Market Review and Outlook—October 8, 2011

The Sky is Falling—Or at Least it Feels That Way! The table below shows that stock markets fell very hard in the past quarter. It was worse than any quarter during the dot.com meltdown, and only a little better than the end of 2008, during the global financial meltdown. The past three months witnessed a highly dysfunctional US Congress, the downgrading of US debt by a major credit agency, growing concerns of the US economy falling back into recession, and a significant worsening of the European sovereign debt crisis. As a result, consumer confidence has plummeted, and investors have 'rushed to the exits.'

There are painfully few bright spots. Cash and bonds did serve their necessary roles of providing a safe haven during tumultuous times. These are the only three categories without three-month losses in the table below. Nothing else was spared; even 'conservative allocation' funds (with about 60% in stocks and 40% in cash/bonds) suffered a harsh 6% decline. Pure stock funds fared worse, much worse.

Losses were led by natural resource stock funds, which fell over 24%. As fears grew of the US economy stalling, Europe appeared at the doorstep of a recession, and slowed economic growth even in emerging markets, demand for energy and other natural resources fell. Smaller US and foreign stocks were not far behind, falling over 20%. The five-year column is littered with losses for most stock categories. Investors were not the only ones panicking, consumers joined in. Consumer confidence, which has remained exceptionally low throughout the past four years, plummeted during the quarter.

We "Raised the Firewall" on September 22nd to acknowledge that investors appear to be in a panic mode. While this holds, anything is possible, making investment decisions much, much more difficult.

Higher quality stocks fell less than lower quality ones, and higher quality bonds also fared better. Growth and small stocks fell hard, as did foreign stocks, especially emerging markets stocks. Investors ran for the exits, and shed the most economically-sensitive stocks first. For bond investors, this meant that treasury bond funds fared quite well, and low quality (including high yield corporate bond funds) suffered losses of 3% or so. Global investors flocked to the US, and the dollar rose, producing losses for foreign bond funds (and worsening results for foreign stock funds).

JP Morgan's chief market strategist Dr. David Kelly summed up the third quarter of 2011 as follows: "I sure am glad that it's over." Amen. However, here we are—what should we do next?

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.02%	+0.43%	+1.96%	+2.04%
Intermediate Term Bond	+1.55%	+3.53%	+8.56%	+5.63%	+5.10%
Intermediate Muni Bond	+2.45%	+2.79%	+6.53%	+4.17%	+4.14%
Large-Cap Stock	-15.84%	-1.79%	+0.29%	-1.81%	+2.56%
Mid-Cap Stock	-20.41%	-3.41%	+1.91%	-0.41%	+6.11%
Small-Cap Stock	-21.77%	-3.70%	+0.61%	-1.12%	+6.18%
Foreign Large-Cap Stock	-20.90%	-11.64%	-1.79%	-3.65%	+4.42%
Real Estate	-14.94%	-0.12%	-1.34%	-3.21%	+8.22%
Natural Resources	-24.11%	-8.42%	-1.55%	+1.69%	+12.50%
Science/Technology	-16.18%	-2.28%	+8.27%	+2.76%	+4.89%
Conservative Allocation	-5.99%	+0.74%	+5.24%	+2.53%	+4.14%

The data in this table comes from Morningstar and is as of September 30, 2011.
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There are very serious problems we are facing, with the European debt crisis and the US debt/deficit crisis near the top of the list. As a result, stock prices have fallen sharply/painfully, 'predicting' both European and US recessions in the next year. The two most likely scenarios are that these recessions occur, or they do not. If they do occur, well, stocks already reflect this—these recessions are already priced into the stock markets. The question for stock investors is not what will happen in the next year, but in the year after. If a recession (in the US, in Europe) comes up in the next year, the following year should bring some recovery, which clearly is NOT reflected in current stock prices.

What if we don't get these two expected recessions? What if only one (European) occurs, or even if neither occur? Stand back. This could lift the veil from investors' eyes, enabling them to see that over $10 billion are invested in money markets losing 1.7% annually to inflation, that bond prices are so high that a buyer of a 10-year Treasury is earning less than inflation, and that US stocks earn more, relative to bonds, than they have in fifty years. For me this appears to be literally a once in a lifetime opportunity.

There are solutions to the fiscal problems in the US and Europe. Unfortunately, those in charge of European appear resolutely unwilling to adopt good policies, and instead have promoted a wide range of attempts, from bad to worse. Eighteen months ago Greece was the only country whose debt was in question. Now there are at least four other troubled countries, including Italy and Spain whose size makes the risk significant. Delaying a fix has negative repercussions. There is a bit of Catch-22 going on, as delay boosts the price tag of a 'fix,' which extends the delay.

There is some (well-concealed) good news. Believe it or not, the circus in Congress this summer did improve our fiscal picture. Our 'debt path' has moved away from the cliff. The path isn't good, but it is not as bad as it was earlier this year. Further good news in the US is that our corporations and individuals have been far more responsible, saving like crazy, and are therefore fairly well prepared for both good and bad times.

This coming holiday season US consumers will be watching their pennies, avoiding the purchase of high-priced items , and buying most items only when on sale. This makes sense. Today's investors can choose to follow this advice, or to do the opposite. Bond prices have risen steadily since 1981, as yields of US treasuries have fallen from 14% to 2%. I have no idea when, but this thirty-year tailwind for bond investors will reverse, and today's bond investors will get hurt. Conversely, stocks appear to offer a 'blue light special,' with valuations cheaper than we have seen in twenty-years.

Firewall Implications—With the firewall up, we await a return to sanity for investors, as there is no way to predict how long this panic will last. In the meantime, we maintain four 'holding pens' within our clients' portfolios—cash, quality bonds, opportunity bonds, and stocks. Investors should consider the same groupings, and should be deliberate with the management of each pen, as just as critically, the shift of money between the pens.

Cash brings safety from loss, but with yields near zero, money markets are guaranteed to lose purchasing power. As such, most investors should avoid large cash balances.

Quality bonds offer an unappealing combination of high prices and low yields. This is particularly true for government bonds. While investors are nervous, this could continue, however in time bond prices will fall and yields rise. Today's investors should be very intentional about the maturities of their bonds—longer-term bonds should fall more in price. Making the decision that much harder is that short-term bond yields are very low, encouraging investors to accept interest rate risk by lengthening their maturities. Proceed carefully!

On a historical basis, stocks look cheap, both in the US and abroad, in both large and small companies, in both developed and emerging economies. Globally stock markets yield more than their country's government bonds. The question for investors is whether the current panic will grow, driving stock prices down further. No one knows when the panic will end. Some investors consider the high current dividend yield offered by stocks to be sufficient incentive to hold onto (or even boost) their stock holdings.

Investors **should** be extremely reluctant to move money from stocks to quality bonds (or worse, to cash). In the short run this will reduce volatility, but it will both immediately cut your portfolio income, and will also prevent your portfolio from recovering as other investors' panic subsides. Very bad economic news through 2012 is already priced into today's stocks. Similarly, stock prices bottomed in March 2009, far before the economy brightened—all of the coming months' bad news was priced in. That is how stock markets work. **What have you learned from 2008-2009?**