

Market Review and Outlook—January 11, 2010

A Come From Behind Victory. The stock markets fell for the first ten weeks of 2009s investors, and yet had its 11th best overall year in half a century. A year ago we still seemed to be teetering on the edge of disaster, throwing trillions of dollars at the problems which appeared to be hopeless. Yet as the months went by, there were slivers of good news. Actually the best news in 2009 was often the lack of further bad news. By year end, it became clear that the economy was in the early stages of a recovery, and despite painful unemployment levels, investor confidence has returned, aided by tremendous profits to both bond and stock investors.

There were two significant positive surprises in 2009. Despite unemployment jumping to 10%, the consumer cut back less than 2% from peak levels. Furthermore, the consumer's cutbacks were generally the big-ticket items, automobiles and housing. This led to surprise #2, despite flat to falling sales figures, many US companies were able to post profits, during this Great Recession. They were able to do this through very aggressive layoffs, cancellation of capital expenditures (plant and equipment purchases and expansions), and through the benefit of much lower interest cost.

There were two less surprising developments. First, when you spend trillions of dollars, people notice. The unprecedented, in size and coordination, government stimulus across the globe brought the global financial system back from the brink, and limited the depth of the recession. Second, after feverishly selling every bond and stock in sight in 2008 and early 2009, investors' fears began to subside; many began to purchase substantial amounts of bonds in 2009.

With dollars from 'nervous investors' firmly withdrawn from stocks by March 2009, the (few) remaining investors could examine stock prices and correctly conclude that they were grossly undervalued. Thus began one of the sharpest stock market recoveries in recent memory.

While gold grabbed the 2009 headlines, gold funds' 51% gain in 2009 was less than half the gain of Latin America stock funds, badly lagged broader emerging markets stock funds, and barely outperformed junk bond funds.

The numbers below, all through 12/31/2009, show the incredible recovery we enjoyed in 2009, despite a very painful start. With two recessions, the entire decade was very weak. Turn the page to see what may lie ahead.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.02%	+0.32%	+2.52%	+2.81%	+2.67%
Intermediate Term Bond	+1.08%	+12.85%	+4.60%	+3.90%	+5.51%
Intermediate Muni Bond	-0.81%	+9.93%	+3.71%	+3.24%	+4.48%
Large-Cap Core Stock	+5.58%	+27.14%	-5.30%	+0.47%	-0.47%
Mid-Cap Core	+5.07%	+36.58%	-4.46%	+1.57%	+3.98%
Small-Cap Core	+4.54%	+31.90%	-5.66%	+0.65%	+5.86%
International Stock	+2.74%	+32.72%	-6.03%	+3.62%	+1.44%
Real Estate	+8.92%	+30.34%	-13.43%	-0.74%	+9.77%
Natural Resources	+5.78%	+40.47%	+0.37%	+9.95%	+10.06%
Science/Technology	+7.43%	+53.81%	-1.88%	+1.46%	-7.18%
Multi-Cap Growth	+6.34%	+38.16%	-3.07%	+1.61%	-1.91%
Multi-Cap Value	+4.51%	+29.00%	-7.65%	-0.35%	+3.56%
Balanced	+3.66%	+23.40%	-1.57%	+2.03%	+2.22%

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.

As I do each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 12, 2009, the MARKET REVIEW AND OUTLOOK suggested that in 2009 1) all broad stock categories would rise 10% or more, 2) growth and value would be within 2% of each other, 3) real estate would rise more than 6%, 4) both US and foreign bonds would produce 'normal' returns of 4-6%, and 6) high-yield bonds would outperform, rising 8% or more. I concluded the report with "Let's hope for the recovery to be well under way by the next January report, for stocks to do much better in '09." We can call that a home-run!

Remarkably, my 2009 predictions, which at the time appeared much too optimistic, instead proved to be much too conservative. Rather than rising 10% or more, stocks rose over 25%! Real Estate jumped over 30%, far above my '6% or more' call. Rather than rising 4-6%, most bonds rose 13% or so. Rather than rising 8% or more, high yield bonds rose over 46%. The tide not only turned in 2009, but a flood (of relative calm) followed, with a vengeance. I was correct in my five open-ended calls (rising X% or more), too conservative on my two bracketed calls (rising 4 to 6%), and far off on my value/growth call, as growth sharply outperformed value in 2009.

Sector	2009 Prediction	2009 Actual	2010 Prediction
Large-Cap US Stocks	Up 10% or more	+27.1%	Up 8% or more
Smaller US Stocks	Up 10% or more	+35.0%	Up 7% or more
Non-US Stocks	Up 10% or more	+32.7%	Up 7% or more
Growth vs Value	Within 2% of each other	Value +29.0% Growth +38.2%	Value outperforms, by more than 8%
Real Estate	Up 6% or more	+30.3%	Up 6% or more
General Bonds	Up 4 to 6%	+12.85%	Up no more than 4%
High-yield bonds	Up 8% or more	+46.4%	Up 6% or more
Non-US bonds	Up 4 to 6%	+18.8%	Up 4% or more

2010 Predictions—My primary theme for 2010 is for a continuation of an upward stock market. This is based on three major factors. First, 75% or so of the federal economic stimulus has yet to be spent, and throughout 2010 this will provide strong economic growth. Second, there are still trillions of investors' dollars 'on the sidelines.' When investors tire of near-zero returns from their money markets, and wish for the gains that stocks have been providing, their purchases will help push stock prices higher. Finally, US firms have incredibly maintained most of their profitability during the Great Recession, through aggressive cost cutting. If they can be profitable in a shrinking economy, just think what they can do in a growing/recovering economy! Profit growth in 2010 is expected to be explosive.

There was a 'dash to cash' in 2008, as panicked investors fled to Treasuries and money markets. In 2009 there was a 'rush to junk,' as smaller companies and growth (technology) companies enjoyed some of the strongest flows of money. In 2010 I expect 'back to basics,' a moderation of sorts in which investors rediscover 'normal stocks.' I expect strong relative gains in 2010 from large companies, and more stable (value) companies, those that lagged a bit in 2009. I continue to expect stronger gains beyond the US than at home, that investors in foreign stocks will be well rewarded.

Bonds require caution. The pendulum swings faster for bonds, and intermediate- to long-term bond funds' 2009 gains of 14% or more are almost certain to reverse in 2010. Bond investors who do not shorten the term of their investments are running a high risk of losses in 2010. I expect that foreign and high yield bonds will outperform US bonds.

2010 Gameplan—If you haven't already, consider getting your allocation to stocks up to target levels, at least over a few months if not right away. Don't chase yesterday's winners, but build a traditional balance of large and small, US and foreign. Shorten bond maturities, and consider some foreign and high yield bonds to complement your high quality holdings. Most importantly, manage your portfolio based on your gameplan, not based on daily headlines.

This optimism does not ignore the significant challenges we face. 10% unemployment, crippling federal and state budget deficits, and a toxic environment in Washington DC and in the media top the list. I expect that the US and global economies will grow well in 2010, and that this will serve to reduce each of these critical concerns. 2009 showed us that an improving economy makes the world brighter. I am hopeful that this will continue throughout 2010.