Market Review and Outlook—July 12, 2007

The global stock markets stumbled in late February, and began to rebound in March. That rebound continued strongly during the 2nd calendar quarter, as both US and foreign stocks rose 6% or so in just those three months. The rebound was led by strengthening energy and other commodity prices, and by strong results from technology companies, which had provided a pronounced lack of rebound since the dot-com bubble's implosion. Energy, communications, and technology funds all rose from 10 to 13% during the quarter. Foreign markets were as strong, or stronger, than US markets during the quarter, led by Latin America, Pacific without Japan, and Emerging Markets, which each returned more than 16%. The worst performance came from REITs and real estate funds, and from bonds, especially long-term bond funds. Both real estate funds and bonds lost money during the quarter, with real estate falling over 7%.

The slump in residential housing, and the subprime mortgage troubles are dampening the US economy, however the market saw some silver lining in this area during the quarter. Strength in non-US economies continues, and can help balance out weakness in a single sector of the US economy, and especially large US companies with broad global reach have been rewarded. Further, housing and financial sector weakness in the US economy appears to be sufficient to enable the Fed from needing to increase overnight interest rates in order to combat inflation pressures. If housing and financials were doing well at this time, the Fed would be so worried about an overheating US economy (too much of a good thing) that they may feel compelled to raise rates further to dampen the economy.

JP Morgan's "Market Scorecard" gives the markets high marks on investment returns, the overall economy, employment, and neutral marks on corporate earnings, inflation, and fund flows (investor purchases of stocks, bonds, and funds). Negative marks are earned for interest rates and for key news items: housing and subprime mortgages, hedge funds and an impasse on immigration reform.

Expectations—The following table presents past returns for many types of investments. I apologize for the spotty data; Barrons appears to have stopped providing these results, and Morningstar does not provide 10-year results. Regardless, the critical point to make is that trailing returns have been tremendously good, and **you should not expect these to continue**. I consider normal annual levels to be 2 to 3% for inflation, 4 to 6% for bonds, and 6 to 9% for stocks. Returns greater than that are welcome exceptions; they are **not** the rule.

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Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg
One-Month Treasury Bill	+1.21%	+5.00%	+3.63%	+2.63%
Intermediate Term Bond	-0.66%	+5.22%	+3.33%	+4.11%
Intermediate Muni Bond	-0.41%	+3.40%	+3.40%	+2.83%
Large-Cap Core Stock	+6.00%	+20.96%	+13.03%	+11.98%
Mid-Cap Core	+6.45%	+23.52%	+16.40%	+16.47%
Small-Cap Core	+5.47%	+19.89%	+16.04%	+16.24%
International Stock	+6.97%	+29.50%	+22.91%	+17.73%
Real Estate	-7.35%	+12.16%	+20.39%	+20.65%
Natural Resources	+12.56%	+21.11%	+29.57%	+26.46%
Science/Technology	+10.19%	+29.25%	+12.73%	+13.77%
Multi-Cap Growth		+18.87%	+11.64%	+11.38%
Multi-Cap Value		+20.74%	+14.02%	+12.23%
Balanced		+13.95%	+9.02%	+8.54%

The data in this table comes from the Barron's Mutual Fund Quarterly Review, IDC, and Morningstar Advisor Workstation.
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Growth versus Value—I have been cautiously optimistic about growth investing for several quarters. 2007 has seen strength in growth, and I expect this to continue. The primary reason is that value stocks have done so well since the depths of the bear market, that they have been bid up to high enough prices that they no longer provide the margin of safety they have traditionally. Growth has in a sense become a good value.

Foreign—Overseas stock markets have been incredibly strong for several years. This has been so pronounced that investors should ensure that their portfolios have not seen their foreign allocations 'creep up' such that the portfolio has more at risk in foreign stocks than intended. I feel more concerned in the 'hot' areas—Latin America, China, much of the Pacific, and emerging markets stocks in general—and am getting more comfortable with the Japanese stock market.

Real Estate—I was a Pollyanna here, predicting doom and gloom (in hindsight) WAY too early for this sector. Quarter after quarter I have been proven mistaken. Well, finally, the sector took a hit, due largely to the combination of housing weakness and subprime mortgage woes. Of course the losses were not too surprising given that the sector had been performing so (incredibly) well since the bear market. I suspect that this offers an **attractive opportunity to re-establish a position in real estate** (REIT) funds, for portfolios that had left due to the sectors apparent overvaluation.

Energy—This sector has led every other major sector since the 2002 market low. The past gains have left some companies seemingly overvalued. At the least, investors should expect more mundane results going forward, and there could be multiple quarters of below-market results in the future for the energy sector. The S&P 500 assigns a 11% weight to energy; I am comfortable with this level, and would be willing to boost it towards 15% if energy stock prices moderated.

Inflation—'Core' inflation, which excludes food and energy, rose 2.2% in the past year, while 'headline' CPI, which includes food and energy, rose 2.7%. I expect core inflation to remain between 2 and 2.5%, and at this level investors and corporations have a very favorable environment to plan for the future. The futures market expects oil prices to decline slightly from $70 currently to $67 a barrel (Brent Crude), over the coming eight years. This could indeed lead to relatively low inflation for the coming years. My fingers are crossed.

Bonds—We have a very flat yield curve, with 2-year treasuries paying 4.9%, and 30-year treasuries paying only 5.1%. Bond investors have little incentive to lock up their dollars for the long-term in this environment. Inflation-linked bonds are yielding about 2.7% (above inflation). This is fair, neither a bargain nor excessively low. High yield bonds offer yields about 3% more than treasuries, and emerging markets bonds offer yields about 2% higher. Neither 'spread' appears large enough to justify a large allocation. US interest rates are higher than the both the UK and 'EuroLand'. They are of course much higher than Japan (known for years as having 0% interest rates), although Japan has been boosting their interest rates.

Bonds should continue to offer miserly results, however they should also provide stability during future periods of stock market instability. It is difficult, however, to justify buying a 10 year treasury paying 5.1% when a six-month CD yields the same.