

Market Review and Outlook—July 9, 2010

The stock market recovery train jumped the tracks this quarter. The European stock markets began to retreat in early April, as problems with Greece's sovereign debt made headlines, and concerns that this would spread (to Portugal, Italy, Ireland, and Spain). US stock markets caught the bug, and later in April began to decline. Trouble often travels in threes, as the BP drilling platform disaster began in April, and China's recently announced steps to cool its economy raised further concerns. A stock market glitch ('flash crash') in early May didn't help nervous investors. While US jobs grew during the quarter, some of them were temporary government census jobs. Home sales and prices appear to have bottomed, however we will need to see how they fare after the 'first-time homeowners credit' has expired. Importantly, 30-year mortgage rates are at lows, and housing affordability is at 35 year lows. One client called me to note that their adjustable-rate mortgage rate fell sharply last month!

JP Morgan's Chief Market Strategist Dr. David Kelly, CFA notes "if markets appear to be over-reacting to every headline while the economy stays on track, it's a good bet that, in time, markets will revert to more rational levels."

The US economy indeed appears to be on track. Jobs are being created by the private sector. US companies are exceptionally strong, financially, much stronger than at this point in most recoveries. This should lead to 1) rising dividends, 2) stock buybacks, 3) mergers/acquisitions, 4) capital expenditures, and/or 5) hiring. The rate of this recovery will likely be anemic, but growth is growth, and is in the right direction. The Conference Board's Leading Economic Index for the US has been rising for over a year, and indicates that our economy is on course.

The concerns of a double dip recession in the US are misplaced. There have been three occurrences in the past 150 years, and all were due to abysmal economic policy. An example of such bad policy is if the Congress today insisted that the federal budget had to be immediately balanced. That is being discussed by some European countries, and could lead to very poor economic results there, if followed.

How much does it cost to buy some profit? In the past year it has cost \$1,400 to earn \$1 in a money market fund. It costs \$55 to earn \$1 interest from a five-year Treasury bond, and about \$25 to buy \$1 of interest from a five-year corporate bond. It costs about \$8 to buy \$1 of earnings (not dividends) from US stocks. Why are people avoiding stocks?

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.07%	+1.74%	+2.64%	+2.41%
Intermediate Term Bond	+2.88%	+12.96%	+6.26%	+4.57%	+5.74%
Intermediate Muni Bond	+1.73%	+7.44%	+4.62%	+3.49%	+4.39%
Large-Cap Core Stock	-12.26%	+12.10%	-10.00%	-1.10%	-1.19%
Mid-Cap Core	-9.91%	+21.64%	-8.71%	+0.58%	+2.34%
Small-Cap Core	-9.38%	+21.60%	-8.74%	+0.44%	+5.21%
International Stock	-13.07%	+7.78%	-12.80%	+1.28%	+0.42%
Real Estate	-4.02%	+51.95%	-10.17%	-0.76%	+8.73%
Natural Resources	-13.41%	+7.77%	-10.84%	+2.59%	+6.72%
Science/Technology	-10.22%	+15.37%	-7.84%	+0.95%	-9.33%
Multi-Cap Growth	-10.98%	+15.32%	-8.10%	+0.64%	-2.91%
Multi-Cap Value	-11.34%	+16.57%	-11.56%	-1.58%	+2.82%
Balanced	-6.33%	+12.74%	-4.07%	+1.34%	+1.77%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center. Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

During the past quarter, gold funds were the only funds that glittered, gaining over 9%. Europe stock funds fell 14%, and US stocks 10% or so. Bonds provided stability, with long-term US government bond funds doing the best. High yield and foreign bond funds fell. One-year figures in the table have come back to earth, and three-year figures are down-right scary. **Don't misuse the performance table.** It is backward looking—you wouldn't drive a car by staring out the back window. In many cases, the investment with the strongest recent record will post the worst next results.

Going forward, **managing bond money will be quite tricky.** Once the economic recovery is more solid, the Fed will start to raise short-term rates, and rising interest rates hurt most bonds. This was expected to begin this Fall, but with the European debt crisis, the start of higher rates will likely wait until early 2011. It is unlikely that this will affect all bonds the same. In the coming few years, as the US economy gradually grows, high yield bonds should provide attractive returns. Also in the coming years some foreign bonds should provide support when the US dollar weakens, especially bonds from countries with trade and fiscal surpluses (Asia, and commodity-rich areas such as Canada and Australia). I continue to favor 'bank loan funds' which hold bonds with adjustable interest rates, and expect them to do well when interest rates rise with a recovering economy. I use high quality short-term bonds for most money market needs, and split high quality bond money amongst short- and intermediate-term bond funds.

Stocks are also quite tricky at this point. There are valuation (are they cheap or expensive), currency, and country/economic issues. Europe will likely recover at an anemic rate, and they have high labor costs. On the plus side, their currency is cheap, which helps their companies' exports, and which means also that you are buying shares (which appear cheap) using stronger US dollars. The US will likely recover at a faster (but still modest) pace, has moderate labor costs, and has high productivity/efficiency. Large US companies generally have very strong balance sheets, and can best benefit from our global environment. Asia offers the strongest economic growth, has some of the strongest government finances (excluding Japan), but occasionally gets overpriced.

I remain committed to directing 40% of most clients' stock money to foreign stocks. While the majority should be in large, multi-national foreign companies, a reasonable amount should be directed to Asia and other emerging markets, with another reasonable amount in smaller companies in larger foreign countries. I like each sector in the US markets—large, small, growth, value. Spreading your US stock dollars around makes sense at this time.

Government Debt—The US has total government debt equal to 66% of its economy (GDP). Greece's figure is over 100%, Italy is at 116%, and Japan at over 120%. France, Germany, the United Kingdom, and Portugal also each has more debt:GDP than us. 25% of our debt is owned by foreigners. 99% of Greece's debt is foreign-owned, 60% of Portugal's, 56% of Italy's, 49% of France's, 47% of Ireland's and 40% of Germany's. Only 14% of Japan's debt is foreign-owned, as Japan has a strong culture of savers. Our current account balance (how much money we send outside our country, largely due to net imports) is 3.3% of our GDP. Spain (5.3%), Portugal (9%) and Greece (9.7%) are higher. Germany, Japan, and Ireland each sport a surplus. The 'sovereign debt crisis' requires several problem factors, a significant level of deficit spending (adding to debt), high debt relative to that country's economy, much of that debt held by investors outside that country. Greece is certainly in the worst position, and Portugal does not look very strong. The other countries, including the US, are much further away from a crisis point.

In April, the IMF and the European Central Bank (ECB) formed a plan to provide \$900 billion in funding to 'backstop weaker economies.' This was done to eliminate the panic that could set in if the Greek government found that it could no longer meet the obligations of its debt. The size of the fund was set large enough that it could handle multiple crises—larger than Greece alone should require, so that we don't play "Whack a Mole," where as soon as one crisis is encountered and addressed, another pops up its head and requires another bailout fund, and so on.

US investors have had a lot to digest in the past year. We have had major health care reform and major financial reform. While many investors may dislike various aspects of new laws, at least the uncertainty in these two areas has been eliminated. There are, however, **two significant, remaining areas of uncertainty—energy reform and tax reform.** Only the House has passed the energy reform, and thus we don't know if such reform will pass and what the final version will include. Further, the 'Bush tax cuts' expire on December 31st, when they revert to 'Clinton levels.' Estate taxes similarly change substantially on December 31st. I expect that investors will obtain some clarity at least on income and estate taxes before the end of the year, and that this upcoming certainty will help stocks.

This quarter, pay more attention to the economy and less to the markets, and expect to gradually see improving news.