Market Review and Outlook—July 3, 2012

Three steps forward, one back. After the first calendar quarter brought double-digit gains for most stocks, the past quarter saw some of that gain disappear. This was tied to slowing economies in emerging markets, including China, growing expectations of a recession for Europe, and continuing dramas in the European sovereign debt crisis, now in its third year.

The debt crisis continued in the headlines, leading up to Greece's June elections. There were fears that a new political party would win, and call for an abandonment of the Euro and its debts. These fears were put to rest by the voters, who instead selected a more 'mainstream' party, dedicated to working through their problems. Spain made headlines as the security of some of its banks came into question, leading to rising interest rates in Spain, and further concerns over 'contagion.'

In the US, economic growth slowed but has remained positive. Concerns heightened during the quarter over the impact on the US economic recovery from slowing foreign economies. A silver lining is that the global concerns have led to a fairly sharp decline in oil and gasoline prices. **Our economic recovery has been described as a draft horse**—slow and steady, never going to win a race, but also hard to push off the path.

Market analysts have begun using the phrase '**risk on**' to describe times when investors are feeling more comfortable increasing the risk in their portfolios—boosting their high-yield bonds and their stocks, for instance. The first calendar quarter was a 'risk-on' period. 'Risk off' describes the opposite, and can be used to describe the past quarter as a whole (although April was flat, May was bad (clearly 'risk off'), and June brought a partial recovery). Investors are definitely behaving in a love/hate manner—one day loving stocks and the next hating them.

In the past quarter, the greatest losses came from precious metals (which have fallen almost 25% in the past year), natural resources, and energy-heavy Latin American stocks, each of which fell 10% or more. Long-term government bonds did the best in the quarter; however, investors need to realize that they are playing with firecrackers here—careless investors are poised to lose limbs in long-term government bonds, which are at dizzyingly high prices and low yields. This is the subject of our *Bond Buyer Beware* article in the current quarterly ***Mallard Flyer*** newsletter.

Investors' continued risk-on/risk-off behavior, while emotionally frustrating to long-term investors, provides clear benefits. It provides opportunities to earn incremental profits through **regular rebalancing**, trimming some profits here, adding assets at cheap prices there (providing for future profits). This is an especially good time to revisit your portfolios, and see if there are any areas that need shoring up—likely those showing up in red, below.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.02%	+0.07%	+1.21%	+1.89%
Intermediate Term Bond	+1.80%	+6.55%	+8.31%	+6.20%	+5.29%
Intermediate Muni Bond	+1.54%	+7.82%	+6.64%	+5.06%	+4.30%
Large-Cap Stock	-4.17%	+0.97%	+14.20%	-0.94%	+4.67%
Mid-Cap Stock	-5.49%	-5.09%	+15.93%	-0.75%	+6.76%
Small-Cap Stock	-4.91%	-3.71%	+17.17%	-0.40%	+6.61%
Foreign Large-Cap Stock	-6.68%	-13.92%	+6.43%	-5.65%	+4.75%
Real Estate	+3.35%	+11.72%	+31.44%	+1.85%	+9.39%
Natural Resources	-10.24%	-18.92%	+8.16%	-2.76%	+10.17%
Technology	-8.95%	-2.11%	+15.92%	+2.70%	+7.40%
Moderate Allocation	-2.26%	+0.84%	+11.28%	+1.34%	+5.23%

The data in this table comes from Morningstar and is as of June 30, 2012.
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The US economy continues to chug along, although at a very low pace. It is unlikely that investor confidence will be able to 'break out' and rise much while we have **two major questions** facing us—what will November's elections bring, and how will our federal government handle the year-end 'fiscal cliff.' The cliff refers to the impact of many stimulus measures passed under Presidents Bush and Obama terminating on December 31st. If nothing is done, these expirations will almost certainly drive the US into a recession next year. This danger is so clear that most analysts expect that Congress and the President will take positive action prior to year-end, to avoid the cliff.

This action needs to be taken this year, **before** the newly elected Congresspersons are installed; it is expected to be accomplished by the current Congress, in lame-duck sessions. While the current Congress has shown its inability to work across party lines, analysts expect that the price of inaction is too great, much greater than the price of last summer's delayed action on the debt-ceiling issue, and that Congress will in fact make necessary adjustments by year-end.

Picture a snake that eats an egg. The egg slowly moves from head to tail as the snake digests the egg. In 2008 and 2009, investors ate an egg—they took most of their stocks, and much of their bonds, and placed them into money markets. In the past three years, they have gradually shifted their cash into bonds, moving the egg down the body from the mouth. This has led to bonds' high three-year trailing returns, high prices, and low yields. In time, much of this money will gradually be shifted from bonds into stocks. As that unfolds, bond prices will decline and stock prices will rise. How long will this take? No one knows, but it is likely to take years, perhaps five or more just to reach 'normal levels.'

Emerging Market Stocks Foreign Stocks Smaller US Stocks Large US Stocks High Yield Bonds Corporate Bonds Gov't Bonds Money Market

Starting in 2009, investors have feverishly added money to bonds—hundreds of billions of dollars each year. How will they most likely begin the move into stocks? Investors are likely to begin with shares of large US companies, with well-known names, and those with solid and growing dividends. In time, they will become comfortable with US growth stocks and smaller US companies. If Europe has begun to get its fiscal house in order by then, foreign stocks and emerging markets stocks will be the final phase. Note that this should produce a '**virtuous cycle**.' As investors shift money from bonds to stocks, bond returns will begin to fall, and stock returns will begin to rise. This should lead to investors increasing their willingness to rebuild their stock positions, and stock outperformance over bonds should increase.

While recent quarters have seen a fairly even balance of 'risk-on' and 'risk-off' periods, in the coming years we should see more 'risk on' quarters and fewer 'risk off' ones. My fingers are crossed.

Within stocks, prices seem low/cheap, both compared with historical levels and compared with current bond prices. As such, we like both US and foreign stocks, both large and small companies, in both developed and emerging markets. We expect that, as the snake-eating-the-egg analogy indicates, large US value stocks will come into sustained favor before large US growth stocks and smaller US stocks, which should each come into sustained favor before foreign stocks, both developed and emerging.

At this time, we think that investors should **aim to hold more stocks than normal, and fewer bonds than normal**. To smooth results, investors may prefer to hold more in large US stocks than in smaller US and in foreign stocks.

Bonds are overpriced; however, **investors can be smart about their bonds**. Investors should avoid long-term bonds, especially long-term government bonds. Since interest rates are expected to remain low for two or more years, we like both short-term and intermediate-term corporate and municipal bonds. In the higher-risk arena, we especially like high-yield bonds and other credit-sensitive types of bonds.

While it does not feel good at the time, **investors are rewarded for being 'early'**—selling before others do and buying before others do. As our proverbial snake is in the bond-digesting mode, we know that large US stock-digesting should be next, and that smaller US stock and foreign stock digesting should follow. Buying cheap stocks 'too early' is generally not as bad as it seems. Most often, including the present time, when you buy cheap stocks well before others do, you are earning an attractive dividend yield while patiently awaiting others to recognize the value that you already recognize. Successful investing is aided through identifying risk and value in advance, and acting accordingly.