

## March Monthly Commentary/Q1 2016 Quarterly Letter

April 1, 2016

### Stock Market & Portfolio Performance

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**First Quarter 2016:** After a terrible early start to the year, stocks recovered in the second half of the quarter. For the full quarter, large-cap U.S. stocks posted modest gains, while small-cap U.S. and international stocks ended with small losses. Bonds generated solid returns for the quarter.

	Mar 2016	1st Qtr 2016	Description:
Without Dividends:			
S&P 500	6.6%	0.8%	500 Largest Public U.S. Companies
Russell 2000	7.7%	-1.9%	2000 of the smallest U.S. stocks
MSCI EAFE	6.0%	-3.7%	international stock index
U.S. Aggr Bond	0.9%	3.0%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	5.3%	0.6%	non-very conservative MAM portfolios
MAM Conserv	3.5%	1.6%	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.*

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The first quarter of 2016 was interesting for investors. For the first half, most stock indices were down over 10% in response to plunging oil prices, concerns about global growth, and the risk of the U.S. economy slipping into a recession. I sent out a stock market update via email on February 12<sup>th</sup>, stating two key factors that I was monitoring: oil prices and the performance of the U.S. economy. Since then, stock prices rallied sharply, with most indices fully recovering their losses.



Is the market correction over? It is difficult to say. While I am hopeful that the worst is behind us, I am guarded in my outlook. Most of the problems that afflicted the market during the first six weeks of 2016 remain with us. China's economic growth continues to be sluggish, most commodity producers are still losing money, and the European Central Bank and the Bank of Japan are promoting negative interest rates in a desperate effort to jumpstart their economies.

Nonetheless, investors have been encouraged by:

- Oil prices snapping back nearly 50% from their February lows.
- The yield on junk bonds, which had spiked as the price of junk bonds fell, has dropped more than 1.6% from its peak.
- Jobless claims, which after creeping up in late 2015, have fallen back near a 42-year low.
- On March 16<sup>th</sup>, the Federal Reserve reduced estimates of how much they expect to raise short-term interest rates in 2016 and beyond, nodding to lingering risks to the economic outlook posed by soft global growth and financial market volatility.

As I see it, there are three major risks to the current rally:

- 1) **Rising U.S. Dollar:** This is an important issue for investors. See P.3-4 for the article "Will the U.S. Dollar Continue to Rise?"
- 2) **Oil Prices:** As I have written in previous Commentaries, falling oil prices should be a net positive for the U.S. economy. Nonetheless, in the last few months, stock prices have moved in sync with oil prices. Oil prices recovering to about \$50 per barrel would probably be very beneficial for the stock market. While I am confident that it is just a matter of time before that happens, predicting prices over the next year is very difficult:
  - ◇ The 50% rise in prices since mid-February is primarily due to efforts by OPEC and Russia to freeze production. OPEC will hold a meeting with other major producers on April 17<sup>th</sup> in Doha, Qatar to discuss this. If efforts at that meeting fail, prices may drop again in the short-run.
  - ◇ Longer-term (two to three years out), I am confident that oil prices will recover to \$50 to \$60 a barrel as rising global demand catches up to global supply.

## Stock Market Recovery– Is It For Real?- Con't

- 3) **Performance of U.S. Economy:** The key to the performance of the U.S. economy is consumer spending, which makes up about 67% of our GDP. Here there are a number of positives:
1. **Employment and income.** Steady improvements in labor market conditions have led to consistent gains in wage income. Wages are the biggest component of disposable personal income, which recently rose 2.5% from the previous year.
  2. **Consumer confidence.** While readings of consumer confidence have fallen from early 2015, they do not suggest a significant drop-off in spending in the near-term.
  3. **Savings rate.** The personal saving rate was 5.2% in January, close to its average of 5.1% over the past 12 months and well above the 3.9% average of the prior expansion. While historically a higher savings rate has meant a slower pace of spending growth, it also means consumers have more of a cushion to withstand negative economic shocks.
  4. **Wealth effect.** The perceived increase in wealth from rising values of real estate or financial assets typically induces people to spend more out of their disposable income.

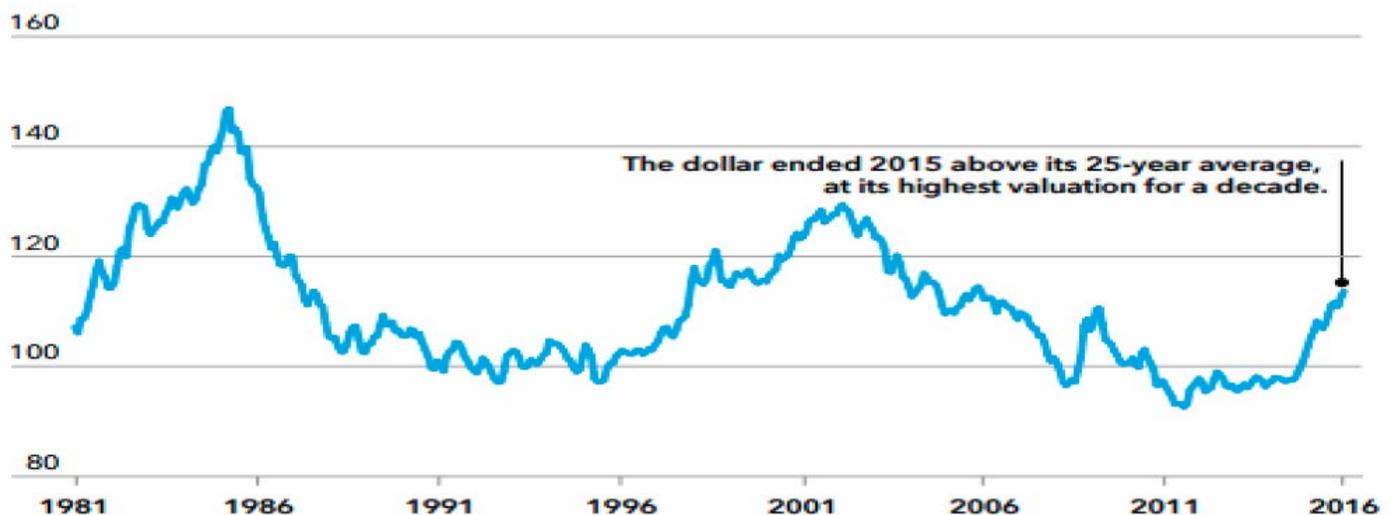
**Conclusion:** The sharp drop the stock market experienced early this year unnerved many investors. While I am now more optimistic that this was just another temporary correction, I am cautious as this old bull market, which started in March of 2009, is now in its seventh year.

## Will the U.S. Dollar Continue to Rise?

In 2015, virtually every currency weakened against the dollar, with some experiencing a double-digit percentage decline. The U.S. dollar is now close to a 10-year high, as can be seen from the J.P. Morgan chart below.

### The Dollar's Value Has Reached a 10-Year High

Value of U.S. Dollar: January 1981–December 2015 (Rebased to 100 as of 2010)



Source: J.P. Morgan. Mid-month monthly data for the J.P. Morgan Broad Trade-Weighted Real Exchange Rate Index, (U.S. Dollar), which reflects inflation-adjusted exchange rates for the currencies of 47 countries. Investors cannot invest directly in an index.

## Will the U.S. Dollar Continue to Rise?- Con't



Whether the dollar continues to climb is important to investors for at least a couple of reasons:

- For U.S. investors, a rising U.S. dollar has a negative impact on international and global stock and bond investments. For instance, if both U.S. stocks and European stocks perform comparably in their own currency, but the dollar appreciates 10% relative to the euro, then all else equal, the U.S. stocks will outperform the European stocks by 10%. This has been the case for the last few years as international stocks have significantly underperformed U.S. stocks for U.S. investors.
- A rising U.S. dollar makes our exported goods more expensive to foreigners, hurting the competitiveness of American exports and the profitability of many U.S. firms.

Conventional wisdom holds that the dollar bull market could continue for an extended period, thanks to the likelihood that U.S. interest rates will gradually rise, while central banks in the euro zone, Japan and many other economies will continue to loosen their monetary conditions. The theory is that investor capital will flow toward economies where higher interest rates are available.

The most significant sustained rise in the U.S. dollar occurred in the early to mid-1980's, as can be seen on the chart on P. 3. That was a classic case of a strong U.S. economy compared to weak growth in the rest of the world. Among other factors, relatively high inflation outside the U.S. allowed the dollar to appreciate without greatly hindering U.S. competitiveness.

Today's environment looks quite different. The global economy and markets are more interconnected, inflation is low in the U.S. and elsewhere, and many currencies have already declined substantially relative to the dollar.

While the timing of this is very difficult to predict, it seems that perhaps sometime later this year, the U.S. dollar will end its current appreciation phase. This would be a very significant positive occurrence for investors as both international investments and U.S. exporters will benefit.

## Portability— An Important Estate Tax Concept

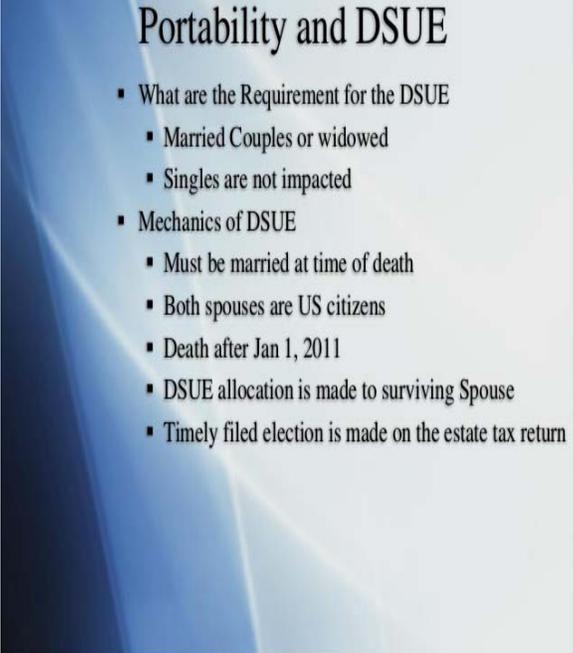
A common estate planning goal of a married couple is to take full advantage of both spouses' estate tax exclusion. This allows them to leave twice as much to their heirs free of estate tax. Typically, this is done by funding a Bypass Trust at the death of the first-to-die with the exclusion amount and leaving the rest to one's spouse (outright or in trust). There is a relatively new estate planning strategy called "Portability" that in many cases may be better than the use of a Bypass Trust.



## Portability– An Important Estate Tax Concept– Con't

“Portability” was first introduced into law on January 1, 2011. As a result of the passage of the 2012 Tax Act, portability is now permanent (subject, of course, to Congress later changing the law). What does portability do? Like the Bypass Trust, it allows the surviving spouse to utilize both spouses’ estate tax exclusion. By electing portability, the decedent’s unused exclusion (DSUE) (up to \$5.45 million in 2016) is transferred to the surviving spouse. *This could allow the surviving spouse to have close to \$11 million in assets and avoid gift or estate tax.* **An advantage of electing portability is that, unlike with assets in a Bypass Trust, assets subject to it receive a step-up in basis upon the death of the surviving spouse.**

In 2015, the Internal Revenue Service released final regulations on the estate tax portability election. **Importantly, in order for the surviving spouse to be able to use the DSUE amount (i.e. to elect portability), the executor of the first-to-die’s estate must make an election on a timely-filed estate tax return.** This would necessitate the preparation and filing of an estate return just to make this election when a return might not otherwise be needed.



### Portability and DSUE

- What are the Requirement for the DSUE
  - Married Couples or widowed
  - Singles are not impacted
- Mechanics of DSUE
  - Must be married at time of death
  - Both spouses are US citizens
  - Death after Jan 1, 2011
  - DSUE allocation is made to surviving Spouse
  - Timely filed election is made on the estate tax return

*Some experts worry that executors will overlook the deadline to file an estate tax return, especially if an estate is smaller than the exemption and there is no reason to file an estate return other than electing portability.* Not opting for portability can “short-change” the survivor and can put the executor at risk of being sued.

The purpose of this article is to make you aware of what portability can do. Estate planning can be complicated, and involves more than just minimizing estate tax. *We recommend that you discuss with a knowledgeable estate planning attorney whether portability should be incorporated into your estate plan.*

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

### Tax Reminders:

- April 18th is the deadline for filing 2015 individual income tax returns and making 2015 IRA, SEP-IRA, Roth IRA and Education Savings Account contributions.
- It is also the deadline for first quarter 2016 Federal and State estimated payments.
- April 10th is the deadline for California property tax payments for the first half of 2016.



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