Market Review and Outlook—July 14, 2005

The markets in the second quarter of 2005 seemed to follow the weather—they started cool but were hot by the end of June. For the past three months (through June 30th), US stocks gained 2.2% while non-US stocks fell 0.7% and bond funds rose 2.1%. Is the early Summer heat sustainable?

Like storm clouds gathering in the afternoon, two factors threaten to cool the hot markets: oil prices and inflation. After subsiding in late Spring, oil prices rose to new highs by the end of June. Higher energy costs have put pressure on manufacturers and distributors of finished goods to raise prices. The growing economies of India and China have been competing for the supply of other raw materials, driving costs higher. This effect is partially offset by the declining cost for items produced in India and China and consumed here. India and China also appear to feature prominently in the future of oil. In the past few days, Cnooc, a Chinese oil company, has offered to purchase US oil company Unocal. Clearly the Chinese government is concerned about access to oil in the future, and this should cause US investors to also be concerned.

As anticipated, the Fed raised rates earlier this month—a move designed more to reduce the availability of cheap credit than to cool an overheated economy (while the US economy appears to be recovering, it is far from overheated). Alan Greenspan seems to have one eye on furthering economic expansion and the other on keeping inflation in check. The bond markets have responded oddly. As expected, short term yields have increased, but surprisingly long term bond yields have been declining. This traditionally signals an impending recession, however in this case the causes appear to have less to do with the US economy's direction, and more to do with foreign governments' purchases of US Treasuries. We will continue to monitor these developments.

In the past three months few sectors, strategies, or groups saw declines, and when they did (such as for non-US stocks and for gold funds), the losses were small, 1% or less. Real Estate and Latin American funds were the strongest; both gaining over 10%. [Paul reports that Belize **was** hot.] Large US stocks lagged their smaller brethren, and growth rebounded nicely, almost doubling value's gains. Longer term bonds outperformed, as did US government bonds.

The data in the following table comes from the 7/11/2005 issue of Barron's and from Morningstar Principia Pro.

Category	2005Q2	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Money Market—Taxable	+0.47%	+1.25%	+0.86%	+1.46%	+2.26%
Intermediate Term Bond	+2.60%	+6.06%	+5.40%	+6.66%	+5.98%
Intermediate Muni Bond	+2.28%	+4.95%	+3.86%	+5.17%	+4.84%
Large-Cap Core Stock	+1.21%	+4.40%	+6.15%	-3.63%	+8.18%
Mid-Cap Core	+3.24%	+11.79%	+11.96%	+4.64%	+11.45%
Small-Cap Core	+3.30%	+10.48%	+12.79%	+8.34%	+11.03%
International Stock	-0.74%	+12.63%	+10.29%	-1.41%	+6.09%
Real Estate	+13.13%	+31.88%	+20.80%	+19.69%	+15.29%
Natural Resources	+3.55%	+37.65%	+21.27%	+14.04%	+14.25%
Science/Technology	+3.68%	-1.09%	+10.99%	-18.68%	+6.32%
Multi-Cap Growth	+3.12%	+5.01%	+9.36%	-8.58%	+8.46%
Multi-Cap Value	+1.62%	+10.73%	+10.08%	+6.22%	+10.14%
Balanced	+1.73%	+6.44%	+6.96%	+1.90%	+7.66%

What Does the Future Hold? We have been scouring the prognostications of stock, bond, market, and economic analysts. Initially this was due to our desire to more fully comprehend the implications of the large US budget and trade deficits. Some economists are issuing dire warnings. One doomsday scenario calls for the Chinese government to threaten to dump its large holdings of US government bonds should the US object to a Chinese assault on Taiwan, for instance. Even if this has next to no chance of occurring, its mere existence as a possibility reveals the damage that our continued trade deficit has inflicted on our future political options.

We therefore studied and have arrived at our best guesses for the direction of inflation, bond yields, and stock prices. <u>This is a normal part of our quarterly review process</u>. This time, however, our conclusions are in many ways markedly different from our conclusions in prior quarters. When these altered conclusions are then used as assumptions, we find ourselves altering our overall strategy recommendation, in ways that we will detail next.

Victory is Announced! We began a program of building up clients' TIPS (inflation bonds) about two years ago, with the goal of having inflation-linked bonds comprise half of all clients' bond portfolios within five years. We now plan to 'unwind' this, and the reason for this reversal is largely due to its 'premature success'.

When we began the TIPS purchases, their 'real yield' (the yield which is received in addition to an inflation return) was only about 2%. We acknowledged that it was low, but that the desire to get inflation protection outweighed the modest risk of the real yield rising. Actually, the real yield fell, and is now approximately 1.5%. Due partially to this yield decline, **our TIPS have outperformed**. The Vanguard TIPS fund has returned 6.3% annually in the past two years, while the average intermediate government bond fund has gained only 2.6%. We strongly fear that this superior performance is highly vulnerable to a reversal, and we therefore recommend that clients cut their TIPS holdings.

This recommendation is strengthened by our belief that future inflation in the next decade is likely to be controlled. This, too, is a bit of a reversal, and it, too, is largely due to the information that we have reviewed from analysts that we admire, including PIMCO's Bill Gross. The most common projections call for inflation to peak at about 3% and fall towards 2.5% for the balance of the decade. In a low to modest inflationary environment, TIPS are simply not superior investments.

So Now What? We continue to believe strongly in globally balanced portfolios, utilizing both bonds and stocks, and for stocks to include both US and non-US holdings. Specifically, we are recommending that **clients shift TIPS holdings to general bond funds** (preferably with managers who are constantly looking to see if our assumptions are being contradicted). We continue to recommend that the core of clients' bond holdings are complemented with 'strategic' bond funds that include high yield and non-US bonds.

We are **introducing global stock funds (preferably large-cap) as a fundamental holding** (something we have been considering for more than six months), and reducing pure US stocks (primarily large-cap) to make room. We continue to like to maintain mid– and small-cap US stocks, and as long as we have the large-cap global stock component, we will be focusing our other non-US stocks into small-cap and emerging markets (including China and India).

Growth may be coming out of its five-year hibernation. Its past results continue to look miserable compared with value's, however this may indicate brighter future returns for growth. At this time we slightly favor growth over value, but not so much as to reverse client's Investment Policy Statements that specifically dictate a value-preference.

Given the red-hot past returns for **real estate investments, we recommend strong reductions** as a way of capturing the profits, before they evaporate. The potential for further gains is simply outweighed by the risk of substantial price pullbacks. While energy investments have enjoyed strong past growth, we are less concerned about the need to take profits; we are comfortable **'letting it ride' with energy.**

Summary Our view of future inflation and the substantial impact of further globalization compels us to adjust our recommended allocations in some notable ways. We do not consider these to be short-term moves, but rather reflect what we consider to be long-term changes to factors that will substantially affect our clients' portfolio investments in the future few years.