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Shock and Awe

"We speak with a certain amount of awe, since the last thing in the world we anticipated a few short months ago was that the Dow would be up some 16% on the year, unless it was that the S&P would be up more than 14%." - Barron's, December 18, 2006.

In my earlier letters, I have expressed concern about the slowing economy, inverted yield curve, weakening capital spending and housing market. In the middle of the year, we had a sharp drop in the market owing to a sudden lack of confidence in the Federal Reserve, and a war in the Middle East. Markets dropped sharply, clients expressed concern. We moved to cash and a defensive posture. Still the markets reached new highs for the year. The result is that we underperformed the market on the year, for the first time since 2001. The underperformance was the result of our cautious approach an effort to protect our portfolios from what we perceived as strong risks to the market.

Our portfolios have twin objectives. One objective is to outperform the market over time, but the other is to not lose money. Sometimes these objectives come into conflict as they did last year. Because of our concern over the direction of the market we became cautious. We are not afraid to raise cash in such circumstances, and did so. As it turned out, that move made us money on the year but caused us to trail the market. However, we were in good company. Indeed the average mutual fund manager underperformed the market last year. Large cap growth managers managed a 5.6% return on the year.

I have recited a number of times, the causes for concern about the market. These concerns explain the conservative position I have taken with respect to client portfolios. Given the risks in the market last year, I believe we took the better course. Those with exposure to international markets benefited from the gain in those markets.

To be sure the economy was aided by declining oil prices, controlled inflation numbers, strengthening consumer confidence, strengthening home sales, and purchasing management index, and therefore managed to turn in an impressive rally in time for the year end. But has this rally borrowed from the usual Santa Claus rally that often happens at year end? Is this bull market getting long in the tooth?

The outlook remains much the same, a threat of inflation, oil at about $60 a barrel but falling, slowing GDP, a fading housing market, and possibly falling consumer spending which would affect business confidence. While a soft landing looks more possible, it seems unlikely that the

Fed will ease rates any time soon. There is still the possibility of further slowing in the economy next year, but I think it less likely that we will fall into a recession.

For the time being we will remain defensive, with a diversified portfolio, featuring healthcare, consumer staples, and financials. This will naturally lead us to larger capitalization, and multinational companies. We will maintain our fixed income allocations and international where have been directed. This approach should shield the portfolio from decline and provide growth as well.

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