April 2010

GENERAL MARKET COMMENTARY

The market has been on a non-stop rally over the past two months with the S&P up nearly 15% in that time period, causing anxiety among many investors who are still un-invested. We received our bull market buy signal last summer, when there were many unbelievers out there. While our bull market signal is a technical and not a fundamental indicator, there are some fundamental reasons why we think this market should move higher. Many still do not believe that a genuine bull market, let alone an economic recovery, is underway. Reasons for this are twofold. First, the economy is emerging from the longest recession since the 1930's. But it is emerging. Secondly, long recessions create high unemployment, which is the most difficult problem to solve, and this pessimism will not dissipate quickly. But that does not mean stocks will not go up. Stocks typically lead the economy by 6 to 9 months prior to the news events.

By historical standards, at just 13 months of age, this bull market is still in its infancy. And, according to InvesTech Research, not one bull market in over 60 years has made it to its first birthday… without achieving its second. And four of the past five bull markets have lasted five years or longer. The *average* bull market duration of the past 80 years is 3.8 years.

Other reasons to remain bullish this year include very strong breadth indicators, with nearly all sectors participating, and sector rotation in full gear. Bull markets typically do not end with strong leadership like we currently have.

The infamous bond king, Bill Gross from Pimco Investment Company, stated recently on CNBC, "I prefer stocks over bonds right now".

Many investors don't remember that government bonds can have capital losses when yields begin rising, which is likely to happen when the Federal Reserve begins to raise rates later this year. (Over the past 12 months, the Vanguard Long-Term U.S. Treasury Fund has lost 6%).

STOCKS VS. INVESTMENT ALTERNATIVES

Keeping a longer term perspective is important for investors so they don't get caught up in a short-term investment prejudice which may cause them to lose touch with historic norms.

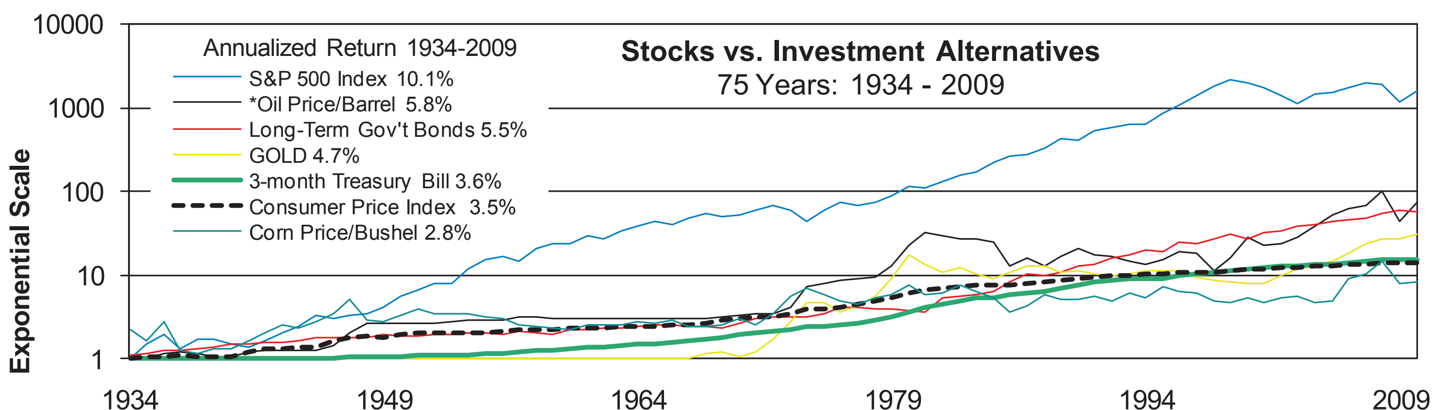
The chart below illustrates that the long-term trend of the stock market for the past 75 years has been steadily higher in spite of all those bear markets, world wars, terrorist attacks, recessions, and commodity price bubbles.

Stocks continue to outperform almost all asset classes over long periods. It is important to remember that bear markets end, bringing substantial returns back into investors' pockets.

This chart illustrates long-term rates of return for various investments. The 10% average annual returns for stocks (S&P 500 Index) have outperformed the inflation rate by nearly 7% per year on average. Government bonds have beaten inflation by about 2% per year. T-Bills (3-month Treasury Bill) performed exactly the same as the inflation rate, so money market returns have not created wealth, but will actually show a loss after taxes. What may be most surprising to investors is that gold, oil, and grains have not kept up with the stock market, except for only brief speculative periods.

Gold is a "crisis" investment, and when things get back to normal it may stop appreciating at a rapid rate. The same is true of oil and grains. When supplies increase, prices will drop. Of course, if inflation accelerates, oil and grain will appreciate at a higher rate as well.

Stocks should continue to rise in value as innovative corporate management finds new ways to make money. This is not the time to be afraid of investing in stocks, but is an opportunity to build wealth over longer periods. Using Spectrum's management strategies, clients should profit by participating in equity markets while managing risk in the bear markets. It remains a good time to invest funds that are sitting in a money market earning little or nothing.



HIGH YIELD CORPORATE BOND UPDATE

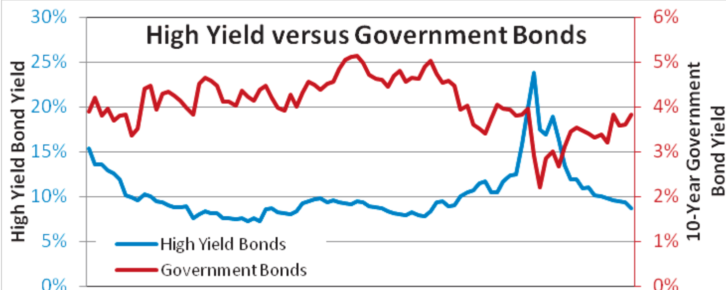
Many people are wondering where the high yield bond market may be heading after the average high yield bond fund increased by 50% in the past year. In our newsletter, exactly one year ago, we wrote the following:

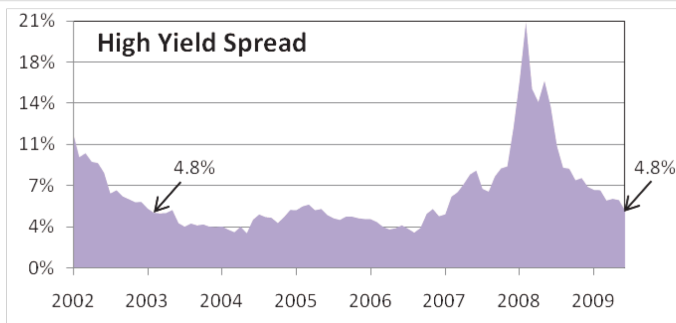
"While there is no guarantee of how profitable this next year may be (for high yield bonds) if prices return to normal, the last time the yield spread was even close to this level (about 10%) was in the recession of 1991. The total return of high yield bonds over that next 24-month period was over 60%"

High yield bonds, unlike stocks, are somewhat more predictable. They produce an income stream that is much more predictable than the earnings stream of companies. And while stocks normally outperform bonds over longer periods of time, there are periods of time when bonds are preferable over stocks, and vice versa. Corporate bonds perform well when yields are high, and when we are coming out of a recession. Stocks perform well when company earnings are increasing.

This chart illustrates what happened after the recession of 2002. If the yield spread does what it did from '03 to '04 and bottoms out at about 3%, high yield bonds could still generate a double-digit return. Historically, the 12-month return on high yield bonds from that point (left arrow) was about 10%, and for the 12-month period following that, the annual returns dropped to about 3%. Now that the yield spread is down to about 4.8% (or a total yield of about 8.6%, right arrow), the potential gains are much more limited for high yield bonds. Stocks performed slightly better over that period.

We still like high yield bonds, but want to remind investors that stocks have historically performed better over longer periods. While the annualized return for the S&P 500 Stock Index for the past 10 years has been 0.5%, the annualized return for the past 20 years has been 9% per year. Additionally, for the past 75 years this index has averaged an annualized return of 10.9% per year. We recommend that clients have a diversified portfolio, and not just one asset class.





PERSONAL PERSPECTIVE *by* Ralph Doudera

I have been observing with great interest the events unfolding in Greece. Once the premier civilization of the world, it is currently on the verge of financial ruin. As the birthplace of democracy, their ideals inspired the fathers of the U.S. Constitution. Its history stretches back almost 4,000 years, and even the Olympic Games have a history of nearly 3,000 years.

What happened? Simply, a lifestyle of living beyond their income. Public debt is currently 125% of Gross Domestic Product, twice that of the United States, and six times greater than China. Last year current Government spending exceeded income by about 40%, and about 40% of the GDP was spent on the public sector. When everyone works for, or is receiving benefits from the government, where do funds come from to pay everyone?

The solution is straightforward: increase income, decrease spending, or default on all the country's debt. So when Prime Minister Papandreou made plans to reduce spending to balance the budget, what was the response of the Greek citizens? Riots, work stoppages and civil disobedience.

If I lost my job, and went home to tell my kids that I would have to reduce their allowance until we got back on our feet, would they respond by refusing to do their chores around the house until they got their money? Not in my house!

Debt is insidious: *"The rich rule over the poor and the borrower is slave to the lender" Proverbs 22:7*

This teaching reminded me to adjust to my slave status when I got a real estate development loan called for no reason by my lender at a very inappropriate time last year. *Slave* is a hard lesson to learn.

Last weekend, my 7-year-old asked me for some quarters to play a video game. I quickly responded with the question *"Yes, are you willing to borrow them now and do yard work to pay me back?"* She walked away without answering. Smart kid.

Our country may be heading down the path to slavery as well. There will never be enough money to do everything. We can't have funds for bailouts, free healthcare, social security, two wars, and a space program to land on Mars while keeping all the government programs funded with generous pensions and benefit plans. Our leaders must have the character and fortitude to apply the common sense of a 7-year-old.

"Steady plodding brings prosperity; hasty speculation brings poverty" (Proverbs 21:5, LB)

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