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Oil and Greece Extinguish Flames of Economic Recovery

May Market Review From Your Portfolio Management Team—June 10, 2010

The title of this commentary seems hard to fathom. It seems unlikely that an oil spill off the coast of Louisiana, coupled with economic travails of the 27th largest economy, could derail this impressive global recovery. And yet, judging by the reaction in the U.S. stock market, with the S&P 500 index down 8% in May (worst showing since February 2009), one could conclude that investors are indeed concerned with the spillover (no pun intended) of these events. As you might imagine, foreign stocks are feeling the impact more sharply, with European stocks down around 13% for the month.

Most stocks peaked around April 23, and from that level (through the close on Friday June 4) the S&P 500 index is down roughly 12%, while the Dow Jones Industrial Average is down about 11%. This marks the first official correction (any drop in prices greater than 10%) since the stock market began its recovery back in March 2009.

As our faithful readers know, we have been expecting this correction for some time, as far back as last summer. While we had two or three minor pullbacks along the way, we have been surprised at the strength of this market rebound without any meaningful corrections. As a result, we have maintained our heavy bond positions throughout this rebound, while our equity positions were no higher than 20% on average.

In response to the growing intensity of the correction, we have been building up our money market positions. As we saw volatility increasing, it was a sign to us that a change in market direction could be coming. As a result, we trimmed back the few equity positions that we had, and even trimmed back our high yield bond positions, which are influenced by what is going on with stocks. Our money market allocation has increased from roughly 15% on average, to nearly 50%.

While stocks are down 10% - 15% from late April, high yield bonds are down only 4% (according to data from Fasttrack). Many of the investment grade bond funds, as well as the municipal bond funds (used in most taxable accounts) are actually positive from late April. In our more aggressive strategies, such as Core Equity and Tactical Growth, we added inverse high yield funds that are designed to go up in price when high yield bonds are falling. The end result of this activity is that our accounts have held up quite well since the market turmoil began. On average, our accounts are down just a fraction of the decline in the popular stock indices, and for the year their returns are positive, on average, while the major indices are down.

With money market yields close to zero, we only want to keep money in that asset class for as short a time as possible; however, when volatility is high and many assets classes are falling, it is a safe port to weather the storm. Once the markets calm down, we will look for new opportunities wherever we can find them—stocks, bonds, or something else.

Please let us know if there is anything we can add to these updates that will help you better understand what is going on in your accounts.