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In the distance, I see a frightful storm brewing in the form of untethered government debt. ...... Unless we take steps to deal with it, the long-term fiscal situation of the federal government will be unimaginably more devastating to our economic prosperity than the subprime debacle and the recent debauching of credit markets that we are now working so hard to correct. - Federal Reserve Bank of Dallas President, Richard Fisher

What About the Recession and the Bear Market?

Interestingly, it looks now like there may be no recession. Several factors seem to be at work. First, as noted in my earlier newsletters, the economic woes seem fairly concentrated in certain consumer discretionary, financial and real estate sectors. Other areas of the economy, such as technology, industrials, staples, transportation and healthcare have been relatively stronger. Second, the aggressive Fed actions lowering interest rates are definitely working (whether you agree with the philosophy). And third, we are reminded once again that recessions cannot be predicted, confirmed or influenced by what certain “experts” say or the number of times the word appears in print or on the web.

Another similar outcome may be shaping up with the bear market, i.e. we may not really be in a bear market but we may have actually experienced a severe correction within the late stages of the ongoing bull market. What is the difference? True cyclical bear markets drop much lower than what we’ve seen and last much longer.

For all the talk about subprime mortgages, the freeze-up in the credit markets, home prices tanking and banks being on the ropes, the far greater threat to the global bull market is the developing mania in energy prices. Fortunately, there is evidence that we may be about to see a pause and correction.

2008 has been characterized by high volatility and sudden steep declines, before nearly returning to breakeven as of the end of May. The most difficult thing about investing in periods such as this is that the strongest investments generally correct the most, i.e. appear the weakest. Examples this year are technology and many foreign markets (China foremost). Technology stocks have been considered good value but, being inherently more volatile, dropped well more than the averages in January and March.

So What is Ahead?

I still believe, as I wrote in January, that 2008 will be a positive year for stocks (more or less depending on the sector and region). There is a wall of worry to climb (as is always the case with the stock market), especially given that energy prices are not terribly far from the choke point. However there are positives, including the low interest rate environment, relatively strong global markets and the positive earnings outlook in many industry sectors.

A true, deeper cyclical bear market lurks somewhere in our future but my thinking is that it may more likely occur late in 2009 or even 2010. It's all just speculation, but I suspect that a certain combination of inflation, ever higher energy costs, higher interest rates and surprises (especially political) may bring the recession and major stock market decline that have been much anticipated for 2008. Historically, recessions correlate more typically with the start of a new decade. Also, the first and second years of a new presidential term are far less kind to the markets – due to the inevitable surprises. When and if that happens I will be doing my best to position the stock models accordingly – just as I am today.

What Am I Doing?

I am keeping the portfolios invested in the sectors that should be strong. In particular, despite the possibility of a short term pull back in energy prices, I'm staying invested in energy stocks for the long term. The energy market is in what we call a secular uptrend and that is not likely to change as long as global demand keeps increasing while supply decreases. Aside from energy, I'm focused in technology, medical and industrial equipment and international stocks, with special emphasis on Latin America. I intend to stay invested within the risk profile you provide.

What Should You Do?

We are not far from breakeven for 2008, following a very good year in 2007. I would suggest that now is a good time to rethink your investment orientation and make sure you are happy with how you are positioned. You've experienced high volatility. Are you comfortable with your risk profile or should we discuss it? I am available by phone and email. Remember that my opinions regarding the future are just opinions. My day job is not to give opinions – it is to look for sectors, funds and regions that are likely to outperform when the markets resume their ascent.

I agree with changing your risk profile if the change is intended to be long term. Those few of you who instructed me to sell out of the markets in January or February succumbed regrettably to human nature, which is seldom a faithful guide in investing. Why didn't anyone think about calling me in October when the markets where cresting?

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