

Market Review and Outlook—April 9, 2010

The recovery train keeps chugging along. Despite a slow start, stocks posted a good first quarter. US stocks outpaced foreign stocks. Some of this was due to concerns with Greece and other weak European markets, which in turn led to a rising US dollar. Stocks globally rose in price, as the economy continued to show signs of strengthening. Listed below, stocks' one-year figures could be the best you will ever see, as they represent the first year after hitting a severe, panic-driven low point. In this column we'll explore whether the bounce is finished.

What's the worst economic news of the past quarter? Greece's government has been in danger of defaulting on its debt. Let's put this in proper perspective. Greece makes up less than 0.5% of the world's economy. What's the best economic news of the past quarter? You've got several choices. I think that the end of US monthly job losses is the top story, with a close second place earned by significant earnings gains in corporate America.

During the past quarter, investors added a slight amount (\$2.4B) of new cash to US stock funds, while adding \$24B to foreign stocks, and \$91B to bond funds. Value stocks have recently become more popular, partially due to recovering fortunes of financial firms—'the reports of my death have been greatly exaggerated.' Due somewhat to the tremendous assistance of the US taxpayer, most 'too big to fail' financial firms have risen from the ashes in recent months.

Despite exceptional returns during the worst of the economic crisis, gold funds fell during the quarter, and are up only 34% in the past year, far less than most figures in the table below. Counter to the hype, gold serves best as a modest (small position) diversifier, not as an all-weather foundation to an investment portfolio.

Bond returns have been strong over the past year. Much of their gains, however, is due to investors' desire to gingerly return to investing, first to bonds, and later (in the future) to stocks. This tailwind for bonds will shift to a headwind fairly soon, as interest rates rise and as investors shift more new money (and some existing bond money) into stocks. This should feed on itself and intensify. **Investors should consider paring back their exposure to bonds**, avoid long-term bonds, and also consider the use of foreign bonds, high-yield bonds, and floating-rate bonds (such as are held by 'bank loan funds'). These last two types of bond funds should hold up well in a strengthening economy that is accompanied by rising interest rates and strengthening corporate balance sheets.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.12%	+2.13%	+2.73%	+2.54%
Intermediate Term Bond	+2.43%	+16.76%	+4.81%	+4.48%	+5.60%
Intermediate Muni Bond	+0.97%	+8.85%	+3.87%	+3.76%	+4.57%
Large-Cap Core Stock	+5.07%	+50.08%	-4.35%	+1.82%	+0.21%
Mid-Cap Core	+7.78%	+62.63%	-3.59%	+3.21%	+3.94%
Small-Cap Core	+8.18%	+65.42%	-4.30%	+2.78%	+6.10%
International Stock	+1.28%	+53.26%	-6.84%	+3.92%	+0.54%
Real Estate	+9.33%	+104.91%	-11.46%	+2.47%	+10.56%
Natural Resources	+1.34%	+56.38%	+0.77%	+10.12%	+13.32%
Science/Technology	+2.67%	+55.00%	-1.65%	+3.80%	-8.41%
Multi-Cap Growth	+4.88%	+52.07%	-2.07%	+3.66%	-2.77%
Multi-Cap Value	+6.43%	+56.02%	-6.27%	+1.12%	+3.81%
Balanced	+3.70%	+35.63%	-0.77%	+3.10%	+2.38%

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.

The next year should bring continued glad tidings. The Conference Board's index of Leading Economic Indices (LEI) has been rising EVERY month for the past year. The index of 'coincident' leading indicators has also been rising, for nine straight months. They describe the US economy as moving 'from recovery to early phases of an expansion.'

Over 60% of the \$787B economic stimulus money has not yet been spent. This will help the economy in the coming few quarters. Companies' profits are strong and growing. This is also quite favorable for the coming quarters. Both individual and institutional investors have large amounts of money on the sidelines. While this is favorable for stocks, the timing of this positive factor is quite uncertain (how long with such investors remain spooked by the markets?).

The Fed has stopped propping up the mortgage market, and in the coming quarters will gradually sell their inventory of mortgage bonds back to investors. This is based on their judgment that this sector no longer requires 'life support.' Similarly, the Fed should within a year permit the Fed interest rate to begin to rise, also based on their judgment that (by then) the US economy no longer requires the current level of 'life support.' **These changes are mixed blessings**—there will be less external assistance, but this is due to the economy's improving condition.

Corporate America is doing pretty well. Many industries (with the notable exceptions of the auto, housing, and finance sectors) were able to withstand the Great Recession with little harm. Some US companies managed to grow their profits even as revenues were falling a bit. I noted in the past that this is a significant sign of strength. Revenues are now rising, broadly across the economy. As a result, corporate profits are growing at a healthy clip.

What can US companies do with their profits, and how does this affect stock investors? They can buy other companies (which boosts those companies' stock prices), they can boost their own dividends (boosting your profits), they can purchase plants and equipment (boosting sales at other companies, and hopefully enabling them to become more profitable in the future), they can hire more employees (cutting unemployment numbers and boosting tax revenues), and they can simply build up their cash reserves (making them more secure the next time the economy weakens). Of course they will end up doing some of all of these actions. **EACH STEP IS POSITIVE**, and many will help rebuild consumer confidence, which strengthens the US economy in a self-fulfilling manner.

It is early in this economic recovery. While this recovery will likely not be as steep as most, it should last several years, as most do. S&P 500 companies' earnings are currently 29% below 2007's peak levels, and the S&P index is still 21% below its peak. Typically earnings will reach their pre-crisis levels, and then rise further (after taking one step backward, we eventually take two or three forward). This is the reason that, despite the strong one-year performance figures, **stocks appear fairly priced at this time.** Partly due to the miniscule yields on alternatives (money markets and bonds), stocks remain attractive.

Investors who sold stocks in the past three years likely missed out on quite a recovery rally, but that is water under the bridge. **Stocks, both in the US and abroad, continue to offer compelling value for a few years.** Investors who hold fewer stocks than is normal for them should develop a plan to quickly build up their stocks to target levels.

Foreign stocks appear to offer a special opportunity at this time, due to the strong US dollar's current strength which is tied to the high level of fear over Greece. The Greece crisis will eventually pass, and global investors will shift their concern to the US government's deficit spending. That should drive the US dollar back downward, and reward US investors already who hold appropriate levels of foreign stocks.

Emerging market stocks have slowed from their earlier, torrid pace, but remain very strong. They deserve to 'take a breather,' offering investors a chance to build up their allocations at more reasonable prices. Note that many foreign companies have substantial sales to emerging markets, which is another reason to build up foreign stocks.

I don't expect **inflation** will be troublesome for several years (I am giving a presentation on this topic on June 9th). I do, however, expect bond yields to rise in the coming years, and as such am avoiding long-term bonds while simultaneously maintaining a healthy amount of short-term bonds, which I expect to shift to intermediate-term bonds when yields rise.

In this environment, I favor building stocks up to normal levels (if not higher), favoring foreign stocks, being defensive with high quality bonds, while selectively utilizing high-yield bonds, foreign bonds, and bank-loan funds. Use the past crisis to help you identify how much stocks is right for you (how much you can stomach), and **get to that level!**