Market Review and Outlook—April 11, 2008

The stock losses from the 4th quarter of 2007 pale in relation to the past quarter's losses. All major types of stocks fell 9 to 10% in the past three months—there were no safe havens, except in money markets and a few bonds. January was particularly painful as foreign stocks led the rout, falling 8.5%. The markets have fallen due to evidence that the credit (the sub-prime problems have overflowed into the entire credit market) and housing troubles are no longer isolated—they are beginning to spread across the US economy (and to a lesser extent, across the global economy).

Geopolitically, the past three months brought little news. Politically there has been a lot of news, in the US focused on the presidential primaries, as come-from-behind John McCain has sewn up the Republican nomination, and as Hillary Clinton and Barack Obama continue to slug it out for the Democratic nomination.

The quarter's most notable news has come from the economy. Consumer sentiment and spending have been falling, which isn't surprising as foreclosures are rising sharply. The Federal Reserve Bank (the Fed) is tasked with smoothing out the US economy. At this time that means that it tries to keep recessions short in duration and shallow in depth. While they had been cutting rates for months to help the economy, the Fed in January took far bolder steps. It appeared that the Fed suddenly saw the 'contagiousness' of credit and housing troubles. Stocks fell sharply, for until then investors believed what they heard from the Fed—"we're taking care of it, there's nothing to worry about". Investors' worries solidified when news broke in March of the Fed-orchestrated bailout of investment bank Bear Stearns.

The sharp Fed rate cuts only weakened the US dollar further. Adding insult to injury, the weakening dollar contributed to rising oil prices. This week oil crested $110 a barrel, having risen 61% in the past year.

The figures below show the substantial declines in the past quarter and year in most stocks. The current stock market levels appear to assume that the recession will last long, and be harsh. If so, stocks could well fall further and take more than six months to begin their rebound. I am skeptical of this pessimism; I think that the US economy will begin to recover in a few months, and that stocks are thus near 'bargain levels'. I continue to stand by my tired refrain—keep to your targets, rebalance to these now, especially since stocks have fallen so far.

The following data is through 3/31/08. I do not have current data for money markets this quarter.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	NA	NA	NA	NA	NA
Intermediate Term Bond	+0.39%	+3.73%	+3.88%	+3.75%	+5.06%
Intermediate Muni Bond	-0.11%	+2.07%	+3.00%	+2.95%	+4.06%
Large-Cap Core Stock	-9.73%	-5.13%	+5.69%	+11.15%	+3.60%
Mid-Cap Core	-9.75%	-9.11%	+5.75%	+14.30%	+6.77%
Small-Cap Core	-9.83%	-13.29%	+4.47%	+14.63%	+6.21%
International Stock	-9.27%	-1.20%	+13.72%	+20.16%	+5.51%
Real Estate	-0.94%	-18.36%	+10.29%	+17.49%	+10.33%
Natural Resources	-2.66%	+26.25%	+22.04%	+28.77%	+14.76%
Science/Technology	-16.01%	-3.71%	+6.47%	+12.48%	+3.25%
Morningstar US Growth	-11.98%	-2.29%	+6.07%	+9.59%	-0.14%
Morningstar US Value	-9.41%	-12.45%	+5.90%	+14.06%	+5.62%
Balanced—Conservative Allocation	-3.02%	+0.03%	+4.49%	+6.28%	+4.07%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.
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Recession, recession, recession. There, I said it. I'd like to take some of the fear out of the word, and explore it more closely. We may be in a recession, but we won't know for certain for a few more months.
Why are we so hung up on a recession? Recessions are a normal part of 'the business cycle', occurring every few years, lasting a few months, at which point an 'expansion' naturally follows. Let's examine 2001. The dot-com driven expansion had overstayed its welcome; stock prices and company profits were at record levels. The economy was far overdue for a breather, a recession.
While a recession indeed followed, it was not terribly long or deep, largely due to consumers. The US consumer's spending accounts for about 70% of the US economy. While consumer's portfolios were falling from 2000-2002, the impact on their wealth was modest (a balanced portfolio lost about 12% from 3/00 to 3/02). During the same time, housing prices were stable to slightly rising, and so consumers could keep spending, in many cases by tapping their home equity a bit to maintain their standard of living as their stocks were declining. This served to prop up the US economy, and limit the length and depth of the 2001 recession.

Housing thus helped 'solve' 2001 recession, but is a leading cause in this recession. Most homeowners have a mortgage. This introduces 'leverage'. If you own a $200,000 house, with a $160,000 mortgage, you have $40,000 of equity. If your house rises 10% in value to $220K, your equity rises 50%, from $40K to $60K. If, however, your house falls 10% in value, your equity falls 50%, to only $20K. If your house falls 20% in price, you now have no equity at all.
Thus a 20% decline in stock prices can, with proper diversification, be limited to a 12% or so decline in portfolio value, but a 20% decline in housing prices could wipe out all house equity wealth, due to the impact of leverage/mortgages. For this reason, economists are more concerned with a decline of 10% in housing prices than they are with a 10% decline in stock prices. The minority of economists who expect that this recession will be longer and deeper than past ones believe that the sharp loss in housing wealth will prevent consumers from helping the economy recover later this year.

Leading the Witness—In times like these, it is important to distinguish between leading, concurrent, and lagging indicators. Stock prices generally lead the economy. The S&P 500 stock index began falling in November 2007, and yet the economy was still growing (albeit slowly) at that time. Stocks typically move six to nine months ahead of the economy. Therefore, if the US economy begins to recover by year-end 2008, stocks should begin their recovery in the next few months. This is the expectation of the slim majority of economists at this time, and I share this outlook.

So what's an investor to do? The table on the prior page shows that a lot of air has been let out of stocks. The past quarter and one-year performance figures are ugly for all but energy stocks/funds. The three-year figures are anemic for US stocks. To a die-hard contrarian, this indicates that great opportunities are present.
Money market and CD rates have fallen sharply by the Fed's rate cuts. **Bonds** should continue to provide low returns. However in the past quarter, as stocks fell 10%, a stable position in bonds felt wonderful.
US stocks should provide good long-term returns (in other words, I don't know when they will really rebound). While we would all prefer to buy at 'the bottom', we won't know until much later where the bottom was. I consider the current levels low enough to put sufficient odds in investors' favor, and that it is advisable to build up your US stocks to target levels. More aggressive investors can consider building US stocks above long-term levels (if your normal target is 40% US stocks, consider boosting current levels closer to 45%, for instance).
Foreign stocks have been hard hit, however they have done so well in the past five years that they appear to still be more expensive than US stocks. There are some good reasons for this—future growth in overseas economies seems stronger than future US economic growth. The recent declines in foreign stocks lead me to favor building foreign stocks up towards the long-term target levels.
As I've mentioned in recent outlooks, I have begun rebuilding positions in **real estate** funds and stocks, and am continuing this gradual process. Ultimately I expect to aim for a 5% position in REITs and real estate funds for many portfolios..
Energy is a tough call. I am fundamentally a contrarian, and I can't stand buying investments which are at record levels, such as energy stocks and funds over the past few months. That said, I also regularly consider the economics, and many factors argue for continued rise in commodity prices (food, energy, and other natural resources). I therefore am most comfortable in relying on my targets. Currently that leads to cutting back, reducing some of the strongest energy positions to bring them back to normal levels. I occasionally comfort myself by spinning this as 'harvesting profits'.
On the topic of harvesting, investors with stocks and stock funds in taxable accounts should jump at the opportunity to **harvest tax losses**, selling positions with losses that can lower your tax bill for 2008, and beyond. Beware the temptation to simply sell, as this will lower your stock allocation further below target levels. Instead, try to do 'swaps', selling one position with a loss and redeploying the proceeds into a similar investment that will maintain your overall allocation.