Market Review and Outlook—July 9, 2008

The numbers lie. The figures below appear to describe a boring quarter, with stocks up or down less than 2%. What it doesn't show is that the quarter saw stocks surge in April and May (one mid-cap index rose 13% in those two months), only to fall quite sharply in June. What happened in June to tip the stock market downward, reversing its recovery? Economists and market watchers began to lose their conviction that the US economy would definitely regain its footing by year-end. Sky-high and ever-rising gasoline prices brought consumers to their breaking point, a breaking point that could not be avoided by a mere $600 or $1,200 'economic stimulus check'. While rising exports have helped the US economy to avoid (thus far) a technical recession, this is driven by a falling dollar which is hitting consumers hard when buying food, cars, travel, or, of course, gas.

There are three areas that I would like to point out in the table, below. Bonds, for the past decade, have returned less than 5% a year, less than 3% annually for the past five years. A thirty-year treasury yields less than 4.5% now. While investors are scared of stocks, which have fallen 10% or more in the past year, the alternatives are pretty uninspiring.

Growth stocks outperformed value stocks by 12% in the past quarter, and by almost 19% in the past year. This is quite a reversal, and is due to the high concentration in all of the 'toxic industries' within the value spectrum—housing and financial stocks. Just as trees do not grow to the skies, the reverse is also true—stocks, and even toxic industries, eventually reach a bottom. We will continue to need banks and houses—these industries will recover, and investors will in time enjoy these stocks' rebounds.

On the topic of trees growing to the skies, Natural Resource (energy) stocks are up over 19% for the quarter, and over 31% annually for the past five years. That cannot continue. Oil has more than doubled in 18 months. I do not believe that it will not do so in the next 18 months, and this will disappoint many investors. Don't be one of them.

The table shows that stocks have been beaten down, and everyone who holds stocks has suffered in the past year. If you have written down your investment goals, take them out and read them. They will likely tell you that in times like these you don't panic, and that you may even want to rebalance your portfolio, to shift money from bonds into stocks. If you haven't written down your investment goals, don't you wish that you had? Write them down now, and consider reviewing them in a year or two, after the stocks have recovered.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Intermediate Term Bond	-1.14%	+3.38%	+2.57%	+2.88%	+4.77%
Intermediate Muni Bond	+0.08%	+2.88%	+2.21%	+2.46%	+3.91%
Large-Cap Blend Stock	-1.60%	-12.27%	+4.55%	+7.64%	+3.32%
Mid-Cap Blend	+1.96%	-13.23%	+5.42%	+10.75%	+6.98%
Small-Cap Blend	+0.91%	-17.03%	+3.66%	+10.62%	+6.99%
International Stock	-1.58%	-9.04%	+13.41%	+15.90%	+5.28%
Real Estate	-6.93%	-17.34%	+4.05%	+13.50%	+10.46%
Natural Resources	+19.42%	+35.84%	+29.24%	+31.23%	+17.72%
Science/Technology	+2.85%	-9.28%	+6.31%	+8.19%	+2.54%
Morningstar US Growth	+5.28%	-3.76%	+6.77%	+7.76%	-0.14%
Morningstar US Value	-6.96%	-22.37%	+2.42%	+8.62%	+4.95%
Balanced—Conservative Allocation	-0.89%	-2.51%	+3.51%	+4.53%	+3.85%

The data in this table comes from Morningstar Advisor Workstation™.

Where's the Recession? We haven't technically been in a recession, but it feels like one. Businesses are slowing down, jobs are being lost, consumers are spending less, and stocks have fallen. It may as well be a recession. What is more important is when will the economy start growing again. I had expected the economy to be recovering by year end. I still expect this, however my level of conviction has fallen, largely due to the continued high price for oil. Lately I have begun to suspect that oil prices will begin falling soon, and this will help the economy to begin to recover.

Oil Can Fall? Really? There are several factors that can combine to bring down the **price of oil**. One is conservation. Many Americans are driving less due to the high cost of gas—they are selling their Hummer and buying a Prius, and airlines are eliminating flights. This cuts demand. Many emerging countries including India and Malaysia have reduced their governments' subsidies for oil, and last week China boosted the price of gasoline by 18%. This angers citizens, but it ultimately cuts demand. Saudia Arabia will be sharply boosting their output next year, and has already agreed to pump more this year. That increases supply. Classic economics theory holds that there is a tipping point for the price of oil, above which demand will diminish—we may have already crossed it. If the Fed begins to raise interest rates to control inflation, this should strengthen the dollar, which could help to reverse the direction of oil prices. Barrons magazine has an article this week noting that oil could fall to as low as $100 a barrel later this year. Really!

Housing seems to continue to fall. Most strategists expect housing to bottom out by next year, earlier in some areas. We don't need an immediate housing recovery; just the end to the housing decline will dramatically improve the economic climate, for consumers, for financial firms, and for the stock market in general. Remember that stocks are leading indicators—by the time that the housing market has turned the corner, housing and financial stocks should be well into their recovery.

The dot-com boom showed us that a sector's good times eventually end. The dot-com bomb showed us that a stock market's decline eventually ends. This is sometimes referred to as **'reversion to the mean'**. Like a pendulum, stocks eventually swing back to the middle.

Energy stocks have been extremely profitable. This will end.

US and foreign stocks have fallen hard. Housing and financial stocks have fallen sharply. This will end.

There is a real risk of 'being early', of adding to your stocks during a downturn, only to see the markets continue to fall. This was the case in 2001 and in early 2002. Despite sharp declines through that point, stocks didn't stop falling until late 2002. However stocks did rebound. Stocks rose from 10% to 20% both in 2Q03 and 4Q03.

Chris Davis runs the Selected American Shares mutual fund, and comes from a family that has managed investments for generations. He noted that 'My grandfather always said, "You make most of your money during a bear market; you just don't realize it at the time."' We are in a bear market. How are you going to make your money?

This economic slowdown is unlikely to continue much longer, nor is the related stock market decline. MFS Chief Investment Strategist Jim Swanson notes that, unlike the typical recession, companies had not overspent, over hired, or had became overleveraged. Companies still have free cash flow and they have cash. Stocks were not over-priced last year, as they were in early 2000, and as they have been when entering most recent economic downturns.

So what do you do? Stock markets fall, and then they rise again. I prefer an **all-weather approach** that keeps each portfolio close to its long-term target, and that opportunistically adds to stocks when they are cheap and cuts back when they seem overpriced. It makes sense that this approach puts odds in your favor. If you concur, examine your overall stock/bond balance. You likely have less in stocks than your long-term goal. If you are not rebalancing now, you should have a good reason, other than fear.

In addition to focusing on the big picture, and thus getting stocks up to target levels, I prefer at this time to cut back on energy positions, and to boost real estate (which has been battered). Furthermore, value has been clobbered, and so I prefer to have portfolios adopt a value tilt at this time, to prepare for an eventual 'value-rebound'.

Don't be an ostrich. It is scary out there, but times like these provide opportunities to earn money by sticking to your plan and by fighting the crowd.