Dec. Monthly Commentary/Q4 2016 Quarterly Letter

Jan 3, 2017

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Stock Market & Portfolio Performance

4th Qtr & Full Year 2016: U.S. and foreign stocks posted strong gains for the month, while bonds were modestly positive.

	4th Qtr	FY 2016	Description:
Without Dividends:			
S&P 500	3.3%	9.5%	500 Largest Public U.S. Companies
Russell 2000	8.4%	19.5%	2000 of the smallest U.S. stocks
MSCI EAFE	-1.0%	-1.9%	international stock index
U.S. Aggr Bond	-3.0%	2.7%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	1.0%	7.7%	non-very conservative MAM portfolios
MAM Conserv	-0.2%	6.3%	portfolios with 50%+ bond allocation

The returns showed above are unaudited. Past performance is not indicative of future results. Returns for McCarthy Asset Management Portfolios ("MAM Portfolios") are net of management fees and transaction costs, and reflect the reinvestment of dividends. Results represent a composite of clients using a similar investment strategy, individual results will vary.

Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for the indices would be lower if these costs were reflected.

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2017 Economic & Stock Market Outlook

This is the time forecasters like to make predictions about the performance of the stock market for the next twelve months. While I don't have any unique insight into the short-term direction of the stock market, **my 2017 outlook is the same as it was for 2016** when I wrote in the December 2016 Monthly Commentary: "I am cautiously optimistic for modest gains in 2016, and favor stocks over bonds, although it is likely we are toward the tail end of a tremendous bull market that started in March 2009." Stocks did have a pretty good year in 2016, and outperformed bonds. **With my 2017 expectation that the U.S. economy will continue its slow growth path and that corporate earnings exhibit solid growth, I am hopeful for additional stock markets gains for 2017 with stocks again outperforming bonds.**

The Economy

Economic Growth: Economists currently project 2017 GDP growth to range between 1.9% to 2.3%, up from 1.6% for 2016. This will be helped by wages, which are estimated to rise 3% in 2017 as the labor market continues to tighten. The economy should also benefit from increased consumer spending, which accounts for nearly 70% of the domestic economy, as consumers are in good shape given the 9-year surge in stock and real estate prices.

Consumers are Confident: Consumer sentiment, as measured by the University of Michigan sentiment index, shows consumers are relatively confident about the economy and their financial health. The index rose 4.7% in December to a reading of 98.2, the highest level since January 2004. Possible tax cuts for individuals may provide a further boost in 2017.

Job Gains Have Been Steady: Economic growth should continue to benefit from a record 75 straight months of job gains, with an average around 200,000 per month. Wages, based on average hourly earnings, have once again started to grow, rising 2.8% year-over-year in October, up from 2.7% in September and the strongest since June of 2009.

Trump's Pro-Growth Policies: Stock prices rallied following the surprising win by Donald Trump because many of his policies are viewed as "pro-growth" for the economy. In particular, individual and corporate tax cuts, deregulation, and fiscal stimulus through infrastructure spending could accelerate U.S. growth, although the impact is more likely in 2018 than in 2017.

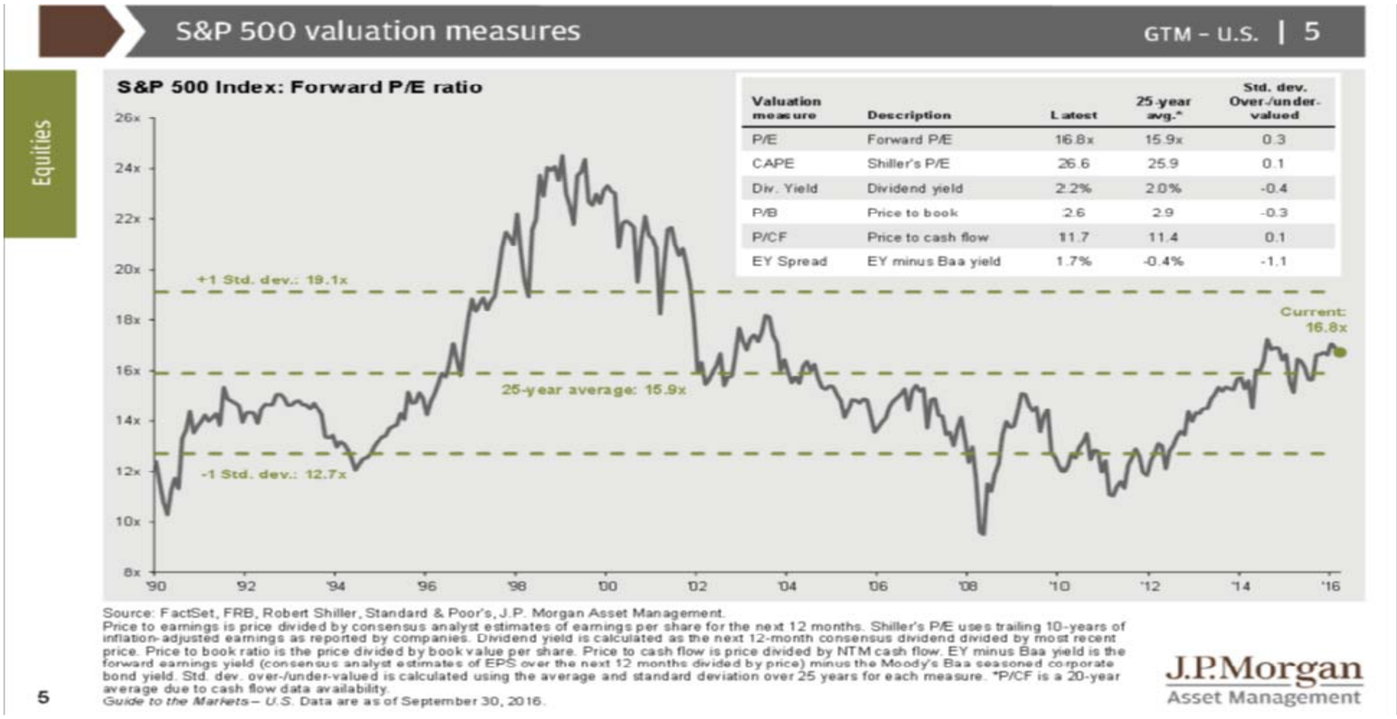
No Recession in Sight: Barring an unforeseen shock, there is little chance of the economy slipping into a recession in 2017. While it is hard to predict beyond a year or two, by 2019 we could see an economic contraction as by then it will have been ten years since the last recession.

Interest Rates

The Federal Reserve: After raising the federal funds rate last month for the first time in a year, the Fed is expected to raise rates two or three times in 2017, with the Federal funds rate reaching a still modest 1.1% to 1.5% by the end of 2017. The 10-year Treasury rate, which is more indicative of mortgages rates, could climb to 3% by year-end 2017, after rising sharply in the later part of 2016.

Stock Price Valuation

Slightly Elevated Values: Stock market valuations are somewhat high, with the forward price-earnings ratio of the S&P 500 at roughly 17, compared to the 25-year average of 15.9. As can be seen on the J.P. Morgan chart below, this is nowhere near the euphoric levels of the late 1990s, when P/E multiples were consistently in the upper 20s.



Earnings Looking Up: After five quarters of a profit recession, companies recovered in the third quarter of 2016 and are now growing their year-over-year earnings. According to a recent article discussing corporate earnings (click here to access) from Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co, after three consecutive years (2014, 2015 and 2016) of S&P earnings of about $118—i.e., no growth—Thomson Reuters has nearly $133 as an expectation for 2017. While every one of the 11 S&P 500 sectors is now expected to show positive growth next year, the most dramatic improvement is expected to be in the energy sector due to recovering oil prices.

As indicated in the chart above, the forward P/E for the S&P 500 was 16.8 as of September, 2016. With the fourth quarter stock market rally, by year-end 2016, it climbed to approximately 17. While this appears high compared to a 25-year average of 15.9, in her article, Sonders said valuations should never be viewed in a vacuum relative to historical averages. Inflation needs to be considered given that earnings are more valuable when inflation is low (but not too low.) The article displays a table using data going back to 1958. The table shows that the "sweet spot" for the highest average S&P 500 P/E is when inflation is between 2% to 3%. When inflation averaged this level, the average P/E was 17.6 times earnings. Sonders writes that with inflation currently in this range, the market may actually be slightly under-valued. Any acceleration in inflation, though, beyond current projections could put some downward pressure on stock prices. (For instance, when inflation is between 3% and 4%, the average P/E was 16.0.)

Impact of Trump's Policies

Our November 2016 Monthly Commentary (click here to access) addressed both Trump's proposed tax cuts and the possible impact of Trump's win on the stock and bond markets. As such, I am not going to discuss this further here except to summarize:

- With an estimated 10-year cost of nearly $6 trillion, Trump's tax cuts for individuals would likely cause the Federal deficit to balloon. As such, it is questionable what tax cuts will be enacted.

- A more likely law change will be for revisions to corporate taxes, with the marginal rates being reduced and a one-time reduced repatriation tax rate to encourage U.S. companies to bring back to the United States the trillions of dollars in cash that is held overseas . Both of these moves would likely be beneficial for the U.S. economy and stock prices.

- While much of Trump's economic agenda appears to be pro-growth, if he were to follow through with his foreign trade policy of imposing tariffs and canceling trade agreements, there is a risk of triggering a global recession. This is something that we will be monitoring during his term in office.

Market Risks

Below are some of the economic risks that could derail our cautiously optimistic 2017 outlook:

1) **Global Trade War:** Restrictions on free trade and immigration could inhibit growth. While higher import tariffs and restrictions on free trade may temporarily boost U.S. growth, any short-term positives could be undone by a subsequent global recession.

2) **U.S. Dollar Strength:** The U.S. dollar surged to a 14-year high in the wake of Donald Trump's victory. A further rise in the dollar is a threat to U.S. manufacturers by making their exports more expensive and their foreign earnings less valuable. This is what happened in 2015, when the dollar rallied to a peak of roughly 20% year-over-year gains, which contributed to the earnings recession.

3) **Trump Team's Execution Risk:** Congress may not be compliant with Trump's policies and gridlock could still occur. A Republican House dominated by fiscal conservatives is unlikely to provide a blank check for fiscal stimulus.

4) **European Union Instability:** Europe has its own wave of populism driven by stagnant economic growth, years of austerity and resistance to rising immigration. France, Germany, the Netherlands and Italy have elections in 2017, with populist politicians and policies gaining increasing support.

5) **Acceleration in Inflation:** Since the financial crisis, inflation has remained stubbornly low despite central banks' accommodating monetary policies. Eight years of efforts to boost the economy combined with Donald Trump's growth initiatives could spike inflation, causing the Fed to accelerate its plans for raising interest rates.

Current Asset Allocation of MAM Portfolios

MAM portfolios are well diversified among U.S. equities, bonds, foreign equities and alternative assets. Here are a few comments regarding how portfolios are currently positioned:

- **Current Allocation; Recent Changes:** While the asset allocation for a specific client depends on his/her risk tolerance score and other factors, the average MAM portfolio has approximately 57% in U.S. equities, 28% in bonds & cash, 12% in foreign equities and 3% in alternative assets. The most significant recent change we made was an increase in a U.S. small company exposure as a result of Trump's win.

- **Increase in ETFs:** Exchange-traded funds constitute approximately 20% of most portfolios, an increase from the 10% to 15% weighting a few years ago. We may continue to shift part of the portfolio allocation to ETFs given their benefits of low operating expenses and tax efficiency.

- **Focus on Dividend-Paying Stocks**: A major theme continues to be investing in mutual funds and ETFs that focus on stocks that pay an increasing dividend over time. Reasons we find such stocks appealing include:

    1. Historically stocks that pay an increasing dividend have outperformed other stocks.

    2. In a low-return environment (which we feel we are in) dividends provide a significant portion of the portfolio return.

    3. Dividend-paying stocks tend to be less volatile than non-dividend paying stocks.

Assets under Management and Referrals

As of December 31, 2016, MAM assets under management were in excess of $185 million, up over $10 million from the beginning of 2016. Thank you for being a client. Also, thank you to those who added to their investments or referred us to friends or family. We really appreciate referrals, as they are our primary source of new clients. While our minimum amount to manage for new clients is $500,000, we are able to be flexible depending on the individual's situation.

Sincerely,

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- **MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.**

Financial Planning Services:

- **The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.**
- **"Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.**
- **Social Security Planning is an analysis of the best strategy for when and how to start claiming Social Security benefits.**

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- **Tax Return Preparation**
- **Income Tax Projections**
- **Tax Minimization Ideas**
- **Tax Authority Representation**

Other Services: MAM has retained outside experts, whose services are available at no cost to our clients:

- **Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.**
- **Medicare Advisory Program (MAP) - Eileen Hamm**

Reminders/Updates

1) **Estimated Tax Payments**: 4th Quarter 2016 Federal & State Estimated Payments are due January 16, 2017.

2) **ADV Part II**: You were provided a copy of our ADV Part II when you became a MAM client. As a Registered Investment Advisor, we file this this document annually with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees, experience and educational back-grounds. Each year, the SEC requires us to offer clients the oppor-tunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy