McCarthy Asset Management, Inc.

Personalized Wealth Management

Dec. Monthly Commentary/Q4 2017 Quarterly Letter

Jan. 2, 2018

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Stock Market & Portfolio Performance

Fourth Quarter 2017: U.S. and international stocks posted strong returns for both the fourth quarter and full year 2017. Meanwhile, bonds were up modestly.

	4th Qtr	FY 2017	Description:
Without Dividends:			
S&P 500	6.2%	19.4%	500 Largest Public U.S. Companies
Russell 2000	3.0%	13.1%	2000 of the smallest U.S. stocks
MSCI EAFE	3.9%	21.8%	international stock index
U.S. Aggr Bond	0.4%	3.5%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	4.3%	15.4%	non-very conservative MAM portfolios
MAM Conserv	2.4%	9.0%	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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2018 Economic & Stock Market Outlook

With the bull market now in its 9th year and after an especially strong 2017, it is a fair question to ask whether this market still has room to run. While we don't have any unique insight into the short-term direction of the stock market, we feel this bull still has some "legs". Catalysts include the U.S. and global economies continuing to show steady growth, corporate earnings are climbing nicely, and interest rates remain low as the Federal Reserve institutes modest interest rate increases. **With this backdrop, we expect the equity bull market to continue—at least for now, although with a likely increase in volatility. Furthermore, we expect stocks will outperform bonds for the year, but with gains much more muted than in 2017.**

The Economy

U.S. Economic Growth: The U.S. economy picked up steam in 2017 with back-to-back quarters of 3%+ growth and current estimates of another 3.0%+ growth for the fourth quarter of 2017. Additionally, the employment picture is healthy, with unemployment claims near record lows and the unemployment rate down to 4.1%. Furthermore, business and consumer confidence is booming, both the manufacturing and services Institute of Supply Management's indexes show robust growth, and the Index of Leading Economic Indicators continues to rise.

Global Economic Growth: For the first time in a decade, in 2017, all of the world's developed economies grew. Expectations are for this global synchronized growth to continue in 2018 with improved performance in developed countries aiding recoveries in emerging markets. The International Monetary Fund projects global economic growth of 3.7% in 2018.

No Recession in Sight: While the economy has now expanded for the last eight years, the growth has been modest. This tepid growth has so far kept the economy out of the typical boom-and-bust cycle, lengthening the expansion. Barring an unforeseen shock, signs of a recession are remote to nonexistent for 2018. While it is hard to predict beyond a year, by 2019, rising interest rates could potentially trigger an economic contraction.

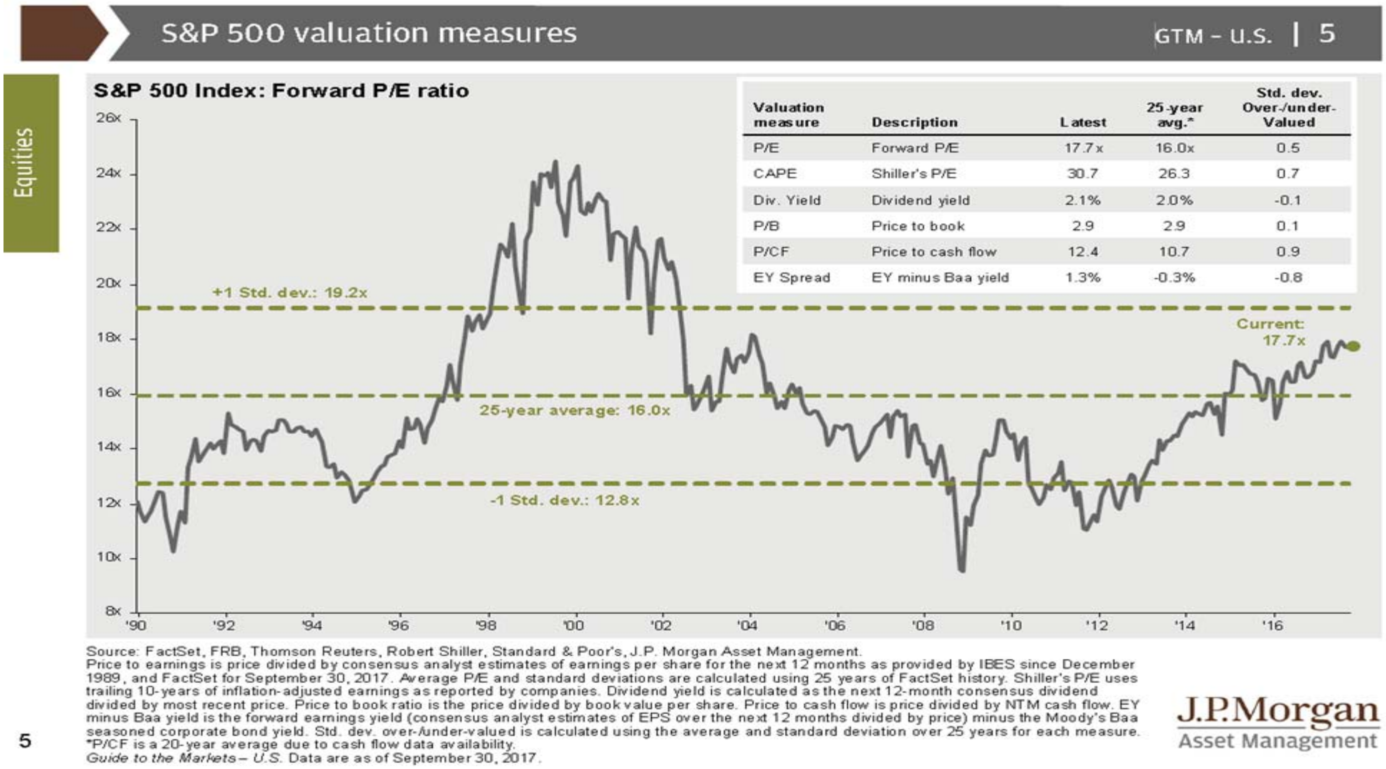
Interest Rates

The Federal Reserve: Last month, the Fed raised the federal funds rate for the third time in 2017, to a still modest range of 1.25% to 1.5%. Although inflation is still low, the Fed expects that it will increase toward its 2% target over the medium term. Currently, the Fed is expected to raise rates between two and four times in 2018. The 10-year Treasury rate, which is more indicative of mortgage rates, could climb to 3% by year-end 2018, up from 2.5% at the end of 2017.

Stock Price Valuation

Elevated Values: Stock market valuations are relatively high, with the forward price-earnings ratio of the S&P 500 at roughly 18, up from 17 on 12/31/16 and higher than its 25-year average of 16. As can be seen on the J.P. Morgan chart on the following page, this is nowhere near the euphoric levels of the late 1990s, when P/E multiples were consistently in the upper 20s.

2018 Economic & Stock Market Outlook– Con't



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.7x	16.0x	0.5
CAPE	Shiller's P/E	30.7	26.3	0.7
Div. Yield	Dividend yield	2.1%	2.0%	-0.1
P/B	Price to book	2.9	2.9	0.1
P/CF	Price to cash flow	12.4	10.7	0.9
EY Spread	EY minus Baa yield	1.3%	-0.3%	-0.8

Solid Corporate Earnings: Earnings growth for the S&P 500 companies has been very strong for 2017. In particular, growth for the first three quarters of 2017 relative to the prior year's quarter was 15.8% for the first quarter, 11.6% for the second and 9% for the third. This trend of declining growth throughout 2017 is somewhat misleading. The data for the third quarter is distorted as it includes billions of dollars in losses booked by insurance companies due to three hurricanes and two Mexican earthquakes. Per Steve Chiavarone, portfolio manager at Federated Investors, without theses natural disasters, third quarter earnings growth would have been closer to 12%.

Earnings growth for S&P 500 companies is expected to remain strong during 2018, particularly due to the positive impact of the recently passed tax bill, which will reduce the tax rate for many U.S. corporations.

Stock Market Risks

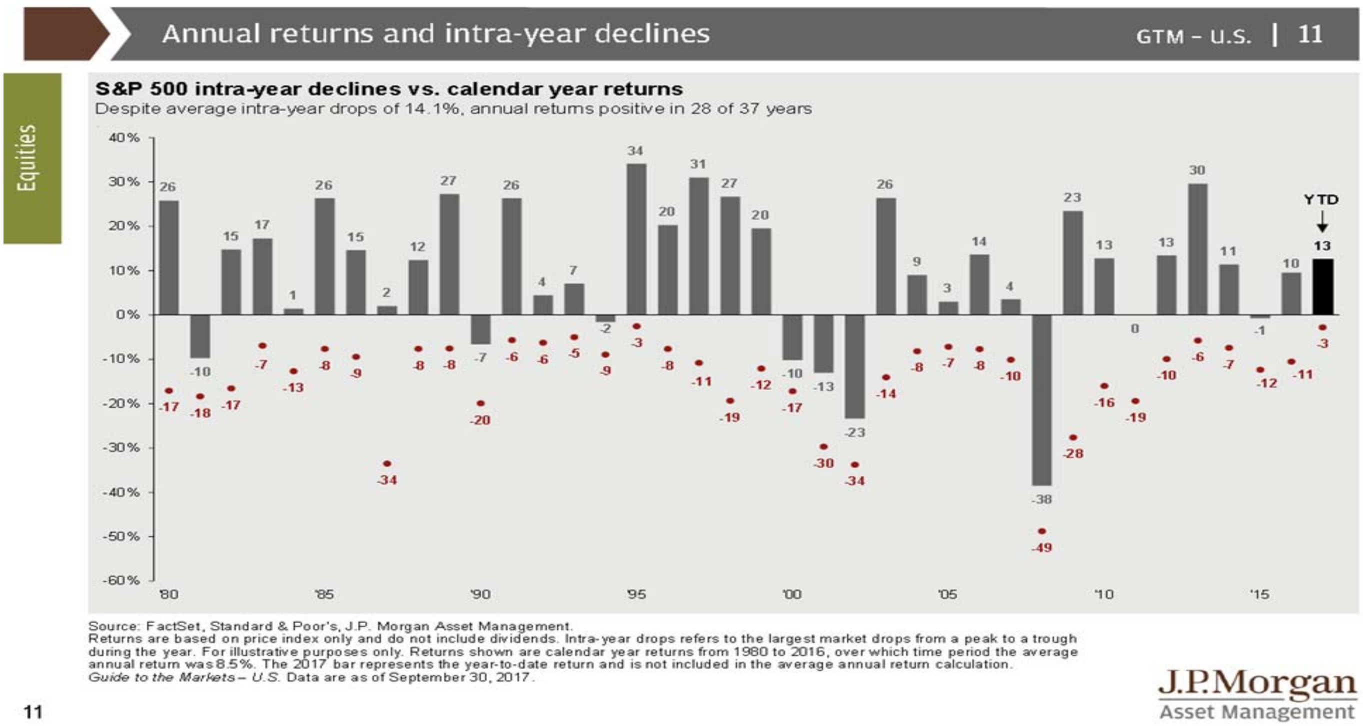
The economic expansion reached 100 months in October and is now the third longest since World War II. Meanwhile, the bull market is the second longest at nearly 9 years old. Some believe this alone means that the U.S. economy may soon slide into a recession and end this powerful bull market. But bull markets don't die of old age, they die of economic excesses, and we haven't yet seen the types of excesses observed at previous market peaks. Nonetheless, stock market valuations are less attractive than they were several years ago and we have enjoyed a long period of low volatility and positive economic surprises, which could mean markets are overdue for a more significant setback. While we don't yet see the necessary ingredients to cause an end to the current economic expansion or equity bull market, we do see risks on the horizon. In particular:

1) **Acceleration in Inflation:** Since the financial crisis, inflation has remained stubbornly low despite central banks' accommodating monetary policies. One of the greatest risks is that the already tight labor market (with the unemployment rate down to 4.1%) will grow tighter, leading to wage inflation. A wage or inflation spike in 2018 could lead markets to anticipate the Fed will be more aggressive in increasing interest rates. This then could lead to the classic trigger of an economic recession, which would likely cause stocks to slip into a bear market.

Stock Market Risks– Con't

2) **<u>Excess Optimism by Investors:</u>** Attitudinal measures of investor sentiment are currently showing excess optimism, which is typically a negative indicator. These measures are calculated by asking investors about their outlook for stocks. Probably more importantly, behavioral measures of investor sentiment still show caution as the net cumulative flows into domestic equity funds (including exchanged-traded funds) continues to be negative, indicating that investors are not backing up their optimistic outlook with excessive speculation.

3) **<u>Extended Period of Low Volatility:</u>** We are now in the longest period in S&P 500 history without a 3%+ correction, with no move of that size since November 4, 2016. The extremely low volatility is a bit concerning. Although the absence of a pullback does not mean that one will necessarily come soon, we clearly are overdue for at least a modest correction. As can be seen from the J.P. Morgan chart below, pullbacks are a normal part of markets; historically, on average, a few occur each year. Although we don't try to predict or time short-term market pullbacks, the odds do favor a dip in the not too distant future.



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:

- **<u>Current Allocation:</u>** While the asset allocation for a specific client depends on their risk tolerance score and other factors, the average MAM portfolio has approximately 54% in U.S. equities, 28% in bonds & cash, 15% in foreign equities and 3% in alternative assets. The change from one year ago is a 3% decrease in U.S. equities and a 3% increase in foreign equities.
- **<u>Allocation to ETFs:</u>** Exchange-traded funds constitute approximately 20% of most portfolios, a slight increase from one year ago. We may continue to shift part of the portfolio allocation to ETFs given their benefits of low operating expenses and tax efficiency.

Current Asset Allocation of MAM Portfolios– Con't

- **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. For instance, see here for an article and chart from DivendInvestor.com and T. Rowe Price.

   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, 2017, MAM assets under management were in excess of $220 million, up over $35 million from the beginning of 2017. 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 2017 Federal & State Estimated Payments are due January 16, 2018.

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