Market Review and Outlook—October 6, 2014

Hey, that hurt! Three months ago the chart below was all black, not a negative figure in sight. This month the three-month column is almost all red, representing losses. **I have to accept some of the blame here**—I jinxed investors by highlighting in the July review how there were no negative figures. Sorry! I was not the only factor, however.

The quarter brought heightened global concerns with Ukraine, Palestine, and ISIS/Syria. The US began bombing some ISIS locations in September. Late last month, Scotland voters considered but rejected independence from Great Britain. In Hong Kong, pro-democracy advocates are organizing very large protests, due to a recent court ruling that the 2017 city elections will be limited to pre-approved candidates. This has led security forces to some fairly harsh clamp-downs.

The US has its own uncertainty. We have our own elections in a month. The latest predictions call for the US Senate to switch from Democratic to Republican leadership. The Federal Reserve Bank (Fed) is set to end its quantitative easing bond purchase program this month, which has artificially inflated bond prices. For an inexplicable reason, bond investors disregarded this factor in the first half of the 2014, and drove long-term bond prices up (and yields down), only to reverse this behavior somewhat in the 3rd quarter. Not knowing what the Fed will do next, and when, is worrying bond investors.

Stock investors have been pretty skittish recently. The market losses are not based on fundamentals—company profits continue to set new all-time highs, and the falling bond yields should make stocks even more attractive. I often note that stock prices are driven by a combination of economics and emotions. In the 3rd quarter, the emotion factor overwhelmed the economic factor, and this can certainly continue. Ultimately, however, stock markets cannot disregard positive fundamental economics.

Long-term investors have had few opportunities in recent quarters to 'buy cheap.' **Recent losses may have presented an attractive opportunity.** Those who regularly rebalance will automatically capture this opportunity, by shifting a bit now from bonds to stocks, and specifically by rebuilding their smaller US and foreign stock positions. This makes good sense.

Let me finish by drawing your attention to the right column, the ten year average annual returns. With the exception of the money market, these are all reasonable, with low-mid single-digit gains for bonds, and upper-single digit gains for stocks. Importantly, it shows an average return for a Moderate Allocation (60% stock) fund of a little over 6%. **These are reasonable historical figures**, as they are for a time period in which neither the start nor end date was unreasonably high or low.

Category	**3 Months**	**12 Months**	**3-Yr Avg**	**5-Yr Avg**	**10-Yr Avg**
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.03%	+1.66%
Intermediate Term Bond	-0.09%	+4.34%	+3.41%	+4.80%	+4.45%
Intermediate Muni Bond	+1.03%	+5.84%	+3.66%	+3.87%	+3.72%
Large-Cap Stock	-0.08%	+16.84%	+21.59%	+14.10%	+7.51%
Mid-Cap Stock	-3.30%	+12.20%	+21.86%	+14.91%	+8.64%
Small-Cap Stock	-6.75%	+5.66%	+20.91%	+14.18%	+8.10%
Foreign Large-Cap Stock	-5.62%	+3.75%	+13.05%	+6.22%	+6.25%
Real Estate	-3.01%	+12.64%	+15.77%	+15.05%	+7.70%
Natural Resources	-9.38%	+4.95%	+8.74%	+6.13%	+8.34%
Technology	+0.45%	+18.69%	+20.18%	+14.33%	+9.71%
Moderate Allocation (60% stocks)	-1.28%	+9.80%	+13.26%	+9.75%	+6.34%

The data in this table comes from Morningstar and is as of September 30, 2014.
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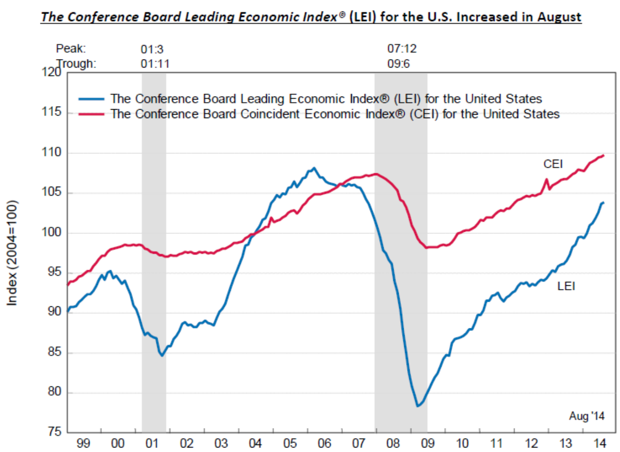
Good News and Bad News—The good news is that the US economic recovery is steadily continuing. The bad news is that the US economic recovery is steadily continuing. This is good as it leads US companies to continue to increase their earnings, and this is quite good for stock investors. At 5.9%, unemployment is lower than the long-term historical level of 6.1%. In a review last month of 20 countries, and the outlook of 'purchasing managers,' the US has the strongest score, by quite a bit. How is this bad news?

The Federal Reserve Bank (the Fed), after six years of nursing, has determined that it is almost time to release its patient. They have stopped buying bonds to prop up the bond market and keep intermediate-term interest rates artificially low, and next year they expect to let short-term interest rates slowly move to more normal levels from their current near-zero levels. They are preparing for these moves, due to their conviction that the US economy doesn't need this help any longer. They are ready to remove our training wheels—will the US economy be able to proceed on its own? How will this impact bond and stock markets?

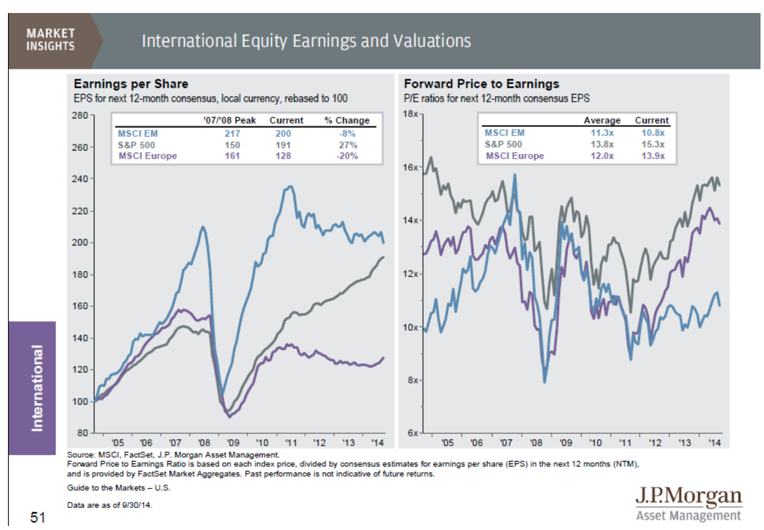
Bonds—We all knew that this day would come; it is a bit surprising that it has taken this long. Bond investors have been warned for years that the day of reckoning was coming, and yet it continues to be delayed. Very surprisingly, for much of 2014 bond investors have been buying bonds, and pushing interest rates down—defying gravity. While it is certain that in the coming years interest rates will rise and bond prices will fall, the current consensus holds that these moves will be gradual, and that sharp price declines will be avoided. Nonetheless, we continue to favor a 67/33 balance of quality/opportunity bonds, with 33% in such bond types as high yield and emerging market bonds. We also take a fairly conservative stance with our quality bonds, with more than half invested in short-term quality bonds.



Latest LEI Trough March 2009, Latest CEI Trough June 2009
Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee.
Source: The Conference Board

US Economy—The accompanying graph shows 15 years of reported leading and coincident (concurrent) economic indicators (LEI and CEI). These indicators are broad, including measures that cover the majority of our economy. It shows that the LEI peaked in 2006, began falling in 2007, fell sharply until early 2009, and has charged upward, with minimal stumbling, ever since. It is very hard to question the conclusion that the US economy is on firm footing.

Stocks—The second exhibit has two sides, and each side presents 10 years of data for US, European, and Emerging Markets (EM) stock markets. The left graph shows that the US earnings (gray line) have rebound nicely, and again, with minimal stumbling, since 2009. EM earnings fell harder and recovered more strongly, but have been drifting downward in recent years. Europe shows a rebound that was stalled (thanks, Greece!). The right side shows PE levels, which measure how much investors favor markets. The US stocks are the most loved at this time; Europe comes in second, and EM's come in a distant third.



Stock prices change based on economics (earnings) and emotions (PE levels). Since US PE levels are already a bit above normal, for US stocks to do well they need to continue to grow their earnings. Fortunately, the leading indicators and purchasing managers expect US companies to be able to continue to grow their earnings. In Europe, emotions are ahead of earnings (PE levels are a little above average, but earnings remain well below 2007 peak levels). This is a bit surprising; while we are optimistic that earnings will recover in Europe in the next few years, we do not see that as 'conventional wisdom.' Regardless, we are very comfortable with stocks in Europe, believing that the earnings will come. In EM, emotions (PE levels) seem unreasonably low to us. We are patient, and expect that in time both earnings and PE levels will rise for Emerging Markets, and reward this patience.