McCarthy Asset Management, Inc.

Personalized Wealth Management

June Monthly Commentary/Q2 2017 Quarterly Letter

July 3, 2017

Stock Market & Portfolio Performance

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Second Quarter 2017: U.S. and international stocks posted excellent returns for both the second quarter and first six months of 2017. Meanwhile, bonds were up modestly.

	2nd Qtr	YTD 2017	Description:
Without Dividends:			
S&P 500	2.5%	8.2%	500 Largest Public U.S. Companies
Russell 2000	2.1%	4.3%	2000 of the smallest U.S. stocks
MSCI EAFE	5.0%	11.8%	international stock index
U.S. Aggr Bond	1.5%	2.3%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	2.4%	7.4%	non-very conservative MAM portfolios
MAM Conserv	1.9%	4.6%	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.

Advisor Team

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

STEVE MCCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com

Lauree Murphy, CFP®, EA
Financial Planner
Tax Specialist
650 610-9540 x 304
lauree@mamportfolios.com

ANTHONY BERTOLACCI , EA
Director of Compliance
Tax Accountant
650 610-9540 x 302
anthony@mamportfolios.com

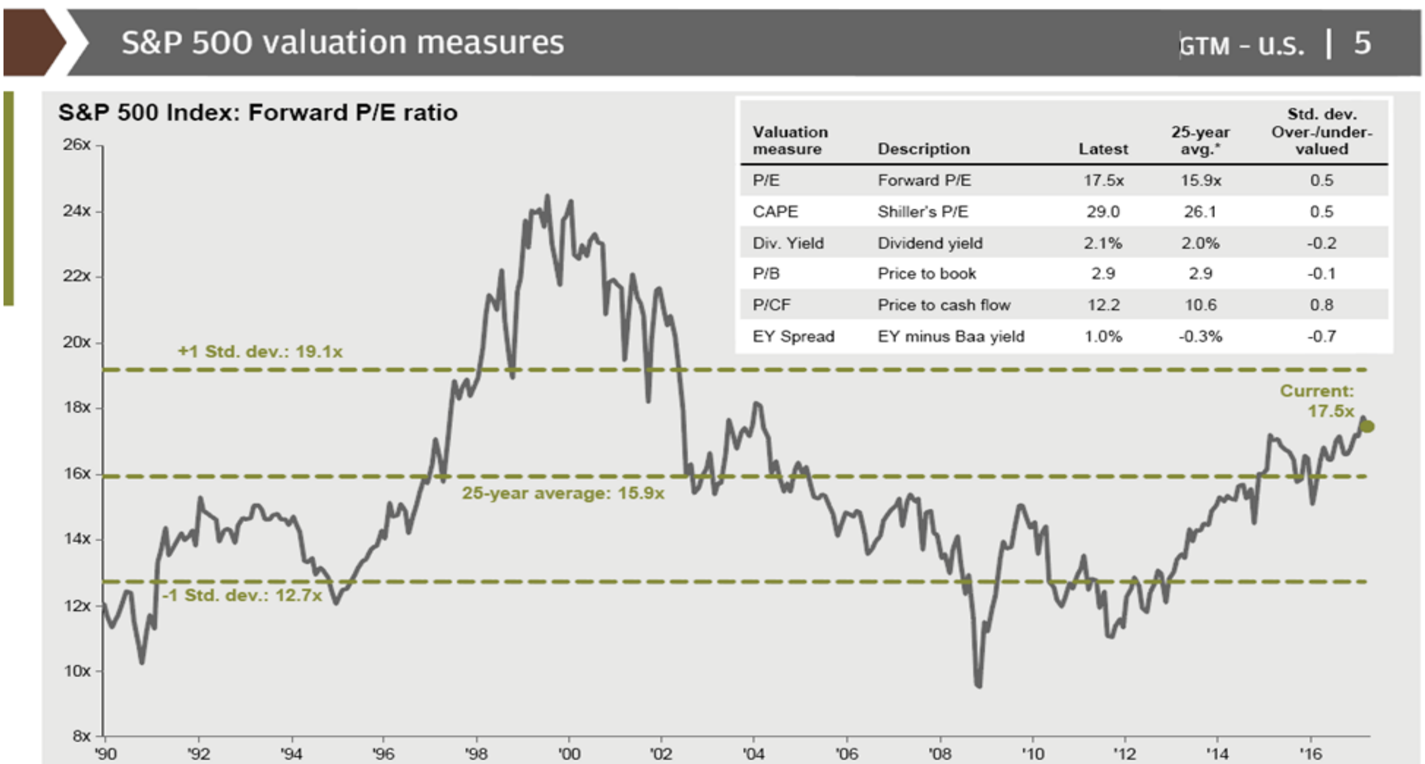
MARILYN BLANCARTE, PACE
Executive Assistant
650 610-9540 x 305
marilyn@mamportfolios.com

Stock Market Outlook Continues to Look Good (For Now)

<u>Great Performance:</u> The stock market performed very well for the first six months of 2017, with the S&P 500 returning 8.2% (before dividends). Reasons for the strong performance include a combination of moderate economic growth, healthy gains in corporate profits, low interest rates, and subdued inflation.

The U.S. is now in the 9th year of economic growth. This is the third longest expansion since the Civil War. But unlike most prior expansions, growth has been slow. Meanwhile, the stock market is now in its 9th year of a bull market, which is second in length only to the 1987-2000 technology boom.

<u>Stocks Are Somewhat Expensive:</u> The price-earnings ratio based on forward 12-month projected earnings is 17.6 for the S&P 500. As can be seen on the J.P. Morgan graph below, this compares to a 25-year historical average of 15.9. The higher current rate may be justified given the current low level of interest rates and inflation. Furthermore, investors today are benefitting from a rare period of sustained, synchronized economic expansion around the world. The International Monetary Fund forecasts world economic growth at 3.5% in 2017, the fastest rate in five years and up from 3.2% in 2016.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	17.5x	15.9x	0.5
CAPE	Shiller's P/E	29.0	26.1	0.5
Div. Yield	Dividend yield	2.1%	2.0%	-0.2
P/B	Price to book	2.9	2.9	-0.1
P/CF	Price to cash flow	12.2	10.6	0.8
EY Spread	EY minus Baa yield	1.0%	-0.3%	-0.7

Source: FactSet, FRB, IBES, 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 as provided by IBES since December 1989, and FactSet for March 31, 2017. Average P/E and standard deviations are calculated using 25 years of FactSet history. 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 March 31, 2017.

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Consumer confidence measures are also the highest since the early 2000s, which bodes well because consumer spending accounts for roughly 70% of the U.S. economy. Furthermore, at 4.4%, the unemployment rate is at the lowest level since May 2007, and wages are ticking higher.

<u>Good Earnings Growth:</u> Corporate earnings—an important determinant of share prices—are experiencing a strong growth spurt. First-quarter profits for the S&P 500 companies increased nearly 15% from the same period in 2016, the fastest growth rate since the third quarter of 2011. For all of 2017, Wall Street analysts predict earnings growth of more than 11%, a significant improvement from 2016, when earnings were flat compared with the previous year.

Stock Market Outlook Continues to Look Good (For Now)- Con't

Outlook: We believe the current economic expansion and strong corporate earnings have the potential to lead to further stock market gains over the next twelve months. Most bear markets occur near recessions, and the U.S. economy is not showing signs of excesses that historically have built up and led to an economic downturn. In the absence of a recession, stock market declines tend to be more modest. While market volatility has been very low this year, increased volatility for the remainder of the year should not be a surprise, particularly given uncertainty over the impact of actions by the Federal Reserve (see pages 3-5). By late 2018 or early 2019, our outlook would likely change if it appears the next recession is getting close at hand.

The Federal Reserve's Efforts to Tighten Monetary Policy

At its meeting last month, the Federal Reserve announced an expected 0.25% increase in the federal funds rate, which directly increases short-term interest rates. In addition, it announced plans to start unwinding its balance sheet, which is likely to cause long-term rates to rise.

Unwinding the Fed's Balance Sheet: Beginning in late 2008, the Federal Reserve began large-scale purchases of U.S. treasuries and mortgage-backed securities (MBS) to prevent a collapse of the U.S. financial system. For six years, the Fed embarked on this asset purchasing program—known as quantitative easing—which dropped interest rates to record-low levels to spur an economic recovery. During this time, the Fed's balance sheet grew significantly from $869 billion on August 8, 2007, to well over $4 trillion currently. The program appears to have worked as the economy has been on a slow, but stable long-term growth trajectory since the financial crisis.

At its June meeting, the Fed stated that because the economy is on a sustainable growth track, unemployment is very low and inflation is increasing toward its 2% target rate, it is now time for a tighter monetary policy. As such, the Fed presented how it will start shrinking its balance sheet by tapering reinvestments of principal and interest gradually, and then letting bonds mature off its balance sheet over the next few years. The Fed will limit the initial value of bonds that mature and are not reinvested to $10 billion per month for the first three months and then increase the cap over time. However, the total value of maturing bonds will be limited to $50 billion per month.

By slowly reducing the supply of bonds it holds, the increase in long-term rates will hopefully be gradual. However, since this is unchartered territory (i.e. the Fed has never done this before), there are risks of unforeseen consequences, such as a spike in long-term rates triggering a recession.

Increase in Short-Term Interest Rates: As expected, at the June meeting the Federal Reserve also raised the target range for the federal funds rate by a quarter of a percentage point, bringing the benchmark rate to a 1.0% to 1.25% range. The Fed also stayed with its projection of another rate hike later this year, followed by three more quarter-point increases in both 2018 and 2019.

This most recent federal funds increase is the 3rd since December of 2015. **Given that we are now in a prolonged period of rising interest rates, what could this mean about the prospects for the stock market?** Aren't rising interest rates bad for stocks? The answer is "it depends." According to a Standard & Poor's study, which tracked market performance going back to 1953, U.S. stocks actually posted their best returns when 10-year Treasury yields rose towards 4%. On the other hand, when yields exceeded 6%, stocks started to lose money. "The 'sweet spot' for equity prices appears to be a rising rate environment between 3% and 4%", explained Sam Stovall, S&P's chief equity strategist. Because the 10-year Treasury closed at 2.3% at the end of June, it may be awhile before the Fed rate increases hurt the performance of the stock market.

The Federal Reserve's Efforts to Tighten Monetary Policy– Con't

The chart below from J.P. Morgan Asset Management displays the historical impact on the performance of the S&P 500 of the Fed's increases in the federal funds rate. Since 1980, there were five times when the Fed raised rates at least six times within a 24-month period. The average gain for the S&P 500 during those five hiking cycles was only 3.0%. There are two significant differences between the current rising rate cycle and the preceding five periods:

1. The federal funds rate at the start of this cycle was close to 0%, an extremely low level.
2. This time the Fed is being very gradually with its hikes, as the most recent one was only the 3rd increase in the last 16 months.

Historical impact of Fed tightening

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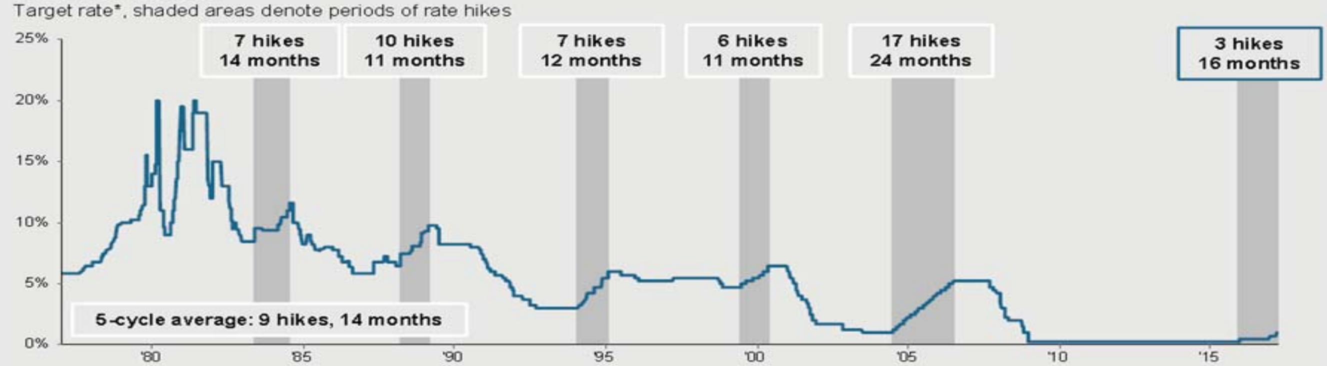
Fixed income

Federal funds rate

Target rate*, shaded areas denote periods of rate hikes



Market reaction during previous rate hiking cycles

	May 1983 – July 1984	March 1988 – February 1989	February 1994 – February 1995	June 1999 – May 2000	June 2004 – June 2006	Average of past five rate hiking cycles	Cycle beginning December 2015
Yield change (bps)							
Federal funds rate	313	325	300	175	425	**308**	75
2-year Treasury	311	227	305	121	238	**240**	25
10-year Treasury	274	91	185	50	52	**130**	10
S&P 500 return	-9.6%	6.8%	-2.1%	8.5%	12.0%	**3.1%**	14.0%
U.S. dollar	10.4%	1.7%	-4.7%	3.4%	-5.8%	**1.0%**	-0.3%

Source: FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.
S&P 500 returns are price returns and do not include reinvestment of dividends. Averages do not include the current cycle. *Between 1979 and 1982, the FOMC changed its approach to monetary policy, focusing on the money supply, rather than the federal funds rate. In the fall of 1982, however, the Federal Reserve shifted back to its approach of targeting the "price" rather than the "quantity" of money. Thus, because the federal funds rate was not the FOMC's key policy tool, we exclude increases in the federal funds rate between 1979 to 1982 in our analysis of rate hike cycles.
Guide to the Markets – U.S. Data are as of March 31, 2017.

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Not surprisingly, the stock market has responded very well to the increases since December 2015 with the S&P 500 up 14.0% through March 31, 2017.

Risk of an Inverted Yield Curve: One risk that we monitor is the occurrence of an "inverted yield curve." Historically, when short-term interest rates rise above long-term rates, bull markets cease and bear markets start. When the spread between these rates turns negative, it is referred to as "inverting the yield curve."

Why does an inverted yield curve signal a major peak for the stock market? According to a recent article from Charles Schwab & Co, "every recession in the United States over the past 50 years was preceded by an inverted yield curve. The yield curve inversion usually takes place about 12 months before the start of the recession, but the lead time ranges from about 5 to 16 months. The peak in the stock market comes around the time of the yield curve inversion, ahead of the recession and accompanying downturn in corporate profits."

The Federal Reserve's Efforts to Tighten Monetary Policy– Con't

Currently, the yield curve is still positive, indicating that the risk of a recession for the next twelve months is low. As the Fed continues to raise the federal funds rate, short-term interest rates will increase. With the current Fed target of one more 0.25% increase this year, 3 increases in 2018 and 3 more in 2019, the federal funds rate would reach 3% by the end of 2019. Meanwhile, the unwinding of the Fed's balance sheet should gradually increase long-term interest rates. We will be keeping a close eye to see if short-term rates move above long-term rates. If such an inverted yield curve occurs again, we will likely get more defensive with portfolio positioning.

Sincerely,

Stephen P McCarthy, CPA, CFP®,

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McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

Phone: 650-610-9540
Fax: 610-9541
E-mail: Steve@mamportfolios.com

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

*Are you on course for a financially-comfortable retirement? A **Retirement Analysis** can be very helpful in answering that. Please let us know if you would like to have us prepare one for you.*

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