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# Market Commentary

**By Stephen C. Browne, CFA, CIO**

The equity market declines in the second quarter resulted in most major indexes declining 10% or more. The combination of a strengthening dollar and fears about Greece and the other Southern European Countries made Europe the worst performing major geographical area with the MSCI Europe Index returning -14.8%. The US and Japan did better, returning -11.3% and -10.1%, respectively. As the declines in the second quarter were more or less uniform, the areas that outperformed during the first quarter – small cap, low quality, financials, and emerging markets – remain the top performers year to date. Master Limited Partnerships (MLPs) continued their strong performance with the Alerian MLP Index posting a total return of 11.8% for the year.

The financial markets were spooked by a combination of the sovereign debt crisis in Greece and several key barometers of economic growth such as initial jobless claims and existing home sales coming in below expectations. Inflation for April and May turned slightly negative, indicating that the deflationary period begun in 2008 has not yet ended. Of concern is the expiration of unemployment benefits, housing incentives and the lackluster impact of the 47% of the approximately $800 billion of the stimulus program that has entered the economy to date.

### The Bond Market

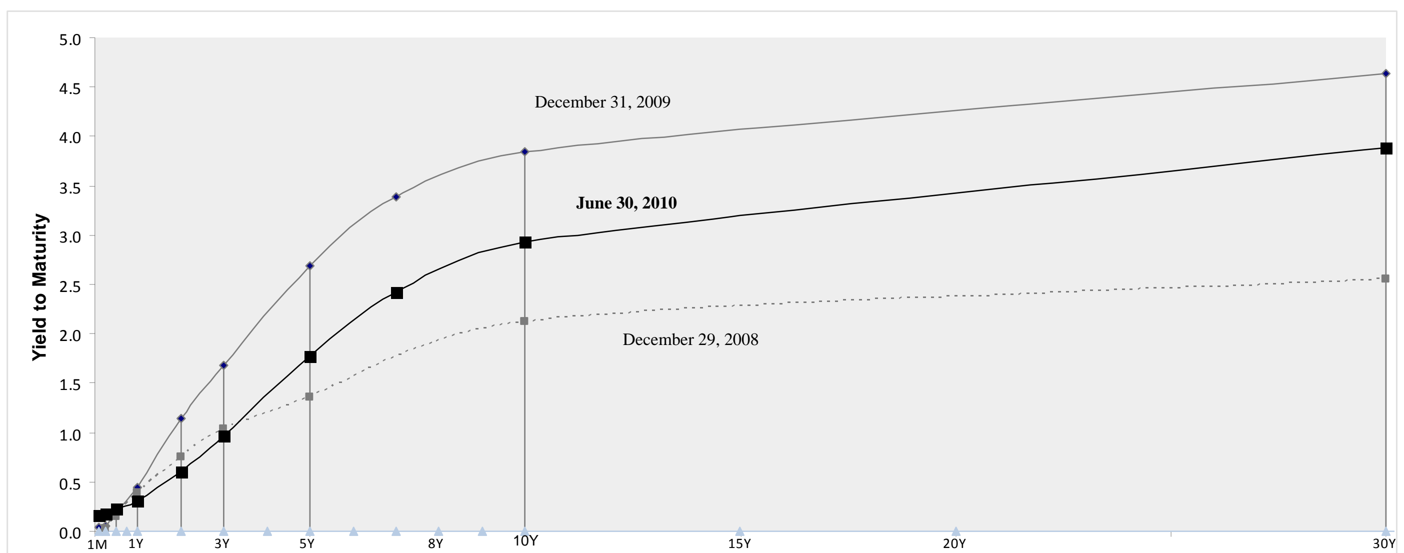
The bond market reacted with a substantial rally causing yields on Ten Year Treasury Bonds to decline to just over 3.0%, about halfway between where they began the year and the absolute post-Lehman bottom on December 29, 2008. Unlike late 2008, TIPS, the Treasury Inflation Protected Securities, rallied as well with the ten year TIPS falling to record low yields of 1%.

The difference between nominal Ten Year Treasuries and TIPS indicates a market inflation expectation of 2% over the next ten years. This compares to a slightly negative spread at the end of 2008 where the bond market was pricing in ten years of outright deflation.

### The Truth About Market Forecasting

Forecasts of the economy or the stock market warrant extreme skepticism regardless of the credentials or past track record of the forecaster. Empirical studies indicate that economists as a group cannot predict the future state of the economy, nor do the track records of individual "star" forecasters warrant any reliance. Given that the future state of the global economy depends upon the fu-

**US Treasury Bond Yield Curves, 2008, 2009 and June 2010**



ture decisions of millions of individuals this is not surprising. Out of a population of hundreds of trained economic forecasters, a few are sure to make what appear to be prescient calls after the fact. Fortunately successful investing does not depend on forecasting the future; indeed no successful investors I am aware of have derived their success from having better forecasts than others.

**The Prechtler Prediction**

On July 4, 2010, an article in *The New York Times* featured Robert Prechtler, an "Elliott Wave Theorist" predicting a 90%+ decline in the US Stock Market. Elliott Wave Theory is a financial equivalent of astrology – it is vague enough for practitioners to concoct explanations for anything in hindsight but has no value predicting the future.

Prechtler earned fame when he "predicted" the bull market of the early 1980s. Since then, it is difficult to find a circumstance in which he has been right. Early in 1987 Robert Prechtler famously predicted the Dow would rise to 3600 (it was around 2000 at the time). Turns out he missed the 1987 crash and his prediction eventually came true, but not until 1993. In 1998 he predicted a 2365 Dow the following year (1999 was the year the Dow hit 10,000 for the first time) and he also predicted a Dow below 1000 in 2003 (the year the Dow hit 10,000 for the third or fourth time).

Nevertheless, people with the barest modicum of credentials who are willing to make bold predictions find a willing audience in the financial press, which should not be surprising as the number of investment publications sold with the headline "Diversify, Own Quality and be Patient" is without a doubt far less than the number of "correct" Robert Prechtler predictions.

With thousands of investment managers, professional economists and market commentators out there, there will always be a few whose predictions come true. This can simply be attributed to luck and the subsequent predictions of these individuals usually turn out to be disappointing. For individuals it is irresponsible, and for fiduciaries negligent, to entrust the success of their financial goals in the predictive ability of any individual or firm.

**No Forecasts Needed**

Real investing involves purchasing cash flow streams at prices that discount their inherent risk, not gambling on unknowable future outcomes. These cash flow streams can be set contractually in a bond or, in the case of stocks, a participation in the profits of the business. This is not to say that economics is worthless in regard to investing. Investors do need to understand how their investments may perform in a range of economic outcomes. In today's environment it also involves understanding the dynamics of these cash flow streams during periods of inflation or deflation. High quality stocks continue to be priced at levels that support long term real returns of 5-6% which is in line with historical averages. The aftermath of the financial crisis will continue to cause both economic and market volatility.

No magic bullet exists for dealing with the current environment. The global economy appears to be assured of several years of anemic growth as credit remains tight and highly leveraged borrowers, both public and private, struggle with servicing their debt. Stocks remain priced for attractive returns once the current volatility passes, but the time this will take is uncertain. "Safe" investments such as Treasury Bills and gold are certain losers once spending needs and inflation are accounted for.

The only real option is diversification and making sure that portfolio liquidity is sufficient for at least five years of distribution needs. Investors should know what they own and why they own it. Periods of volatility like this should be expected to occur periodically over the next several years as individuals, governments and businesses continue to deleverage and the economy struggles to recover back to full employment.

*Please feel free to give us a call at (713) 977 2694 with any questions or to discuss further.*

## Smart Investing Conference Calls

**Upcoming Call:**

The Comstock Perspective on the Second Quarter
Tuesday, July 20, 2010 at 2:00pm Central.

We will be discussing the current market trends, recent developments, and sharing our thoughts on what it means to you going forward as an investor.

For more information on upcoming calls or to listen to recordings of past calls, please visit our website **www.paulcomstockpartners.com** under Smart Investing Resources/Conference Calls.

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