Market Review and Outlook—April 11, 2006

During the past quarter stocks ruled while bonds drooled. The average US stock fund rose more than 5%, while the average intermediate-term bond fund fell 1/2%. The Fed, now led by Ben Bernanke, is continuing to raise rates, due to signs of a strengthening US economy. While that hurts bonds, it has been a cause for rejoicing in stocks.

Led by red-hot results in emerging markets, non-US stock markets delivered very strong results during the past quarter. Due largely to their energy (oil) holdings, Natural Resource funds rebounded from a weak 4th quarter, and rose over 10% during the quarter. Real-estate investing (I'm talking about REITs, Real Estate Investment Trusts, that invest in office buildings, retail malls, storage facilities, apartment complexes, etc, not housing) have seemed overpriced to us for two years, and yet they posted a 14% gain in just three months!

Only two sectors did better than real estate during the quarter. Latin American stock funds rose almost 17%. A Brazil fund returned 27%; it is up 81% annually in the past three years. Emerging Market stock funds rose almost 13%, about the same as European Region funds. Japanese stock funds rose only 4.5%, restraining Pacific Region funds to 'only 11%'.

The top sector was gold, where funds rose 20.5% during the quarter, and posted a 64% one-year gain. Gold shines when worries rise, and there are many areas to worry about now: the Iraq War, Iran, avian flu, Venezuela, oil prices, North Korea, Israel/Palestine, and political fights in Washington DC.

Valuations, the economy, and catalysts help drive the markets. We began the year with limited cases of sky-high prices. Real estate funds appeared the most overpriced, and they just kept rising during the quarter, continuing to defy gravity. The economy continued to strengthen during the quarter, so much so that the Fed feels that it needs to boost rates a little more to keep it from overheating. The two main catalysts in the past quarter are 1) further evidence that the corporate sector is recovering enough to lessen the need for consumer spending to fully support the economy, and 2) a slowly growing recognition that growth, like the phoenix, can rise from the ashes of the dot.com meltdown.

The following data, reflecting results through 3/31/2006, comes from Barron's and Morningstar's Principia Pro.

Category	**3 Months**	**Past Year**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Money Market—Taxable	+0.90%	+2.93%	+1.49%	+1.71%	+3.42%
Intermediate Term Bond	-0.55%	+1.85%	+2.79%	+4.51%	+5.55%
Intermediate Muni Bond	-0.07%	+2.31%	+2.29%	+3.66%	+4.42%
Large-Cap Core Stock	+3.94%	+11.64%	+15.46%	+2.58%	+7.34%
Mid-Cap Core	+7.56%	+20.13%	+24.65%	+10.55%	+11.54%
Small-Cap Core	+12.07%	+23.41%	+28.52%	+13.33%	+11.60%
International Stock	+9.73%	+26.35%	+29.86%	+9.15%	+7.53%
Real Estate	+13.99%	+36.77%	+31.66%	+22.25%	+15.96%
Natural Resources	+10.64%	+39.11%	+40.03%	+18.66%	+15.22%
Science/Technology	+8.01%	+24.59%	+23.51%	-0.29%	+7.97%
Multi-Cap Growth	+5.43%	+20.63%	+20.49%	+3.80%	+7.86%
Multi-Cap Value	+5.35%	+13.00%	+21.01%	+7.45%	+9.66%
Balanced	+4.60%	+13.14%	+14.93%	+5.94%	+6.38%

What a conundrum! Stocks have been doing quite well, and bonds have been bleak at best. Your gut (as supported by behavioral finance research, which Mark discusses in his recent article) tells you to keep the faith with stocks, and minimize your use of bonds. The problem is that at some point stocks will 'turn', and begin losing money. Economies such as ours go in cycles, and we are likely nearing the end of the upward portion of our cycle. Stock investors begin to cut back their stock holdings when they feel that a recession (the down portion of the business cycle) is approaching. While it may be comforting to think that you can pull out at the last moment, the odds are stacked against you. We favor being early, adding to stocks before a recovery is clear, and cutting back on stocks before a downturn is obvious.

The conundrum is two-fold. Being early is fine, being too early can be expensive. We were real early on cutting back client's use of real estate funds. This sector has continued to rise, and by cutting back very early, we have caused our clients to miss an opportunity. While we feel that US and foreign stocks will stop their strong upward trend, we don't know whether this will begin this Spring, or perhaps not even until the Winter.

The second unknowable question is, if you cut back on stocks due to worries of a downturn, what do you do with the proceeds? Bond returns have been anemic (up less than 3% a year in the past three years). Even though low bond returns typically signal stronger bond returns (think peaks and troughs), due to a variety of reasons, bond returns for the next five to ten years are not expected to return to their levels during the 90s, when they returned about 7% a year.

A client today mentioned that a newsletter writer compared this to a farmer deciding when to 'bring in the crop'. Should we let our allocation to stocks run a little longer, or start to harvest?

Unlike a farmer, we don't regularly harvest our entire crop, for there is no time during which our crops (stocks) are known to not grow; we have no such clearly-timed Winter. Rather, we choose a long-term allocation target, an all-weather program, and we adjust it up and down depending on the 'weather forecast'.

Due to the strong returns from stocks since the rebound began in late 2002/early 2003, and especially due to the strong results of the past quarter, most portfolio's have more stocks than their long-term plan calls for. At this time, for all but the most aggressive investors, we recommend that investors cut their stocks back at least to their target levels.

This will occur when , as investors rightly worry

An overpriced market can continue to rise, but its days are numbered. At this time, we feel that small-cap US stocks are coming to the end of their decade-plus winning streak. While large US and foreign stocks have some strong results in the past 3-years, these come off the bottom of a bear market, a trough. As such, we are not as worried about. Having just returned from the Gulf Coast, the upcoming hurricane season is a real concern in that area of the country.

The new abbreviation in the investment world is BRIC—emerging markets Brazil, Russia, India, and China.

.In our June report we predicted that the Fed would end the steady hikes in overnight interest rates later in 2005. Almost a year later, and we still await the last hike; we are hopeful that the last increase will come very soon. A jobless recovery strengthened in 2005—who cared that it was largely financed by consumers spending the equity in their inflated home prices? Fortunately for the economy, while Americans were trading their savings for more consumption, US corporations were strengthening their balance sheets, sitting on growing piles of cash rather than spending on plants and equipment to add capacity and enhance productivity. This could enable corporations to take the baton from consumers and help carry the economy in 2006 and 2007. Core inflation, which seemed tame this time last year, has increased, significantly when energy is included. Foreigners have been willing to fund the Federal debt (they hold more than half of treasuries maturing from one to ten years), and we do not yet see signs of their appetite weakening. This is one reason that the record deficits and debt has not caused spiraling inflation.

So how have things changed since June? We've seen higher gasoline prices, as hurricanes put further pressures on the shaky energy situation, and the war in Iraq deteriorated with no end in sight. Consumer confidence dropped sharply due to Katrina, but has largely recovered. Housing prices are cooling without collapsing. Incomes and spending by consumers have both seen solid gains. Payrolls have been expanding slowly despite Detroit's woes. Factory expansions have