NOW'S A GOOD TIME TO GET SOME GOOD ADVICE

Now What?

In our March 14th piece, “Some Flurries of Good News”, we said that the current bear market rally would last longer and go higher than any rally over the last 18 months. We were right on. From the lows of March to the highs in June, markets rallied 40% to 50% -- one of the fastest rates of appreciation in stock market history. Unfortunately, phenomenal rebound not withstanding, the major averages were barely in positive territory by the end of June. Still, our portfolios, on average, have done a lot better year-to-date and over several longer cycles than the major averages. (This may be better or worse if compared against benchmarks other than the major averages.) Why is this so? In order to explain this, we will need to step back and describe the kind of market investors are navigating.

Today's market is a secular (more than one cycle) bear, much like the period between 1965 to 1981, when the Dow Jones Industrial Average bounced back and forth from 600 to 1000. In the '65-81 secular bear, there were “Bull” and “Bear” phases that lasted several years. To make money investors had to be in and out of those assets that did well during those sixteen years and avoid underperforming assets. Investors also had to trade the swings between 600 and 1000. A buy and hold approach or a simple diversification approach employed during the secular bull market of the 80' and 90's, just did not produce good returns. Our “adjusted benchmark portfolio” (described in “Some Flurries of Good News”), deals with this range bound environment quite well. It shows us how to capture the upside when appropriate (buy low) and lets us protect the downside when times get rough (sell high). To get a true measure of how a portfolio is doing, it is important to measure the returns over a complete cycle (market top to top or market trough to

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trough). At the end of the day, in this kind of market, you can't sit tight. Money made should be taken off the table before it goes away in the next downturn. The last complete cycle, trough to trough, ended October, 2002. The current trough **may** have bottomed in early March, 2009. If so, then you have had a bull phase from October 2002 until October 2007 and a bear phase from October 2007 until March 2009. For you to analyze your own investment portfolio skills, you need to assess your results using this framework of bull and bear phase and the complete cycle.

As the S&P approaches 1000, what do we expect for the market through the end of the year? The question is whether the rally marks the end of the bear market, or if it represents a temporary bounce from oversold conditions? We believe it does not matter, as it is time, again, to get defensive. We think there will be better buying opportunities, overall, this coming fall, as the market has come a long way in discounting a recovery and is ready for a breather.

Current Economy

United States Economy

This Great Recession will not be meaningfully over by the 3rd quarter. Never before has the bottom fallen out so fast or affected so many people so deeply; people are still in shock and still uncertain about the future. Virtually no organization or group of workers has been left unscathed. Dramatic interest rate cuts, stimulus programs, capital injections, bank rescues and a plethora of new government initiatives have helped to combat credit-related deflation risks (like bankruptcy) and stabilized the economy. The economic freefall may have ended, but a self-sustaining upturn is not in place. In fact, a second stimulus package may be needed to keep things going on a permanent basis. The consumer has been crushed and will not start spending freely anytime soon. Housing kicked off this downturn and tight **credit** (have you talked to anyone who has tried to get a mortgage or refinance lately?) and a **new foreclosure wave** cast substantial doubt on a sustained rebound near-term. Delinquency rates on mortgage payments typically rise in tandem with unemployment, which we expect to reach 11% in 2010.[1] This many Americans haven't been out of work since the Depression. (Keep in mind it takes 100,000 new jobs per month to keep the unemployment rate steady.)[2] **The bulk of the most recent foreclosures were on prime, fixed-rate loans**, extended to the most credit worthy borrowers -- the bedrock of home ownership in America. The first wave of foreclosures was mostly on subprime loans held by the riskiest borrowers. The number of houses in foreclosure in the first quarter of this year jumped to a record 3.85% of outstanding U.S.mortgages. We expect this to eventually peak at 4.5%.[3] We do not expect a housing recovery until the end of 2012. It is likely that government actions thus far will boost the economy to a positive GDP (Gross Domestic Product) number by the fourth quarter, but we expect 2010 to grow a tepid 1% to 2%.[4] Even as the economic numbers may force a declaration that “the recession is over”, for most people it will still feel like one.

World Economy

The worst may be over for the global economy, but only in the narrow sense that the absolute rate of decline may have peaked. Given the unprecedented and unsustainable magnitude of fiscal and monetary stimulus worldwide, it would be surprising if we were not seeing some signs of stabilization. However, no conventional, self-sustaining, recovery is in sight. Projected growth over the next three years will be too feeble to prevent rising unemployment, expanding excess capacity and weak profit growth. Overall growth in the industrial economies may decline by 4% in 2009; by 2010 the developed world may see growth of .2% to 1%. In 2009 and 2010, we expect the emerging market economies to show growth of 1% to 2%.[5]

Asset Allocation

U.S. Stocks and Bonds

The U.S. stock market is still a bear. Investors that have enjoyed the recent rally should begin to get defensive. We will be in the process of raising cash, buying inverse mutual funds and/or ETFs (Exchange Traded Funds) and/or buying S&P 500 put options. For some portfolios we have written call options against current long positions. We continue to avoid financials, real estate and consumer durables. We will keep consumer staples, health care, biotech, industrials and high technology. Health care stocks look particularly attractive as their prices have been held down by the health care reform debate. With more government regulations, there are legitimate concerns about decreasing profit margins. On the other hand, here come the aging boomers and a lot of money is going to be spent in the coming years and many companies will undoubtedly benefit. It is too early to tell whether the decline will be shallow or deep. Assuming a severe decline, we will be erring on the side of downside protection.

20+ year treasury bond prices fell almost 30% from December, 2008, until June, 2009, (so much for the risk-free investment!!), as investors sold their "safe haven" security and switched to riskier investments. 20+ year and 7-10 year treasuries are now at attractive levels, particularly as a safe haven against a declining stock market. We also recommend investment grade and high yield corporate bonds or bond funds. We have taken profits on some international bonds as the U.S. dollar could strengthen during a stock market drop into the Fall.

International Stocks

We still favor the Far East, China, Latin America and the commodity rich countries of Canada and Australia. However, all of these markets have had huge rallies from their lows in March, in anticipation of a global economic recovery. Prices have risen too fast to be sustainable, so it is time for a breather and to begin to pare back in this area. As with the U.S. market, we will add to these markets when they show weakness again (when the news is bad, as they would not be down otherwise) and be ready for another rally phase into next spring.

Natural Resources and Energy

All portfolios should have natural resource and energy holdings on a long-term basis. Nevertheless, given our overall market outlook, it is time to begin to reduce exposure in this area for a short time. For many years, we have traded in and out of gold bullion and/or gold stocks. Gold is an excellent hedge against a declining dollar. The history of gold has always been intertwined with the interests of governments.

560 B.C.	First, pure gold coins were struck by King Croesus of Lydia (now Turkey).
1834	United States adopts gold standard at $20.67 dollars to one troy oz.
1934	The Gold Reserve Act outlawed most private possessions of gold, forcing individuals to sell it to the Treasury. It also devalued the dollar by raising the price of gold to $35 per ounce.
1973	Official gold price increased to $42.22 per ounce; **U.S. abandons gold standard**.
1974	**U.S. allowed buying gold and gold coins for the first time in forty years.**
1975	The U.S. Treasury begins the sale of its gold holdings.
1980	Gold prices peak at an historic daily high of $850, **equivalent to $2200 in current dollars**.
1999	European Central Banks begin the sale of their gold holdings.
2003	**China** begins aggressively to buy gold.
2009	The International Monetary Fund stated that it should continue to hold a relatively large amount of gold among its assets, not only for prudential reasons, but also to meet unforeseen contingencies.[6]

Gold reserves are held in significant quantities by many nations, forming the bulk of their liquid currency reserves and as a means of defending their currency. Weakness in the U.S. dollar tends to be offset by a strengthening in gold prices. The liquidity crisis last autumn had a profound effect on central bank thinking. While Far East central banks and India have been accumulating gold, most European central banks have been sellers over the past 10 years. Gold has shifted back from a sovereign reserve asset central banks were inclined to underplay to one of growing, strategic interest. This shift is logical: gold remains the world's primary financial asset that is no one's liability. Over the last six months China has bought more gold for their reserves than all of the European Central Banks have sold in the **last six years**.[7] Gold is now seen as an extremely useful, counter-cyclical tool for future crises. China, Russia and Saudi Arabia are questioning whether the dollar should remain the de-facto reserve currency for the world. China is attempting to make the Chinese renminbi or yuan more acceptable for international trade. One of the ways China is doing this is by buying gold. China appears to be moving toward backing some of its currency with gold reserves, a more substantial international means of exchange. If gold is valuable as a holding for central bankers, it is wise for individuals to mimic them and own some in their own portfolios.

Real Estate

At current prices, REITs have discounted a 45% decline in real estate values from their peak.[8] Valuations are attractive, but we see REITs the same way we see financials, a broken former leader that investors should underweight until stability in underlying real estate prices and cash flows emerge. We expect REIT cash flows, on average, to decline 10% in 2009.[9] Many REITs have begun huge recapitalizations, which reduces debt maturity risk (risk of default on debt near maturity) but is dilutive to earnings and dividends for current shareholders.

Summary

While we may see a positive GDP number by year end, it will not be a sign of a return to robust growth. We expect growth to be around 1% to 2% in 2010, followed by a couple of years of the same sub-trend growth. Right now, it is time to move back toward a defensive position. We recommend cash, short, intermediate and long-term investment grade and treasury bonds and using options and/or inverse funds to protect portfolios. We are positive on consumer staples, health care, biotech and selected industrial and high technology stocks and are negative on financials, real estate and consumer durables.

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1 Mercurynews.com
2 Mercurynews.com
3 Reuters.com
4 Imf.org
5 Cass Research Associates
6 Gold.org
7 Gold.org
8 Cohenandsteers.com
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