Market Review and Outlook—April 7, 2015

Foreign stocks showed signs of life. After sharply underperforming the US stock markets in 2014, foreign stocks leapt in the first quarter. Nonetheless foreign stocks remain 10% lower than their 2007 highs, while US stocks are 32% higher than their 2007 highs. The first quarter foreign stock outperformance could have been due to improving economic outlooks overseas, slowing economic outlook in the US, profit-taking by US stock investors, or bargain-hunting by foreign stock investors. Most likely it was a **combination** of all four of these factors.

The quarter brought a wide range of results. In the US, growth stocks sharply outperformed value stocks, and smaller stocks outperformed larger ones, and by wide margins. Overseas, emerging markets rose 1.1%, but foreign small companies and foreign large companies did even better, gaining over 4.6%. Natural resource funds lost 1.4% in the quarter, but the loss was much smaller than the prior quarter's. Precious metals funds lost 3.9%, while real estate funds slowed down but still notched a 4.4% gain. Technology funds rose 3.0%, while health stock funds continued to soar, rising 10.7%.

Continuing to confound market analysts, **investors continued to drive bond prices even higher, and yields even lower**. As such, long-term bonds (+2.8%) outperformed intermediate ones (+1.5%), which outperformed short-term bonds (+0.8%). Almost every type of bond had modest price increases and yield declines during the quarter. The reason that this troubles market analysts is that we are only a few months from when the Fed is fully expected to begin boosting the Fed rate from its current near-zero level to a more normal level of at least 4%, and the Fed has already begun selling some of its historically large inventory of bonds it purchased in the past six years to help the economy.

While both stock and bond markets have constantly surprised analysts in recent years, I draw your attention to the Moderate Allocation line in the table, below. In the past decade it has produced an annualized gain of over 6%. **A steady approach like this has provided attractive, long-term stable growth.** I use the term steady to emphasize that long-term investing is helped by regular rebalancing (in this case to keep the Moderate Allocation close to 60% stocks, whether stocks are doing well or poorly).

This is the same reason that **I continue to recommend that investors regularly rebalance their portfolios**. At this time, that could mean cutting back stocks a little bit, taking some profits from growth stocks and perhaps health funds. As there was not any sharp gains or losses in bonds this past quarter, there could be minimal rebalancing needed in your bonds now.

Category	3 Months	12 Months	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.01%	+0.02%	+1.56%
Intermediate Term Bond	+1.54%	+4.75%	+3.44%	+4.62%	+4.64%
Intermediate Muni Bond	+0.73%	+4.97%	+3.11%	+4.22%	+3.94%
Large-Cap Stock	+1.13%	+10.34%	+14.87%	+12.97%	+7.32%
Mid-Cap Stock	+3.29%	+8.76%	+15.68%	+13.75%	+8.40%
Small-Cap Stock	+3.60%	+6.03%	+14.88%	+13.72%	+8.30%
Foreign Large-Cap Stock	+4.70%	-0.76%	+7.86%	+5.68%	+5.00%
Real Estate	+4.38%	+22.53%	+13.07%	+15.05%	+8.76%
Natural Resources	-1.42%	-15.69%	-2.91%	+0.72%	+4.87%
Technology	+2.99%	+13.10%	+13.73%	+13.54%	+9.79%
Moderate Allocation (60% stocks)	+1.81%	+6.19%	+9.45%	+8.97%	+6.26%

The data in this table comes from Morningstar and is as of March 31, 2015.

It's the Economy. The US economic picture has diminished in the past quarter. While the lower price of oil has helped the US economy, and will continue to help it until it recovers towards $100 a barrel, the stronger US dollar has hurt the US economy (US companies' earnings fell in the past quarter), and its negative impact is greater than the oil net benefit. Overall, if oil prices and the US dollar remain steady at the current levels (yes, I know, this will not happen), then the US economy's growth could be cut by about 0.4% annually for several years. While 0.4% sounds small, real GDP annual growth has been running around 2.0%, so this marks a sharp cut. **New headwinds have arrived in the US**.

The US economic growth is also **hampered by our labor pool**. Due to our demographics, we have more retirees than new labor force entrants, and this should continue for a long time. Productivity has also declined, to about 1% annually. Together this indicates that future US real annual economic growth could be stuck under 2% in the coming years.

In comparison, **foreign economies** have greater upside. The fallen price of oil helps most of Europe, and the US dollar's rise helps Europe further. Unemployment in Europe is twice as high as the US. While this is a problem today (especially if you are unemployed today in France), it provides substantial labor force growth, and therefore economic growth, ahead of Europe. Furthermore, high unemployment in the US over the past six years has enabled US companies to grow their earnings, due to low labor costs and low labor cost growth, and European companies' good times await.

US stock markets don't appear overly expensive, but they also aren't cheap. If the bond market was normal, stocks would seem expensive. But interest rates are so low that 1) alternatives to stocks are unattractive, 2) companies can remain very profitable when interest rates are low, and therefore 3) **stocks seem reasonable**. Given the strong US stock results over the past several years, many investors are sitting on large gains, and the temptation to seal in those gains is strong. This profit taking likely contributed to the mediocre results during the quarter from large US stocks.

Foreign stock markets are more mixed, with some seeming cheap and others expensive—there is a wider range to consider. The range is even more eye-opening in emerging markets, where oil-producing countries (Russia and Brazil) have suffered, but **many emerging markets appear reasonable**. Fortunately, emerging markets generally have attractive economic growth rates, due to both favorable demographics (young, growing labor forces) coupled with a low economic base from which strong growth is easier to achieve.

Bonds and interest rates continue to vex investors. The Fed has largely claimed success over helping the US recover from its recession, and is **poised to begin the long march upward to 'normal' interest rates**. This climb should begin this summer/fall, and continue for several years, with a slow, steady rate of increase in rates. The bond market appears delusional, as bond investors have driven rates down for half a year. A greater risk appears to be that rates will rise faster than expected, rather than slower—thus the most likely surprise for bond investors appears to be negative.

We continue to favor 'opportunity bonds' over 'quality bonds,' as quality bonds should fare the worse from our recovered economy and soon-to-be rising interest rates. This has worked so far since the meltdown—in the past five years high-yield bonds have outperformed intermediate-term quality bonds +7.5% versus +4.6% annualized—and we expect this to continue for now. Once rates approach a normal level several years from now, however, it will be time to drastically cut back our opportunity bond positions and to boost our quality bond positions.

At this time **we are still overallocating to stocks**, setting the current strategic target to 103% of long-term target levels. Thus a 60.0% stock target portfolio will have closer to 61.8% of stocks this month. We do this due to our concern for weak future returns for bonds in general. Within stocks we are maintaining a 57/43% US/foreign balance. While this fairly heavy foreign balance hurt us in 2014, it has helped in the past quarter. We continue to feel that foreign stocks offer better upside, and that this balance is warranted.

With clients' bonds, we are maintaining a 65/35 % balance of quality/opportunity bonds. We have introduced a 'quality US dollar emerging markets bond' sleeve to our quality side, with a 2% weight, and cut back our inflation-protected bonds to make room. We still have 33% in short-term bonds, 16% in intermediate-term, and 4% in long-term. In our opportunity side we have eliminated short-term high yield and boosted multi-sector bonds.

2015 has already surprised investors, and should continue to do so. We are expecting foreign stocks to continue to do well, and for quality bonds to begin a long-awaited and likely lengthy (multi-year) price decline. We continue to have prepared portfolios for these likelihoods, with additional preparation for other paths forward. There are no guarantees!