moderately. In another positive sign, last week the amount of commercial paper outstanding (i.e. short-term, unsecured loans companies get to finance their operations) rose for the first time in seven weeks.

Real Estate Downturn: Many industry experts don't expect real estate prices to hit bottom until at least the middle of 2010. Given that the real estate downturn is what triggered the credit crisis, I think it will be important to see signs that the residential real estate market is starting to stabilize. So far the Federal efforts at alleviating the credit crisis have been primarily directed at financial institutions. There are now discussions that some of the attention will be directed to the homeowners at risk. Recently the U.S. Treasury and the Federal Deposit Insurance Corporation (FDIC) announced they are considering a program that may offer about \$500 billion in guarantees for troubled mortgages to stem record foreclosures. The government is considering multiple options and not yet made a final decision. In addition, some financial institutions are also instituting their own efforts. For instance, last Friday J.P. Morgan Chase (the buyer of Washington Mutual) launched an ambitious plan to modify the terms of \$70 billion in mortgages for borrowers who are behind on their payments. The move by the New York bank will cover as many as 400,000 borrowers who may be moved into loans carrying lower interest rates, smaller principal amounts or other more affordable terms.

U.S. Recession: Although it has not yet been officially proclaimed, there is little doubt that the U.S. economy is in a recession (officially defined as two consecutive quarters of negative gross domestic product). On October 30th the Commerce Department released its initial estimate for the July-September quarter, reporting that the GDP shrank at a 0.3 percent annual rate. Consumer spending, which makes up more than 70% of total economic activity, fell at a 3.1% annual rate in the quarter, the first drop in 17 years and the sharpest decline since 1980. Economists expect the GDP in the current quarter to decline more than 3% and continue contracting in the first three months of next year. The unemployment rate, now at 6.1%, is likely to top 7% in the coming months and some forecasts show it hitting 8% by the end of next year.

While I believe it is too late to avoid a recession, this is not necessarily a terrible thing as recessions are a natural, regular occurrence in a capitalistic economy. Recessions help ring the excesses out of the system, causing consumers to reign in spending and reduce debt, and helping corporations become leaner and increase productivity. While recessions play a role in long-term economic growth, a deep or long recession would be painful.

Our last two recessions were quick and shallow, and were triggered by a reduction in corporate spending. This recession, though, is being led by a reduction in consumer spending. This slowdown is very understandable. For years U.S. consumers have spent freely as readily available credit allowed many of them to live beyond their means. Consumers are now faced with a sharp reduction in the availability of credit, ten consecutive months of falling employment, the worst real estate downturn since the Great Depression, and one of the worst stock markets in decades. The important question for investors is how long and deep will this recession be? While that remains to be seen, I see three factors that will act to lessen the severity of this recession: lower interest rates, fiscal stimulus and lower oil and other commodity prices.

1. Interest Rate Cuts: There is now a globally-synchronized effort to lower interest rates, which should provide a boost to consumers and businesses. During the last couple of weeks, interest rate cuts have occurred throughout the world, including the European Union, China, and India. Last Wednesday the U.S. Federal Reserve announced a half a percentage point reduction in the federal funds rate to 1%. This is the lowest federal funds rate since 2004. In fact the federal funds rate has not been less than 1% since 1958, when Dwight Eisenhower was president.

2. Fiscal Stimulus: Last January when the first indications of a recession appeared, lawmakers quickly passed the Economic Stimulus Act of 2008, a \$152 billion package that included rebates to 130 million Americans. Receipt of those rebates was a significant factor in the strong GDP growth experienced in the second quarter of 2008. I expect that early next year Congress and the new Administration will act aggressively in passing additional stimulus measures.

3. Sharply Lower Commodity Prices: Oil prices closed the month at \$67.81 a barrel, down 33% from the prior month while the Dow Jones-AIG Commodity Index, a basket of 19 commodities, fell 21.3% for the month, the steepest one-month decline in the history of the index, which dates back to 1991. After peaking at over \$145 a barrel in May, oil prices have now fallen over 50%. Meanwhile the national average price of gasoline has fallen from a peak of \$4.11 per gallon on July 16, 2008 to \$2.78 recently, a drop of \$1.33 a gallon. Economists estimate the each dollar-a-gallon drop in pump prices, if sustained, would free up \$100 billion in spending. Therefore the benefit to consumers of the recent plunge in gas prices is comparable to last January's tax rebate stimulus bill. Consumers should further benefit as trucking companies, airlines, and other businesses pass through their lower energy costs. The drop in other commodity prices will also provide a boost to consumers as food costs should also decline.

Importance of Not Reacting Emotionally

As I have discussed previously, the average investor underperforms the stock market due to their emotionally-driven market timing decisions. According to a recently updated study from Dalbar, Inc., over the period from 1988-2007, the average stock fund returned 11.6% annually, while the average stock fund investor earned only 4.5%. *Why did investors sacrifice nearly two-thirds of their potential returns?* Driven by emotions like fear and greed, they engaged in such negative behaviors as chasing the hot manager or asset class, avoiding areas of the market that were out of favor, attempting to time the market, or otherwise abandoning their investment plan. Great investors throughout history (such as Benjamin Graham, Warren Buffet, and Peter Lynch) have understood that building long-term wealth requires the ability to control one's emotions and avoid self-destructive investor behavior.

Although I haven't seen specific figures yet, I imagine that many individual investors did flee the stock market this past month as fear drove stock prices lower and lower. I have been very impressed, though, with the patience and confidence that the vast majority of MAM clients have shown during this very difficult time. As it became clear that the market drop was worsening, I made an effort to directly contact each of you to provide my insight into what was going on and to find out where you were emotionally. The last time I contacted each of my clients was the summer of 2000, during the early stage of the "dot com crash". My feeling back then was that technology stocks were overvalued. My reaction was to reduce the technology stock exposure in portfolios and increase small cap stocks and REITs. With the current bear market, I don't view any significant asset class as overvalued. Therefore for most portfolios my only response so far has been to slightly reduce international equity exposure due to what I believe is a temporary surge in the U.S. dollar. For those clients that are particularly worried about a further drop in the stock market, I reduced equity exposure and added to bonds or cash.

Better Times Ahead?

While the recovery last week was welcomed, I am not positive that stock prices have hit bottom. That really won't be clear until stock prices start to stage a sustained recovery. While I won't be surprised to see an initial surge up in prices, I don't expect the recovery to be smooth. It will take time to resolve the global credit crisis and for investors to regain confidence. I am confident, though, that whenever the bottom occurs, stocks will be significantly undervalued setting the stage for significant subsequent returns. Below I list some of the factors that give me confidence of an eventual significant recovery in stock prices.

Bear Markets: As measured from the closing low one week ago, the stock market has fallen 43% in the last 12 months. This ranks as the fifth worst bear market since 1926. There have been 13 other bear markets (periods when the stock market declines by 20% or more from the peak) since 1926, an average of one every six years. The good news is that the twelve months following the 13 previous bear market lows have always seen above-average performance, with one-year stock returns averaging nearly 46%.

Recessions: Historically, on average, the equity markets typically started to recover five to six months *before* the GDP hit bottom. Analysts as T. Rowe Price looked at the last ten recessions and found that the median increase in the S & P 500 six months after the market hit its low was 24%. Twelve months after the low point, the median rise was 32%. Since stocks start to recover *before* a recession ends, a good time to get more bullish is when you are feeling particularly negative about the economy and the headlines are filled with gloom and doom. Or, to put it another way, *the middle of a recession is one of the worst times to be selling stocks.*

Consumer Confidence: Reflecting the worries many investors feel, consumer confidence is now at its lowest point since 1990. On October 17th the Reuters/University of Michigan Surveys of Consumers said its index of confidence plummeted to 57.5 in October from 70.3 in September. This represented the steepest monthly drop since its 1952 inception. Is this bad news for stocks? To the contrary, historically this has been a bullish measure. Specifically, *there have been only three other instances in the past 40 years that consumer confidence has reached a reading below sixty, and in every instance there were large positive effects for equity investors over the next year.* During these three instances (1974, 1980 and 1990), the S & P 500 rose between 30% and 37% over the next twelve months. The logic behind this is that with investing, you typically get paid high returns during periods when you feel most anxious.

The Stock Market is a Discounting Mechanism: *Stock prices are a current measurement of everyone's future expectations.* This means that the market decline already reflects the pessimistic outlook everyone has for the future. So the question for investors is not where the economy will be in six months, but what our expectations will be six months from now. Currently the stock market is telling us the economy will be in worse shape six months from now. But what will our expectations be at that time? It is highly possible that our outlook will be far more optimistic than it is today and the market could reflect that by being at higher levels.

Valuations: Unlike the 2000-2002 "Dot Com Crash" when technology stocks got crushed and small-cap valued stocks, bonds, and REITs performed well, in this bear market the prices of just about all asset classes have dropped dramatically. As a result, I expect that with the exception of U.S. Treasuries, all asset classes will perform well in the recovery. Opportunities abound everywhere. Large cap stocks are as cheap as I have seen in the last fifteen years, as illustrated by General Electric which sells at a price-earnings ratio of less than ten and a dividend yield of over 6%. International stocks have been hit especially hard this year. As a result, global stocks are trading at roughly 10.3 times their earnings for the previous 12 months and European stocks are trading with a dividend yield of over 5%.

Bonds prices have also been ravaged. High quality corporate bonds now trade with yields of 7% to 9%, while high yield bonds trade with an average yield of nearly 18%, a record spread relative to U.S. Treasuries. Assuming high yield defaults similar to what happened in the Great Depression, high yield bonds would provide annual returns in the high single digits over the next five years. Municipal bonds, which offer long-term tax-free yields topping nearly 6%, have almost never looked so attractive to U.S. Treasuries. A 6% muni yield is equivalent to a 10% taxable yield for residents of high income-tax states like California, assuming in-state bonds are owned.

In Summary: I believe we are in a significant recession triggered by a very sharp real estate downturn and a serious global credit crisis. Central banks and governments around the world are taking aggressive steps to address the situation. Since the stock prices are based on investors' future expectations of the economy, stock prices should start to recover five to six months prior to the end of the recession. While the timing is unknown and the stock market could fall further in the short run, I feel the stage is being set for outstanding returns from nearly all asset classes over the next several years.

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