

Market Comments



January Volatile, Ends on Positive Note

Up, down, up, down, up... all in all, January was a pretty good month. Most U.S. stock indices were up over 1% and bonds were up between .25% and 1%. International was largely flat with emerging markets down for the month.

Bonds

Higher quality bonds will be one of the places investors go when they are uncertain or fearful. The Federal Reserve has decided to leave rates where they are for now, and as long as inflation stays in check, rates should remain in their current ranges. And if there were a flight to safety as the year progresses, the demand would also push values higher.

Larger Company Stocks

The bull market in large cap stocks is still intact, but its strength is questionable. On one hand are low inflation, low interest rates, a growing economy, consumer confidence, low unemployment and more buyers than sellers. Together, these present a formidable support for stocks.

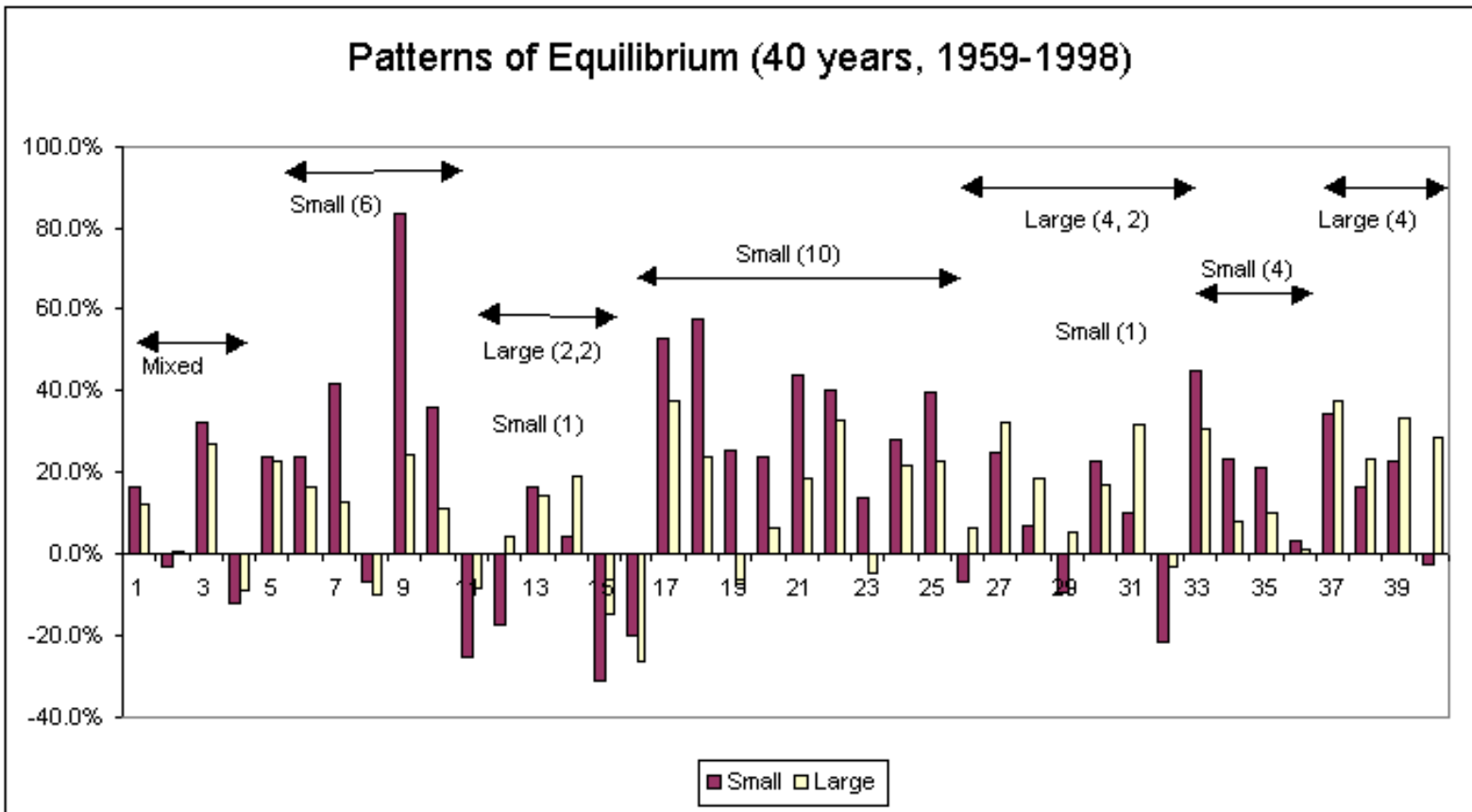
But on the other are areas of high valuation, narrow concentration, speculation and overconfidence. A number of large companies are priced at multiples of earnings far above historical averages. The vast majority of stocks are not advancing much, and many have fallen despite the gains in indexes. Some stocks, particularly Internet stocks have been bid up to speculative levels rarely seen. For many, common sense is taking a back seat to overconfidence.

And as the year continues, stocks are likely to become more and more vulnerable to mood swings. While it appears likely that Y2K computer problems will not be serious enough to cause economic meltdown, there may be enough doubts in many minds to cause more conservative behavior. A retreat to safer havens could limit significant advances, and any serious bad news or even simple herd behavior could cause another correction whether it is warranted or not. Some caution (not fear) is recommended.

Smaller Company Stocks

Smaller companies will generally move in the same direction as the broad markets. Therefore, most of the same factors will affect small stocks as well as large stocks. But as I look at a longer-term view, i.e. five years, I find small caps more attractive.

Historically, large caps will beat small caps for 3-5 years and then small caps will outperform large caps. Consider the chart below. Over the last 40 years, small caps appreciated more than large caps in three periods of four years or longer. Large caps also won the race in three periods. From 1991 through 1994 it was small caps (four years). The last four years large caps have decidedly outpaced small caps. If the patterns of history are reliable, one has to assume that equilibrium will return small caps to the forefront., probably within the next year.



International

While the international markets remain fraught with land mines, it is hard to escape some long-term probabilities. The direction toward freer enterprise is still intact. Technology is allowing faster advances in productivity. People are working. The demand for higher standards of living is strong. Stock prices in many international markets are much cheaper than in the U.S.

This year will continue to see concerns about currencies, recessions and governmental policies, and Y2K presents problems for other countries, too. But the long-term potential is very positive.

Alternative Categories

Gold has made some small moves, but has generally been flat. Fear and/or inflation tend to exert the

most dramatic influence on gold, and neither has existed in sufficient quantities to cause a marked increase in price.

Real estate has been mostly flat even though the construction market has been healthy and occupancies are reasonably good. Low inflation is a factor, plus demand is not as strong as long as stocks and other investments continue to attract investment dollars. But, real estate offers further diversification and should not be ignored.

The energy and natural resources markets have been hard hit due to large current supplies, low inflation and investment dollars heading elsewhere. But this is likely to be a temporary situation. The increasing demand for energy and natural resources will kick in sooner or later. Consumption by third world economies is projected to exceed that of the larger economies within ten to fifteen years. If you believe in the concept of "buy low, sell high", cheap energy looks like a good long-term buy.

Specific sectors, such as health care and technology are likely to continue to advance strongly, with relatively minor interruptions along the way. Some areas are a bit expensive, though.

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