Market Review and Outlook—March 8, 2011

The Stock Market Rebound Keeps on Ticking. The US stock market has marched upward since the end of August, with only two breathers, in late November and late February. The three month gains in the table below are remarkable—every stock category rose more than +10%. The one year figures are +20% or more, and even most three-year stock figures begin with plus signs, despite the worst financial crisis since the Great Depression. Calm investors who avoided selling in 2008 and 2009 have benefited handsomely in the past two years.

Bonds Suffered. The figures below fail to reflect the sharp drop in bonds from early November through mid-December, as efforts by the Fed to stimulate the economy caused bond investors to ratchet up their worries about imminent inflation. February brought renewed worries for municipal bond investors that not only rising rates, but also rising bankruptcies for municipalities are on the horizon. In the past three months, as bonds fared poorly, at least they had the decency to do so while stocks were doing well.

Overpriced Bonds and Underpriced Stocks. Three years from now I expect the US and the global economy to be (much) stronger than it is now, as unemployment is worked down. I also expect bond yields to be higher three years from now. If this indeed occurs, stocks should outperform bonds nicely over the next three years, albeit with a very bumpy ride likely.

Bonds Strategy. With bonds, we are living in the present, but preparing for the future. This means that we continue to use intermediate-term bonds until the rise of interest rates appears more imminent. We are also preparing for two coming storms, a weakening US dollar and rising interest rates, and choosing specialized bond funds to benefit from these two future trends. Finally, while the economy is strengthening, we are using more economically-sensitive bonds such as high yield bond funds.

Stock Strategy. Diversify, diversify. Mallard's broken record continues. Smaller US stocks have done very, very well compared with foreign and with large US stocks in the past (choose the time, 3 months, 3 years, 10 years, whatever). As such, we favor cutting back winners and sealing in profits, and redeploying dollars to stock areas which have been less appreciated.

Rebalance. Regardless, the top job for investors is to diversify the entire portfolio. When stocks finish a year up 20-30%, it is likely that many investors (those who had not abandoned stocks in 2008/2009) need to cut back their stocks. They can set the gains aside for a rainy day, the next time that stocks fall for a few weeks or months, and buy low. Volatility is here to stay. Ensure that you plan to work with it, rather than against it.

Category	3 Months	Past Year	3-Year Avg	5 Year Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.04%	+0.74%	+2.25%	+2.02%
Intermediate Term Bond	+0.16%	+6.47%	+5.39%	+5.30%	+5.20%
Intermediate Muni Bond	-0.67%	+1.59%	+4.57%	+3.49%	+3.93%
Large-Cap Core Stock	+12.22%	+20.92%	+1.55%	+2.38%	+2.66%
Mid-Cap Core	+13.34%	+28.40%	+5.06%	+4.13%	+6.68%
Small-Cap Core	+13.49%	+31.10%	+6.92%	+3.45%	+7.78%
International Stock	+11.95%	+20.63%	-2.70%	+2.26%	+4.31%
Real Estate	+12.26%	+36.70%	+3.79%	+1.72%	+10.59%
Natural Resources	+16.01%	+30.07%	-0.07%	+9.04%	+14.75%
Technology	+12.71%	+33.14%	+10.24%	+6.21%	+1.34%
Moderate Allocation	+7.72%	+15.88%	+3.07%	+3.66%	+3.95%

The data in this table comes from Morningstar, and is as of February 28, 2011