Market Review and Outlook—January 10, 2011

Back from the Brink—Year Two. While it was a very bumpy ride, 2010 brought a second consecutive year of strong recoveries for stock markets. In a rare turnabout, US stocks (or at least smaller US stocks) outperformed foreign stocks. Mid cap and small-cap stocks earned over 20%, outperforming even emerging markets. Gold continued to glitter, but in 2010 these funds 'only earned 43.6%.' Real estate funds continued to rebound, gaining over 27%, while across the country the residential real estate market, at best, has finally reached a bottom.

This has come despite many challenges. Greece hit the wall financially in the Spring, and Ireland in the Fall, and Italy, Portugal, and Spain continue to cause worries that their days of crisis are approaching. This has restrained the European stock markets, as has the short-term impact of the austerity measures that the UK and some of the European countries have adopted. The US suffered a major oil spill in the Gulf in April and a 'Flash Crash' in early May, shaking the faith that many have held in our markets' computerized foundations. The US budget deficit has grown, as has the anxiety over its trajectory. This raised concerns of a double-dip recession over the Summer. The November elections brought a split Congress—voters have chosen to slow down legislative changes for the next two years, which is understandable given the brisk pace of changes in 2010 (with both a major health-care reform law and also a major financial reform law—designed to reduce the risk of another US-led global financial crisis).

The year ended with the US stock markets rising sharply, confirming that they favor an end to uncertainty. As the November election results came in, and as the lame duck Congress passed a substantial tax law in December, uncertainty fell and US stocks leapt, by double digits.

Bonds have been whipsawed by opposing forces. Generally bond returns move in the opposite direction of the economy. As the US economy continued its weak recovery in 2010, bond returns came down to earth (back to the single digits). Municipal bonds suffered more than most, as the weak economy threatens a few notable states, and investors worry about defaults more than interest income. The positive force for bonds comes from the Fed, which has been using newly printed money to purchase bonds (Treasury and mortgages) in a strategy called 'quantitative easing' (QE). QE is designed to keep borrowing costs for both individuals and companies low, to help encourage the economy.

The figures below, through year-end, demonstrate the good year investors enjoyed, with stocks far outpacing bonds.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.04%	+0.97%	+2.37%	+2.12%
Intermediate Term Bond	-0.94%	+7.72%	+5.51%	+5.18%	+5.34%
Intermediate Muni Bond	-3.24%	+2.13%	+3.47%	+3.38%	+3.79%
Large-Cap Core Stock	+10.41%	+12.94%	-3.23%	+1.93%	+1.34%
Mid-Cap Core	+13.35%	+22.87%	+0.43%	+4.04%	+5.46%
Small-Cap Core	+15.59%	+25.22%	+2.04%	+4.08%	+7.32%
International Stock	+7.35%	+10.74%	-6.47%	+2.89%	+3.81%
Real Estate	+7.02%	+27.60%	-0.22%	+1.91%	+9.64%
Natural Resources	+21.16%	+21.30%	-4.86%	+5.78%	+9.14%
Science/Technology	+12.02%	+19.87%	+0.14%	+4.29%	-2.48%
Multi-Cap Growth	+11.97%	+18.62%	-1.92%	+3.46%	+1.20%
Multi-Cap Value	+10.98%	+16.15%	-2.85%	+1.38%	+3.89%
Balanced	+6.15%	+11.81%	+0.22%	+3.41%	+3.21%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.

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 11, 2010, the MARKET REVIEW AND OUTLOOK forecasted that 2010 would bring a continued stock market recovery. Specifically, I expected that 1) all broad stock categories would rise 7% or more, 2) value would outperform growth handily, 3) real estate would rise more than 6%, 4) foreign bonds would outperform US bonds, and 6) high-yield bonds would outperform, rising 6% or more. I concluded the report with the call that the economy would continue to improve throughout 2010. Most of these calls came to pass.

My 2010 predictions were largely accurate, but as usual, there were some significant surprises. Indeed all three major stock categories rose 7% or more, with smaller US stocks knocking the ball out of the park. Value failed to outperform growth. Real estate not only gained more than 6%, it gained more than 26%! Foreign bonds barely outperformed US bonds, which is incredible, given the European government troubles. High yield bonds also fared much better than I expected, gaining over 14%. I was correct in six of the seven open-ended calls (rising X% or more), but I failed to foresee US bonds' solid year. I was wrong on my value/growth call, as growth modestly outperformed value in 2010.

Sector	2010 Prediction	2010 Actual	2011 Prediction
Large-Cap US Stocks	Up 8% or more	+12.9%	Up 8% or more
Smaller US Stocks	Up 7% or more	+23.7%	Up 5% or more
Non-US Stocks	Up 7% or more	+10.7%	Up 8% or more
Growth vs Value	Value outperforms, by more than 8%	Value +16.2% Growth +18.6%	Value outperforms Growth
Real Estate	Up 6% or more	+27.6%	Up 6% or more
General Bonds	Up no more than 4%	+7.7%	Up no more than 4%
High-yield bonds	Up 6% or more	+14.2%	Up 6% or more
Non-US bonds	Up 4% or more	+8.0%	Up 5% or more

2011 Predictions—My primary theme for 2011 is for more of the same from stocks. This is based on three major factors. First, the US economy has been recovering for 18 months, and this should continue in 2011. Second, while investors have been pulling money out of stock funds for four years, the real risk of losses in bonds in 2011 and beyond, coupled with two years of strong stock market gains, could convince many investors to shift significant dollars from their bonds to stocks. This results in stocks appearing to be undervalued, certainly in light of high current bond prices. Finally, US firms remain very strong, with more cash than anytime in the past decade, with profit margins comfortably above normal levels, and with very low labor costs.

With the Fed and Congress providing significant liquidity, I don't expect bond prices to crash, however returns from high quality bonds are likely to disappoint in 2011. Municipal bond investors' fears should continue to rise in 2011, unless the economy kicks into high gear, which isn't likely. Steady improvement from our economy should aid high yield and bank loan bond funds. The US dollar is likely to weaken in 2011, partially due to the austerity measures that some of our trading partners have been taking, while we continue to spend freely. Foreign bond funds should fare well.

2011 Gameplan—If 2010 was any indicator, 2011 will bring us both ups and downs. These provide investors with opportunities to buy on fear and sell on euphoria. Set a target level for your portfolio's stocks. When stocks jump, sell some, especially of the hot areas. Then when markets drop, take some of that cash and buy back stocks while they are 'on sale.' This worked quite well in 2010, and should serve you well in 2011.

As I stated last January, "Don't chase yesterday's winners, but build a traditional balance of large and small, US and foreign." Hedge your bets with bonds—prepare for both rising and falling interest rates. The piper will have to be paid for the Fed's and Congress' spending, however it will likely be more than a year from now. Use caution on municipal bonds, and consider boosting your foreign and high yield bonds.

We face wide-ranging scenarios—a consumer-driven double-dip recession, or an economic recovery stronger than currently expected (with rising rates and inflation). While emerging markets have enjoyed solid growth, their gains in the past two years warrant caution going forward. Things look good in 2011 for stocks, but avoid overconfidence.