STAAR℠ Strategies Report

Market Comments

Review: 1999 Investment Performance Similar To Anticipated Pattern

At the beginning of the year I wrote that the U.S. stock market would likely rise in the early part of the year, then stall. As the year progressed I saw a good probability of increased market volatility and a correction or two. I told people I would be pleased with an average return of around 10-11% from the S&P 500. The year has progressed very close to that scenario, except that the S&P total return is about 14%.

I also mused early in the year that it was time for Small Company and International stocks to start outperforming the more highly valued Large Company stocks. Small caps have been generally keeping pace and the EAFE international index has outperformed U.S. stocks significantly.

I did not, however, think bonds would have as bad a year as they have. I was not expecting big gains, but I did think they would be positive. Wrong. Many bond indexes and funds have negative total returns so far in 1999.

It may be at least a 50% probability that December could see a correction in stocks, bringing the year-end returns down a bit. This is in spite of December normally being one of the more positive months. Bonds are likely to end the year similar to where they are now.

U. S. Stocks Advance Strongly Back To Upper End of Trading Range

If you recall the charts we provided a couple months ago, the support level for the S&P500 was in the 1270 range. That was the approximate level at that time. We also pointed out that the higher part of the range was around 1440. The S&P 500 now stands at 1388.91 after reaching 1424.94. If the market drops again, the support level would now be around 1300. The upper range wold be around 1450.

Small Stocks Outpaced Large Stocks In Recent Months

Anticipated Shift Appears to Have Begun

Over the past two months, the Average Small Cap Fund (Lipper) rose 13.8% compared to the S&P 500 at 8.3%. As we pointed out early in the year, historical patterns (and common sense) indicated that after four or five years where large companies do better than small companies, the trend is likely to reverse for awhile. If so, the next few years could see small caps perform better than large caps.

Contrarian Confidence In International Stocks Has Paid Off

Strength Has Been Mostly Uninterrupted, But Year-End Concerns Could Cause Pullback

By late 1998 international stocks had taken a beating. If you were a courageous contrarian and believed in "buying low", international was the place to begin. The steady pace has been remarkable. While the U.S. markets have been relatively volatile, the EAFE index has climbed quite steadily, with hardly a hesitation. There is still much upside potential in the international markets, though it is likely to be more volatile than it has been this year.

Bonds Continue To Suffer

But Fed's "Neutral" Stance Could Mean Interest Rates Might Top Out Soon

When interest rates rise the value of bonds falls. That has been the story of 1999 for bonds. Not since Alan Greenspan radically raised interest rates in 1994 has the bond market showed negative returns. Hopefully, the Fed's actions will deter inflation and interest rates will stabilize in 2000, perhaps falling some by year end.

POSITIVE FACTORS FOR INVESTORS

1. Inflation numbers are not terrible and the Federal Reserve's "Neutral" bias could mean interest rates will peak early in 2000.

2. Productivity continues to be strong and earnings of companies are continuing to meet or exceed market expectations.

3. The international recovery has been strong, relieving worries about possible insolvent economies and the fears of global recession.

4. World peace is generally good and democracy continues to make headway around the world. Markets are more "free" than ever. Opportunities abound.

5. Technological advances have not had such a profound effect on global productivity and standards of living since the late 1800's and early 1900's. We are probably only ten to twenty years into a thirty to forty year period of growth, assuming no major interruptions occur (i.e. world war or other catastrophe)

6. Y2K computer problems appear to be mostly solved and remaining problems should be manageable. Spring garage sales could offer some great bargains in unused generators and survival supplies.

7. Concerns about moral decay dooming the U.S. and/or the rest of the planet are very possibly overly pessimistic. While these concerns are relevant and always important, it appears to this writer that it may not be much worse than it has ever been. It's just more visible and publicized. Yes, there are disturbing trends, but there are also counter-trends. Don't give up the ship just yet.

8. Saving and investing patterns continue to benefit the markets. People, especially baby boomers have continued to pour money into the markets in their 401(K) and other plans. There has been a growing confidence in owning valuable companies and property. Also, boomers will be inheriting billions over the next 20 years, much of which is not invested in the market. There doesn't seem to be a shortage of "fuel" yet.

NEGATIVE FACTORS FOR INVESTORS

1. Inflation pressures are real, and if recent interest rate hikes don't slow it down, the Fed will continue to raise rates in the future. This would act as a drag on both stocks and bonds.

2. Consumer debt has risen to alarming levels. Some are counting too much on stock market gains to pay for it. This is like an informal "margin account" where investors borrow money to make investments. This increases risk.

3. Strong market gains make market "corrections" (downturns) more likely. All that is needed right now is the right excuse to sell and the market could retreat 5-10% or more from today's levels.

4. Overconfidence in stocks can drive up prices to unreasonable levels, sometimes called a "bubble". When such a bubble bursts it can be catastrophic. The U.S. market in the late 1920's and the Japanese market in the late 1980's and early 1990's are two major examples of markets driven up by overconfident and/or speculative investors.

5. Y2K fears could cause conservative selling over the next few weeks. Even if we believe there is a low probability of a major problem, there is that lingering thought, "Just what if some of what the doomsayers have been crying about does happen?" It doesn't have to be real for people to behave as if it might be.

6. Y2K could still cause problems. While it looks like a paper tiger, it is still possible for some more serious problems to occur. Ultimately only the turning of the clock will tell us for sure.

7. Attacks on free markets and restrictions on trade and individual freedoms can have a profoundly negative effect on economies. We only need to look at the former Soviet Union to see what happens when the state restricts private ownership. The Chinese have got the message and are reengineering their economy to allow more private ownership and economic competition. Should politicians get in the way in the U.S. and abroad, they could at least make the golden goose sick.

An unknown or unforeseen event or events may be the biggest risk of all. Investors don't like negative surprises, especially those that increase fear. Terrorists with a nuclear bomb or biological weapons would be at the top of my list of possibilities that could create market panic. Another oil embargo or military conflict involving China or Russia would likely cause turmoil even if the U.S. wasn't involved. Another monetary crisis overseas would be more difficult to overcome than this most recent one.

Long-Term Outlook Remains Positive

On balance the next fifteen to twenty years look good. Barring the unforeseen, the world is in position to raise the standard of living significantly. The last decade saw the greatest increases in wealth in history. The next decade could produce even more. But common sense and a cursory understanding of history should alert us to the fact that even advances will not come without pain. Stock markets will not simply continue to rise. Not only will corrections occur; there will be recessions and bear markets. Therefore, we must remain diversified, well planned, vigilant and prepared for the unknown.