Market Review and Outlook—July 5, 2013

Quite a Change! In the first calendar quarter US stocks rose over 10%, while bonds were flat. This past quarter, US stocks rose less than 3%, foreign stocks lost a little, and bonds fell 2-3%. Quarterly gains of over 2% from US stocks may sound trivial, but that is a solid three-month gain. Foreign stocks fell a bit, but their economies are steadying, and recovery appears imminent. The bond declines came primarily in June, as the Federal Reserve Bank reminded us that as the US economy solidifies, the Fed will gradually remove its stimulus steps, including the essentially-zero overnight rate. Bond investors (finally) recognized that interest rates can rise, and thus that bond prices can fall.

US Economic News The economy here is improving. Unemployment is falling, jobs are being created, more houses are being built, and more cars are being purchased. Consumer confidence is rising, and inflation is tame. This improvement comes despite the federal government cutbacks earlier this year (payroll tax, sequestration reductions).

End of the Party In late June the Fed's Ben Bernanke noted that the Fed may cut back the stimulus as soon as the unemployment rates reaches 7% (the target rate had been 6%, the fifty-year average level, then later raised to 6.5%). At 7%, we could reach the end of the stimulus party as soon as later this year. This recognition drove investors to exit the bond market in June. That made sense. This recognition also appears to have led investors to sell US stocks. This makes less sense, as unemployment falling to 7% is an indication of a solid economy, and a solid economy should attract stock investors.

An Improving Mess Overseas? Investors have continued to avoid foreign stocks, which fell 3% in June alone. Emerging markets stocks fell twice as much in June. While Europe remains in a recession (it has four consecutive quarters of shrinking economic activity), most forward indicators are better than they were three months ago, and one year ago. We are no longer reading headlines with a rumor about a country (Greece) at risk for being kicked out of the Euro, or runs on banks (Cyprus). Another positive development is that government debt, as a percent of the economy, has fallen sharply throughout Europe in the past few years. Investors remain unconvinced.

Therefore… The table below shows that most investors tread water over the past quarter, but have double-digit gains in the past year. US stocks have led for both periods. Foreign stock investors have endured a very bumpy ride, which as been unpleasant recently. Bond investors are beginning to recognize that their 20-year gravy train ride has concluded. We continue to sound our broken record; times like these provide excellent opportunities to rebalance, selling some US stocks, and boosting foreign stocks, and even bonds.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.02%	+0.39%	+1.76%
Intermediate Term Bond	-2.62%	+0.91%	+4.29%	+5.61%	+4.38%
Intermediate Muni Bond	-3.05%	-0.17%	+3.70%	+4.43%	+3.47%
Large-Cap Stock	+2.56%	+20.83%	+16.69%	+5.84%	+6.85%
Mid-Cap Stock	+2.20%	+25.06%	+17.40%	+6.67%	+8.94%
Small-Cap Stock	+2.58%	+24.56%	+18.00%	+8.01%	+9.30%
Foreign Large-Cap Stock	-1.21%	+16.25%	+9.28%	-0.92%	+7.34%
Real Estate	-2.03%	+7.74%	+16.89%	+6.68%	+9.85%
Natural Resources	-7.23%	+3.11%	+6.50%	-5.63%	+10.66%
Science/Technology	+2.84%	+13.44%	+13.98%	+7.18%	+8.10%
Moderate Allocation	+0.04%	+12.20%	+11.11%	+5.05%	+6.11%

The data in this table comes from Morningstar and is as of June 30, 2013.

Economic Outlook The past is clear, it is the future which is tricky. In the past, the US economy has waged a steady recovery, and analysts expect it to grow at a greater pace in the coming quarters, as economic shocks such as payroll tax hikes and sequestration cuts are behind us. The housing industry, which helped to sink the economy five years ago, is clearly on the mend, and there are substantial, positive 'carry over' consequences that this brings. In baseball terms, the housing recovery is barely in the second inning, which bodes very well for our economy.

While Europe is still in a recession, many signs point to its recovery. This is reinforced by moderate interest rates for European countries—under 5% for Spain, Italy, and Ireland, although over 6% for Portugal and over 10% for Greece. European governments appear to be learning from the US' example, that inflexible austerity can aggravate a recession, and that measures stimulus plus patience can be the trick.

Currently, emerging markets are most affected by two factors—how China is doing, and how commodities are doing (as many emerging markets are rich in natural resources). Most recently China has been orchestrating a slow down, especially of its property values. Furthermore, energy prices have been restrained, due to the low level of global economic growth coupled with the natural gas and oil boom from the shale oil and fracking. As a result, emerging market stocks have been shunned by many investors this year.

Market Outlook The US in the past five years perfectly illustrated the lesson that stock markets rise well before economies heal. This provides an incentive for investors to look forward, beyond today's challenges to tomorrow's promise, and conversely, beyond today's promise and to tomorrow's challenges.

US stocks appear to be valued fairly, perhaps a bit cheap when compared to alternatives such as cash and bonds, and when the economy's growth path is considered. That said, most other stock markets seem to offer better values today than the US markets. This of course makes sense, as the US is much further along in its recovery. That said, there appears to be greater downside risk in US stocks, and greater upside potential in non-US stocks at this time. Emerging markets stocks, in particular, offer very attractive potential at today's prices.

Reality has begun to creep into bond prices this year, as the red ink in the table on the other page illustrates. We continue to favor a quality/opportunity division of bond money, and are currently using a 70/30 balance between the two. We have cut back the maturity of clients' quality bonds, with a notable emphasis on short-term quality bonds. Note that traditional inflation-linked bonds fell sharply during the quarter. Within opportunity bonds we are limiting the use of high-yield bonds, as we feel that these are 'in the seventh inning or later.' We are increasing our use of floating rate bonds, and are considering boosting our non-US bonds, due to recent strength in the US dollar.

Contrarian Investing Pays Off In the past five years it has paid to be a contrarian investor. Holding US stocks and high yield bonds in late 2008, and not giving up on them, has enabled contrarians to outperform the more popular intermediate-term bonds in the past five years. Yet contrarian investing requires looking out the front windshield, not the rear view mirror. It requires placing faith, and dollars, into sectors that are unpopular. At this time, we find that foreign stocks, and foreign emerging markets stocks in particular, are quite unpopular. Energy stocks are similarly unpopular. I hesitate to mention it, but gold and precious metals stocks/funds can be considered a contrarian holding, as these funds are down over 45% in the first half of 2013.

Our Plans For our clients we continue to favor stocks over bonds, keeping stock levels 2% above normal (if a client has a long-term target of 60% stocks, we will hold their stocks at about 61.2%). We also continue to direct 42% of stocks to overseas stocks. Given recent results, this will typically mean selling some US stocks and buying more foreign stocks. Within foreign stocks we will be maintaining a healthy amount of emerging markets stocks, to take advantage of today's weak prices for these markets.

For five years now we have spent about as much attention to clients' bonds as their stocks, for bonds have been incredibly heterogeneous, as varied in their behavior as stock types. At this time for bonds, we are continuing our 70% quality/30% opportunity balance. Within the quality bonds, we have a notable emphasis on short-term, and a below-normal level of intermediate-term bonds. We continue to use inflation-linked bonds, but avoid actual TIPS, Treasury inflation-linked bonds, which we feel continue to be overpriced. Within opportunity bonds we have reduced the credit risk of our junk bonds, have boosted our floating-rate bond funds, and are now boosting our use of foreign bonds. For the time being, we expect that there is greater risk in longer-term quality bonds than in opportunity bonds, including high-yield.