Market Review and Outlook—June 6, 2011

The Economic Recovery has Stumbled. In May (and so far this month), the US economy has shown a mixed set of strengths and weaknesses. In the prior year or two its recovery has been fairly steady, and so this has disappointed investors. Investors shifted from stocks to bonds therefore, and thus stock gains year-to-date fell back one to three percent in May, while bond investors saw their gains jump. Globally, continued uncertainty over the aftermath of the Japanese earthquake and tsunami, over the democratic challenges to governments in the Arab world, and over the continuing financial trouble in the European fringe countries (Greece, Spain, Portugal, etc), has resulted in reduced expectations for global growth. This has resulted in recent losses in not only stocks, but also in the price of gold and precious metals, and oil and other natural resources.

Tipping Points. There are several factors that have been weak recently. If they continue to disappoint, then our economic recovery's future is in jeopardy. If the weakness is replaced by the strength we have come to expect over the past year, then there is much less reason to worry. The Conference Board maintains a Leading Economic Index (LEI), which it reported last month had fallen in April for the first time in almost a year. By itself this is not worrisome; if it continues, it is a serious problem. While the country is producing jobs, too few jobs were gained in May to bring down unemployment, another worrisome factor if it continues.

The Greater Risk. It appears that the global recovery will resume, which will lead to rising interest rates, energy prices, and inflation. In this environment, stocks should outperform bonds, by a sizeable amount. Unfortunately, to benefit from this scenario, investors will have to bear the high level of volatility that has become the standard in the past several years. Hold on tight!

Bonds Strategy. With bonds, we continue to invest for today and for tomorrow. We are shortening the maturity of our bonds, to protect against losses from rising rates in the future. We are using high-yield bonds, foreign (unhedged) bonds, and floating-rate bonds (bank loan bond funds) to protect against losses from rising rates, and other bonds that should fare better than most bonds should the economy indeed resume its recovery.

Stock Strategy. The chart below shows that mid-cap and small-cap US stocks have been outperforming large US and foreign stocks. As contrarians, we see opportunity in the weaker areas, and we favor cutting back on the outperforming mid- and small-cap US stocks, and boosting large US and foreign stocks at this time.

Rebalance. In choppy times such as these, there are always opportunities to rebalance, to buy low/sell high. Sticking to a rebalancing plan such as this is the most critical during uncertain times.

Category	3 Months	Past Year	3-Year Avg	5 Year Avg	10-Yr Avg
Taxable Money Market	+0.01%	+0.03%	+0.38%	+1.92%	+1.81%
Intermediate Term Bond	+2.47%	+7.40%	+6.63%	+6.08%	+5.39%
Intermediate Muni Bond	+2.53%	+3.07%	+4.32%	+4.05%	+4.14%
Large-Cap Core Stock	+1.84%	+25.04%	+0.36%	+2.86%	+2.64%
Mid-Cap Core	+3.22%	+29.59%	+3.28%	+4.86%	+6.74%
Small-Cap Core	+3.02%	+29.41%	+5.25%	+4.08%	+7.50%
International Stock	+1.90%	+31.21%	-3.93%	+1.89%	+4.95%
Real Estate	+5.31%	+30.06%	+2.01%	+3.25%	+10.64%
Natural Resources	-1.02%	+35.86%	-4.07%	+7.02%	+13.45%
Technology	+0.62%	+31.70%	+6.49%	+7.91%	+2.12%
Moderate Allocation	+2.06%	+18.96%	+2.71%	+4.19%	+4.08%

The data in this table comes from Morningstar, and is as of May 31, 2011