

Q1 2014 Quarterly Letter
(also March 2014 Monthly Commentary)

April 1, 2014

Stock Market & Portfolio Performance

Inside this issue:

1st Qtr 2014: U.S. stocks posted modest gains , foreign stocks were flat, and bonds performed relatively well.

Market & Portfolio Performance	1		Mar 2014	1st Qtr 2014	Description:
Without Dividends:					
Happy Fifth Birthday Bull Market– Where Do We Go From Here?	2-3	S&P 500	0.7%	1.3%	500 Largest Public U.S. Companies
		NASDAQ	-2.7%	0.5%	stocks trading on the Nasdaq
Fed May Raise Interest Rates as Early as Next Spring	4	Russell 2000	-0.9%	0.8%	2000 of the smallest U.S. stocks
		MSCI EAFE	-1.0%	0.0%	international stock index
		U.S. Aggr Bond	-0.2%	1.8%	index of U.S. bonds
Penalty for Not Having Health Insurance	5	With Dividends, after all fees:			
Our Services	6	MAM portfolios	0.4%	1.5%	non-very conservative MAM portfolios
		MAM Conserv	0.4%	1.8%	portfolios with 50%+ bond allocation

Comment: Behind the modest rise in stock prices for the 1st quarter, a significant sector and style rotation may have started. In particular, some of last year's high-flying segments of the market, such as the U.S. biotech industry, are now starting to come under pressure. The market may also be experiencing a rotation away from growth and into value styles. For the month of March, large-cap value stocks gained approximately 1.3%, while large-cap growth lost over 2.0%.

Advisor Team

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA



STEVE MCCARTHY
CPA, CFP®,
Owner and Principal
650 610-9540 x 303
steve@mamportfolios.com

ANTHONY BERTOLACCI ,
RTRP
Director of Compliance
Tax Accountant
650 610-9540 x 302
anthony@mamportfolios.com

MARILYN BLANCARTE
Executive Assistant
650 610-9540 x 305
marilyn@mamportfolios.com

The bull market celebrated its 5th birthday this past month. Since bottoming on March 9, 2009, the S&P 500 has gained nearly 200% on a total return basis. A bull market is defined as “a 20% rise in stock prices that lasts at least six months and isn’t interrupted by a 20% decline”. According to data from Merrill Lynch and Bloomberg, there have been 25 bull markets since 1929. Of these, the average length was 31 months and average appreciation 105.5%. So the current bull market already well exceeds the duration and appreciation of the average bull market. Should this be a cause for concern? Here are three considerations:



- Bull markets don’t die of old age. They typically end because of a speculative frenzy (i.e. the dot.com boom that ended in March of 2000), a rapidly growing economy or surging inflation. None of these factors are currently present.
- The current bull market was triggered by the ending of the worst bear market since the Great Depression. In March of 2009, investor pessimism and fear was very high, major banks and financial firms were failing and credit became extremely tight. Were it not for a government bailout, Ford & Chrysler would have gone bankrupt and even General Electric needed help from Warren Buffet.
- A key indicator to keep an eye on is when and how quickly the Federal Reserve raises interest rates.

Federal Reserve Has Been A Big Factor: The Federal Reserve’s ongoing policy of keeping short-term interest rates near zero has been a significant factor in this bull market. In a world of ultra-low interest rates, investors have come to believe there is really no other place to invest but in stocks. Although the Federal Reserve is now tapering its quantitative easing, it is expected to keep short-term rates near zero for about another year (see article on P. 4).

Investor Sentiment Has Been Subdued: As we have written before, this current bull market has been one that has gotten little respect (see P. 2 of our January 2013 Monthly Commentary “[The Rodney Dangerfield of Bull Markets](#)”). Throughout much of the last five years, investors have been favoring bonds over stocks. It was not until 2013 that fund flows into equity mutual funds finally turned positive.

Overdue for a Correction: A concern that we have written about is that the stock market has not experienced a significant correction (i.e. a drop of 10% or more) since the autumn of 2011. Based on history, the longer the market goes without experiencing a correction, the greater is the drop when the correction does finally occur.

Correction or not, bull markets don’t die just from old age. Just because stocks are trading in record territory and the bull has lasted longer and posted greater gains than average, doesn’t mean the run can’t continue. Assuming economic growth and corporate earnings continue to rise, the current bull market could continue for another year or two. Drivers could include the surge in U.S. energy production, a rebound in infrastructure spending, households with lower debt loads and cash to spend, and the positive impact on consumer spending from the massive wealth gains from the stock & real estate rallies.

Happy Fifth Birthday Bull Market— Where Do We Go From Here?- Con't

Bull Market Killers: If old age doesn't kill an aging bull market, what does? Here are four potential bull killers:

1. **Recessions:** “Most bear markets are caused by recessions”, says David Bianco, chief U.S. equity strategist at Deutsche Bank. The reason is that when the economy contracts, so do corporate earnings, the lifeblood of a healthy stock market. Per David Rosenberg, former chief economist at Merrill Lynch, the chances of a recession in the next year or two are close to zero. He believes we are only in the fourth or fifth inning of the business cycle, with consumer spending expected to be strong, which typically occurs midway through a business cycle.
2. **Hostile Monetary Policy and Inflation:** Federal Reserve interest rate hikes are often bull market killers. Higher rates tend to slow growth, reduce risk-taking and cool hot markets. Per Rosenberg, “Liquidity—the oxygen for financial assets—needs to be plentiful. Get the economy right, get the Fed right, and I'll tell you 90% of the time you will get your market call right.”
3. **Excessive Valuation:** Stock markets that sport sky-high price-to-earnings ratios are also vulnerable to a big drop. A prime example was the bear market following the dot-com tech stock bust in 2000, when stocks became wildly overvalued relative to business fundamentals. Currently, the S&P 500 Index has a forward P/E ratio of a little over 15 times earnings (see chart to the right), which is slightly below the longer-term P/E of nearly 16.

Bob Brinker wrote in the March 2014 issue of Marketimer, “the outlook for low inflation should make it possible for the S&P 500 Index to command a P/E ratio within the 16 to 16.5 range, which is in line with the 50-year valuation average”.

4. **Exogenous Shocks:** Significant external events such as the OPEC Oil Embargo of 1973-1974 can trigger a recession. The problem with forecasting exogenous shocks is how do you predict the unpredictable? A current geo-political concern is Russia's actions to take over the eastern portion of the Ukraine. We feel the best way to protect against the unpredictable is to maintain a diversified portfolio with sufficient downside protection (i.e. bonds).



Our Outlook: While the current slow-economic growth we are experiencing provides a good environment for the stock market, 2013's very strong gains makes it unlikely that stocks will continue to race ahead. A choppy market with modest gains is more likely. While we are not yet ready to increase the downside protection for portfolios, we are watching for signs that this bull market could be coming close to its end.

Fed May Raise Interest Rate as Early as Next Spring

On March 19th, Federal Reserve Chairwoman Janet Yellen said short-term interest rate increases could begin in the first half of 2015, around six months after it winds down its bond-buying program. In announcing its view on future rates after a two-day policy meeting, the Fed dropped a set of guideposts it was using to help the public anticipate when it would finally start bumping overnight borrowing cost up from zero. Since late 2012, the Fed had said it wouldn't consider raising interest rates until the jobless rate fell to 6.5%, provided inflation looked likely to remain below 2.5%. In the new policy statement, the Fed dropped the reference to the 6.5% jobless rate and indicated that they would follow a "broad array" of indicators, including "financial developments".

The majority of members of the Fed Open Market Committee (FOMC) see the first rate hike in 2015, and the pace of rate hikes is projected to be slightly quicker than previously estimated. Yellen used her first press conference as chair to emphasize that rates will stay low for a while, rise only gradually, and could end up staying lower than normal "for some time" even after the economy regains its health given lasting scars from the financial crisis.

So if the Fed were to raise interest rates earlier than previously thought, what would that mean for the financial markets? Here are possible impacts:



- Since the Fed's move to raise short-term rates is still dependent on the economy performing well, stocks may continue to rise. It would be a different story if the Fed were raising rates to suppress inflationary pressures.
- It would likely mean a stronger U.S. dollar.
- Short & intermediate bonds may become more volatile with greater risk to the downside.
- Gold prices could come under further pressure. After the dramatic drop in the price of gold last year, the price partially recovered in the first quarter of 2014.

Penalty for Not Having Health Insurance

Headaches over the healthcare overhaul are likely to grow this year as tens of millions of Americans face the task of establishing that they have insurance coverage to avoid paying penalties. Under the Affordable Care Act of 2010 (aka ObamaCare), individuals will be subject to a penalty on their 2014 Federal tax return if they are not signed up for a health insurance policy by March 31, 2014. The insurance mandate is a pillar of the 2010 health law, designed to ensure that young people become part of the insurance pool to help offset the cost of covering older, often less healthy individuals.

2014 Penalty: Unless you qualify for an exemption, if you weren't signed up for health insurance coverage by March 31, 2014, you will subject to a penalty, which is to be reported on your 2014 Federal return. The penalty in 2014 is calculated one of two ways. You will pay whichever of these amounts is higher:

- **1% of your yearly household income.** The maximum penalty is the national average yearly premium for a bronze plan.
- **\$95 per person for the year (\$47.50 per child under 18).** The maximum penalty per family using this method is \$285.



If you're uninsured for just part of the year, 1/12 of the yearly penalty applies to each month you're uninsured.

Hardship Exemptions: There is a bewilderedly list of hardship exemptions (check out www.healthcare.gov/exemptions/).

Penalty After 2014: The penalty increases every year. In 2015, it's 2% of income or \$325 per person. In 2016 and later years it's 2.5% of income or \$695 per person. After that it's adjusted for inflation.

Speculation Regarding a Delay in the Mandate: Consistent with other delays recently announced, some tax experts feel that the Obama administration might end up waiving the individual-mandate penalty for 2014, or minimize its impact by granting widespread exemptions.

Sincerely,

Stephen P McCarthy, CPA, CFP®,

McCarthy Asset Management, Inc.

Three Lagoon Drive Suite # 155
Redwood Shores, CA 94065
USA

Phone: 650-610-9540
Fax: 610-9541
E-mail: Steve@mamportfolios.com



Our Services

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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

Tax Reminders: April 15th is the deadline for filing 2013 individual income tax returns and making 2013 IRA, SEP-IRA, Roth IRA and Education Savings Account contributions.

It is also the deadline for first quarter 2014 Federal and State estimated payments.

April 10th is the deadline for

California property tax payments for the first half of 2014.



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