# Market Review and Outlook—October 12, 2005

What a quarter! The third quarter of 2005 started with very strong indications that the economy was kicking into high gear. Gas prices were high, but not that high. Interest rates were rising, but at a measured pace. Inflation was increasing, but with signs of moderation. The budget deficit was high, but improving, as a stronger economy was generating greater tax revenues. Everything was going well. Then came Katrina.

The immediate after-effects of Katrina failed to derail the strong quarter; in fact in September stocks rose almost 1%. In a twisted sense, investors felt that Katrina would slow the economy enough to enable the Fed to 'stand down', and stop raising interest rates. More to the point, investors saw Katrina as delaying the ultimate end of the current expansion, and they celebrated by shifting dollars to stocks. Bond investors, however, were concerned on two fronts, the inflationary pressures that the energy shortages were causing, and the President's plan for further deficit spending to pay for the Katrina rebuilding. These left bonds with a loss for the quarter.

Natural Resources (think energy) and Gold funds had a blow-out quarter, each rising more than 20%. International stocks surged more than 11% during the quarter, as Japanese funds rose 18% and Latin American funds rose 29%. Real estate finally cooled, rising only 3% during the quarter. Real estate's trailing returns continue to indicate the top of a market. Growth outperformed Value during the quarter, and the year, as technology and biotech and telecomm each rose 7% or more for the quarter . Small companies continued to lead larger companies by a healthy margin (5.2% versus 3.7% during the quarter). The jury is still out on whether this party, too, is coming to an end.

Most bond funds fell during the quarter, but by no more than 1%. The notable exception were high yield bonds, which rose 1.3% for the quarter. Money market yields are rising, with annual yields recently exceeding 3%.

*The data in the following table comes from Morningstar Principia Pro and from the Mutual Fund Yardstick in the October 8th issue of Barron's*

| Category | 2005Q3 | Past Year | 3-Yr Avg | 5-Yr Avg | 10-Yr Avg |
|---|---|---|---|---|---|
| **Money Market—Taxable** | +0.66% | +2.01% | +1.11% | +1.88% | +3.48% |
| **Intermediate Term Bond** | -0.61% | +2.41% | +3.97% | +5.99% | +5.75% |
| **Intermediate Muni Bond** | -0.28% | +1.79% | +2.59% | +4.91% | +4.82% |
| **Large-Cap Core Stock** | +3.70% | +11.55% | +14.28% | -2.89% | +7.86% |
| **Mid-Cap Core** | +5.22% | +20.21% | +21.05% | +4.63% | +10.81% |
| **Small-Cap Core** | +5.26% | +18.87% | +23.39% | +8.59% | +11.17% |
| **International Stock** | +11.08% | +25.15% | +22.03% | +1.15% | +6.25% |
| **Real Estate** | +3.22% | +26.05% | +26.02% | +18.55% | +15.04% |
| **Natural Resources** | +22.51% | +52.00% | +38.09% | +16.96% | +16.14% |
| **Science/Technology** | +7.56% | +17.47% | +24.76% | -17.20% | +5.29% |
| **Multi-Cap Growth** | +6.75% | +17.70% | +18.78% | -7.74% | +7.98% |
| **Multi-Cap Value** | +3.69% | +15.13% | +18.97% | +5.80% | +9.80% |
| **Balanced** | +2.71% | +9.74% | +11.60% | +2.05% | +7.40% |

# Market Outlook

The economy is expected to continue to advance, however consumers are quite skeptical. The Fed continues to raise rates due to their conviction that the economy is moving forward. Companies are reporting that they are continuing to hire employees and to make capital purchases. Joe and Jane America are unconvinced.

Due to the devastation of the twin hurricanes, and the regularly rising, and now drastically rising, energy prices, consumers are worried. They appear to be finally slowing their demand for gas-guzzling vehicles (I am at a loss as to why this took so long). It feels like the final stretches of a housing price boom, and with it the dramatic pace of refinancings. What will consumers do when the ATM that is their house fails to churn out money for their spending? Recently, even these worries aren't enough—predictions are being made of the risk of an avian flu that could reach pandemic levels.

The US budget deficit had been coming down during the summer as revenues were strengthening. The administration's "spend and borrow" plans for the Katrina rebuilding effort, however, threaten to jeopardize the already weak dollar further, and to give foreigners more reason to cut back on their support of our runaway deficit spending.

Inflation remains a wildcard. There are strong reasons for it to rise, and other strong reasons for it to fall back. We consider uncertain times to be the healthiest, for when all signs point in one direction, it is time to look over your shoulder. We feel that inflation is **not** likely to be a sustained, growing concern. This is backed up by the bond market, where long-term bond yields indicate little risk of runaway inflation.

US stock markets have enjoyed a sustained, three-year rebound/rally. International markets began their rebound more recently, but have risen as much. Latin American markets have been red hot, Emerging Markets have been strong, and with the return of Japan (finally), the Pacific region has also posted wonderful results. Energy funds continue to post scorching returns (22% for 3 months, 52% for the past year, and 38% annually in the past 3 years). Gold glittered during the quarter, and utilities funds are up over 33% during the past year.

Looking forward, we are always wary of markets that have been red hot. At this time, this includes energy and overseas stocks. We are wary about the 3-year strength in utilities, real estate, telecommunications funds also, along with emerging markets. Smaller companies have risen in price far more than large US companies during this recovery. The disparity has been so great that we suggest that investors fight the urge to abandon large stocks; they appear to offer far more downside risk than small US stocks at this time. Due to the multiple areas of strong recent growth, **we strongly recommend that investors pare back their 'winners'**, sealing in profits, and directing sales proceeds to sectors that have not seen as stellar gains.

We continue to favor globally balanced, all-weather, portfolios. We favor including large US stocks along with smaller ones. For foreign stocks, we have recently introduced a preference for global large-company funds, those that invest in large caps both outside and inside the US. We commonly also include one or more of the following subcategories: international small-cap, emerging markets, and 'Chindia' (China and/or India). We have drastically cut back on our use of real estate funds, due to our concern of downside risk. We are beginning to do the same for energy. We have used a commodity fund for several clients, and continue to use this in a modest size.

For bonds, we expect that the Fed will continue to bump up short-term rates, that long-term rates do not offer high enough yields to be compelling, and that the US dollar is more likely to weaken over time than strengthen. For this reason, we continue to favor a core of high-quality intermediate-term bonds, supplemented by a smattering of high yield and non-US bonds. Money market yields have risen to the point where you don't have to be embarrassed to admit that you are carrying a balance—finally!