Market Review and Outlook—July 9, 2009

Has 'the' recovery begun? The S&P 500 stock index rose almost 16% in the past quarter, after falling the prior six quarters. The last time the S&P rose so much was the 4th quarter of 1998. Smaller US stocks and foreign stocks and even junk bonds rose higher. What explains such a rebound, what great news surprised us?

In the past three months, no news was good news. The biggest positive development was the lack of negative news. There were no new financial scandals (Madoff, Stanford), nor any new financial meltdowns (AIG, GM, Chrysler). There were no new stimulus (bailout) bills before Congress. Some areas of past concerns, GM and Chrysler, saw greater visibility to their path forward. Uncertainty is an investor's enemy, and uncertainty fell in the past quarter.

What concerns remain? The new concern is the ability of the US government to digest the current and projected spending it has already committed to, and that it is considering. This leads to concerns of a weakening US dollar. Tied to this first concern is that of sharply rising inflation. Counter-concerns include the concern that unemployment will continue to rise for several quarters, and will remain high for a few years, and also the concern that, even with a recovery, US economic growth will fail to recover all the way to its earlier level.

In the past quarter the positives drastically overwhelmed the negatives, and investors went bipolar—jumping from not wanting to own any risky investment (such as a stock fund) to buying large amounts of some of the most risky investments (emerging markets stock funds and commodity funds), in an attempt to make up for lost time. In the 1st quarter of the year quarter, ten of the 13 categories listed below lost money. This time every one made money; six of them made 20% or more. Painfully, nine of the categories still have one-year losses of 20% or more.

With the wild fluctuations of the past year, it is more important than ever that investors keep on top of their portfolios. Resist the temptation to over-load-up on hot risky areas such as emerging markets. Be intentional. Ensure that your safety net of cash and bonds is sufficient, and invested with adequate safety in mind. Next, examine your stocks in light of the constantly shifting environment, and ensure that your allocation is where and how you want, and has not been blown off course by the recent sharp recovery.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.07%	+1.19%	+3.28%	+2.86%	+2.90%
Intermediate Term Bond	+5.72%	+1.64%	+3.62%	+3.19%	+4.82%
Intermediate Muni Bond	+3.21%	+4.06%	+3.55%	+3.29%	+4.03%
Large-Cap Core Stock	+16.79%	-26.41%	-8.34%	-2.06%	-1.50%
Mid-Cap Core	+20.06%	-28.13%	-9.00%	-1.35%	+2.90%
Small-Cap Core	+22.27%	-25.97%	-10.78%	-1.78%	+4.25%
International Stock	+23.96%	-32.42%	-8.24%	+2.09%	+1.11%
Real Estate	+29.88%	-43.13%	-19.10%	-3.70%	+4.89%
Natural Resources	+20.66%	-46.59%	-7.04%	+7.86%	+9.67%
Science/Technology	+21.05%	-20.11%	-3.89%	-1.00%	-3.82%
Multi-Cap Growth	+16.53%	-28.21%	-7.46%	-1.25%	-1.34%
Multi-Cap Value	+18.66%	-26.87%	-10.73%	-2.46%	+1.29%
Conservative Allocation	+10.35%	-9.99%	-1.04%	+1.53%	+2.25%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center. Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

I have just reviewed several analysis pieces from PIMCO, the fund family that runs the largest bond fund and the largest commodity mutual fund in the country. I find their commentary to be helpful in looking forward, and use them below to frame my thoughts on many important issues facing investors asking themselves, 'where do we go from here?'

My favorite quote is Bill Gross' label for what we went through in the past year as the **'Great Recession.'** This recession and this stock market collapse have been the worst in many decades, in some cases the worst since the Great Depression. It is important to respect the scale of the downturn—this was worse than the crash of '87 or the dot-com bust.

In the 18th century, economist Adam Smith described the 'invisible hand' to describe how economics works, silently, behind the scenes, but with a definite steering impact. PIMCO describes current events as bringing 'a shift from the **invisible hand** of the markets to the **visible fist** of governments.' They note that a critical task is for governments to deftly step back as the economy recovers, to hand-off to the invisible hand, when government action is no longer helpful. Failing to do that has very serious negative consequences. They note that there is an important new risk factor for investors, a **'public policy risk factor'** that captures the risk to investors of governments not stepping back effectively.

PIMCO points out the folly in expecting a swift return to the 'good old days'. Instead they suggest that 'the US economy is on a bumpy journey to a **new normal**.' In their 'new normal' projected future, PIMCO predicts 'higher savings, lower consumption, and an economic growth rate that staggers forward to a new normal closer to 2 as opposed to 3 1/2%.' In another analysis, they note that 'for the next three to five years we expect a world of muted growth.' This slow economic recovery leads one PIMCO analyst to note: '… the first Fed rate hike? Call it no sooner than 2011.'

I especially like PIMCO's depiction of the wide-ranging actions by governments across the globe as 'the **economic equivalent of a drug trial** being applied to huge populations. There is a case for the medicine, yet there also remains considerable uncertainty about effectiveness, lags and side effects.' Investors have been the witness to economic history being made. Most investors, if given the choice, would prefer to witness the future.

The economic uncertainty going forward prevents me from recommending 'playing catch-up,' loading up on stocks now to make up for losses suffered in the past year. While I expect that stock levels will drift upward, I worry that the sharpest gains were provided in the past few months, and that future gains will be uneven. The eventual stock market recovery is partially dependent on investors concluding that it is safe enough to move their cash back into the markets, and these investors have clearly shown in the past year that they are anything but dependable. In this environment, I favor stubborn dedication to portfolio discipline—keeping long-term stock money in stocks and avoiding the temptation to time the markets. That said, there do appear to be sweet spots within bonds, and within stocks.

Bond Policy—I continue to find yields on treasury bonds to be too low to justify, yielding under 1% for 2-year notes. Corporate bonds with fairly high credit quality (A or better) appear to offer a good mix of security and yield. High-yield bonds offer compelling yields (often 10% or more), however I think that, like stocks, high-yield bonds' best returns have already been earned by investors in the 2nd quarter of 2009. Over time, I expect that they will do well. Multi-sector bond funds (aka strategic income funds) permit the manager to use both high yield and foreign bonds to complement high quality US bonds. This is notably more risky than a high quality corporate bond fund. I typically dedicate 80% of client bond money to the high quality core, and limit high yield, foreign, and multi-sector to 20% of bond money. Aggressive investors could consider boosting these higher-risk bonds to 30% of their overall bond allocation.

Stock Policy—This arena has seen incredible volatility in the past few months. The top three questions for each stock investor is what proportion to invest overseas, what proportion to invest in large companies, and what proportion to direct to value stocks (slower but typically more reliable growth rates than growth stocks, but with higher and typically more reliable dividends). **I prefer a value-bias at this time.** Ten years ago I directed 25% of clients' stocks to foreign stocks/funds. In the past five years I boosted this level to 33%. Due to a variety of macro-economic factors, I am now **boosting my target for this proportion of foreign stocks to 40%.** For many years I have maintained a 60-70% level of large companies, 20-30% mid-cap companies, and 10-20% small companies. I believe that this balance is appropriate at this time.

Inflation Hedges—Despite recent headlines, I share PIMCO's view that inflation is not today's concern, and likely it will be several years before this is a clear danger to investors. As such, I favor limiting total dedicated inflation hedges (commodity/natural resource/energy/real estate) investments to no more than 5% of a portfolio at this time.