Prepared Comments from 4/15/2011 Conference Call

My last conference call was on January 20th. US stocks have since gained 3%. The 1st quarter brought gains of 5 to 8% for US stocks, foreign stocks rose about 3%, and bonds managed gains of ½ to 1%. These positive results came despite several geo-political events—an earthquake and tsunami in Japan, and anti-government waves in Northern Africa and the Mid-East. To me this shows that the strong economic news has been compelling.

The Fed continues to stimulate the economy—its bond purchases continue to climb, however this is expected to reverse by mid-year. The federal government passed legislation in December which is quite stimulative to the economy. The proof is in the pudding—real GDP has been growing for six consecutive quarters, and unemployment has fallen 1% to 8.8%, as 200,000 private sector jobs have been created monthly for two quarters. We are clearly not out of the woods, however daylight beckons.

Car sales are rising but remain well below normal levels. Housing starts remain at basement levels, and median housing prices continue to decline—we have yet to find the bottom of the housing market. With housing prices low and mortgage rates low, affordability is high. Anecdotally, prospective buyers have the income to qualify, but due to the evaporation of homeowners' home equity, prospective buyers (upgraders) cannot find the required downpayment. This cycle has yet to turn.

US companies remain well situated, with plenty of cash in the bank, healthy profit margins, and the ability to hire whenever the need is clear. In the meantime, dividends and stock buybacks are increasing.

Inflation (excluding food and energy) remains well under control, rising 0.1% in March, and only 1.2% in the past year. Energy, however, has been jumping, rising 3.5% in March, and 15.5% in the past year (led by over a 27% one-year gain in gas prices, and 34% rise in fuel oil prices).

As I noted in January, it is likely that the earnings for the S&P 500 companies in 2011 will exceed their highwater mark from early 2007. Yet the S&P 500 stands 16% below its 2007 peak level.

Just today the University of Michigan's Index of Consumer Sentiment was released, and it rose 3% since last month, but remains well below its 2007 levels.

The Conference Board's Leading Economic Index has not yet been released for March, but the prior three months were all increases. The US economic recovery appears to be solid, even though it is not brisk, it is moving forward steadily.

Globally, Europe continues to be concerned with the fragility of some of the fringe country's sovereign debt, with Portugal the top current concern, while also concerned with the proper approach to handling their diverse economies, with economic stimulation, or austerity. The challenge is that some countries clearly need stimulation, while others need austerity. How will the EuroZone handle this dichotomy?

Emerging markets should rarely be lumped together. Generally they are seeing rising inflation, both from food and energy prices. Their respective central banks are beginning to put on the brakes, raising their version of Fed rates.

Stocks had a good 1st quarter. US stocks again outperformed foreign stocks, and smaller US stocks outperformed larger ones. In a surprise emerging markets stocks underperformed those from developed markets. I suspect that foreign stocks will regain the lead as investors recognize that there are higher growth rates outside the US. I also suspect that investors will recognize that large US stocks are notably less expensive than smaller US stocks. When these turn of events occur is anyone's guess.

Bonds are a significant challenge from this point forward. Inflation and interest rates are generally accepted to be rising in the coming quarters, and that is a prescription for losses to bond investors. The average investor appears to be firmly in denial, as they continue to boost their bond fund holdings. At least they are reducing their mountain of money market balances, which are earning near zero percent.

Municipal bonds brought significant heartache to investors in the past six months. It appears that the fear is now considered to have been overblown—risk are not zero, but they also don't appear to be significant. Most state and local governments are now operating in the black, largely due to significant layoffs, and also to stronger recent revenues.

Investor's lack of appetite for stocks, coupled with the economic recovery thus far, has resulted in what appears to be attractive valuations for stocks, despite their near 100% gain in the past two years. As mentioned earlier, I favor larger US stocks, and I favor foreign stocks, the most unloved in the past two years.

Earlier this week I prepared my 2011 Market Review and Outlook.

I offer caution to bond investors. The coming quarters should be quite difficult for them. Have a plan for protecting them during future periods of rising rates.

We continue to recommend directing 35% of bond money to 'opportunity bonds.' This 35% is spread amongst high yield (aka junk) bonds, bank loan/floating rate bonds, multisector bonds, and foreign bonds. We are emphasizing foreign stocks and large US stocks, and de-emphasizing smaller US stocks. This strategy helps us sleep better at night.