# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

February 1, 2011

## Monthly Investment Commentary- January 2011

***Stock Market Performance for January:*** January provided a positive start to the year. With the exception of small cap and emerging market stocks, performance was good. Unadjusted for dividends, the S & P 500 rose 2.3%, the NASDAQ climbed 1.8%, the small cap Russell 2000 fell 0.3%, and the international equity index MSCI EAFE rose 2.3%. Bonds, as represented by the Barclay's Global Aggregate Index, rose 0.2% for the month.

***MAM January Performance:*** MAM portfolios underperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which rose 0.5%), MAM portfolios rose 0.9% (after all fees), versus a rise of 2.4% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. While most of the large-cap U.S. funds used by MAM performed comparably to the S & P 500 (with the exception of a 1.0% loss for Fairholme), performance was held back by the lower returns from the bond and balanced funds and negative returns from the emerging market funds.

## *Economic Update- Now in the Expansion Phase*

Last week the Commerce Department released its initial estimate of 4$^{th}$ quarter 2010 Gross Domestic Product (GDP). The report showed that economic output grew at a 3.2% annual rate, the sixth straight quarter of positive growth. For 2010 as a whole, GDP rose 2.9%, the fastest growth since 2005 and a dramatic reversal compared with negative 2.6% for 2009. When commenting on the report, the White House Council of Economic Advisers said: "Private forecasters have predicted that the tax cut package signed by President Obama in December will have a significant positive impact on economic growth this year. We are on the right path, but have a lot more work to do to accelerate growth so that we are creating the jobs we need."

The latest GDP report increased the nation's total output to its highest level since the end of 2007, when the recession started. **Therefore, the economy has officially moved from the recovery phase into the expansion phase.** Per a January 31, 2011 letter from Liz Ann Sonders, Chief Investment Strategist at Charles Schwab & Co, this recovery from the 2007 Great Recession "was the longest stretch in at least 60 years for the economy to return to the expansion stage. The good news (potentially) is that, historically, expansions have lasted at least three years."

The economic outlook for 2011 is promising. Last month economists surveyed by The Wall Street Journal showed they are increasingly optimistic, predicting the U.S. will grow at better than a 3.2% annual rate in each quarter this year. "The U.S. economy appears to have successfully navigated the adjustment from a recovery driven primarily from economic stimulus and inventory rebuilding to one driven by private domestic demand and rising exports," said economists at Wells Fargo & Co. "Three percent growth looks pretty good, particularly with housing stuck in low gear." While 2011 is expected to be another dismal year for new home construction, hopefully it will start adding to economic growth in 2012.

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## ***Corporate Earnings Reports- Revenue Growth is the Key***

Corporate earnings growth for the 4th quarter of 2010 has been good so far. With 40% of the companies in the S & P 500 reported so far, the biggest surprise has been the strength of revenue growth. According to Fact-Set, 70% of the reporting companies beat analysts' revenue estimates, up from an average of 56% since the start of 2009. Revenue for the S & P 500 companies is on track to rise 8.1% year-to-year in the fourth quarter. This is an important shift from the robust profit gains and lagging revenues that marked the initial phase of the recovery. Much of the sharp rebound in corporate profits during the last two years resulted from cost cutting, which is why employment growth has remained so tepid. Companies ultimately need sales growth to sustain their business and eventually start hiring. **Strong revenue growth will be the key to the economy generating enough jobs to bring down the unemployment rate.**

## ***Positive Stock Market Outlook***

My Fourth Quarter 2010 MAM Letter listed the reasons I am optimistic for the stock market recovery continuing in 2011. So far, nothing has occurred to change my thinking. In that letter, I asked clients to contact me if they were comfortable with taking on a little more volatility with their portfolio(s). Since then I got a little more aggressive for forty clients by making a small reduction in their bond allocation and a small increase in their equity allocation. My expectation for the foreseeable future is that equities will outperform bonds. **If you have not already done so, please call or email if you would like to have me adjust your portfolio(s).** As I also said in last month's letter, I am hesitant to adjust all portfolios to a more aggressive allocation because I feel many clients are still concerned about another possible downturn in the stock market. While I would like clients to more fully benefit from any recovery in the stock market, it is very important that clients are comfortable with how their portfolios are allocated. As seen with the current upheaval in Egypt, unpredictable geo-political events can quickly change the short-term outlook for the investment markets.

Despite my optimism, I do think the stock market is due for a short-term correction. Such a correction could be healthy given the strong run that stocks have made during the last few months. Short-term corrections are a natural part of a healthy bull market, as they help curb excessive speculation, and set the stage for further gains.

With the stock market near a 2 ½ year high, some investors may be wondering if the stock market could be close to reaching a peak. The most recent weekly report from Lowry's, the nation's oldest continuously published Technical Investment Advisory (since 1938), addressed this question. It said that since 1933, the average bull market lasted 39 months, while the current bull market has now been underway for approximately 23 months. If this bull market were to match the historical average, it might have a life expectancy of about another 16 months.

More importantly, Lowry's says the current bull market is not displaying any of the typical signs of a market top. Normally, in the final stage of a bull market, which on average lasts for about 4 to 6 months, Selling Pressure may begin to rise at a faster pace as profit-taking takes hold. More importantly, Buying Power stops making new highs and begins to noticeably weaken, even though the major price indexes continue to make new highs. Currently the stock market's Selling Pressure has yet to establish an uptrend pattern and Buying Power is still within just a few points of a new multi-year high. These are both bullish indicators.

## ***2010 Tax Reporting- Schwab 1099s***

Charles Schwab recently announced that their 2010 Form 1099-Composite will be mailed in mid-February. As with last year, Schwab is issuing the Form 1099s later to minimize the issuance of corrected Form 1099s. This worked well last tax season as there was not a need to amend previously-filed 2009 tax returns for the corrected Form 1099s that were issued late in February of 2010.

*For those of you who are tax clients, there is no need to wait until you receive your Schwab Form 1099 before providing us with your tax packet. Schwab will be providing us with a copy of the Form 1099 for accounts that we manage. If you have everything else, please provide us with your tax packet.*

For those of you who are not tax clients and who have a taxable Schwab account managed by MAM, Inc, a couple of weeks ago we mailed your 2010 Realized Gains and Losses Report, along with instructions explaining how to reference and attach the report to your tax return. Be sure to provide this report and letter to your tax preparer, as having this information really simplifies preparation of your return.

## **Cost Basis Reporting**

You may have heard news recently about new regulations requiring custodians (i.e. Charles Schwab) to track cost basis and report gain and loss details to the IRS for 2011 tax returns. This requirement will be phased in over a three-year period.

For their retail accounts, Schwab is asking customers to select a cost basis method. We have taken care of this for the accounts we manage. We have selected the method “high cost” for all client accounts, meaning that the highest cost shares are considered to be sold first. Furthermore, with the most recent upgrade we made to our portfolio management software, we are now able to run daily cost basis reconciliations with Schwab. This is important because we use the Gain/Loss report from our portfolio management software for tax reporting.

Please call or email me if you have any questions or would like to discuss your portfolio(s) or any other financial matters.

Sincerely,

Stephen P. McCarthy, CPA, CFP