Market Review and Outlook—April 12, 2011

Markets Look Beyond Crises in Japan, Northern Africa, and the Mid-East On March 11th Japan was hit with the worst earthquake to strike the country in recorded history. Deaths top 12,000, and could rise above 20,000. Over 100,000 buildings have been damaged or destroyed, and three nuclear energy plants suffered explosions, and this crisis has not yet been resolved. In addition, dramatic political unrest has come to Tunisia, Egypt, Libya, and several Mid-East countries. Libya's government response has been a harsh crackdown, which has led the UN to intervene. Portugese government is in jeopardy of going bankrupt. Oil prices leapt 19% and gasoline jumped 18%. Gold rose 1.3%, setting another all-time nominal (not inflation-adjusted) record close.

What has been the stock markets' response? In the past quarter, stock markets have risen from 3 to 8%. How is this possible? The phrase popularized by the 1992 presidential campaign of Bill Clinton provides the answer: "It's the economy, stupid." Despite these global crises, global economic indicators have continued to strengthen over the past quarter. The US has seen 200,000 or more new private sector jobs each month, and unemployment has fallen below 9%. Core inflation is running just above 1%, while annual US economic growth has risen to over 3%. Companies have strong balance sheets, are maintaining healthy profit margins, and are boosting their earnings.

After a difficult 4th quarter, especially in municipals, bonds stabilized in the 1st quarter. The news in the bond world was no news—no state or city bankruptcies, no notable corporate troubles. Investors added money to bond funds throughout the quarter, drawing down their money market balances (which were providing zero returns), although they primarily added to their corporate/treasury bond funds, not much going to municipal bond funds.

Value stocks (finally) outperformed growth stocks in the past quarter. Ever since the financial and housing meltdown growth has run circles around value. At some point investors will appreciate the strong dividends that value stocks offer. Similarly, mid-caps and small-caps have been outperforming large US stocks for five straight quarters, leaving large US stocks appearing undervalued. Finally, US stocks have been outperforming foreign stocks for most of the past year (due to both the European sovereign debt crisis and the strong US stimulus). This, too, should reverse in time.

The following figures, through 3/31/2011, show solid progress on our global recovery.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.04%	+0.64%	+2.19%	+1.97%
Intermediate Term Bond	+0.98%	+6.16%	+5.63%	+5.50%	+5.15%
Intermediate Muni Bond	+0.54%	+1.84%	+3.73%	+3.56%	+3.82%
Large-Cap Core Stock	+5.61%	+14.52%	+1.98%	+2.13%	+3.28%
Mid-Cap Core	+7.94%	+22.72%	+6.42%	+3.98%	+7.61%
Small-Cap Core	+7.92%	+25.29%	+8.02%	+3.12%	+8.50%
International Stock	+2.99%	+12.12%	-2.74%	+1.32%	+5.01%
Real Estate	+6.07%	+23.22%	+1.49%	+0.49%	+10.42%
Natural Resources	+7.64%	+25.82%	+1.48%	+8.10%	+15.36%
Science/Technology	+5.96%	+23.21%	+10.24%	+5.54%	+2.88%
Multi-Cap Growth	+6.29%	+20.39%	+4.88%	+3.59%	+4.01%
Multi-Cap Value	+6.90%	+16.07%	+2.65%	+1.65%	+5.09%
Balanced	+3.78%	+11.91%	+3.49%	+3.51%	+4.18%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.
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Bond Investors, Beware Almost every investor holds bonds, perhaps for income, for stability. With the Great Recession, bond investors have seen their income plummet. Money markets pay close to zero, Treasury bonds yield less than 4% for a ten-year treasury, 10-year TIPS, Treasury inflation bonds, yield less than 1% plus inflation, and municipal bonds yield 3.5% for a ten-year bond amid worries about states and municipalities balancing their budgets. And it is going to get worse for bond investors.

JP Morgan reviewed returns over the past forty years, in four environments: high and rising inflation, high and falling inflation, low and falling inflation, and low and rising inflation. We seem to clearly be entering the last environment, with current inflation very low, but with investors recognizing that the piper must be paid, and that inflation and bond interest rates will rise, and as bond interest rates rise, their prices will fall. This environment in the past has brought the worst results for bonds, both on an absolute basis, and relative to stocks and relative to commodities. **The lesson for bond investors is clear. Beware.**

We approach this challenge in two ways. We manage clients' bonds for this environment, and we favor stocks in this environment.

How to manage bonds in a rising rate/rising inflation environment? There are a few ways. The easiest is to play defense, to shorten maturities, by emphasizing short-term bond funds. This should result in smaller (if any) losses than intermediate– and long-term bonds/bond funds. When to shorten maturities is an open question, since if you do so too soon, you will earn less income (versus intermediate– and long-term bonds) while you wait for rates to rise. We have been doing so gradually, so that by the time that rising rates appear imminent, most of our high quality bonds will be invested short term.

<u>The second approach is to go on the offense</u>. Rates rise and inflation rises when an economy is expanding. There are some bonds which are more economically sensitive, whose prices should hold up well in strengthening economic times. These include high-yield bonds. A second offensive approach is to use floating-rate bonds. Like adjustable-rate mortgages, floating rate bonds have their interest rate rise as bond interest rates rise. This prevents the normal price decline that fixed-rate bonds suffer when market interest rates rise. These are typically fairly low-quality bonds, and thus they are NOT an all-weather approach. They should, however, fare pretty well in a growing economy, even as bond interest rates and inflation are increasing.

Academically, inflation-linked bonds (such as TIPS) should be an investment-of-choice in a rising rate/inflation environment. The difficulty this time is that prices on TIPS are absurdly high and yields are extremely low, limiting the upside of this approach. This is also the case with normal Treasury bonds, and EE and I bonds.

If inflation is worse in the US than abroad, due to excessive deficit spending by our federal government, then another approach to consider is to own foreign bonds—corporate and government bonds from outside the US, typically denominated in a currency other than the dollar. In this manner, as US inflation rises the US dollar weakens, which provides a boost to the value of your non-US bonds.

Investors can take a short-cut, and use a 'multi-sector bond fund.' These funds charge the manager with making the decisions of how much to invest in US bonds, high quality, low quality, short-term, intermediate term, along with foreign bonds (both high and low quality, short and long). In environments of a growing economy, and rising inflation and interest rates, this approach could well pay off.

Given the coming economic environment, <u>you may wish to shift a bit from your bonds to your stocks</u>. Bonds have had their yields fall and prices rise for twenty years. Ten year treasury yields have fallen from 15.8% to 3.5% during those twenty years. This cannot continue, and bonds are in for regular headwinds. Within your stocks, I favor the out-of-favor areas—large US stocks, value stocks, and foreign stocks. What can I say? I like bargains, and lower relative prices produce tailwinds for future returns.

We have made it through a very challenging decade, and the years ahead appear to continue to challenge investors. The best approach is to plan ahead, and to stick to that plan. Be intentional with your bond/stock balance, and have a plan for managing your investments in the likely coming environment of a growing economy, rising inflation, and rising interest rates.