Market Review and Outlook—July 7, 2014

What is missing, below? There are no figures in red below, indicating that of the 11 categories listed, none have lost money in the past 3 months, 1, 3, 5, or 10 years. That is pretty exceptional. The 4-6% annual returns from bonds are quite ordinary. The ten-year average annual return of 6% for Moderate Allocation funds (which hold about 60% in stocks) is a very solid long-term result. The multi-year figures from the stock fund categories have a fairly wide range of variations, reflecting the breadth of factors that affect different types of economies and stock markets and stock sectors.

The past calendar quarter was good for bonds, as the economy showed **further signs of steady recovery**. Investors surprised analysts by continuing to buy long-term government bonds, despite the clear future prospect of higher interest rates. Stocks enjoyed solid results during the quarter, with the best gains provided by precious metals, utility stocks, natural resource stocks, real estate, and emerging market stocks.

Stocks and bonds both advanced during the quarter due to continued increases in investor confidence. Investors become more confident by reviewing continued positive economic news, including rising company profits. All of this can become a '**life-spiral,**' the opposite of a 'death-spiral,' as every piece of good news builds confidence, which can lead to more economic activity, which produces better news (such as decreased unemployment), and so forth. A more common phrase is a '**virtuous cycle**.' These cycles do not continue forever; however, they can last longer when the rate of growth is lower (I can walk for hours, but I have real limits to how long I can run). This recovery, which is notable in its low rate of growth, could become notable in its duration—we are already over five years into the recovery.

Overseas, geopolitics played Whack-a-Mole, with the Ukraine cooling a little, but Palestine and Iraq heating up. The bulk of the world, however, has maintained an above-average stance so far this year, economically.

Almost every quarter, I repeat the recommendation—rebalance, rebalance, rebalance. Stocks have outperformed bonds, and so rebalancing between your stocks and bonds is likely needed. We are getting closer and closer to the point of rising interest rates, so be VERY intentional in how you spread your bonds. I address this more on the next page. All stock investors had lost a significant portion of their life savings as of early 2009. US stock levels are well above their prior (2007) highs, while foreign stock markets are not. Despite incredible stock returns over the past five years, bonds have also delivered very respectable results. However, the question is not what you should have done for the **past** five years, but what you should do for the **next** five years. When in doubt, rebalance!

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.05%	+1.68%
Intermediate Term Bond	+2.09%	+5.07%	+4.08%	+6.02%	+4.77%
Intermediate Muni Bond	+2.10%	+5.03%	+4.23%	+4.96%	+3.94%
Large-Cap Stock	+4.63%	+23.65%	+14.86%	+17.47%	+7.32%
Mid-Cap Stock	+3.90%	+24.74%	+14.15%	+19.76%	+8.73%
Small-Cap Stock	+2.31%	+23.78%	+14.25%	+19.87%	+8.73%
Foreign Large-Cap Stock	+3.71%	+20.83%	+6.62%	+11.27%	+6.83%
Real Estate	+6.88%	+13.14%	+10.89%	+22.56%	+8.91%
Natural Resources	+8.34%	+26.79%	+2.37%	+11.86%	+10.59%
Technology	+4.55%	+32.27%	+12.97%	+17.99%	+8.57%
Moderate Allocation (60% stocks)	+3.60%	+16.03%	+9.61%	+12.57%	+6.44%

The data in this table comes from Morningstar and is as of June 30, 2014.
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.

I really value insights shared by Dr. David Kelly, the Chief Global Strategist from JP Morgan; I have referenced his viewpoints in past Market Review and Updates. His current theme is "**Be careful, the future is closer than we think.**" During the great meltdown of 2007-2008, PIMCO's Bill Gross and others penned the term the New Normal, which describes a world where global economic growth took a long-term downward shift—that real economic growth rates would be stuck in a 1-2% range, inflation would remain under 2%, that bond yields would remain below 4% (less than 2% after inflation), and stock returns would come in at 5% after inflation if we were lucky.

This multi-year period of doldrums has been reinforced by the US Federal Reserve Bank (the Fed), which has kept overnight rates near zero for five-plus years, and which indicates that rates will be barely above 1% by the end of next year. The Fed has bought trillions of dollars of bonds since 2008, propping up bond prices and keeping bond yields low. This has been done to support the US economy, to keep economic growth upward and to bring unemployment down.

The good news is that it has worked, quite well. Last week, the US unemployment rate was lowered to 6.1%, its fifty-year average. The US has created more jobs since 2009 than it lost in 2008 and early 2009. We are selling more light vehicles now than our 20-year average. Average household net worth is almost $15,000 higher now than its 2007 peak ($83,500 versus $68,900). The inventory of houses for sale are now at average levels, after cresting at about 200% of normal levels. The federal budget deficit, at 2.8% of GDP, is below the levels it ran in the early 1990s, and has fallen 2/3rds from its 2008-9 levels. The 500 companies in the S&P 500 index are earning over 10% more per share than they did at their 2007 peak. Economics has worked.

The bad news is that **the free ride is coming to an end**, and sooner than most people expect, including the Fed. Many have raised the concern that the Fed's heavy use of the dollar printing press would lead to runaway inflation, and for five years they have been dead wrong, or at least WAY too early. However, it is almost time for the Fed to take action to prevent those predictions from coming true. This action can have painful consequences. First, <u>they will need to sell close to **$4 trillion** worth of bonds</u>. That will lead to higher interest rates, for individuals, for companies, for mortgages, car loans, credit cards, etc. That will also lead to lower prices for bonds, and lower returns, if not losses, for bond funds. The pain will be modest if the actions are spread over a long-enough period of time. However, the Fed could need to act more quickly, if inflation becomes a problem. Ultimately, we don't know when the action will begin, and at what pace.

This will be very challenging for bonds, but <u>this could actually support stock returns</u>. The factors that will lead the Fed to reverse the stimulus—good auto sales, good home sales, low unemployment, good corporate profits, solid household net worth, good consumer confidence, good investor confidence—are factors that are very good for the economy. The Fed's actions can lead to investors selling bonds, and many of these dollars are likely to be used to purchase stocks.

The Fed's upcoming removal of the training wheels will bring both challenges and opportunities, and the uncertain timing complicates investors' responsibilities. For portfolios, we continue to feel that a slight overweight to stocks, and a slight underweight to bonds, is warranted. Within stocks, while the US economy is nice and steady, foreign stock markets and economies provide compelling values, and we continue to utilize a 57%/43% US/foreign stock balance. Partly because of investors' current strong preference for dividends, we favor growth stocks over value stocks (since some types of value stocks may have become overpriced). We are currently using a 70/20/10 large/mid/small-cap balance for our stocks.

Overseas, we continue to spread dollars 57/31/12 large/emerging/small-mid cap. We have introduced some **frontier emerging markets** into the 31% sleeve, and we are maintaining specific infrastructure and Europe stocks within the 57% large-cap sleeve. We continue to prefer the use of global stock funds to provide much of the large-cap exposure. While the emerging markets exposure has been a drag for clients for several quarters, it has recently become a leader.

While bonds will be facing headwinds, abandoning them and shifting to all stocks would be a dangerous course. To address the headwinds and uncertainty, **we are really embracing a 'eggs-in-many-baskets' strategy**, with 11 baskets. We are continuing our 67/33 quality/opportunity bond balance. For the 67% in quality bonds, we use 35/17/10/5 short/intermediate/inflation-protected/long term bonds. Thus, more than half of quality bonds are short-term, to help manage/limit risk from rising rates. For the 33% in opportunity bonds, we are using 15/10/5/3 high-yield/multi-sector/emerging markets/floating rate bonds. The 15% in high-yield bonds are further divided into 5/5/3/2 short-term/higher-quality/tax-free/traditional. We are hopeful that by using many baskets, we have some pieces that will hold up well in whichever path we end up facing. This is the goal of diversification, and perhaps it is more important now in bonds than in stocks.