# McCarthy Asset Management, Inc.

Registered Investment Advisor

Re: Third Quarter 2012 MAM Letter

Tuesday, October 2, 2012

The stock market performed well in the third quarter and has achieved solid returns for the first nine months of 2012. With the pending elections and "fiscal cliff", I have mixed feelings on my outlook for the fourth quarter, although longer-term I expect the stock market to perform well relative to bonds and other asset classes. MAM portfolios continue to maintain significant downside protection as a hedge on my guarded short-term outlook. This letter discusses:

- Fed Announces QE3
- Home Prices Are Recovering
- Fiscal Cliff- Getting Closer
- 3rd Quarter Earnings Projected To Drop
- Stock Market Outlook
- Surge In Energy Production- A Game Changer for the U.S.?

## Stock Market & MAM Performance for Third Quarter

*Unadjusted for dividends,* the S & P 500 rose 5.8%, the Nasdaq climbed 6.2%, the Russell 2000 rose 4.9%, and the international equity index MSCI EAFE climbed 6.1%. Bonds, as represented by the Barclays U.S. Aggregate Index, were up 1.6% for the quarter.

**MAM Portfolio Performance:** Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 4.7% (after MAM fees) versus a gain of 6.3% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. The quarter's performance for assets in the "very conservative" portfolios was a gain of 3.9%.

## Stock Market & MAM Performance for YTD 2012

*Unadjusted for dividends,* the S & P 500 rose 14.6%, the Nasdaq jumped 19.6%, the Russell 2000 climbed 13.0%, and the international equity index MSCI EAFE rose 7.0%. Bonds, as represented by the Barclays U.S. Aggregate Index, were up 4.0% for first nine months of 2012.

**MAM Portfolio Performance:** Excluding the "very conservative" portfolios, the composite return of assets in MAM portfolios was a gain of 10.0% (after MAM fees) versus a gain of 16.3% for the Vanguard Index 500 Fund (symbol VFINX) with dividends reinvested. For the first nine months of 2012, the composite return for assets in the "very conservative" portfolios was a gain of 8.1%.

**Oldest Portfolio:** The MAM portfolio with the longest track record is a moderately aggressive portfolio that was fully invested on September 13, 1999. As of September 30, 2012, the original $50,000 had risen to $94,190 plus $1,193 of cumulative withdrawals. This represents a cumulative return of 90.8%.

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During the same time, the S & P 500 (as represented by the Vanguard Index 500 Fund) rose 30.9%. For the quarter ended September 30, 2012, the portfolio rose 4.8%, and for the first nine months of 2012, it rose 10.2%. All returns quoted for this portfolio (and for all MAM portfolios) are net of MAM fees. Also, past performance does not guarantee future results.

## Fed Announces QE3

On September 13th, the Federal Reserve announced a third round of quantitative easing ("QE3"), where it will buy additional mortgage-backed securities at a pace of $40 billion per month. The Fed said it also will "closely monitor" the economy and financial markets and continue these purchases and possibly expand them until they see "substantial" improvement in the labor market.

Additionally, the Fed said they would not likely raise the short-term federal funds rate from the current near 0% level until at least mid-2015. Previously, it had set such guidance at late 2014. Based on the Fed's indication that it will maintain near-zero rates for a "considerable time" after any strengthening in the economic recovery, it appears to be saying that the federal funds rate will remain near 0% until the unemployment rate drops to around 6%.

What is the significance of this latest Fed program? While economists debate the likely effectiveness of these continued, aggressive Fed policy moves, we believe in the old adage "Don't fight the Fed":

- **Good for Stocks**: In general, the policy move should be supportive of many asset classes, particularly stocks, real estate and commodities.

- **Bad for Savers, Good for Conservative Portfolios**: Savers will be hurt in that CDs, money market, and savings accounts will continue to yield next to nothing. Three and-a-half years ago we introduced the bond-heavy "very conservative" portfolios as a fairly low risk alternative to low-yielding savings accounts. Since then, the performance of these conservative portfolios relative to savings accounts has been very good. Given the likelihood that savings rates will stay near 0% for another three years, the portfolios should benefit. Note that while these portfolios have a conservative asset allocation, they do experience some volatility (unlike savings accounts).

- **Good for Homeowners**: With the Fed aggressively purchasing mortgage-backed securities, mortgage rates could fall even further from their current levels of near historical lows.

## Home Prices Are Recovering

I last wrote about the outlook for real estate in the January 2012 Monthly Commentary in a section titled "Real Estate- Has It Hit Bottom?". I wrote at the time "The news regarding housing has been bad for so long (since 2007) that a sustainable recovery in prices may seem far away…Sometimes it can be difficult to recognize when the "bad" news is actually a sign of a turnaround." It now appears that real estate prices hit bottom this past winter. Since then home prices notched their strongest year-to-date gains since 2005, climbing 5.9% through July, signaling the housing market is starting to recover.

Nationally, home prices are still approximately 30% below their 2006 peak. Karl Case, the economist who co-created the S&P/Case-Shiller index, said recently "We're at bottom but I don't think we'll come roaring back out of here. You've got problems in the economy, problems abroad, and got the demographics to worry about." Recently Fiserv, an analytics firm, forecast that prices will rise an average of 3.7% a year for the next five years (and 4.4% for California). With these recovery rates, it may be ten years or more for prices to return to their 2006 highs. Nonetheless, <u>the turnaround in real estate prices is very good news for the economy</u>:

- <u>Homes Underwater</u>: For the first time in years, negative home equity has declined sharply as the result of improving home values, moving some one million homeowners into the black. According to CoreLogic, the increase in home prices helped lift 700,000 homeowners "above water" during the first quarter of 2012, and another 600,000 in the second quarter. As of June 30, 2012, 10.8 million homeowners had negative home equity, down from 12.1 million at the end of 2011. CoreLogic estimates that another 2 million homeowners will reach positive equity if prices rise 5% from their level of June 30, 2012.

- <u>Impact on GDP</u>: A dramatic decline in new home construction was one of the big contributing factors that caused the 2007 to 2009 recession. Historically, new home construction contributes on average 4.5% to U.S. GDP (gross domestic product). Recently, new home construction has started to recover as residential investment has now added to GDP growth for five straight quarters. In August, construction of single-family housing reached its highest level in more than two years, though it is still far below its pre-bubble level.

- <u>Impact on Employment</u>: Of the 8 million American jobs that were lost in the recession, approximately 2 million of them were directly related to construction. While 4 million new jobs have been added since employment bottomed in February 2010, very few of the construction jobs have returned as new home construction remains well below historical levels. As the pace of new homes built picks up, over 1 million construction jobs could return.

- <u>The Wealth Effect</u>: The dramatic drop in real estate prices from their 2006 peak have made Americans feel less wealthy and less willing to spend on everything from home renovations and appliances to restaurant meals. The gradual recovery in home values will help boast consumer spending which makes up 70% of GDP.

## <u>Fiscal Cliff- Getting Closer</u>

The "fiscal cliff" has been in the news quite a bit lately and its ultimate resolution is far from certain. As I discussed at length in the First Quarter 2012 MAM Letter ("Concern About 2012 Tax & Fiscal Policy Changes"), "pending 2013 tax increases and spending cuts (i.e. the "fiscal cliff") pose a serious risk to the U.S. economy. The scheduled tax increases and spending cuts are already in the law and would need to be changed to mitigate the economic impact (estimated to be a huge decrease of $500 billion or 3.5% of GDP)." As I indicated in the letter, "Congress probably won't address the projected tax increases or automatic spending cuts until after the November elections, giving it less than two months before the New Year for complex lame-duck negotiations".

Unfortunately, nothing has changed since I wrote this last April and now Congress is on recess. I am still hopeful that Congress will come to some sort of agreement during a last-minute lame duck session after the November elections to soften or delay some of the scheduled provisions. The negative impact on the economy and the stock market of not reaching some agreement is why we have not been more aggressive this year in the positioning of MAM portfolios.

## 3rd Quarter Corporate Earnings Projected to Drop

Thomson Reuters reports that third quarter 2012 earnings for companies in the S & P 500 are projected to drop 2% from a year ago (and 3% from the second quarter of 2012), the first such decline since the third quarter of 2009, just after the recession ended. The causes of the expected decline are many: slow growth in the U.S. economy, much of Europe has fallen into a recession, and growth in China has slowed. There is also the looming prospect of automatic tax increases and spending cuts in Washington which has caused some companies to be conservative in their spending.

Since stock market investors are forward looking, what will be much more important during the next two months than the actual third quarter results will be companies' outlooks for the fourth quarter and for 2013. While analysts currently project a resumption of growth for the 4th quarter and a jump in 2013 earnings of 12%, this seems unrealistic. Given the concerns mentioned above, low-to-mid single-digit earnings growth is probably the best to hope for in 2013.

## Stock Market Outlook

After more than a decade of dismal returns, the popular press has yet again proclaimed "the death of equities". Investors seem to agree as some have continued to reduce their equity holdings and increase their bond holdings. My feeling is the returns from the stock market for the next ten years, while still below the long-term average of 10% annually, will be significantly better than the last decade. In addition, although bonds have outperformed stocks for the last ten years, I think it is very unlikely they will outperform them for the next ten years.

I think stocks will perform relatively well (compared to alternative investments) for the next ten years because U.S. companies are in terrific shape, balance sheets are strong with record cash levels, and corporate earnings are at record levels (even with the expected decrease this quarter). Despite the strong returns since the stock market lows in March of 2009, many investors remain fairly pessimistic in their outlook toward stocks. With the massive amount of cash available on the sidelines, a gradual improvement in sentiment could contribute to another strong run in stocks over the intermediate term. In addition, a potential boom in U.S. energy production can have widespread, dramatically positive implications for U.S. companies and the U.S. economy.

## Surge in Energy Production- A Game Changer for U.S.?

Every president since Richard Nixon has called for the U.S. to wean itself from the need for imported oil. A dozen years after Texas wildcatter George Mitchell commercialized a new gas-drilling technology called hydraulic fracking, a new U.S. energy boom is taking off. <u>While there are still environment issues to be dealt with</u>, according to numerous forecasters, the nation's new found energy riches are likely to bring energy independence closer to reality in the next decade and could have a dramatic impact on the U.S. economy:

- <u>Production Boom</u>: In a report issued earlier this year, Citi says U.S. oil and gas production is going to skyrocket in the next six years due to strides in natural resource extraction. This, along with a trend toward declining U.S. energy consumption, will completely transform both the domestic economy and the threats the U.S. will face in the future (i.e. no longer dependent on Middle Eastern oil!). Citi economists expect total liquids production to as much as double for the continent in the next decade, and predict that the U.S. could overtake both Russia and Saudi Arabia in oil production by 2020.

- Dramatic Drop In Oil Imports: In a report issued last month by Bentek, an energy analysis firm, the U.S. will see its oil production rise nearly five million barrels a day, or 74%, in the next decade. In that time, reliance on countries outside of Canada will largely disappear. The U.S. today imports 45% of its petroleum, half from OPEC countries. But by 2022, Bentek projects only a million barrels per day will be delivered to the U.S. shore by tanker—down from 6.7 million in 2011 and just 5% of total demand. This Bentek projection, however, is an ambitious one, significantly surpassing the 2022 expectations of the federal U.S. Energy Income Administration (although the EIA forecast is in the midst of an upward revision). Clearly, though, there is a U.S. oil boom, which has come amid a drilling frenzy. Three years ago, 288 U.S. rigs were drilling for oil. Recently, according to data tracked by energy services firm Baker Hughes, 1409 rigs were working, a nearly fivefold increase.

- Employment Growth: All this new energy is creating jobs across the country. For instance, North Dakota, now the nation's fourth-largest oil producing state, boasts a 3% unemployment rate, the nation's lowest. Projections for new energy-related jobs vary, but are all pretty large. More than two-thirds of Citi's estimate of 3.6 million new jobs will come from the multiplier effect, as the 550,000 new workers in fossil fuel-related jobs spend their incomes, or as other Americans spend the money they save from cheaper energy. IHS Global Insight says the natural-gas boom alone has created 600,000 jobs and will rise to 1.6 million by 2025.

- Export Surge: In a report released last month the Boston Consulting Group, rising U.S. factory productivity, spurred by falling natural gas prices, could help the nation boost exports of products such as locomotives and factory machinery and add between 2.5 million and 5 million manufacturing and support jobs by 2020. High worker productivity and low energy prices, driven by the surge in shale gas production, will give the U.S. a cost advantage in exports against Western European and Japanese rivals. In particular, BCG forecasts that a glut of natural gas production in the U.S. will keep the nation's prices of the fuel 50% below those of Europe and Japan, as well as hold down electricity costs.

The bottom line is, rather than worrying about running out of oil and becoming more dependent on OPEC for oil imports, the U.S. is experiencing an oil and gas boom that potentially has very positive implications on the U.S. economy and many U.S. companies.

## Thank You For Your Referrals

I want to thank those of you who have added to their investments or have referred the services of McCarthy Asset Management, Inc. to their friends and family. I really appreciate this as referrals are our primary source of new clients. While our minimum amount to manage for new clients is $500,000, I am willing to be flexible depending on the individual's situation.

Please call me if you wish to discuss the stock market or your portfolio(s).

Very truly yours,

Stephen P. McCarthy, CPA, CFP®

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