Market Review and Outlook—December 11, 2008

This year has been horrible. The chart below shows one-year losses of 40-50%, with losses overseas sharper than here in the states. Critically, there have been very few safe havens, as only US Treasuries and money markets have held up. Bonds have fallen a few percent, while high yield bonds have fallen almost 30% in the past year. Despite a strong rise through early July, natural resource funds tanked in the 2nd half, as oil fell 70%. The average 'moderate allocation' mutual fund has fallen over 30% in the past year!

It's the Leverage Housing and construction makes up less than 4% of the US economy. So how did this one sector bring the US economy to its knees? Financial engineering (credit default swaps, and tranches of collateralized mortgage obligations) obscured the actual risk that these new-fangled investments included. When financial firms leveraged their 'bets' 30:1, a 3% position that goes belly-up could cause a 90% loss. The first shoe to drop was Bear Stearns in March, but after a fairly quiet summer, in September the financial house of cards began to crumble (Fannie Mae, AIG, Lehman Brothers, Merrill Lynch, $700 billion rescue bill, etc). Leverage is not new, but the degree to which it was used was substantial, and served to drastically accelerate the market decline.

It's the Economy Late this summer it became clear that the world economies were slowing, and that the next six months would likely bring sharp pullbacks. Fortunately, dramatic efforts by US and global governments and central banks have already been taken, and more are being regularly considered. These steps are necessary and substantial, and will in time bear fruit. What isn't known is whether the economies will begin to recover in late 2009 or 2010.

Stock markets reflect future economic activity. Thus stock markets typically lead economic conditions by six to twelve months. The sharp decline in stock prices in recent months reflect investor's concerns about the economy over the next year. Thus rising unemployment in the coming quarters is already incorporated in today's stock prices.

What to do? I am hopeful that we saw the stock market bottom three weeks ago. I therefore feel strongly that investors should resist every urge to sell shares of stocks and stock funds. When they need cash, investors should first use money markets and then CDs and bonds and bond funds (hopefully those that have fallen less than 30%). Aggressive investors can consider boosting their allocation to stocks until they rebound, at which point they can get their portfolio's back to their normal allocation. Taxable investors should **harvest paper losses** (which could be substantial) by year-end, but should ensure that they **reinvest the proceeds into similar investments**, so that they are not 'net sellers' of stocks at the current prices, which appear to be at bargain basement levels.

The following data, reflecting results through 11/30/2008,
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	-6.88%	-7.78%	+0.23%	+1.37%	+3.69%
Intermediate Muni Bond	-4.74%	-3.02%	+1.35%	+1.79%	+3.27%
Large-Cap Blend Stock	-31.18%	-39.62%	-9.62%	-1.99%	-0.47%
Mid-Cap Blend	-37.06%	-42.02%	-11.05%	-2.24%	+3.09%
Small-Cap Blend	-36.62%	-40.10%	-11.70%	-1.93%	+4.31%
International Stock	-35.94%	-48.59%	-8.13%	+1.23%	+0.43%
Real Estate	-47.92%	-50.60%	-16.95%	-2.95%	+5.27%
Natural Resources	-44.91%	-44.99%	-6.41%	+8.86%	+10.29%
Technology	-38.40%	-46.77%	-12.83%	-5.75%	-2.65%
Multi-Cap Growth	NA	-43.16%	-11.10%	-2.85%	NA
Multi-Cap Value	NA	-40.23%	-11.00%	-1.83%	NA
Conservative Allocation	-17.31%	-21.15%	-3.18%	+0.32%	+1.67%

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