Market Review and Outlook—October 4, 2013

Stocks Rally In the face of the Federal Reserve considering removing its historic stimulus, and despite an imminent government shutdown, US stocks fared well in the past quarter, returning about 6-9%. Foreign stocks did even better, as the slowdown orchestrated by China is largely behind us, and Europe appears to be looking up, finally. Overseas stocks rose about 10-13%, although emerging markets stocks rose only about 6½%. Investors are not only putting more money into stock funds than bond funds, they are putting a LOT more money into stock funds than bond funds.

Which brings us to bonds—despite some near-panic in June over the possible end of the fiscal stimulus from the Fed, bonds ended the quarter close to where they started (with a flat July, a down August, and a recovering September). Quality bonds earned about ½%, while opportunity bonds earned about 1%.

Out of the Woods? While the news from Washington DC has been disappointing, the news on the US economy has been solid this year. Unemployment has continued to fall, down ½% from 7.8% where it ended 2012. The most recent economic growth figure is from the 2nd quarter, when we had solid 2½% real (after-inflation) growth. This is only 0.1% less than the 20-year average. Capital-goods orders are well above average levels. Car sales are now above the 20-year average, and the five-year depressed levels should lead to years of above-average sales. While no where near recovered, housing is certainly recovering. Housing inventories (houses on the market) have fallen very sharply since 2008, and are near normal levels. Household net worth is 10% higher than its prior peak in 2007. Consumer sentiment is lower than normal, but actually touched the average level earlier this year for the first time since before the meltdown.

Great Results The table below shows some incredible trailing results, especially for US stocks. The 5-year figures have a strong advantage, as the period began near the low-point, as markets bottomed in early 2008. Yet the 10-year figures are also impressive, and this period began well into the recovery from the dot-com bust. The table illustrates that a disciplined (aka stubborn) investment approach has paid off.

When you have strong trailing results, our discipline requires that we consider 'taking profits' by cutting back. Cutting back, in turn, requires something else, a destination for the funds raised from cutting back. There is not a large list of undervalued investments these days—bonds face future losses as rates rise, and stock prices have more than doubled since the 2008 trough. We prefer 'mechanistic rebalancing,' which means cutting back smaller US stocks at this time, and shifting a bit into foreign stocks, large US stocks, and even bonds. With strong trailing results, you need to go to your written plan, and follow your stated steps for rebalancing. Now is a very good time.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.02%	+0.26%	+1.74%
Intermediate Term Bond	+0.61%	-0.96%	+3.39%	+6.43%	+4.45%
Intermediate Muni Bond	+0.20%	-2.06%	+2.68%	+5.01%	+3.48%
Large-Cap Stock	+5.74%	+20.43%	+14.75%	+9.29%	+7.18%
Mid-Cap Stock	+7.54%	+27.46%	+15.63%	+11.17%	+9.03%
Small-Cap Stock	+9.19%	+28.86%	+17.24%	+11.27%	+9.52%
Foreign Large-Cap Stock	+9.93%	+19.93%	+7.19%	+5.85%	+7.65%
Real Estate	-2.54%	+4.21%	+11.27%	+5.77%	+8.66%
Natural Resources	+9.49%	+4.08%	+4.58%	+4.26%	+11.21%
Technology	+12.17%	+21.16%	+12.49%	+13.32%	+8.30%
Moderate Allocation	+4.26%	+11.87%	+9.61%	+7.94%	+6.31%

The data in this table comes from Morningstar and is as of September 30, 2013.
Information herein should not be construed by any consumer and/or prospective client as a solicitation to effect, or attempt to effect transactions in securities, or the rendering of personalized investment advice for compensation.

Economic Outlook We are firmly in recovery mode. Despite very sluggish auto and home sales, the US economy has trudged forward in the past five-years, and continues to deliver. Autos and housing have begun recovering, and this has enabled the economy to grow this year despite the dreaded 'sequester,' as federal spending has fallen. As consumers are responsible for 3½ times as much of the economy as the government, it is not surprising that the economy can continue to grow despite government reductions. With the Federal Reserve maintaining its policy of stimulating the US economy, there is little reason to see a slowdown here in the US for several quarters.

The economic news overseas is similarly positive. Finally, Europe appears to be climbing out of its recession. As a measure of investor confidence, yields on Greek government bonds are under 10%—they peaked in 2010 at about 35%. China has successfully cut its high economic growth rate from over 10% to just under 8%. This concerted effort impacted China's trading partners, slowing their growth, also. Now that the slowdown has ended, China's growth and that of its neighbors can be less limited.

Market Prices While the US stock market has doubled its 2009 lows and risen above its prior 2007 high, this is completely natural. The US economy is much greater than it was in 2007, and so the US stock market deserves to be higher. Just this summer investors have begun to recognize this, and shift substantial dollars from bond to stock funds, by tens of billions of dollars, monthly. Should this continue, it could bring continued anemic returns from bonds, but continued superior results from stocks.

Based on traditional valuations, both US and foreign stocks are fairly valued. Normally this would lead to us being very moderate in our recommendations. The challenge is the painful answer to the question: *if not in stocks, where do I put my money?* Money markets continue to yield essentially zero, and bonds face storm clouds ahead. Even commodities are underwhelming, largely due to the glut of natural gas in the US due to the shale gas and the fracking extraction processes. "In the land of the blind, the one-eyed man is king." In 2013, stocks look pretty attractive.

How Bad are Bonds? The short answer is that we don't know. Bond prices and returns in the future are highly dependent on two factors—how quickly investors will shift from bonds to stocks, and how quickly the Fed will 1) scale back and end its bond purchasing (Quantitative Easing) and 2) raise overnight interest rates. Another critical factor is how the many different types of bonds react. High-yield (aka junk) bonds behave VERY differently from long-term bonds. We have defined two groups of bonds—quality bonds and opportunity bonds. When you hear and read that bonds are overpriced and facing a difficult future few years, this analysis typically is restricted to quality bonds. In the first nine months of 2013, the average intermediate-term corporate bond fund (quality) has lost about 1.7%, while the average multi-sector bond fund (opportunity) has posted a slight 0.1% gain.

We still hold a significant amount of our clients' bonds in quality bonds, despite the hovering storm clouds. We do 'tune' quality bonds, for instance, by focusing them on short-term rather than intermediate-term bonds. This limits the damage that falling bond prices can inflict on our clients' portfolios. We hold some intermediate-term bonds, for three reasons. The Fed could take quite a long time before it removes all of the stimulus it has been providing, perhaps years. Secondly, economic mis-steps (such as defaulting on the US debt) could bring on a recession, and this unlikely path probably would be accompanied by a 'rush to safety,' causing rising prices for quality bonds. Finally, investors periodically need to make withdrawals, and quality bonds provide relatively high confidence in being able to make a future withdrawal, as the 2008 stock market meltdown made painfully clear.

We do like opportunity bonds, for they should produce the best returns within the bond universe should our economy continue its gradual, recovering path. We have some protection, for opportunity bonds at this time provide higher yields than quality bonds. One type of opportunity bonds are bank-loan funds, which hold floating-rate bonds. These bonds could actually rise in price when interest rates rise, compensating for likely losses from quality bonds during these times.

Therefore… As is always the case, the future is not clear. There are risks and opportunities aplenty. We like stocks, both US and foreign, more than bonds at this time. However, there are good reasons to hold both quality and opportunity bonds now. The strong trailing stock returns makes the case very strong to rebalance, both between stocks and bonds, and amongst stocks (large and small, US and foreign, for instance). Rebalancing enables you to seal in high prices for shares you sell, and pick up shares of other investments at lower prices. While rebalancing provides the same mathematical advantages when applied after stocks fall, it always feels better to rebalance after stocks rise. So, enjoy!