The Tonge Telegraph
April 2005

April Showers

The month of March witnessed a reversal in both the stock and bond markets. Although astute observers expected both reactions, the timing, depth, and duration were unpredictable and remain unknown.

The bond markets finally reacted to the pressure of the Federal Reserve's 'measured pace' of interest rate increases. At some point in the process of raising rates, bond prices must react. To the Fed's credit, the process of slowly increasing rates over the last year, combined with an open communication with the securities industry, mitigated the typical knee-jerk reaction at the first sign of a rate increase.

The reversal in the stock market means primarily one thing to investors: quite simply, the risk premium in equity exposure has heightened. It doesn't mean the market indexes have to skid off their upward path and fall off a cliff. Perhaps this is a 'pause that refreshes' the markets, producing a simple regression to the mean. We saw something of this effect last summer when the markets corrected before bottoming and supporting a broad rally in the last three months of 2004. The other possibility is an outcome more along the lines of 1998, which resulted in a correction that went well beyond a "normal" regression and took the market directly into washed-out conditions, pulling the average stock down roughly 20% with some moving much lower.

As we can't predict which course the market will follow, our thought process here should be very much as if we are driving a vehicle out of our garage. Sometimes we choose to take on more risk behind the wheel of a car, just as in the market. When the temperature is 20 degrees and there are three inches of snow on the ground, you may still have a successful trip to the office. That said, the risk of having an accident is greatly heightened. Most drivers compensate for this obvious increase in risk by driving more slowly, keeping a little greater distance between themselves and other drivers, and remaining generally more aware of their surroundings. Others ignore the conditions and likely end up riding home "sitting shotgun" in the tow truck.

As a conservative investor, I like to protect portfolios by reducing equity exposure when the markets start declining. I begin by selling the index funds like the S&P 500, Dow Diamonds, and the NASDAQ composite, broad indexes easily repurchased when the market stabilizes.

Currently, I am inclined to think that we're seeing a pause in an overall upward trend. At the same time, I'm also acutely aware that the market could, in the midst of this correction, be hit by some other event, causing a major downturn. In addition, we are near the end of the November-to-May time period, historically a period of the most gains in the stock market. With Spring in the air, we'll hope for no more icy roads, here or on Wall Street!

Tonge Investment Services. 22 Common St. Waterville, ME 04901 T: 800 546 7762 E: rstonge@gwi.net