Prepared Comments from 1/14/2013 Conference Call

The US stock market is up about 2% since our October call. It is up 117% since its March 2009 panic low levels, it remains only 6% below its October 2007 highs.

The past quarter generally brought a slew of headlines, with the November elections and the fiscal cliff leading the worries. While this constrained consumer confidence, our economy grew and private sector jobs were created. The unemployment rate stands at 7.8%, and inflation has been less than 2% in the past year.

In this month's Market Review and Outlook, I list several economic tailwinds, including steady auto sales, and a (finally) strengthening housing sector. This is very significant, as our economy has been recovering, at a very low pace, for over three years with hardly any help from autos and housing. Furthermore, housing in particular is labor intensive, and has significant add-on potential (as more houses are built, the newly-reemployed builders will no longer require unemployment payments from the government, will boost retail sales, and the building companies will be purchasing significant amounts of goods, such as lumber). The resurrection of our housing industry can be only a positive for our economy in the coming quarters. Finally, the housing industry was frozen for so long, it will take years for it to catch up to eventual demand—once it fully awakens, it should be a steady economic positive.

Investors may also be awakening. 2012 was a very kind year for investors, or at least those who invest in stocks, with gains of about 15% across the board. Bonds, on the other hand, returned 5-7%, less for the safer bonds. Furthermore, a bond bubble has not reduced in size—yields remain lower than they have been in fifty years. They will reverse, and when this occurs bond prices will fall and bond funds will lose money.

Patient disciplined investors who continued to maintain their stock exposure over the past four years have been richly rewarded. These riches could slow. While remaining on this path has been far from easy, these have been the easy returns. Stock market recoveries are typically sharpest right after the bottom. Stocks are now reasonably priced, as investors have finally begun to move back into stocks and boost their prices to more normal levels. Future stock market movement will be a combination of profit gain, and investor sentiment (raising prices towards being overpriced, or underpriced.

Companies can certainly boost their profits. They have already fully recovered their profit level from the 2007 pre-crash levels, however this pace has slowed considerably in the past few quarters. Companies are well positioned to grow; financially they are incredibly strong, with record levels of cash in their bank accounts. They are able to boost production, and are able to make acquisitions, once they see increasing consumer demand. I expect that housing strength will boost consumer confidence, which will boost retail sales, which will boost business investment, in a virtuous cycle.

While this sounds quite rosy, these happy times may already be priced into stocks—these bright possibilities could be some of the reason behind 2012's strong stock gains. I have often reminded people that markets are a forward indicator—that stocks fall in anticipation of a recession, and stocks rise before unemployment falls. I therefore warn you not to get overly excited about the positive horizon I lay out today.

Europe is muddling along, and in 2012 it appeared more likely that they will control the damage, and work together in the painfully long process towards recovery. This led investors to reverse the fire-sale pricing that Europe had suffered a year ago—foreign stock markets led US stock markets in 2012.

In the current Market Review and Outlook I share my predictions for 2013, with continued stronger results from stocks and weaker results from bonds. Investment real estate (funds and individual REITs) have done incredibly well—I expected reduced results in 2013. Remember that investment real estate is different from the US housing market—investment real estate holds office buildings, shopping malls, self-storage locations, apartment houses, etc.

I expect foreign stocks to again outperform US stocks. We are earlier in their recovery than in US stock recovery, and so we have more pronounced bargains overseas at this time. I also expect emerging markets to continue to shine, as China appears to have succeeded and slowing its growth rate to a more manageable level.

While I complain often about overpriced bonds, I also regularly note the important role of bonds, even overpriced bonds, in your portfolio. Furthermore, I also note that we divide bonds into Quality Bonds, and Opportunity Bonds. We are maintaining Quality Bonds at 70% of overall bonds, and using intermediate-, short-term quality bonds, and inflation-linked bonds (but not TIPS, as they continue to appear very overpriced). We continue to like Opportunity Bonds, but are harvesting some of our best gains, by cutting back our junk bonds. We are also beginning to boost our position in floating rate bonds, as it appears as though intermediate interest rates could rise later this year.

The bottom line for 2012 is that it was a WONDERFUL year, with gains of over 10% for most balanced investors. While I like much of what I see unfolding in the economy, don't expect 2013 to be a repeat for stock investors.