Market Review and Outlook—April 5, 2012

What a difference six months brings! Yesterday's fears are behind us, or so it seems. The US economy is moving steadily upward, with progress in almost every area other than housing. The European sovereign debt crisis has seen historic measures by the stronger European countries, and the ECB, European Central Bank. As the US did three years ago, Europe appears to have taken several steps back from the edge of the cliff. While there are serious concerns with Iran and its nuclear weapons program, the global community is largely working together to identify an acceptable path. The challenges have not disappeared, but they appear much better contained.

As fears wane, markets rise, and rise they did. The past quarter brought a broad market advance; the table below shows that all four major stock measures gained about 12%—it almost didn't matter how you spread your stocks during the quarter. Actually, sector funds did have a wide spread—technology funds leapt over 20%, while precious metals funds fell almost 2%. While foreign stocks did well, they remain underwater for the past year due to the combination of Europe's troubles and a slowdown in emerging markets' economies.

Bond investors became more comfortable with risk, as high-yield bonds returned over 5%, more than three times as much as intermediate-term bond funds. Government bond funds barely broke even as their yields rose. This 'return to reason' is long overdue, and has much more room to continue.

Most investors remain stuck in a 'cash is great, bonds are good, stocks are bad' mentality that has drastically limited their returns over the past three years. Two and a half years into the US economic recovery, investors continue to put more new dollars into bond funds than stock funds. Americans boosted their cash holdings a mammoth 30% from 2007 to 2009, to $9.9 trillion, and in the past three years, incredibly, they have **maintained** that level, despite earning less than 1/2% annually on their cash. That $9.9 trillion in cash is guaranteed to lose value each year, after inflation.

Investors following Mallard's firewall approach, however, have benefited handsomely by holding onto their stocks during this difficult time. JP Morgan Fund's chief market strategist Dr. David Kelly notes that "*Having proper asset allocation is like having homeowners insurance. You don't know ahead of time when you need it—it is best to always have it*."

The past quarter was rational—zero returns for cash, low returns for quality bonds (but nice returns for bonds with more risk), and great returns for stocks. **Balanced investors earned as much in the past quarter as they would in a 'normal' year.** While it may be tempting to cash out and get back in at the end of 2012, moves like that are most often regretted.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.13%	+1.46%	+1.93%
Intermediate Term Bond	+1.59%	+6.55%	+9.76%	+5.67%	+5.39%
Intermediate Muni Bond	+1.23%	+9.56%	+6.88%	+4.61%	+4.50%
Large-Cap Stock	+12.48%	+5.09%	+21.97%	+1.14%	+3.75%
Mid-Cap Stock	+12.51%	+0.17%	+25.87%	+1.97%	+6.58%
Small-Cap Stock	+12.29%	-0.32%	+27.42%	+1.89%	+6.57%
Foreign Large-Cap Stock	+11.85%	-6.47%	+17.09%	-3.06%	+5.16%
Real Estate	+10.51%	+11.91%	+41.75%	-0.67%	+9.53%
Natural Resources	+6.41%	-14.35%	+19.67%	+2.14%	+11.56%
Technology	+20.81%	+5.43%	+27.54%	+6.46%	+4.98%
Moderate Allocation	+8.09%	+3.82%	+16.74%	+2.60%	+4.72%

The data in this table comes from Morningstar and is as of March 31, 2012.
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What is Going Well? The US economy is doing well, in all areas other than housing. In a sense, it is good that it is not doing great, or even uniformly well, for this leaves much room for further improvements, and it reduces the risk of a slowdown (the dreaded double-dip recession). The economy is doing well since corporations and individuals are doing well (not great, but well). Both corporations and individuals have boosted their cash positions, and thus are able to make more purchases in the future, giving the economy plenty of room for further growth.

Despite incredible three-year gains, stocks remain underpriced. When compared with alternatives (Buffet's currency-based investments and his 'produces nothing' investments such as gold), productive investments such as stocks are very attractive. Investors have the choice of a rising income stream (dividends) from a likely rising investment (stocks) versus a flat income stream (interest income) from a likely falling investment (bonds). Yet in only three of the past forty-eight months have investors bought more stock funds than bond funds! The more investors prefer bonds over stocks, the more compelling stocks have become.

The Federal Reserve Bank (the Fed) has thus far avoided significant mistakes. They recognize their responsibility to remove the punch bowl before the party gets out of hand. They have provided massive liquidity to the financial system. This has enabled consumers to build their cash, by refinancing their mortgages. This has freed the federal government to run record deficits without causing spiking interest payments (which can cause a vicious cycle—just ask Greece). The Fed is regularly considering when, and at what pace, to back out their asset purchases. Some analysts feel that their current 'zero interest rate policy' is causing more harm than good, as it signals the Fed's view that the US economy remains in 'critical care,' and that permitting rates to rise a bit could be viewed as a vote of confidence by the Fed.

What is Worrisome? The US debt and budget deficit remains a serious concern. We are not, however, at a critical phase, such as Greece has reached, and other European countries have neared. My larger concern is not that we aren't doing anything about it, but rather what we are about to do is too much, too soon. The federal government in August passed automatic cuts that begin next January, which is also the time that several current stimulus programs end. We are on track to cut the deficit from the 7.6% of our country's economy (GDP) to 3.8%. That is much too much to occur all at once, to an economy that is only growing modestly. We need a 'glide-path,' not a cliff. Unfortunately, a better approach will require that the federal government works **together** to avoid that cliff, by year-end. Hopefully, they will be better behaved than last summer, although it is foolish to expect strong progress during an election year.

Europe is still in the thick of it. While much progress was made in the past quarter, the path ahead is long and torturous. They have structural problems that are unique to Euroland—they have a common monetary system (currency) but individual fiscal systems (government taxing/spending). This limits their ability to respond to crises. This is coupled with the current situation, with low/negative economic growth and budget deficits. In the US, we responded in 2008-2010 with government (deficit) spending to grow our economy. Europe lacks a single government to lead a program of economic stimulus.

The 'de-coupled' monetary/fiscal systems in Europe lead to a second disadvantage. When economies slow and deficits rise, currencies typically fall. This can lead to growing exports, which lead to higher taxes and a reduction in deficits. However, in Europe, the higher exports and taxes are not uniform, across all countries. Some European countries are seeing higher exports and taxes, while others are not. Often those that enjoy higher exports and taxes are not the ones with the more worrisome deficits. While much progress has been made in recent months, the EQU, European Quasi-Union, has big challenges ahead of it.

Economies in the emerging markets are slowing down. Often this is by design, orchestrated by the government and central bank to avoid unchecked growth. Unlike the US and Europe, these countries have plenty of room to re-stimulate their economies if their slowdown proves too sharp. Emerging markets have been a bright spot for years; this should continue.

Oil prices have risen sharply in the past few months with the tensions with Iran. Most scenarios are priced into oil, including the total stoppage of Iranian oil production. OPEC production **without** Iran is more than enough for current global demand. The biggest concern is that Iranian troubles escalate and lead to the closing of the Strait of Hormuz to oil traffic. While unlikely, if this occurs, concerted global action will be required.

At this time, we have both opportunities and concerns. This is the hallmark of a healthy market. Keep holding on.