Market Review and Outlook—July 6, 2011

A Well-Deserved Breather, or a Turning Point? The table below shows that US stocks fell, while foreign stocks posted a modest gain, and bond funds rose during the 2nd quarter. Natural resource (energy) funds fell over 5%, while real estate funds returned almost 3.5%. One of the strongest areas was municipal bonds, which three months ago were weak on concerns of city and state bankruptcies which haven't thus far come to pass. The table's figures further show that stocks are still up 30-40% over the past year, and so they have 'earned' a break—a three month pull back of less than 2% is by itself not of concern. The real concern is whether the weak quarter is just that, or is this the start of something bigger, a falling stock market that results from upcoming economic backsliding/double dip recession.

Several specific challenges troubled the stock markets in the past quarter. The after-effects of the Japanese earthquake/tsunami, including in the global supply chain, are being felt this Spring, but will these effects subside and be replaced with the beneficial economic impact of the recovery efforts in Japan this summer? In Europe the periphery countries (Portugal, Italy, Ireland, Greece, and Spain) continue to haunt markets. The current consensus is that Greece will 'fail,' but that it may not be alone. Further, what exactly a Greek failure entails is not clear—will it lead to 'domino effects?' Finally, the US is approaching high noon on our federal 'debt ceiling,' and what will occur, and what its ramifications will be, are also unknown. These areas of uncertainty worried both bond and stock investors.

There are reasons behind the up-and-down quarterly results. As states have laid off workers (slowing the recovery in jobs), they have strengthened their finances, leading to higher confidence in municipal bonds over the quarter, and higher prices. High growth economies in the emerging markets have addressed their inflation pressures by raising interest rates. This has brought down oil prices, and with oil prices, natural resource funds have fallen. A further result is that confidence in foreign economic growth has recovered, enabling foreign stock funds to post fine quarterly gain.

In the US, however, the economic tea leaves are mixed. Unemployment remains stubbornly high. Housing remains weak—with no bottoming yet apparent. Residential mortgage delinquency rates are high, but are coming down. Average consumer credit scores are at a high point since at least 1999. US corporations are quite healthy.

This year mutual fund investors continued reducing their hefty money market balances, primarily boosting their bond fund holdings. Unlike last year, investors are beginning to boost their US stocks, yet they still prefer foreign stocks.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Cash	+0.01%	+0.12%	+0.27%	+1.74%	+1.92%
Intermediate Term Bond	+1.84%	+5.33%	+6.69%	+5.99%	+5.30%
Intermediate Muni Bond	+3.07%	+3.34%	+4.79%	+4.21%	+4.10%
Large-Cap Stock	-0.19%	+29.68%	+2.60%	+2.49%	+2.68%
Mid-Cap Stock	-0.77%	+35.49%	+5.12%	+4.41%	+6.57%
Small-Cap Stock	-1.52%	+36.82%	+7.35%	+3.72%	+6.97%
Foreign Large-Cap Stock	+1.18%	+30.80%	-1.65%	+1.70%	+5.14%
Real Estate	+3.47%	+32.51%	+4.77%	+1.59%	+9.65%
Natural Resources	-5.19%	+39.33%	-4.84%	+6.32%	+14.09%
Science/Technology	-1.94%	+35.03%	+8.73%	+7.40%	+1.78%
US Growth	+0.74%	+36.04%	+3.36%	+4.68%	+0.74%
US Value	-0.60%	+31.61%	+3.85%	+1.27%	+4.63%
Conservative Allocation	+0.95%	+14.45%	+4.96%	+4.42%	+4.33%

The data in this table comes from Morningstar and the Wall Street Journal's Quarterly Fund Analysis Markets Data Center.
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Uncertainty reigns—Will the US economy grow or shrink, will the dollar jump or crash, will interest rates leap or tumble? What are good steps for investors to take when surrounded by uncertainty? Good first steps are to separate the possible from the probable, and to separate the eventual from the imminent.

While a run on the US dollar is possible, it is **not** probable. What **is** probable is for the US dollar weakening versus other global currencies. Investors can prepare for this by holding foreign stocks and foreign bonds (which are not hedged back to the US dollar), and by holding US stocks that export a lot, as their products/services will become cheaper to their customers as the dollar falls.

While rising inflation is probable, it does **not** appear imminent, and therefore you likely have time to build your defense. Stocks and commodities (such as natural resource funds) typically do quite well when inflation rises, as do real estate stocks/funds. There are TIPS, treasury bonds with interest rates tied to inflation, however their prices are very high now, removing most of the appeal. For instance, a 5-year TIPS bond currently returns inflation LESS one-half percent a year.

Interest rates will rise, but again, **not imminently**. As long as our economy is growing slowly (or drifting), the Fed is expected to keep overnight rates near zero. The Fed will likely gradually sell off the $2 trillion in bonds they have purchased over the past three years before they sharply boost the overnight rates. These sales should be **very** gradual, and should lead to gently rising longer-term interest rates. For this reason, investors should seriously consider avoiding long-term bonds, and sticking to short– and intermediate-term bonds.

The US economy should continue to plod ahead. Most (non-financial) US companies emerged from the meltdown lean and mean, and can weather a long, gradual recovery quite well. Their bank accounts are overflowing, and cheap labor abounds. They are boosting their dividends, their share buybacks, their capital expenditures, and their merger activity, all of which benefits stock investors. Another investment that should (continue to) benefit from our slow US economic recovery is junk bonds. Investors earn returns from both the coupon of a junk bond, and also from the company's credit quality improvement/deterioration. As a rising tide lifts all boats, an economic recovery helps companies, both strong and weak. Thus a growing economy enables weak companies with junk bonds to better meet the bond interest payments, while reducing the risk of the company going bankrupt, both of which serve to boost the price of their bonds.

It **is** probable that there will be a government default in Europe. How limited or widespread the impact it/they will cause is not known. If the impact is significant, this could include countries dropping the Euro, and the Euro Zone could even disband. If so, this would likely lead to a sharp increase in the US dollar, but a decline in US (and global) economic growth and inflation. High quality US bonds should fare well, while US and foreign stocks should fall in value. This potential fallout is the reason that European authorities will strive to limit the impact, by offering more bailouts.

There are 'black swan' risks—quite unlikely, but severe in their impact should they occur. These risks include (yet another) war, for instance with Iran or North Korea, another global financial meltdown, a double-dip recession, or a deflationary spiral. It is these risks that lead me to temper my observation that the alternatives to stocks stink. Cash pays near zero, and bonds not only yield very low levels of interest, but they also run a very real risk of price declines when interest rates rise. Stocks on the other hand have very strong balance sheets, growing profits, and an inherent advantage in (the most likely) economic growth path we appear to be following. What keeps me from recommending 'backing up the truck' and loading up on stocks, more than clients' long-term target level, is the need to protect against the black swan risks. In these unlikely scenarios, cash and bonds should earn their keep.

When you take a flight, before you leave the gate the attendants go through the safety drill, showing you how to use your safety belts, life vests, air masks, and escape ramps/rafts. Then the flight proceeds to your destination. You could hug the seat cushion to your chest the entire flight, but that is most likely overkill. Investors should also periodically be reminded that emergencies are possible, reviewing what preparations can and have been made, but then can return to focusing on the probable. The media's attention to severe possibilities do **not** make them more likely.

Save the Dates

*Mallard is hosting a **wine tasting on Tuesday, August 23rd** from 5-7pm, at Deerfield Fine Wines in Newark.*
Please call the office at 302-737-4546 if you plan to attend, so that we can have enough refreshments.

*Mallard is hosting a **15th anniversary gala on Saturday, November 19th** from 7-10pm,*
at the Unitarian Universalist Fellowship of Newark. Invitations will be sent closer to the event.