Market Review and Outlook—October 3, 2012

What a difference a quarter makes! Three months ago investors worried about Spain and Greece departing the Euro, China's slowdown infecting global markets, and the US failing to address the fiscal cliff. Two out of three isn't bad—Europe's problems haven't worsened in the past quarter, and China's slowdown appears to be somewhat under control. Congress, however, hasn't budged on preventing a recession next year which will result from their continued inaction. In fact, the soonest they will begin to address it is after the November 6th elections, in a lame duck session.

In the US, while the federal lawmakers fail to act, corporations continue to operate profitably, and consumers continue to show signs of health. Car sales are recovering nicely in the past few years, housing starts have been steadily rising, as the 'inventory' of houses on the market has sharply fallen to a much more normal level. Consumer sentiment, while below normal levels, is up sharply from the depths of the 2008-2009 crisis, and the depths of last summer's levels tied to the debt ceiling debacle. The most significant headwinds for consumers are the stubbornly high level of delinquent home mortgages, and the similarly stubbornly high unemployment rate.

Overseas, Europe continues to stay a step or two ahead of disaster. Most European government bond yields have fallen nicely this year, as investors appear to increasingly believe that the Euro will continue to muddle its way forward. China has brought its inflation down from about 7% to 2%, while economic growth is expected to come in around 7%, quite an enviable level.

During the past quarter, most bonds returned 2-3%, and most stocks 4-6%. Precious Metal funds were phoenix-like: they leapt almost 23% during the quarter, and yet remain underwater in the past year. The chart below shows that investors have had a terrific year. Furthermore, the ten year column shows 'typical' long-term stock and bond results, with bonds 4-6% annually, and stocks 7-10%, despite the past ten years being anything but typical.

Despite the ever-present Fiscal Cliff worries, investors were well rewarded for taking on risk this past quarter. Investors who have kept their stock allocation during this difficult time may find that they need to pare back their stocks. Most investors, who had let their stock levels fall to lower-than-normal levels may do well to just let the quarter's gains remain, to enable the market help them rebuild their stock levels.

We remain very concerned with whether and how Washington DC will address the Fiscal Cliff in November and December. In the past quarter the market has acted as though it is confident that this bullet will ultimately be dodged.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.02%	+0.04%	+0.95%	+1.85%
Intermediate Term Bond	+2.54%	+7.70%	+7.13%	+6.30%	+5.22%
Intermediate Muni Bond	+2.08%	+7.25%	+5.20%	+5.17%	+4.08%
Large-Cap Stock	+6.08%	+27.08%	+10.89%	-0.03%	+7.32%
Mid-Cap Stock	+5.33%	+26.14%	+11.28%	+0.83%	+9.26%
Small-Cap Stock	+5.38%	+29.92%	+12.50%	+1.46%	+9.50%
Foreign Large-Cap Stock	+6.61%	+16.02%	+2.68%	-5.09%	+7.76%
Real Estate	+0.61%	+31.89%	+19.74%	+1.64%	+10.48%
Natural Resources	+9.35%	+16.42%	+5.61%	-2.32%	+13.34%
Technology	+4.67%	+22.36%	+11.53%	+2.31%	+11.17%
Moderate Allocation	+4.57%	+17.84%	+8.72%	+1.92%	+6.84%

The data in this table comes from Morningstar and is as of September 30, 2012.
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Reverse Chinese Water Torture—I use this phrase to describe the gradual improvement of a situation. The US economy has recovered in a **very** moderate pace. We have recovered barely 50% of jobs lost in 2008 and 2009. While we have had twelve straight quarters of economic growth in the US, tell that to our unemployed workers! In this environment, it is very challenging to feel good about 'keeping the faith' in stock investing.

Yet investing requires uncertainty, storm clouds, and dangers. That was recently reinforced in 2008 and early 2009. This was reinforced by the Great Depression, World War II, the Cuban Missile Crisis, the OPEC Oil Crisis, the 1987 Stock Market Crash, the Dot-Com Crash, 9-11, the Great Recession of 2008-2009, and the European Sovereign Debt Crisis. Yet economies survive, recover, and eventually grow beyond them. Furthermore, the most direct manner to harness economies' long-term growth, is through stocks, shares of the companies that make up the economy.

My current newsletter article discusses the challenge of predicting stock markets, given the combination of economic and emotional forces on stock prices. Yet it also stresses that over time the economic forces prevail.

In our best broken-record mantra, **we recommend that investors adopt a solid, preferably written, commitment to a long-term allocation to global stocks**. The rest of the portfolio is best invested in cash and bonds. Proper diversification calls for an intentional and well-informed balance amongst the stocks and amongst the bonds. The most critical factor, though, is this long-term commitment to a set level of stocks.

Look at that 10-year column on the chart on the other page. Who wouldn't be satisfied with those stock results, especially given the sub-2% annual returns from cash? What will you do now, to help you to resist the temptation to sell stocks when they next fall? Trust me, when stocks next fall, you will hear a host of reasons, not only for their decline, but for further declines. You are very likely going to need reassurance. What will you do today to help yourself tomorrow?

The biggest uncertainty before us is the Fiscal Cliff. The results of the national elections appear to be coming into focus, and it is very likely that neither party will control BOTH Congress and the White House. Therefore, no dramatic legislation is likely to pass in the next two years. This is due to the gridlock that our Founding Fathers built into the Constitution. That same gridlock, however, will be a hindrance to addressing the Fiscal Cliff. **The markets are indicating that Congress and the President will skirt the Fiscal Cliff**, that some compromise will be struck that neither side particularly likes, but that both sides hate the least, and most importantly, prevent the US from entering a recession in January. I expect that this will be clear by December 31st, or at least by January 31st.

I further expect Europe to continue to take half-measures to avert disaster—this is their clear preference. Time is a friend. As Asia stabilizes, its growth can help European economies, as can our continued modest economic recovery.

While there is significant risk of investor fear rising, and stocks falling, **there is a growing possibility of investor confidence rising**, with an accompanying boost to stock levels. The October reports which investors receive will be extremely positive, and at some point investors may 'cry uncle,' and rebuild their stock levels. This will most likely occur gradually, however it could occur in periodic leaps. Or perhaps this is just wishful thinking.

Let me close by sharing what we wrote in this newsletter in October 2008, as that fiscal abyss loomed:

There are several positive factors on the horizon. *In less than a month, investors will know who will be the next President, and will be able to plan for the likely direction in public spending (which industries will benefit and which will not) and in the direction of income taxes. The Fed, the US Treasury, Congress, and foreign central banks and governments have taken significant steps to help the global financial industry recover from the crippling impact of the housing industry meltdown and subprime crisis. These steps take time to produce visible progress, but progress will come. IBM yesterday announced that its sales and profits rose in the past quarter.*

Stock investors have a tough enough time having markets rise and fall with the economy. At times this takes a back seat to the impact of investor's emotions, which are very low now, and which have turbo-charged the stock market declines. This will turn, and when it does, ***stubborn stock investors will be rewarded****. Are you stubborn enough?*