McCarthy Asset Management, Inc.
Personalized Wealth Management

October 2013 Monthly Commentary

November 1, 2013

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Stock Market & Portfolio Performance

October 2013: For the month, U.S. and foreign stocks performed well while bonds rose modestly. For the first ten months of 2013, U.S. and foreign stocks had double-digit returns while bonds declined moderately.

	Oct 2013	YTD 2013	Description:
Without Dividends:			
S&P 500	4.5%	23.2%	500 Largest Public U.S. Companies
NASDAQ	4.0%	29.8%	stocks trading on the Nasdaq
Russell 2000	2.4%	29.6%	2000 of the smallest U.S. stocks
MSCI EAFE	3.3%	17.1%	international stock index
U.S. Aggr Bond	0.8%	(1.1)%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	2.7%	16.0%	non-very conservative MAM portfolios
MAM Conserv	1.9%	6.2%	portfolios with 50%+ bond allocation

Comment: As summarized near the middle of page 4, while the return expectations for stocks should be tempered, the current favorable environment indicates that equities may still have room to run.

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Temporary Debt Ceiling Agreement

As we expected and as markets anticipated, an 11th hour short-term deal was made by lawmakers to raise the debt ceiling and end the 16-day government shutdown, the third longest on record. The agreement:

- Was reached truly at the 11th hour, being passed by both houses of Congress and signed by President Obama shortly after midnight on October 17th—the day on which the Treasury had said it would begin running out of cash to pay the nation's bills.

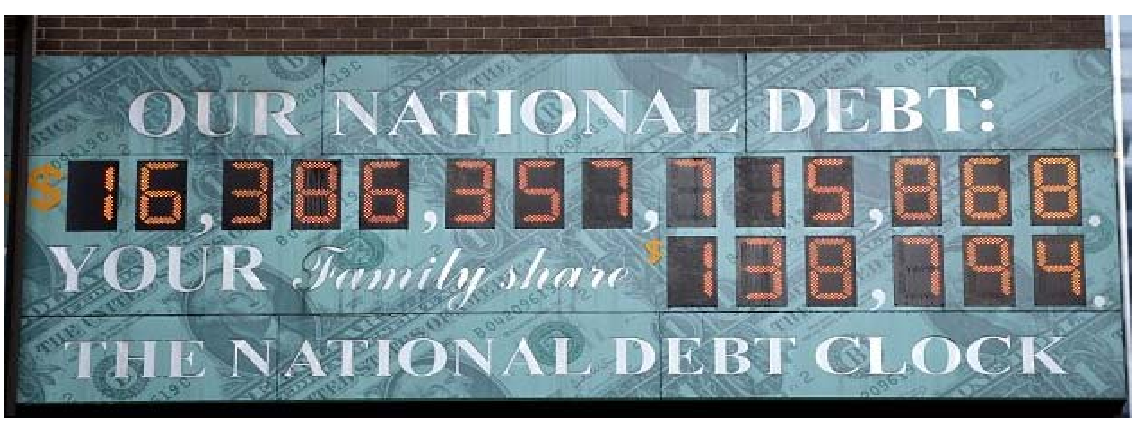
- The deal is only a temporary solution as it suspends the debt ceiling until February 7, 2014 and provides sufficient funding to reopen the government and fund its operations only through January 15, 2014.

- Appointed a bipartisan Congressional budget "conference committee" to negotiate 2014 government spending and issue a report by December 13, 2013. Congress will need to pass another continuing resolution by January 15, 2014 to avoid another partial government shutdown.

<u>Stock Market Reaction</u>: Between September 18, when the stock market first started focusing on the brewing conflict over funding the government, and October 8, when the Republican House leadership acknowledged that it would not permit the nation to default, the S&P 500 lost 4.1%. From October 9 through October 17, when Congress passed the compromise legislation, the S&P 500 gained 4.7% to reach an all-time high.

<u>What Happens Next?</u> The Congressional conference committee will work to replace the next round of "sequestration" spending cuts that otherwise will take effect on January 15, 2014. Republicans will be looking to replace some of the defense spending cuts with deeper cuts to social programs and entitlements (i.e. Social Security and Medicare which are not subject to the sequestration spending cuts). Democrats will resist entitlement changes and will seek to raise new taxes.

If the budget committee fails to reach agreement, then Congress will have to make a choice by January 15. It could fund the government for the remainder of 2014 at the lower spending levels reflected in the sequester or it could fail to pass a funding bill altogether, in which case the government will shut down again. The bigger issue will come after February 7, when Congress will need to raise the debt ceiling again to avoid a default. Stay tuned…



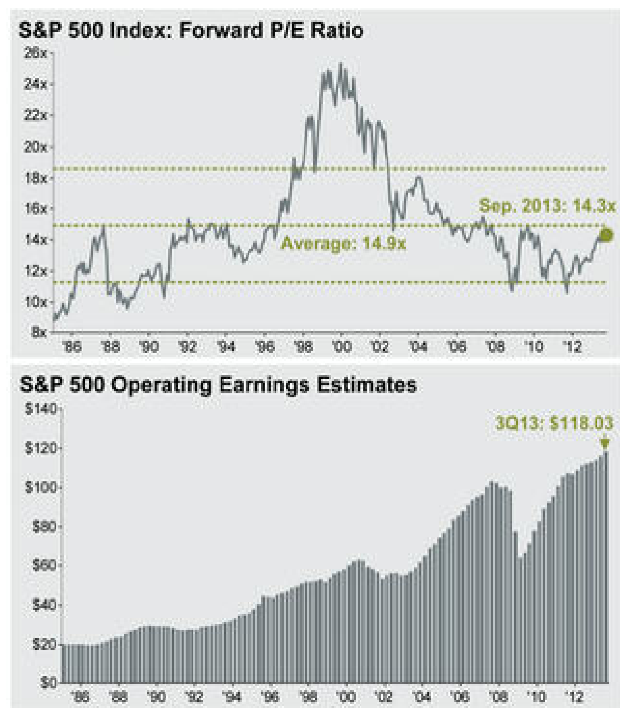
Economic Update and Stock Market Outlook

The economy continues to slowly improve, both in the United States and around the world. The housing market has been a source of strength, the unemployment rate has continued to slowly fall, consumer credit has eased, and tax revenues have picked up.

Economic Growth: The fiscal backdrop has also improved significantly. The federal deficit has dropped from 10% of GDP in mid-2009 to around 4% by the end of this year. Because of the sequester and tax law changes, 2013 has had a lot of fiscal drag (reduction in economic activity due to higher taxes and decreased government spending). Fortunately, this fiscal drag has come at a time when the economy is becoming more sustainable in its expansion, so it has been able to weather it. A positive for 2014 is that the fiscal drag is expected to be less than what it was in 2013. As such, economists expect that U.S. growth will moderately increase next year.

Continued Monetary Stimulus: Though the Federal Reserve could begin tapering as soon as December, the Fed's pace of tapering will likely be slow and dependent on the strength of the U.S. economy. It is possible that the fiscal dysfunction in Washington could keep the Federal Reserve on hold longer than it otherwise would. Furthermore, the Fed is unlikely to raise short-term interest rates before 2015.

Good Environment for Stocks: Analysts who have studied past market behavior say that the current backdrop—moderate economic growth with low inflation and strong central-bank backing—is excellent for stocks. Tim Hayes, chief global investment strategist at Ned Davis Research recently said "When the unemployment rate is above 6% and falling, that is the best situation for the stock market" based on the performance of the S&P 500 going back to the 1940s. Stocks averaged 13.5% annual gains when unemployment is above 6%, and 16.5% when the rate is that high and falling. The September Jobs Report showed employers added 148,000 jobs and that the unemployment rate fell from 7.3% in August to 7.2% in September.



Source: Standard & Poor's, IBES, FactSet, J.P. Morgan Asset Management. Earnings estimates are for the next 12 months and taken at quarter end dates throughout the year. Forward Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months.

Guide to the Markets – U.S.

Data are as of 9/30/13.

Stock Market Is No Longer Inexpensive: While the economic environment for the stock market remains favorable, with the strong gains so far this year stocks are no longer undervalued. The S&P 500 is trading at approximately 15 times projected earnings for the next year. *As can be seen in the chart to the right*, this is comparable to the 14.9 average forward price-earnings ratio since 1986.

Components of Stock Market Return: To get a better understanding of the current stock market valuation, it is insightful to look at the three components that determine the performance of the stock market:

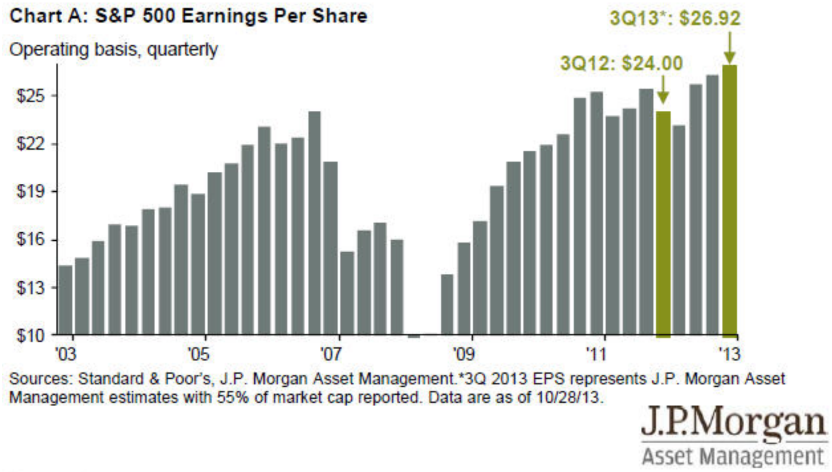
- **Earnings Per Share Growth-** See top of next page for a discussion of the outlook for growth in S&P 500 earnings per share.

- **Dividend Yield-** Currently, the yield on the S&P 500 is approximately 2.0%. While this is a low yield historically, companies are currently paying out only 31% of their earnings as dividends compared to 53% historically. Furthermore, the outlook for dividend growth is good. During the last year, S&P 500 companies increased their dividends by approximately 16%.

- **Price Earnings Ratio-** As mentioned above, the S&P 500 is trading close to its average forward price-earnings ratio since 1986. As such, it is not realistic to expect the price-earnings ratio to significantly increase.

S&P 500 Earnings: A major determinant of stock market returns is the growth in earnings per share. Much of the following information is from an October 28, 2013 Market Bulletin from J.P. Morgan:

- After record-setting earnings in the first two quarters of 2013, the S&P 500 is on track to hit another historical high in profits for the third quarter of 2013. If this occurs, the first three quarters of this year will have been the most profitable ever in the 56-year history of the S&P 500. *The chart on the right depicts the S&P 500 quarterly earnings per share since 2003.*



- Future earnings growth through margin expansion seems unlikely, as an improving labor market and higher interest rates will most likely squeeze margins. However, with no impending recession in sight, stable revenue growth, company share buybacks and the additional use of debt financing should support modest earnings gains in the year ahead. This modest earnings growth combined with strong corporate fundamentals, points to continued strength in equities.

- While many stock market valuation metrics are currently near their long-run averages, bull markets do not end at average valuations (i.e. they end at overvaluations). Investors should be aware of the risks inherent should the market to become too expensive. *Until then, while return expectations for stocks should be tempered, the current favorable environment indicates that equities may still have some room to run*.

2013 Tax Planning Considerations– Tax Increases

The 2013 tax year will be tough for many higher-income taxpayers due to Federal tax law changes that became effective in 2013:

1) **Higher marginal tax rates:** The maximum tax rate is 39.6% (up from 35.0% for 2012) for married filing joint taxpayers with taxable income greater than $450,000 ($400,000 for single taxpayers).

2) **Higher capital gain and qualified dividend tax rates:** For taxpayers who fall into the 39.6% maximum tax rate, the capital gains and qualified dividend rate has been increased to 20% (up from 15% for 2012).

3) The new **3.8% Medicare Tax** is assessed on unearned income, including interest, dividends, rental income and capital gains. The tax applies to taxpayers with modified Adjusted Gross Income in excess for $250,000 for married filing joint taxpayers and $200,000 for single taxpayers.

4) Restoration of the **phase out of itemized deductions and exemptions** for married taxpayers filing jointly with adjusted gross income in excess of $250,000 and $200,000 for single taxpayers.

5) The new **0.9% tax on earned income** in excess of $200,000 for single taxpayers and $250,000 for married taxpayers filing jointly.

We first discussed these tax increases in our First Quarter 2012 MAM Letter (see pages 3 & 4)

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.**

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 several 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) - Allen Hamm**
- **The Savvy Life® Classes, Workshops , and One-on-One Consultations**

Reminders

The Affordable Care (Obamacare): Please let us know if you have any questions related to Obamacare.