McCarthy Asset Management, Inc.
Personalized Wealth Management

January 2016 Monthly Commentary

February 1, 2016

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Stock Market & Portfolio Performance

January 2016: U.S. and international stocks posted losses for the first month of the year. It would have been much worse were it not for a late-month surge which allowed stocks to pare their losses. Meanwhile, bonds generated small gains.

	Jan 2016	YTD 2016	Description:
Without Dividends:			
S&P 500	-5.1%	-5.1%	500 Largest Public U.S. Companies
Russell 2000	-8.8%	-8.8%	2000 of the smallest U.S. stocks
MSCI EAFE	-6.1%	-6.1%	international stock index
U.S. Aggr Bond	1.4%	1.4%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-4.2%	-4.2%	non-very conservative MAM portfolios
MAM Conserv	-1.8%	-1.8%	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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Stock Market Update

For the month of January, the stock market staged one of its worst starts to a year. While dropping as much as 9.1%, the S&P 500 staged a partial recovery and closed down 5.1% for the full month. This raises a number of questions:

<u>What caused the drop?</u> As discussed in the January 13th email sent to clients addressing the market drop, I attributed the decline to fears about slowing growth in China and the continued fall in oil prices. Not mentioned in the email, but also a factor, was a slowdown in global manufacturing.

<u>Is this the start of a new bear market (i.e. a drop of 20% or greater)?</u> While I am hopeful this is just a temporary market correction, I am not as confident about that as I was when stocks dropped 10% last August. A key issue will be how the U.S. economy continues to perform. Severe bear markets rarely happen without a recession.

At this point, I think the chances of the U.S. economy entering a recession in the next year are pretty low. <u>Historically, a recession is caused by at least one of four factors</u>:

- **<u>Financial Crisis-</u>** The financial system is in much better shape than it was in 2008, with banks now having a much larger capital cushion. This is important because there is concern about the potential for widespread loan defaults and bankruptcies for energy companies. While certain regional banks could suffer, at this point major bank exposure to energy companies appears to be relatively limited.

- **<u>Over-Extended Sector (i.e. Asset Bubble)-</u>** The technology bubble of 2000 and the real estate bubble of 2007 both led to a recession. Currently, I don't see any signs of a bubble except for stretched valuations for certain large, private technology companies, particularly the so called "unicorns", which are those with a valuation of greater than $1 billion.

- **<u>Federal Reserve Tightening-</u>** While the Federal Reserve raised rates 0.25% in December, interest rates remain very low. Further Fed interest rate increases are expected to be modest and slow.

- **<u>Inventory Recession-</u>** The U.S. manufacturing sector has been experiencing a slowdown and current inventory levels are too high. Excess inventories hurt future economic growth because companies lower production to reduce the excess. The current excess is only modest, though, and is expected to reduce 2016 GDP growth by less than 0.5%. More importantly, the service sector in the U.S., which is far larger than the manufacturing sector, is still growing.

<u>What risks are there that could cause stocks to fall much further?</u> In addition to the possibility of the U.S. entering a recession, there are the risks of a "hard landing" in China and the impact of falling oil prices. Former Federal Reserve vice chairman Alan Blinder recently wrote a Wall Street Journal article, "Markets Are Scaring Themselves", which addressed these two issues. In the article, he made the following points:

- "If Chinese growth slows, many countries' exports will shrink. That's a big deal to some countries—especially emerging markets that rely heavily on commodity exports—but not the U.S…Over the first three quarters of 2015, exports to China made up less than 1% of U.S. GDP."

Stock Market Update- *Con't*

- "What about oil prices? Here, it appears, the markets have even got the direction wrong. Ask yourself: When the price of something you buy goes down, does that make you better off or worse off? The obvious answer is the correct one. Other things being equal, each of us is better off when the prices of things we buy, including oil, go down…Employment in the oil and gas extraction is (only) about one-eighth of 1% of total nonfarm employment…Capital expenditures from the energy-producing industry are (only) about 5% of the nation's total spending on equipment and structures."

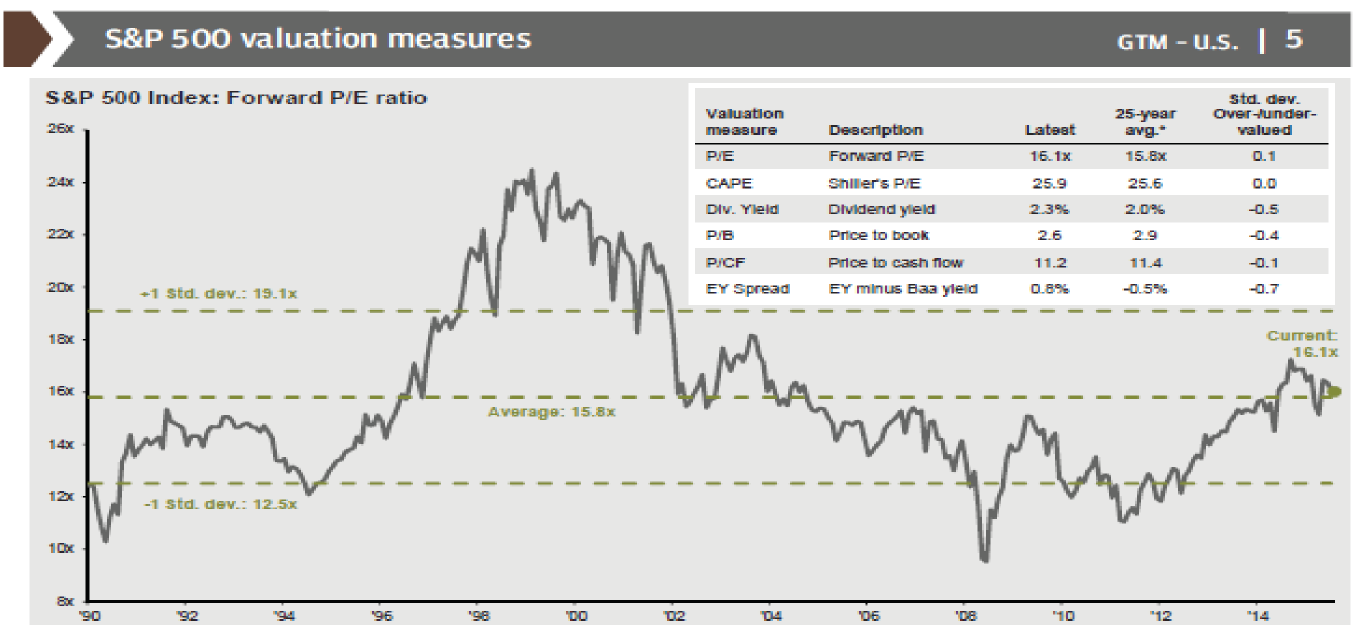
- "In sum, the traders who make stock market prices seem to have a few things wrong: China is not as big a deal to us as they think; and falling oil prices should help, not hurt, U.S. growth. Don't misinterpret any of this as investment advice, however. The market can stay irrational longer than you can stay solvent."

What are positive factors that could help the stock market?

- **Consumer Spending**, which makes up nearly 70% of GDP, has continued to grow. Employment gains have helped. For December, 292,000 jobs were created, well above economists' estimates. For all of 2015, U.S. employment jumped 2.65 million, the second-best annual reading since 1999. The dramatic drop in oil prices should also help consumer spending. It is estimated that the typical American who drives an average of 15,000 miles a year, will save roughly $1,200 annually from lower gasoline prices.

- **Government Spending**: After years of sequestration (which was done to reduce the Federal deficits) Federal & State government spending is increasing again. While larger Federal deficits have negative long-term implications, in the shorter-term they are a positive for the U.S. economy.

- **The Stock Market is now reasonably valued.** Currently, the forward price-earnings ratio for the S&P 500 based on 2016 projected earnings is 15.3, down from 16.1 on December 31, 2015. This compares to a 25-year average of 15.8. For a schematic of this, see the J.P. Morgan chart below, which displays the 25-year history of the forward price-earnings ratio through December 31, 2015 (when the forward P/E was at 16.1).



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.1x	15.8x	0.1
CAPE	Shiller's P/E	25.9	25.6	0.0
Div. Yield	Dividend yield	2.3%	2.0%	-0.5
P/B	Price to book	2.6	2.9	-0.4
P/CF	Price to cash flow	11.2	11.4	-0.1
EY Spread	EY minus Baa yield	0.8%	-0.5%	-0.7

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2015.

J.P.Morgan Asset Management

Stock Market Update– *Con't*

- **Corporate Earnings:** The 70%+ plunge in oil prices has resulted in a very sharp drop in earnings from energy companies. As a result, S&P 500 earnings for 2015 were lower than what they were in 2014. Analysts project solid growth, though, for 2016. Furthermore, corporate earnings have grown significantly over time. According to Bloomberg, profits for the S&P 500 companies were expected to be close to $1 trillion for 2015, compared to $740 billion in 2007 and $490 billion in 2000.

What is MAM doing about the downturn? On Wednesday, January 13th, I sent an email to clients addressing the market drop. In the email, I said unlike with the sharp & sudden stock market drop last August, I am not as confident that this is just a temporary market correction. As a result, we shifted 3% of equity allocation in portfolios to bonds. In explaining the adjustment, I wrote "While this is just a modest adjustment (to increase downside protection in portfolios), market timing is very difficult. It is possible that the release of 4th quarter corporate earnings may help alleviate investors' fears. Depending on how events unfold over the next couple of weeks, we may take additional action to protect portfolios."

Since then, we have not taken additional action although we continue to closely monitor events. For portfolios with cash to invest, we are holding off until we are more confident this is just a temporary market correction.

Recommendation for clients: Try to avoid paying attention to news about the stock market. The media likes to sensationalize events, which unfortunately can make it more likely for investors to react based on emotions. Studies have consistently shown that individual investors dramatically underperform the overall performance of the stock market, undoubtedly due to their emotional decision making (i.e. getting too conservative when things seem bad and too aggressive when things seem good).

What will it take for markets to break out of the current slump? The following will help end this market downturn.

- Stabilizing oil prices would go a long way toward improving investor sentiment
- Signs that the U.S. economy is continuing to grow (i.e. growth in consumer spending, employment and corporate earnings)
- Firmer economic data from China and evidence that policymakers can manage the country's financial conditions

Time to Take a New Look at Earthquake Insurance

No, we are not predicting that a major earthquake is about to strike in California (although, it is probably just a matter of time). The motivation for writing this article is to inform clients about changes the California Earthquake Authority ("CEA"), which sells about 75% of the earthquake insurance policies in California, has recently made to its policies.

According to CEA chief executive officer, Glenn Pomeroy, less than 10% of homes in California have earthquake insurance. The CEA, a publicly managed, privately funded state entity set up after the 1994 Northridge quake, sold about 878,000 policies last year. That is up from about 100,000 since 2008, but "still abysmal" according to Pomeroy. Effective January 1, 2016, the CEA is offering new policy options and other changes in an effort to get more homeowners to sign up. In addition, it is reducing rates by an average of 10% statewide.

Time to Take a New Look at Earthquake Insurance– Con't

Wider Range of Deductibles Now Available

In the past, many homeowners have forgone coverage because of the high premium cost and high deductibles associated with earthquake policies. Deductibles are calculated as a percent of coverage. If you have a $500,000 policy and a 10% deductible, you cover the first $50,000 in damages. Previously, you could choose only a 10% or 15% deductible. Now deductibles are offered at 5%, 10%, 15%, 20% and 25%. Just like with other forms of insurance, the higher the deductible the lower the premium. A calculator to estimate the cost of insurance is available at http://www2.earthquakeauthority.com/Pages/Calc.aspx.

Personal Property and Living Expense Coverages Increase

Other changes include the ability to insure up to $200,000 for personal property coverage. Previously, the maximum for personal property coverage was $100,000. The amount available to cover your living expenses if you can't live in your home has increased from $25,000 to $100,000. Both coverages will cost more if you want the higher coverage.

Discounts for Retrofitted Homes

For older homes that have been retrofitted, CEA previously offered a 5% discount on the cost of the policy without proof of retrofitting. To sweeten the pot for owners of older homes, now a bigger discount of up to 20% will be given if the retrofitting has been signed off by a licensed contractor or engineer.

Apply Now for Money to Retrofit - Even If You Don't Have Earthquake Insurance

The Earthquake Brace and Bolt program provides homeowners up to $3,000 to strengthen homes built before 1979. It's not necessary to have earthquake insurance to apply for the retrofit funds. The program has $4.8 million dollars available. Homeowners who want to be considered for the program must apply by **Feb 20, 2016**. Winners will be selected randomly. A waiting list will be established, in case some winning homeowners don't follow through.

This program is available for homes located in the following Bay Area cities: Albany, Berkeley, Burlingame, Emeryville, Hillsborough, Millbrae, Oakland, Piedmont, San Francisco, San Leandro and Woodside. In Southern California the program covers homes in these cities: Los Angeles, Pasadena, San Bernadino, San Marino, Santa Monica, South Pasadena, and West Hollywood. Homeowners can apply for funds and find out more about eligibility at www.earthquakebracebolt.com.

Should You Have Earthquake Insurance?

This is a personal decision that most California homeowners have either decided "no" or have not thought about. For many, the equity in their home is their biggest asset. Protecting that equity is similar to life insurance and disability insurance, which are important to protect dependents if the wage earner were to die prematurely or become disabled. You hope to never collect on the policy, but it is there for peace of mind. Now that the CEA is offering policies with a greater deductible, it is more affordable to insure at least some of a homeowner's equity, and provide some peace of mind if the next big one hits.

CEA CALIFORNIA EARTHQUAKE AUTHORITY

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

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 document with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees and our educational backgrounds. Each year, the SEC requires us to offer clients the opportunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy.