Market Review and Outlook—October 11, 2006

US Stocks ended their slump in July, and came back strong in August and September, led by the formerly quiet large companies. Earlier this month the Dow Jones Industrial Average finally exceeded its prior peak from early 2000. This stock recovery was partially due to falling energy prices (OK, so they fell to still-outrageous levels) and due to the implications of the current 'wait and see' posture of the Fed.

Energy prices fell, partially due to what didn't happen—there were no awful hurricanes this summer in the Gulf of Mexico, taking wells and refineries off-line as there were in 2005. The Fed appears to be looking both ways before crossing the street: if the housing recession threatens to lead to a broad US economic recession, the Fed will cut rates, but if the US economy can digest falling housing prices and shows signs of heating up in 2007, then the Fed will resume its rate increases. The current breather, however, was welcomed by the US stock markets.

Bond markets finally had a good quarter, due largely to the Fed's stance, and the reputation that Ben Bernanke, its new chairman, is building as being serious about controlling inflation. This led to an aggravation of the 'inverted yield curve', where very short-term interest rates are higher than longer-term ones. This was partially caused by bond investors showing confidence that the Fed would prevent runaway inflation, and their purchases of longer-term bonds both boosted existing bond holders' returns, and led to a fall in longer-term rates, and the current inversion.

During the quarter the average stock fund rose 2% and bond funds rose 3%. US large-cap stock funds and foreign stock funds did even better. Losers were led by energy stock funds, which fell over 8%. Gold funds fell over 6%, US small-cap growth funds fell 3% and Japan stock funds fell 2%. Real estate stock funds continued an unbelievable ascent, returning a further 8% during the quarter.

The following data, reflecting results through 9/30/2006, 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	+1.15%	+3.92%	+2.11%	+1.75%	+3.63%
Intermediate Term Bond	+3.49%	+3.15%	+3.00%	+4.25%	+5.68%
Intermediate Muni Bond	+2.87%	+3.32%	+2.66%	+3.78%	+4.72%
Large-Cap Core Stock	+4.82%	+8.72%	+10.52%	+5.53%	+6.86%
Mid-Cap Core	+0.27%	+7.28%	+14.31%	+11.75%	+9.78%
Small-Cap Core	-0.66%	+7.55%	+15.49%	+13.54%	+10.26%
International Stock	+3.75%	+18.12%	+20.70%	+12.67%	+6.81%
Real Estate	+8.35%	+25.52%	+25.53%	+22.09%	+15.42%
Natural Resources	-8.42%	+3.92%	+31.14%	+21.87%	+13.46%
Science/Technology	+3.79%	+5.06%	+7.67%	+5.78%	+6.62%
Multi-Cap Growth	+1.40%	+4.92%	+10.78%	+6.81%	+6.75%
Multi-Cap Value	+4.51%	+11.13%	+14.80%	+9.83%	+9.33%
Balanced	+3.81%	+7.31%	+8.75%	+6.28%	+6.95%

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In the past two weeks I have heard an economist from Prudential and the President of the Philadelphia Federal Reserve Bank. I also reviewed material from the Chief Economist at Deutsche Asset Management, and PIMCO's Managing Director. The consensus is that the US economy is in a Goldilocks-state, neither too hot nor too cold. This is indeed wonderful, as long as it comes to pass. Yes, there are concerns about a housing market crash, and the impact that this could have on the economy, and there are also concerns about the effect of higher energy costs if they remain at this level (down from their highs, but still much higher than they were two years ago). These economic slowdown concerns are balanced by economic surge concerns, as US companies continue to pile on profits while unemployment remains historically low and inflation remains higher than the Fed's preferred range of 1-2%. I like environments where 'the jury is out', as the actual future is unlikely to vary too much from the broad range of expectations enough to startle the markets.

At Mallard we favor fundamental, contrarian investing. We steer away from investments which are all the rage, and trading at high prices, while we boost investments when they appear to be beaten down. One way to determine this is to review past returns, as are listed in the table on the previous page. This is made more difficult by the 2000-2002 bear market, which skews numbers around that time. The trailing 3-year figures are misleading, as they include the normal strong recovery that follows a bear market. The five-year figures only include half of the bear market, but include the entire recovery. Therefore, it may be most useful to compare the past year figures with the 10-year figures. Most Past Year figures are close (within 2% or so) of the 10-year figures. The exceptions are International Stock and Real Estate, both of which have recent returns way, way above their longer-term levels, and natural resource funds, which have been drastically trailing their longer-term results. **This leads us to believe that investors should ensure that they are harvesting gains when their portfolios get heavy with foreign stocks, that investors may wish to rebuild their energy holdings, but that otherwise investors can stay right on course.** We continue to recommend that one-third of the stocks in clients' portfolios be invested overseas.

In order to determine how under– or over-priced various types of stocks are, I examined some representative stocks in funds that focus on four separate sectors. I looked at the largest five stock holdings in four stock mutual funds, Vanguard's Index 500, Mid Cap Index, Small Cap Index, and the MSCI EAFE foreign stock exchange traded fund. I found that the Index 500 and EAFE each had yields of close to 2.7%, while the smaller US stocks yielded about 0.6%. Future annual earnings growth rates are expected to be just less than 10% for the Index 500 and EAFE, but are 30% for the mid-caps and 20% for the small-caps. PE ratios, which measure investor optimism, is 12-13 for all but mid-cap stocks, where the average PE was 17. The Spring and Summer's fall in smaller US stocks have brought their prices out of the 'worry zone'. Large US and foreign stocks offer reasonable value, including nice dividend yields. Smaller US stocks offer stronger growth prospects, without out-of-line stock prices. **Overall, I don't see any obvious danger signs in the overall stock markets.**

Energy and real estate stocks and funds have parted company. Real estate has appeared overvalued to us ever since 2001, and we have recommended **reduced exposure to real estate stocks/funds** ever since, as painful as this has been. We continue to stand by this view. Energy, however, is quite interesting at this time, given its dramatic sell-off. The US stock market has about a 10% stake in energy companies. Given the sell-off, and our view that long-term energy is a solid investment, **we favor running energy investments ahead of the market, perhaps up at the 12% range or so.**

To uncover a **good strategy for investing in bonds today**, I looked at three Vanguard corporate bond funds. The short-term one currently yields about 5.1%, the intermediate term one 5.3%, and the long-term one 5.7%. For similar municipal bond funds, the corresponding yields are 3.4%, 3.8%, and 3.9%. The GNMA (mortgage) bond fund yield 5.2%, and the high-yield corporate bond fund yields 7.25%. These yields are down in the past quarter. At this time **I favor short-term bonds for moderate-bracket investors and IRAs, and intermediate-term municipal bonds for high-tax bracket investors**. We also prefer diversifying clients' bonds by including high-yield and foreign bonds; we often accomplish this through the use of 'multi-sector' bond funds.

The good news is that investment risks appear more limited than normal, the bad news is that future returns could be modest across the board for awhile.

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