Market Review and Outlook—January 4, 2013

Foreign Stocks Leading the Charge—Can This Be Right? In 2012 foreign stocks staged a 'come from behind win,' as their 4th quarter surge enabled them to outperform their US colleagues for the full year win. The winner for the quarter and the full year were risky assets—in 2012, the riskier, the better. Smaller US stocks outperformed larger, smaller foreign stocks fared better than large, emerging markets did better than developed. This was also true in the bond world, as high yield bonds, both corporate and municipal, outperformed their high-quality alternatives.

In 2012, bond investors shifted out the risk spectrum, pushing corporate prices higher (and yields lower), while Treasury yields ended the year largely unchanged. Shaky European countries saw their bonds' prices rise and yields fall. Annual emerging markets bond purchases have exploded, from pre-meltdown levels of $3B to about $25B in 2012.

Whipsaw Warning—Emerging market stocks fell 18.2% in 2011, but jumped 18.6% in 2012. Foreign stocks similarly went from –11.7% in 2011 to +17.9% in 2012. High-yield bonds went from +2.8% in 2011 to +14.6% in 2012.

What Changed?—Europe is still a basket-case, the US continues to have a scary budget deficit as Congress perfects the job of kicking the can down the road, and over 10% of residential mortgages are delinquent. Where is hope coming from?

Beneath the Headlines, There Were Many Positives—While most of the headlines in 2012 were negative, the US economy grew nicely in 2012, light vehicle sales have recovered to near-normal levels, unemployment is falling with about 36 straight months of job creation, the budget deficit as a percent of the economy has fallen from 10% in 2009 to about 6% in 2013. Housing is improving: housing starts are recovering steadily, housing prices are rising, and the number of houses on the market have fallen in half to more normal levels. Core inflation is a near 2%, which is well under control. Energy prices have been near flat, largely due to a significant boost to US production of natural gas (largely due to the recent rapid growth of hydraulic fracturing—fracking). In the past seven years the US has cut its energy imports almost in half from close to 30% of our energy usage. You can argue that the elections were a positive for the economy and businesses—no change means no surprises, as a split Congress cannot make any drastic changes to taxes or spending or regulations.

2012 Rewarded Consistent Investors Well—Investors who disregarded the 'world is ending' analysts, and who maintained a balanced 60% stock portfolio (listed below as Moderate Allocation) earned over 11% in 2012. In contrast, investors who stuck to money markets doubled their 2011 returns, by earning a whopping 0.02%, and investors who only used intermediate US government bonds earned less than 3%.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.02%	+0.03%	+0.71%	+1.81%
Intermediate Term Bond	+0.74%	+7.00%	+6.96%	+6.07%	+5.11%
Intermediate Muni Bond	+0.49%	+5.62%	+5.56%	+4.99%	+4.06%
Large-Cap Stock	+0.47%	+14.94%	+9.05%	+0.68%	+6.62%
Mid-Cap Stock	+3.38%	+16.14%	+10.82%	+2.26%	+8.92%
Small-Cap Stock	+2.51%	+15.44%	+11.88%	+3.09%	+9.29%
Foreign Large-Cap Stock	+6.50%	+18.30%	+3.89%	-3.61%	+7.92%
Real Estate	+2.31%	+17.60%	+17.29%	+4.86%	+10.66%
Natural Resources	+0.01%	+4.44%	+3.55%	-3.09%	+11.69%
Science/Technology	-1.71%	+13.08%	+7.77%	+2.17%	+9.36%
Moderate Allocation	+1.10%	+11.69%	+7.69%	+2.31%	+6.38%

The data in this table comes from Morningstar and is as of December 31, 2012.
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Regardless of how painful, each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 4, 2012, the MARKET REVIEW AND OUTLOOK forecasted that 2012 would bring solid global stock market recovery. Specifically, I expected that all broad stock categories would rise 7% or more, real estate would be fine, bonds would provide more modest returns while high-yield bonds would shine.

Most of my 2012 predictions were quite good. All major stock segments did very well, with foreign doing the best (I had noted "Positive surprises in Europe are much more likely in 2012, given the grim current sentiment.") Bonds were indeed mediocre, though stronger than I expected, while high-yield bonds did even better than I expected. I was correct in five of the six open-ended calls (rising X% or more). I was correct on my value/growth call, as I chose to not make a call, and the two essentially were tied in 2012. I also chose to not make a call for non-US bonds; they did fairly well—I call this a bad call on my part. Six out of eight is not a bad record, however. I had noted the potential for a strengthening housing market leading to boosted consumer confidence, and my expectation of "valuation-driven gains from emerging markets in 2012." In hindsight, my projections for 2012 were pretty good.

Sector	2012 Prediction	2012 Actual	2013 Prediction
Large-Cap US Stocks	Up 10% or more	+14.9%	Up 7% or more
Smaller US Stocks	Up 7% or more	+15.9%	Up 7% or more
Non-US Stocks	Up 7% or more	+18.3%	Up 9% or more
Growth vs Value	Don't know	Value +14.6%, Growth +15.3%	Growth outperforms
Real Estate	Up 6% or more	+17.6%	Up less than 7%
General Bonds	Up less than 5%	+7.0%	Up less than 5%
High-yield bonds	Up 7% or more	+14.6%	Up 7% or more
Non-US bonds	Don't know	+8.1%	Up less than 7%

2013 Predictions—My primary theme for 2013 is for 'risk assets' to continue to outperform safer assets, but by a smaller margin than in 2012. A strategist at Lord Abbett noted that 'when you prepare for calamity, anything short of calamity is a great development.' In 2012 we were able to avoid calamity, which led to some great market results. As fewer investors are currently preparing for calamity than a year ago, I expect that great market results will be harder to come by in 2013. I do, however, feel that foreign stocks are still priced for near-calamity, and so I expect better returns from them in 2013.

JP Morgan's chief global strategist Dr. David Kelly notes that much of the 'tail risk' disappeared in 2012. By tail risk, he is referring to low-probability, big-negative events (such as the Eurozone disbanding, the US defaulting on its debt, or the US plunging into a sharp recession). US stocks have risen for four straight years. Many investors who abandoned stocks in the 2007-2008 crisis and have been reluctant to return due to the obvious risks. These same investors are earning next to nothing on their money markets, while inflation is fairly steady 2% higher. In 2013, some of these investors may feel that much of the economic healing has been accomplished, and begin to rebuild their stock allocation.

Foreign stocks could outperform US stocks based purely on the lower expectations for them, just as they did in 2012. While foreign stocks outperformed US stocks nicely in 2012, they remain well behind US stocks in their post-crisis recovery. Emerging markets stocks could also have a repeat, with strong results in 2013. This is less a case of low expectations, and more in recognition of the somewhat dependably higher growth rate of emerging markets, versus the US (where very low growth is expected) and Europe (where negative growth is quite possible).

To provide some protection from inflation, we use both (commercial) real estate funds and natural resource/commodity stock funds. Real estate stock funds have done incredibly well since the crisis. I expect them to cool down in 2013, primarily because they have earned it. Natural resource stock funds have underperformed in the past two years. I don't necessarily expect them to rebound in 2013, but they appear much more reasonably priced than real estate.

In 2013 bonds continue to be highly worrisome, highly susceptible to price declines. Their yields are near all-time highs and yields at all-time lows. We recommend sticking to short maturities/durations for your quality bonds. For bond money that you can risk a bit more, we use 'opportunity bonds,' a group in which we include high-yield, floating-rate, foreign, and multi-sector. Note that given their red-hot results in 2012, we are cutting back on high-yield bonds, and emphasizing higher-quality high-yield bond funds.

As always, focus first on the forest, not the trees—ensure that you have your overall stock level consistent with your goals and comfort. Don't permit your portfolio to drift. If you began 2012 with a 'normal' level of stocks (your long-term level), the gains likely left you above your target level. Pare this back, to seal in your profits. Plan your play, and play your plan.