Market Review and Outlook—October 9, 2007

After a seven year hibernation, growth stock investing has awakened. In the past quarter growth stocks rose 5% while value stocks fell 1%, and year-to-date, growth has outperformed 16% versus 6% for value. Usually growth beats value when a growth sector sizzles (for instance internet stocks in the late 1990s). In this case, growth has outperformed due to what it lacks—housing and mortgage companies, which are bread and butter for value stock funds.

The US stock market pulled back in June and July, and began to recover in August when the Fed took steps to help the credit markets that were reeling from subprime worries. US stocks recovered further in September, as the Fed cut the Fed rate by 1/2%. Foreign stock markets didn't recover until September, but they made up for lost time with a sharp gain (almost 6%). Emerging markets returned 12% during the quarter, with both Latin America and the Pacific Rim posting strong results. Gold, after moving sideways all year, jumped 21% in September, and reached a 27-year high. The spike is tied to the expectation that the housing and subprime troubles will spread and force the Fed to continue to cut the Fed rate, driving the US dollar down further, elevating gold to 'safe haven' status.

The big question for investors and the Fed is whether the housing and subprime problems will spill into the overall economy, and whether this will lead to a real recession or only a 'soft landing'. While the Fed can cut the Fed rate further to reduce the risk of a recession, in so doing it subjects the US to two risks—unchecked inflation, and a further decline in the dollar. I suspect that a recession this year or next will be avoided, that the Fed rate will be cut another 1/2 to 1%, that inflation will not rise sharply, and that while the dollar will likely weaken, the decline will be modest.

JP Morgan's "Market Scorecard" gives the markets high marks on interest rates and inflation, and negative marks on key news items (the wars, and the housing industry meltdown). Mixed/neutral ranks are given for investment returns, the overall economy, employment, corporate earnings, and fund flows (investor purchases of stocks, bonds, and funds).

Expectations—The following table presents past returns for many types of investments, through 9/30/2007. Don't let 2007 fool you; stocks do not always recover quickly from stumbles, and stocks do not normally return 12% or more annually year after year. In the future we may see more modest results for stocks, as they 'come back to earth'. When trailing results are so strong, it is always good to rebalance to your long-term targets, locking in your gains.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Three-Month Treasury Bill	+1.07%	+4.73%	+3.92%	+2.79%	+3.55%
Intermediate Term Bond	+2.18%	+4.13%	+3.27%	+3.88%	+5.21%
Intermediate Muni Bond	+1.79%	+2.44%	+2.46%	+2.65%	+4.05%
Large-Cap Core Stock	+1.96%	+15.98%	+12.37%	+13.94%	+5.56%
Mid-Cap Core	-1.56%	+17.82%	+15.03%	+17.75%	+9.26%
Small-Cap Core	-3.44%	+13.37%	+13.16%	+18.02%	+8.27%
International Stock	+3.22%	+26.29%	+23.11%	+22.62%	+8.04%
Real Estate	+1.30%	+6.14%	+18.13%	+21.27%	+11.84%
Natural Resources	+7.56%	+44.10%	+30.96%	+31.36%	+13.79%
Science/Technology	+6.18%	+25.42%	+16.13%	+21.31%	+6.26%
Multi-Cap Growth	+5.21%	+22.91%	+15.17%	+16.93%	+6.31%
Multi-Cap Value	-1.65%	+13.58%	+13.44%	+16.58%	+7.79%
Balanced	+1.98%	+12.57%	+9.93%	+10.96%	+5.93%

The data in this table comes from the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.
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Growth versus Value—After recommending growth for several quarters, it has finally listened, and has some impressive results. I am not yet worried about growth being overpriced but will keep an eye on this.

Foreign—Overseas stock markets continue to shoot skyward. I recognize that there are justifications, however the magnitude of trailing results compels me to recommend caution. If you feel driven to add to your foreign stocks, try to wait until there is at least a short-term decline before adding dollars to an already 'at target' position. This is an even stronger point with emerging markets, which rose more than 50% in the past year. Tread carefully!

Real Estate—In July I mentioned that I am beginning to venture back into real estate (REIT) funds after my stubborn and premature pessimism of this sector. This sector has been lukewarm lately, which I like as I see this as confirmation that the 'irrational exuberance' has left the market, making it safer to return. In recent years, there are now 'global' real estate funds. Caution is warranted here, for the reasons listed above related to overvaluation overseas.

Energy—This sector continues to blow me away. It followed a 12.5% gain in the 2nd quarter with a 7.5% gain this past quarter. It has averaged more than a 30% gain for the past five years. Energy could return 0% for a decade, and it would still have averaged 9.5% annually for 15 years. As I mentioned in July, 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. I would also be comfortable cutting it back to 10% until energy has seen a 'correction'.

Inflation—'Core' inflation, which excludes food and energy, rose 2.0% in the past year, while 'headline' CPI, which includes food and energy, rose 2.1%. I continue to expect that core inflation will remain between 2 and 2.5%, a level that investors, corporations, the economy, and the Fed should enjoy. Oil is currently near $80 a barrel, however the futures market expects oil prices to steadily decline, falling to less than $72 within about two years. This is notably higher than expectations three months ago, however the future trend remains downward, which is good.

Bonds—With September's Fed rate cut, we have a fairly normal yield curve, with lower yields for bonds that maturing earlier. The overall level of interest rates, however, is low, with long-term treasuries yielding less than 5%. US interest rates are much higher than in Japan, slightly higher than 'EuroLand', slightly lower than in the UK, and much lower than in Australia. Inflation-linked bonds are yielding about 2.3% (above inflation), a bit lower than in July. High yield bonds offer yields about 4% more than treasuries, and emerging markets bonds offer yields about 3% higher. While larger than in July, neither 'spread' appears large enough to justify a higher-than-normal allocation.

Short-term CD rates fell in September with the Fed rate cut, and currently yields for any CD, regardless of maturity (from three month out to five-year), run between 4.7% and 4.9%. Money market yields have similarly fallen, to approximately 4.5%.

At this time I don't see any clear areas for great returns from bonds. Rather they should continue to offer stability to a portfolio, while pitching in modest, but steady, income.