McCarthy Asset Management, Inc.

Registered Investment Advisor

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Monthly Investment Commentary- July 2008

Stock Market Performance for July: After reaching a 9-month low on July 15th, the market staged a mini rally through the end of the month led by falling oil prices and rising financial stocks. The month's decent performance as indicated by the indices, masked the underlying weakness of the overall market. For the month, unadjusted for dividends, the S & P 500 fell 1.0%, the NASDAQ climbed 1.4%, and the Russell 2000 jumped 3.6%. Foreign equities fell much more than U.S. equities, bonds were mixed, and commodities fell sharply.

MAM Performance: For the month, MAM portfolios underperformed the S & P 500, with a composite loss of 2.7% (after all fees), versus a drop of 0.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

The five best performing MAM investments for July were Blackrock Health Science (up 6.7%), PIMCO Developing Local (up 2.1%), Dodge & Cox Balanced (up 0.5%), PIMCO Total Return (up 0.1%), and FMI Large Cap (down 0.4%).

The five worst performing MAM investments for July were PIMCO Commodity (down 12.6%), Artisan International Small Cap (down 7.7%), American Fundamental (down 3.7%), American Growth Fund (down 3.5%), and Oakmark Equity Income (down 3.4%).

Year-To-Date Performance: For the first seven months of 2008, unadjusted for dividends, the S & P 500 fell 13.7%, the Nasdaq dropped 12.3%, and the Russell 2000 fell 6.7%. MAM portfolios out performed the S & P 500 so far for 2008 with a composite loss of 10.4%, versus a loss of 12.7% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested.

For the month, the performance of MAM portfolios relative to the S & P 500 was hurt by a mini-recovery in financial stocks, a sharp drop in commodities due to the recent drop in oil prices, and a partial recovery in the value of the U.S. dollar. MAM portfolios are currently under weighted in financial stocks. Excluding Blackrock Health Science, all but one of the equity funds used by MAM underperformed the Vanguard Index 500. In comparison, Oakmark Select, which has a heavy weighting in financial stocks, rose 4.0% for the month. One month does not make a trend. My expectation is that financial stocks will lag the stock market as banks and other financial firms continue to write down the value of their assets.

U.S. Economy: So far this year the U.S. economy has proved surprisingly resilient in the face of tighter credit, soaring energy prices, a tumbling housing sector and consumer gloom. Yesterday, the U.S. Commerce Department reported that the U.S. economy grew at a modest pace in the second quarter, due to strong exports and government stimulus checks. In its initial estimate, the Commerce Department reported that Gross Domestic Product (GDP) grew at a 1.9% annualized rate in the second quarter, up from 0.9% for the first quarter.

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While the U.S. economy has held up so far, I am concerned that rising unemployment, the tumbling housing market, and soaring energy and food costs could lead the U.S. into a recession within the next six to nine months. In addition, the positive impact of the stimulus checks is likely to fade, which could cause consumers to curtail spending, and a slowdown in the global economy would impact U.S. exports. Today the U.S. Labor Department reported that the U.S. unemployment rate hit its highest level (5.7%) in four years during July as employers cut non-farm jobs for a seventh straight month. While the job losses were less than expected, the 51,000 jobs that were eliminated brought the losses so far for 2008 to 463,000 jobs.

Outlook for the Stock Market

In January, after the release of the first negative jobs report, I felt that it was likely the U.S. would enter a recession this year. Furthermore, I felt earnings expectations were too high, and the high likelihood of a recession was not factored into stock prices. As a result we became more conservative in portfolios by shifting 5% of equities to bonds. At the time I wrote "I expect that if a recession were to occur, it would be mild as the Federal Reserve will be very aggressive in cutting interest rates and the strong global economy should continue to provide a boost to U.S. exports. Also, historically one of the best times to invest in stocks is after a recession has started."

Thanks to the actions of the Feds, I was premature in my concern for a recession. Since mid-January the Fed was very aggressive in cutting interest rates by 2 ½ percent and a Tax Rebate Stimulus Plan was passed. Unfortunately, the tumbling housing sector, tightening credit conditions (including the collapse of Bear Sterns and IndyMac), and rising unemployment, combined with soaring energy and food prices, may only be delaying the inevitable. Therefore, at least for now, I plan to remain cautious with the asset allocation within the portfolios. I still have faith in the long-term resilience of the U.S. economy, as it has shown time and time again to overcome adversity. I am just concerned that things could get worse before they get better.

Housing Tax Act of 2008

In late July both the House and Senate passed a bill that is intended to provide relief to the housing industry. President Bush is expected to sign this legislation. While the House and Senate still need to reconcile the differences in their respective bills, the provisions in the final bill are expected to include:

- A new independent regulator will be placed in charge of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

- Resources are to be provided to allow cities and states to buy up and rehabilitate foreclosed properties.

- Mortgage refinancing assistance will be provided to keep an estimated 400,000 families from losing their homes.

- Certain borrowers who are in danger of losing their homes would be able to refinance into lower-cost, government-issued mortgages.

- A refundable credit of up to $7500 will be offered for the purchase of a principal residence by certain "first-time homebuyers". The credit will really be an interest-free loan, as it is to be repaid over 15 years as an addition to income tax.

- A new deduction for property taxes is to be available for individuals who do not itemize. The deduction is limited to $500 ($1000 on joint returns).

What remains to be seen is the extent to which this housing stimulus bill will help stem the number of foreclosures and revitalize the housing market.

Potential Estate Tax Reform

Congress needs to address estate tax reform. Based on current law, the amount of assets exempt from estate tax rises to $3.5 million in 2009, will be unlimited for 2010, and then drops to $1 million for 2011. Based on a recent issue from the Kiplinger Tax Letter, estate tax reform is a year or so away. The outlines of the reform are clear, though, because both McCain and Obama support an estate tax and oppose keeping the current law. Both presidential candidates share common ground on setting the parameters of the estate tax. For the exemption amount (the amount of assets exempt from estate tax), Obama prefers $3.5 million while McCain prefers $5 million. The top estate tax (currently 45%) is their key difference: McCain favors a maximum rate of 15% while Obama prefers 45%. Since the Democrats are expected to control Congress for 2009, a rate closer to 45% seems likely.

In an interesting change from current law, both candidates support making the exemption amount "portable" for spouses. This would greatly simplify estate planning for surviving spouses by eliminating the need for taxpayers to set up Bypass Trusts solely to save on estate tax. When one spouse dies, the unused exemption would pass to the survivor and be available for use when that spouse dies. Obama's proposal would effectively allow for a $7 million estate tax exemption for couples and McCain's plan would make it $10 million. Currently, if a spouse dies without having fully used his or her exemption, the remaining exemption is wasted.

Once estate tax reform is passed, I will be recommending that clients have their existing estate plans reviewed in light of the changes.

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

Sincerely,

Stephen P. McCarthy, CPA, CFP