# *McCarthy Asset Management, Inc.*

Registered Investment Advisor

February 1, 2012

## Monthly Investment Commentary- January 2012

***Stock Market Performance for January:*** 2012 started out well as the stock market enjoyed its best January in 15 years. Unadjusted for dividends, the S & P 500 rose 4.4%, the NASDAQ jumped 8.0%, the small cap Russell 2000 climbed 7.0% and the international equity index MSCI EAFE rose 5.3%. Bonds, as represented by the Barclays Global Aggregate Bond Index, rose 0.9% for the month.

***MAM January Performance:*** MAM portfolios underperformed the S & P 500 for the month. Excluding the "very conservative" portfolios (which rose 2.3%), MAM portfolios rose 3.5% (after all fees), versus a rise of 4.8% for the Vanguard Index 500 fund (symbol VFINX) with dividends reinvested. Net of fees, MAM portfolios captured 73% of the upside of the S & P 500 despite the fact that most portfolios have a 30% to 40% weighting in bonds. At this point I don't plan to make changes to the asset allocation as I prefer to retain the significant bond allocation to provide downside protection to portfolios.

## *Economic Update*

Last week the Commerce Department released its initial estimate of 4th quarter 2011 Gross Domestic Product (GDP). The report showed that economic output grew at a 2.8% annual rate for the quarter, the fastest pace in 18 months, signaling that a sturdier recovery took hold in the U.S. despite troubles in other parts of the world. The faster growth capped an otherwise sluggish year in which the economy grew by 1.7%, slower than the 3.0% growth in 2010.

Even though growth accelerated in the 4th quarter, it still remained below the 3% pace that many economists say is needed to significantly reduce the unemployment rate. Furthermore, the report showed that much of the growth was due to a surge in inventory replenishing by businesses—a trend not likely to last. Consumer spending, which accounts for more than two-thirds of demand in the economy, rose 2.0% in the fourth quarter compared with 1.7% in the third and 0.7% in the second quarter. This increase in spending came as Americans consumers dipped into their savings, as the personal savings rate slipped a bit. Unless employment growth accelerates, the growth in consumer spending is expected to slow. Given these expectations, economists forecast that growth in the U.S. economy in the first half of 2012 will slow to 2.0% or less.

## *Fed to Keep Rates Low Through 2014*

**Last week Federal Reserve officials announced that they plan to keep short-term interest rates near zero for nearly three more years.** Since last August, the Fed had been indicating rates would stay near zero at least until mid-2013. The central bank's most recent pronouncement came after a two-day policy meeting from which officials emerged still frustrated with the slow pace of growth and a bit more confident that inflation is settling down after climbing last year. Officials hope that by signaling their intentions on short-term interest rates, long-term rates will fall, spurring investment, spending and growth. Here are my thoughts

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regarding this:

- By stating that the rates will stay near zero for three more years, the Fed is indicating that they expect economic growth to remain subpar.

- By keeping interest rates low, the Fed is assuring the fact that the safest investments—cash and cash equivalents—will not keep pace with inflation. The "very conservative portfolio" introduced by MAM three years ago, which is invested primarily in bond funds and some dividend-paying stocks, will continue to look appealing relative to very-low yielding CDs and savings accounts on a risk-adjusted basis.

- The Fed is encouraging investor to ratchet up risk in their portfolios. Dividend-paying stocks look more attractive. On the flip side, purchasing annuities looks less appealing.

## ***Real Estate- Has It Hit Bottom?***

The news regarding housing has been bad for so long (since 2007) that a sustainable recovery in prices may still seem far away. As written in a recent report from Deutsche Bank, "Over the last several months, with analysts' attention diverted toward sovereign risks in Europe, a potential global growth slowdown and an unsteady pace of recovery in the U.S. labor market, a modestly improving tone of some key housing metrics may have slipped under the radar. While the housing recovery is still in its nascent stage, we wonder if forecasters have counted this sector out for so long that they are overlooking the possibility that it could pose an unexpected mild boost to the economic outlook in the year ahead. Judging from the new and existing home sales data, we believe that the housing sector is now in recovery mode."

Sometimes it can be difficult to recognize when the "bad" news is actually a sign of a turnaround. For instance, last week the Commerce Department reported that new-home sales fell 2.2% last month to a seasonally adjusted annual pace of 307,000. The pace is less than half the 700,000 that economists say should be sold annually in a healthy economy. The decline made 2011 the worst year for new-home sales on records dating back nearly half a century. Still, sales of new homes rose in the final quarter of 2011, supporting other signs of a slow turnaround that began at the end of the year. In addition, the inventory of newly constructed homes for sale is currently at the lowest level since at least 1963. The recent improvement in homebuilder sentiment appears concurrent with the improving conditions. This index has improved considerably since registering its all-time low in January of 2009. While the index still remains well below what is considered to be a healthy level of confidence, it is now at its highest since June of 2007.

No doubt it will take time to work through the massive foreclosure and short-sale inventory and to get banks to lend again more readily. Still recent data indicates that the housing sector is in the process of turning the corner with the prospect that 2012 could be a better housing year than 2011. At least as significant, the housing sector no longer appears to be acting as a drag on economic growth.

Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, recently wrote an 11-page article entitled "Rock Bottom: Housing May Have Already Hit It". In the article, Sonders writes "I do think the tide is turning for housing and that the bottom is largely in". She then spells out various reasons for her "budding optimism" about housing. Included are several charts that provide some long-term perspective on the state of the housing market. *Please let me know if you are interested in receiving a copy of the article.*

## ***2011 Tax Reporting***

**Schwab 1099s:** Charles Schwab recently announced that their 2011 Form 1099-Composite will be mailed in mid-February. As with the last couple of years, Schwab is issuing the Form 1099s later to minimize the issuance of corrected Form 1099s. This worked well the last two years as there was not a need to amend previously-filed tax returns for the corrected Form 1099s that were issued later in February.

*For those of you who are tax clients, there is no need to wait until you receive your Schwab Form 1099 before providing us with your tax packet. Schwab will be providing us with a copy of the Form 1099 for accounts that we manage. If you have everything else, please provide us with your tax packet.*

For those of you who are not tax clients and who have a taxable Schwab account managed by MAM, Inc, a couple of weeks ago we mailed your 2011 Realized Gains and Losses Report along with instructions explaining how to reference and attach the report to your tax return. Be sure to provide this report and letter to your tax preparer, as having this information really simplifies preparation of your return.

**Cost Basis Reporting:** Starting with the 2011 tax year, the IRS requires reporting of cost basis information for certain sold securities on Form 1099-B. For 2011, only the cost basis for short-term gains and losses will be reported. For 2012, this will be expanded to reporting the cost basis for long-term gains and losses. For tax clients we will continue to use the Realized Gains & Losses Report for reporting capital gains. Our portfolio management software, which generates this report, has a reconciliation report which ensures that the cost basis we report is the same that Charles Schwab reports to the IRS.

**Form 1099 Reporting for Schedule C and Schedule E:** As in prior years, businesses and rental property owners are required to file Form 1099-Misc for annual payments of $600 or more to unincorporated persons, vendors, subcontractors, independent contractors, and others. **New for 2011 is that Schedule C (for sole proprietors) and Schedule E (rental property owners) asks whether Form 1099-Misc were required to be filed and whether they were in fact filed.** If you file a Schedule C or Schedule E and you are a tax client, please indicate in the tax organizer (in the section highlighted on Schedule C or Schedule E) whether you filed all required Form 1099s. The penalty for not filing a Form 1099-Misc has been increased to $100 per occurrence**.**

*If you need to file Form-Misc and you need the IRS forms, please send me an email and Anthony will email the 1099 forms and a letter of instruction to you.*

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

Sincerely,

Stephen P. McCarthy, CPA, CFP®