

## Market Review and Outlook—October 12, 2004

While economists claim that the US is less dependent on oil than in the 1970s, in the past quarter as **the price of oil surged, US stocks fell**. Of course oil hasn't been the only story. The situation in Iraq has worsened, terrorists struck hard in Russia, and the US economic recovery has slowed.

On the positive side, the slow pace of the recovery has calmed fears of sharply rising interest rates. For despite the start of regular small rate increases by the Fed, overall interest rates have been falling, and this has **boosted returns for bonds**.

Bonds had a strong quarter, but have struggled since 'the turn', when rates stopped falling and began to rise.

**US stocks generally fell 2 to 3%** during the quarter, with non-US stocks flat. One-year results are modest, as they now include **nine months of going nowhere**.

Natural resource stocks enjoyed a very strong quarter. Real estate bounced back from a dismal 2nd quarter. While not listed in the table, gold funds had a tremendous quarter, and yet are down almost 8% year-to-date. Science and technology stock funds tumbled more than 10%. Semiconductor stocks were the 2nd weakest stock sector during the quarter, falling more than 22% (it is not a good quarter when only airlines do worse than you). The slowing recovery hit semiconductors hard, as the expectations of strong growth were dashed.

### So where do we go from here?

Last month I heard two economists present their views of the state of the US and global economy. Both feel that **we are in a 'glass half empty' environment**. You may recall that in 1999 and early 2000 the markets viewed all news as 'glass half full'. Some fear is good, as is some greed. But when one gets ahead of itself ... watch out!

There are several positives that appear to be ignored by the stock markets. First, we **are** in an economic recovery. Its slow pace has positive implications, for we are not grappling with imbalances (other than oil), and there is no need to briskly raise interest

rates. The job market is slow to recover, and global job outsourcing has become more common. While this is bad news for under- and unemployed US workers, it is **good for companies**. A deep pool of workers and improved access to lower-cost yet sufficiently skilled labor reduces companies' labor cost and increases profits.

**Neither the US nor foreign stock markets are overpriced**, based on 'the Fed model'. Few analysts are willing to bet against Alan Greenspan, who favors comparing the stock market's earnings yield (S&P 500's earnings divided by its price, expressed in percent) to the yield of the 10-year treasury. The S&P 500 has an earnings yield of 5% for past, and 6% for projected earnings. In contrast, 10-year US Treasuries yield about 4.1%. This implies that **relative to bonds, US stock prices are undervalued**.

While economic growth in Europe is slower than in the US, their stock markets are less expensive, and as a result **European markets appear as attractive as the US** at this time. Asian economies are growing strongly, and Japan appears to be emerging from its decade-plus funk, led by strong export sales to mainland China.

I suspect that most of the common fears are overblown. I expect that the US economy will continue to strengthen, and enable the winners of November's elections **to make a serious dent in the budget deficit**. I believe that fear has boosted oil prices more than simple supply and demand, and thus I expect **oil prices to gradually decline** from their highs.

As a result of these observations, I currently prefer **that portfolios be slightly more aggressive** than long-term targets, I prefer large companies to smaller, and I favor Japan and Asia a bit for non-US stocks. I favor scaling back real estate and natural resources stocks and funds. I prefer shorter-term or 'bullet bonds' (direct bonds rather than funds) for core bond holdings, and 'multi-sector' bond funds for non-core holdings, to take advantage of high yield and non-US bond coverage.

Category	3rd Q '04	Past Year	5-Yr Avg	10-Yr Avg
Money Market—Taxable	+0.22%	+0.60%	+2.55%	+3.77%
Intermediate Term Bond	+2.88%	+3.21%	+6.61%	+6.85%
Intermediate Muni Bond	+2.89%	+2.59%	+5.32%	+5.26%
Large-Cap Core Stock	-2.93%	+10.18%	-2.49%	+8.88%
Mid-Cap Core	-2.18%	+16.58%	+7.96%	+11.13%
Small-Cap Core	-2.16%	+20.62%	+10.58%	+11.51%
Int'l Stock (Large-Cap)	-0.24%	+19.57%	-0.33%	+4.72%
Real Estate	+7.85%	+25.05%	+17.98%	+13.38%
Natural Resources	+10.36%	+44.84%	+12.61%	+12.54%
Science/Technology	-10.18%	+2.76%	-11.39%	+8.69%
Multi-Cap Growth	-4.75%	+9.58%	-4.05%	+9.20%
Multi-Cap Value	-0.32%	+17.66%	+4.83%	+10.76%
Balanced	-0.37%	+9.21%	+2.35%	+8.35%

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Our clients should be aware that there are two alternate office locations that will be activated in the specific order listed below depending upon the severity and the exact nature of the event.

The **primary alternate office** is:

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If we find it necessary to temporarily move our operations, we will attempt to notify you by telephone. Please understand that this may take from 24 to 48 hours.

A complete copy of our Business Continuity Plan may be viewed in our office during regular business hours.

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Form ADV is used to communicate important information about our practice to our current and future clients, and to the SEC (our regulatory agency). On an on-going basis we update our ADV to ensure that it accurately describes our practice.

If you would like the most recent version of our ADV Part II, please call or e-mail Bill Starnes at 302-737-4546 or bill@mallardadvisors.com.

## Mallard's Privacy Statement

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