Market Review and Outlook—September 12, 2008

The ups and downs have been harsh. Oil prices continued their sharp climb in June and the first half of July, but then began a sharp decline (in the June report I raised the possibility of oil being overpriced). The US stock markets largely posted opposite results, falling in June and the first half of July, and recovering in the following six weeks. Foreign stock markets, on the other hand, have been on a steady decline since mid-May, with no letup even since mid-July, to coincide with the decline in oil prices.

What's causing this? It's all connected. The US economy began to slow last summer, initially due to the housing bubble bursting. The global economy, however, was moving steadily upward, creating an increasing demand for oil, which resulted in a significant increase in oil prices. The housing sector bled into the financial sector later in 2007, and then, in early 2008, it appeared that the US economy was at risk of contracting (a recession). Oil prices kept rising in the first half of the year, but US consumers began to cut back. By mid-July it became clear that global oil demand was definitely falling, and that the US economy's weakness was spreading overseas.

Foreign stocks fell in the first quarter, partially recovered, and then began a steady decline in mid-May, reflecting lower expectations for economic growth overseas. The US stock market, however, has strengthened, due to reduced concerns about future inflation (the upside to the falling price of oil) and due to the hope that the US economic slowdown, which has passed its first birthday, will soon have run its course (the overseas slowdown is only just beginning.)

What do the numbers indicate? The table below is depressing. In the past three years, the average annual return for bonds is about 2.5%, 3.5% for US stocks, and only 2% for value stock funds, less than CDs. The hotspot for investors in the past several years, natural resource funds, fell a sharp 14.7% in the past three months. Foreign stocks, which have generally outperformed US stocks since the dot.com recovery began years ago, fell even more than US stocks in the past three months, 16%. In the first week of September, US stocks fell 3% and foreign stocks fell more than 6%, while oil fell 8%, as fears of a substantial economic slowdown overseas took firm hold.

What to do? I expect that the US economy, which began its slowdown first, will recover before foreign economies, and that US stocks will therefore recover first. I am hopeful that US stocks begin a dependable recovery prior to year-end. While bonds should continue to offer stable results, I expect these returns to remain anemic. I do like municipal bonds for higher-bracket investors. Brave investors can consider keeping foreign stocks a bit below target levels, and keeping US stocks above target levels, and, if necessary, cutting back a little on bonds.

The following data, reflecting results through 8/31/2008,
comes from the Wall Street Journal and Morningstar's Advisor Workstation product.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Intermediate Term Bond	-1.06%	+1.57%	+2.28%	+3.34%	+4.63%
Intermediate Muni Bond	+0.45%	+3.91%	+2.64%	+3.30%	+3.89%
Large-Cap Blend Stock	-8.50%	-10.89%	+3.36%	+6.75%	+5.23%
Mid-Cap Blend	-7.73%	-9.10%	+4.14%	+9.17%	+9.89%
Small-Cap Blend	-3.94%	-8.86%	+3.39%	+9.50%	+10.54%
International Stock	-16.03%	-14.78%	+7.59%	+12.80%	+5.87%
Real Estate	-6.99%	-9.36%	+4.23%	+12.74%	+12.83%
Natural Resources	-14.71%	+13.67%	+15.05%	+24.76%	+19.18%
Technology	-9.82%	-10.99%	+4.33%	+5.34%	+5.03%
Multi-Cap Growth	NA	-7.31%	+5.16%	+7.67%	NA
Multi-Cap Value	NA	-14.61%	+1.98%	+7.27%	NA
Conservative Allocation	-4.18%	-3.01%	+2.75%	+4.43%	+4.41%