Market Review and Outlook—October 8, 2010

The stock market recovery train is back on course—for now. After falling in May and June, both US and foreign stocks recovered in July, fell in August, but rose very strongly in September, and are continuing to rise. As the table below shows, stocks ended the 3rd calendar quarter up more than 10%. The quarter was most notable by what didn't happen. No European government defaulted, the US economy did not fall into a double-dip recession or begin to suffer deflation. What did happen? The oil spill in the gulf was capped. 632,000 more civilian jobs were created during the quarter. The recession was officially declared over, a year ago, in June 2009.

What can we expect? The US and other major developed economies are expected to provide positive, but very muted, growth in the coming year or two. Governments are largely tapped out (and that is putting it gently), and consumers are trying to rebuild their reserves, which were devastated by the stock and real estate market collapse of the past three years. Corporations, while financially able to grow/expand/spend/hire, are intentionally proceeding slowly until their customers show stronger signs of recovering.

While no one feels that we are firmly recovering, most of us do feel that our circumstances are not getting worse. That is the likely path that this US economic recovery will follow—very gradual, but most often in a positive direction.

The Alternatives Still Stink—Investors have only a limited number of choices; cash, bonds, stocks, real estate are the most common choices. Cash provides close to zero income. Bonds in the coming years will likely lose money when interest rates rise. Few investors are willing to buy real estate, for fear that we are still far from a bottom, given that foreclosures don't appear to be slowing. Desiderius Erasmus, a Dutch philosopher, wrote '*In the land of the blind, the one-eyed man is king*.' When alternatives stink, like now, stocks look pretty compelling. A slow growth recovery isn't that bad at all for stocks—it is much better than a boom/bust cycle.

Bonds should be managed very carefully, playing both sides: using intermediate-term bonds to obtain higher yields while rates stay low, but using shorter-term bonds, high-yield bonds, and floating-rate bonds to benefit when the economy is more solid and rates rise, and foreign bonds to protect against a dollar that weakens due to continued large budget deficits. My stock strategy follows on the next page.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.04%	+1.35%	+2.51%	+2.26%
Intermediate Term Bond	+3.29%	+10.03%	+6.52%	+5.41%	+5.85%
Intermediate Muni Bond	+3.07%	+5.04%	+5.23%	+4.34%	+4.76%
Large-Cap Core Stock	+11.13%	+8.88%	-7.22%	+0.41%	+0.18%
Mid-Cap Core	+11.81%	+13.80%	-4.72%	+1.66%	+3.58%
Small-Cap Core	+10.93%	+13.56%	-4.61%	+1.11%	+5.56%
International Stock	+17.06%	+5.55%	-9.42%	+2.22%	+1.98%
Real Estate	+12.88%	+29.38%	-6.60%	+1.01%	+9.16%
Natural Resources	+15.09%	+7.49%	-6.36%	+5.29%	+12.63%
Science/Technology	+15.47%	+15.74%	-2.33%	+4.18%	-6.63%
Multi-Cap Growth	+13.14%	+12.68%	-5.84%	+1.78%	
Multi-Cap Value	+10.89%	+9.13%	-8.26%	-0.60%	
Balanced	+8.18%	+9.35%	-1.28%	+2.78%	

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 Sorry State of the US—We have a lot of problems here in the US: a very large budget deficit, future problems in Social Security, Medicare, Medicaid, uncertainty about healthcare costs, Congress, income tax rates, estate taxes, energy policy, the list goes on. When will we get certainty in these important areas? Don't hold your breath.

Prepare to live with uncertainty. The past two years have shown us that, under current Senate rules, legislation can be stopped by only 40 Senators. We haven't had fewer than 40 Senators from either party for 30 years. If the past two years is any indication, don't expect much 'work across the aisle.' Therefore, don't expect much to happen in DC for many years to come. And that's not entirely a bad thing.

Gridlock can be your friend. A friend of mine who teaches political science at Villanova University told me years ago that our Founding Fathers essentially built gridlock into the design of our government, to prevent major changes while the country is fairly evenly divided. Certainly the country has become more partisan, and less compromising in the past several years. I expect that there will be no major laws passed for years to come.

This is bad in several ways. The longer that we fail to address long-term challenges such as Social Security and Medicare, the more painful the fix will be. Inaction is poor policy—permitting the estate tax exemption to return to $1 million for 2011 is only marginally worse than permitting estate taxes to be totally waived, as they are this year.

There is a silver lining here. Investors benefit from certainty, certainty in future tax rates, certainty in future energy policy. Businesses benefit from certainty, certainty in business tax rates, tax credits, tax deductions, certainty in depreciation schedules, in taxation of foreign profits. While we don't have certainty, lack of major laws passing will at least prevent additional causes of uncertainty.

Ronan Carr from Morgan Stanley notes "We are overweight equities as we believe the market is too pessimistic on economic and profit growth." This really needs to be stressed. Investors are investing in companies, and companies are in far better shape than individuals (and consumers). Many companies maintained their profits during the Great Recession, through draconian layoffs and shutdowns. If they can maintain their profits when the economy falls off a cliff, they can certainly soar when the economy moves haltingly upward.

That said, stocks have enjoyed a very strong quarter, so investors should examine their portfolios and likely trim their stock exposure back to long-term levels.

For this reason I see no reason for investors to cut back their long-term allocations to stocks. With a gain of over 10% in the past year in their stocks, investors should in most cases cut back their current allocation, but not their allocation targets. Disciplined rebalancing in 2010 brought stock sales in April, stock purchases in July, and stock sales in October, locking in 'buy low sell high' benefits.

I prefer large US stocks to smaller ones, but not by much. Large companies benefit from greater access to global markets (including ones that are growing at a higher rate than the US), although they are hurt by greater global competition. Compared with smaller companies, large companies generally have stronger finances and greater access to financing (from bank loans, and issuing bonds and shares of stock). It is also more common to have higher dividend yields from larger companies than smaller ones, and higher dividends serve to smooth out the very bumpy ride provided by stocks.

The consensus opinion is that growth stocks will outperform value. As companies are so mindful of profits in the absence of consumers, the story goes, they will rely on technology to cost-effectively boost production (without hiring). Furthermore, with the possible expiration of the 'qualified dividend' income tax feature, investors will have less reason to favor high-yielding stocks. I, as usual, take an opposite view. I believe that at some point this growth-advantage will have been fully priced into stocks, and we may already be at that point. Even if you are early to prefer value stocks (if you favor value stocks before the growth-advantage is fully reflected in stock prices), in the meantime you are enjoying superior cash flow from the higher dividends.

I continue to favor a 60/40 US/foreign global balance to stocks. The global map of economic growth is far from uniform. Many portions of Europe are expected to grow even slower than in the US. The fiscally-strapped Mediterranean countries are in even worse shape. However there are areas of much higher expected growth, including much of Asia and South America. In this environment, our middle-of-the-road guideline stands. Perhaps boring, but appropriate.