# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

February 1, 2008

## Monthly Investment Commentary- January 2008

***Stock Market Performance for January:*** The stock market had one of the worst Januarys ever—unadjusted for dividends, the S & P 500 fell 6.1%, the NASDAQ dropped 9.9%, and the Russell 2000 fell 6.9%. Foreign stock fell even more than U.S. stocks, while bonds and commodities rose sharply.

***MAM Performance:*** For the month, MAM portfolios out performed the S & P 500, with a composite loss of 4.6% (after all fees), versus a drop of 6.1% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. The out performance of MAM portfolios relative to the S & P 500 was due to the downside protection provided by the bond funds and alternative asset investments (PIMCO Commodity and Allied Capital).

The remainder of this Monthly Commentary addresses the following:

1. *Are we headed for a recession?*
2. *MAM Portfolios Repositioned to Increase Downside Protection*
3. *Federal Reserve Interest Rate Cuts and Federal Government Stimulus Package*
4. *My Outlook for the Stock Market*
5. *Great Time to Refinance a Mortgage or obtain a Home Equity Line of Credit*
6. *2007 Tax Reporting*

***Are We Headed for a Recession?*** A recession is defined as two consecutive quarters of negative Gross Domestic Product (GDP) growth. The last recession was a shallow one that started in late 2001. The problem with determining whether we are in a recession is that by the time a recession is officially proclaimed, the economy may have already recovered.

Based on a preliminary estimate, it looks like the economy was very close to being in a recession for the 4th quarter of 2007. Yesterday the Commerce Department released its initial GDP report showing the U.S. economy grew at an anemic 0.6% annual rate for the fourth quarter of 2007. This is down from a 4.9% annual growth rate for the third quarter of 2007. For all of 2007, the initial estimate is that GDP grew 2.2% from 2006.

Consumer spending represents 70% of the U.S. economy. If consumers stop spending, a recession is very likely to occur. The major determinate of consumer spending is employment. Unfortunately, it appears that employment has taken a dramatic turn for the worse. In its December of 2007 Jobs Report, the Labor Department reported that the economy added just 18,000 new jobs, far below expectations of a 70,000 increase. This was followed by today's Labor Department report that showed the economy lost 17,000 jobs in January, the first monthly jobs reduction in over four years.

***MAM Portfolios Repositioned:*** In mid-January we repositioned all MAM portfolios worth over $15,000 to increase downside protection. I decided to make this move because I felt that the

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likelihood of a recession was not fully priced into the stock market and analysts' earnings expectations of 10% growth for 2008 were too optimistic. Generally the changes made were to reduce the allocation to equities by 5% (both U.S. and foreign equities) with a 5% increase in the allocation to bonds. I view this move as a temporary one until stock prices adjust to reflect the present economic risks.

***Federal Reserve Interest Rate Cuts:*** In a rare "between Fed meetings" move, on January 22nd the Federal Reserve announced a 0.75% cut in the federal funds rate to 3.5%. This marks the first time since September 11, 2001 that the Fed cut rates between their regularly scheduled meetings. After its January 29th - 30th meeting, the Fed announced an additional 0.50% cut. These two rate cuts represent the steepest reduction in such a short period since 1982. In addition, since last September, the federal funds rate has now been slashed by 2.25% (from 5.25% to 3.0%). Further cuts are anticipated as the Fed is determined to front-load the interest rate easing ahead of the November Presidential election.

***Federal Government Stimulus Package:*** Politicians have been quick to jump on the "let's spur the economy" bandwagon. On January 22nd President Bush called for an economic stimulus plan that includes tax breaks for individuals and businesses "to keep the economy growing and creating jobs". With unprecedented speed and cooperation (remember this is an election year), on January 25th the leaders in the House of Representatives agreed on a $150 billion economic stimulus plan that would give most taxpayers rebate checks of $600 ($1200 for married taxpayers, and $300 per child). Unfortunately for high earners, the rebates would be phased out for individuals whose incomes exceed $75,000 and joint filers making more than $150,000. The proposed Senate version of the plan would provide $500 in rebates for individuals earning up to $150,000 (and $1000 for joint filers earning up to $300,000). The actual bill should be passed by Congress and signed by Bush within the next few weeks.

***My Outlook For the Stock Market:*** My best guess is that for at least the next few months the stock market will remain very volatile with a possible downward trend as stock prices adjust for the present economic risks and analysts adjust downward their 2008 earnings projections. The recent moves by the Federal Reserve to aggressively cut interest rates will help, but interest rate changes tend to have a six to nine month lag before their impact is felt by the economy. The $150 billion Federal stimulus package will also help as economists estimate that it could add between 1% and 1.5% points to economic growth in the second half of 2008. Personally, though, I feel the government stimulus money would be better spent providing longer-term economic incentives.

Given the current risks, I feel that for now it is best to be a little cautious in managing portfolios. There is an emotional factor here. Studies have shown that the average investor underperforms the market averages by allowing their emotions to cloud their investment decisions. If the market falls much further, some investors will probably panic and bail out at a very inopportune time. By being a little more conservative now, I feel that it will be easier for MAM investors to ride out any further drop in stock prices.

By being cautious, I run the risk of missing what may be an opportune time to get more aggressive. Historically, one of the best times to invest in equities is when the economy is in a recession. This is because the stock prices reflect economic activity that is projected to occur six to nine months in the future. I am not convinced, though, that stock prices have bottomed. Furthermore, I prefer to be a little more conservative now for the emotional comfort of MAM clients.

***Great Time to Refinance a Mortgage:*** A silver lining to the economic slowdown is that now is probably a good time to refinance certain mortgages. If you are interested in doing so, I recommend that you opt for a "no-cost" refinance, where the lender absorbs the points and closing costs. This is because if mortgage rates subsequently fall further (which I feel is very possible), then it may make sense to do another refinance.

Mortgage rates on conforming loans (i.e. up to $417,000) are as low as they have been in nearly four years. While I have not compared different lenders, I did check with Fremont Bank (www.fremontbank.com). As of February 1, 2008, their rate for a conforming loan on a primary residence is 5.99% for a no-cost 30-year fixed and 5.375% for a no-cost 15-year fixed.

Since last summer (i.e. the subprime lending crisis), the rates on jumbo loans (i.e. greater than $417,000) have been about 1% higher than the rates on conforming loans. As of today, Fremont Bank's rate for jumbos is 7.375% for a no-cost 30-year fixed and 6.50% for a no-cost 15-year fixed. *Help is on the way.* The proposed Federal stimulus package changes the definition of a conforming loan to be up 125% of an area's median home price, with a cap placed at $729,750. Once the stimulus bill becomes law and is enacted, the rates on Bay Area mortgages between $417,000 and $729,750 should fall by about 1%.

Now is an excellent time to obtain or refinance a home equity line of credit. In December Schwab Bank reduced the rate on their Home Equity Line of Credit (HELOC) loans for qualified borrowers to "the prime rate less 1%". With the recent Fed rate cuts, the prime rate has fallen to 6%. Therefore the rate on the Schwab Bank HELOC loans is now at 5%. Keep in mind that this is a variable rate. While the prime rate may fall further in the next few months, at some point the economy will recover and the prime rate will increase. Schwab Bank charges no annual fees or closing costs for the HELOC loans, other than a one-time notary fee. To qualify for the "prime minus 1%" rate, borrowers must have a credit score 680 or higher, and the line of credit must be for at least $50,000. Schwab Bank can be reached at 1-800-497-7470.

**2007 Tax Reporting:** For those of you who are tax clients, I want to remind you there is no need to fill out anything in the Tax Organizer related to your taxable Schwab account(s) managed by MAM. Schwab has sent us a copy of your Form 1099(s). In addition, for your mutual fund sales we have produced a gain/loss report that we will attach to your tax return.

For those of you who are not tax clients, we have mailed to you the 2007 Realized Gains and Losses Report, along with instructions explaining how to reference and attach the report to your tax return. Be sure and provide this to your tax preparer, as having this information really simplifies preparation of your return.

Please call or email me if you have any questions or would like to discuss your portfolio(s).

Sincerely,

Stephen P. McCarthy, CPA, CFP