

McCarthy Asset Management, Inc.

Registered Investment Advisor

August 2, 2010

Monthly Investment Commentary- July 2010

Stock Market Performance for July: Recovering from a rough second quarter, July was the best month in a year for the stock market. Unadjusted for dividends, the S & P 500, the NASDAQ, and the Russell 2000 all rose 6.9% and the international equity index MSCI EAFE climbed 9.4%. Bonds and REITs also rose for the month.

MAM July Performance: As expected for a period of strong stock market returns, MAM portfolios under performed the S & P 500 for July. Excluding the “very conservative portfolios” (which rose 1.7%), MAM portfolios rose 4.3% (after all fees), versus a rise of 7.0% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested.

Year-To-Date Performance: The stock market is back close to breakeven for the year-to-date, overcoming a possible credit crisis in Greece and Europe, as well as fears of a double dip recession in the U.S. For the first seven months of 2010, unadjusted for dividends, the S & P 500 fell 1.2%, the NASDAQ dropped 0.6%, the Russell 2000 rose 4.1%, and the international equity index MSCI EAFE fell 6.7%. Excluding the “very conservative portfolios” (which rose 4.1%), MAM portfolios rose 0.7% (after all fees), versus a drop of 0.2% for the Vanguard Index 500 fund with dividends reinvested.

Year-to-date, MAM portfolios have outperformed the S & P 500 as the good performance from bond and balanced funds more than offset the relatively sharp decline in foreign equities. I am satisfied with the fairly conservative positioning of MAM portfolios. Although portfolios will under perform should the stock market continue with July’s strong performance, I am not convinced we have entered a new bull market. *I am monitoring two developments that may influence future portfolio adjustments:*

1. **Growth in the U.S. Job Market:** So far growth in the job market during this recovery has been anemic. For the economic recovery to become sustainable, more significant job growth will be needed. If and when the job growth materializes, I may become more aggressive with portfolio positioning.
2. **2011 Federal Tax Increases:** As discussed below, the pending expiration of the Bush tax cuts could have negative implications on our fragile economy. If by late this year the economic recovery and job growth remains tepid and Congress does nothing to delay or cancel the schedule tax increases, I may become more conservative with portfolio positioning.

Is The Economic Recovery Losing Steam?

Last Friday the Commerce Department released its initial estimate of gross domestic product (GDP) for the second quarter of 2010. GDP grew at a 2.4% annual rate for the quarter, down from an upwardly revised 3.7% for the first quarter and 5.0% for the final quarter of 2009. For the most recent quarter, robust spending by businesses could not overcome a sluggish 1.6%

increase in consumer spending. The GDP slowdown raises concern about growth for the remainder of 2010, and some economists indicated they would cut growth estimates for the second half based on the report. Furthermore, the second-quarter slowdown in GDP growth is likely to reinforce concerns at the Federal Reserve that the recovery is losing momentum, prompting a debate about what steps, if any, to take if the slowdown continues. Deficit angst in Congress and partisan gridlock make any additional fiscal stimulus unlikely unless the economy deteriorates further.

At this point, I am not overly concerned about the slowdown in the economic recovery. There have been some positive developments recently:

1. **Projection for 2010 Global Growth Recently Raised:** On July 8th the International Monetary Fund boosted its forecast for 2010 global growth to 4.6% from 4.2% after a stronger-than expected first half. This would be the largest gain since 2007. Growth in the global economy is very important as I expect exports will become a more significant part of the U.S. economy. During at least the last ten years, consumer spending made up 70% of the U.S. economy as easy-to-obtain credit enabled consumers to spend beyond their means. The high pace of U.S. consumer spending was not sustainable. Consumer debt is now decreasing and Americans are finally starting to save again. Long term I expect the U.S. economy to benefit from increased exports due to the dramatic rise of the middle class in emerging markets. For instance, China recently surpassed the U.S. as the world's largest auto market.
2. **Euro Crisis Has Abated:** The euro crisis has abated, at least for the time being. As of today, the euro has rebounded to nearly \$1.32, up from a low of \$1.17 during the crisis. The recovery in the euro has been due to recent European economic data being better than expected and a "stress test" of 91 banks in 20 European countries revealed that they had the means to absorb hundreds of billions of dollars in potential losses. Furthermore, industrial orders are pouring into Germany, who has the largest economy in the European Union, and unemployment there is projected to fall to the lowest level since 1991.
3. **Consumer Spending Better Than Consumer Confidence:** Consumer confidence remains depressed and far weaker than spending, which is normal for this stage of the recovery. In previous recoveries, consumers increased spending long before their confidence improved. Indeed, consumer spending has increased at a respectable 3.4% annual pace so far this year. Furthermore, consumer finances are improving, modest job growth has resumed, debt is falling, savings rates have increased, default rates are now declining, and asset values are rising again.
4. **Corporations Flush with Cash:** According to the Federal Reserve, U.S. companies had \$1.8 trillion in cash and other liquid assets at the end of the first quarter, up 20% from the previous year. Companies have held on to their cash as protection against another financial meltdown, yet at some point must put this cash to work (as cash now earns practically nothing). This is reflected in the persistent string of acquisition announcements, stock buybacks, dividend increases and capital reinvestment programs.
5. **Investor Pessimism:** As usual, investors are probably doing the wrong thing. Pessimism over the outlook is very high, as is evident by investment newsletters, surveys by the American Association of Individual Investors, and fund flows into bond funds and out of stock funds.

Very Strong Corporate Earnings

As of July 30th, 336 companies in the S & P 500 have reported second quarter earnings, of which 68% exceeded analysis estimates. Before earnings season began, analysts' consensus estimates were for the S & P 500 to earn \$19.61 for the second quarter. With 74% of the market cap already reported, estimates have risen to \$20.77. Analysts currently project that companies in the S & P 500 will earn \$83.02 for 2009 and \$94.62 for 2010. Based on a close last Friday of 1102 for the S & P 500, the market is trading at a price-earnings ratio of 13 based on 2010 projected earnings and 12 based on 2011 projected earnings. While a slowdown in the economic recovery would probably make these earnings projections too high, the stock market is reasonably valued based on corporate earnings.

Stock Market Outlook- A Bullish Case from Jeremy Siegel

Attached is a recent article and video on the views from Jeremy Siegel on why stocks are currently undervalued by as much as 25% to 30%. Jeremy Siegel is a well-known researcher, speaker and writer on historical valuations on the stock market. His books include his best seller "Stocks For the Long-Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies" and he is a professor at the Wharton School of the University of Pennsylvania. In Siegel's view, over the last ten years we have gone from the stock market being very overvalued to being undervalued. His basis for why stocks are currently undervalued is that the S & P 500 is trading at 13-times earnings for 2010 and 11-times earnings for 2011, versus a long-term average of 15 to 16-times earnings.

While I like the analysis that Siegel performs and love his conclusion that the stock market is 25% to 30% undervalued, keep in mind that Siegel tends to be pretty optimistic in his outlook. There are a number of other stock market forecasters who feel that stocks are currently not a bargain at all. In fact, there are often widely divergent opinions on the outlook for the stock market. What I have found to be helpful is to focus on just a few such forecasters that have a successful track record. Among the ones I follow and respect, Lowry's and Bob Brinker have been consistently optimistic on their outlook for equities this year. In particular, in the July issue of Marketimer, Brinker noted that since 1962, in every mid-term off-presidential election year, from the low for the year, the S & P 500 rose at least 27%. He said that he expects this to hold true for this year as well.

2011 Federal Tax Increases- Concerned About The Impact On Economic Recovery

While this Monthly Commentary points out a number of reasons to be optimistic despite an apparent slowdown in the economic recovery, I am concerned that the large tax rate increases that are scheduled to take effect next January could further weaken the economic recovery and possibly push us into a double dip recession. These tax increases are due to Bush tax cuts which expire on December 31, 2010. Goldman Sachs' economists estimate that the tax rate increases are worth more than 2.5% of GDP. Unless new tax legislation is passed, the following is scheduled to occur in 2011:

- **Federal Individual tax rates and deductions:** The two top brackets will increase from 33% and 35% to 36% and 39.6%. Furthermore exemptions and a portion of itemized deductions will be phased-out for high income taxpayers.

- **Capital Gains and dividends:** For 2010, most taxpayers pay a 15% rate on long-term capital gains and qualified dividend income. Starting next year, the rate on long-term capital gains will increase to 20% and dividends will be treated as ordinary income. President Obama has proposed keeping both rates at 15% for those earning less than \$250,000 and at 20% for those making over \$250,000.
- **Estate Tax:** Next year the maximum estate tax rate will increase to 55% (up from 45% for 2009 and 0% for 2010) and the maximum exemption from tax will be \$1 million (down from \$3.5 million for 2009 and unlimited for 2010).

Here are possible scenarios for how these tax increases play out:

1. **Congress extends just the middle income tax breaks for one or two years.** While this is what Obama has proposed, Congressional Republicans would be unlikely to initially support such legislation, since it will not prevent a significant tax increase on those with income above \$250,000.
2. **Congress extends everything, but just for one year.** This is my favorite option, as I don't think taxes should be raised when the economy is recovering so slowly.
3. **Gridlock.** Given the difficulty that Congress has in passing any significant legislation, this seems like the most likely scenario. It is then possible that the higher tax rates will be only temporary, as in early in 2011 the new Congress could pass legislation limiting the tax increases.

Even if the tax increases are limited to higher-income taxpayers (Obama's preference), I am concerned they could unravel the economic recovery. During the past couple of decades, most or all of the net new jobs have come from small businesses and start-ups. With unemployment at approximately 10% (and higher if you add in those who have given up looking for work), this is not the time to raise taxes on the very people (and businesses) we want to be hiring new workers. There is historical precedence for what happens when taxes are raised while the economy is weak. In 1937 while the economy was experiencing high unemployment, Congress foolishly tried to balance the budget by raising taxes, resulting in the second down turn of the Great Depression. More recently, during their no growth environment of the 1980's, Japan raised taxes, contributing to what has been referred to as the "lost decade" for Japan.

Summary

While the economic recovery appears to be slowing, at this point I am not too concerned. Furthermore, based on strong corporate earnings, the stock market is reasonably valued. A key economic indicator that I will focus on is job growth. I will become more optimistic if and when significant job growth returns to the U.S. economy. On the other hand, I am concerned about the pending 2011 tax increases. If later this year the economic recovery is still weak and the tax increases are not at least delayed, I may add to the downside protection in portfolios.

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