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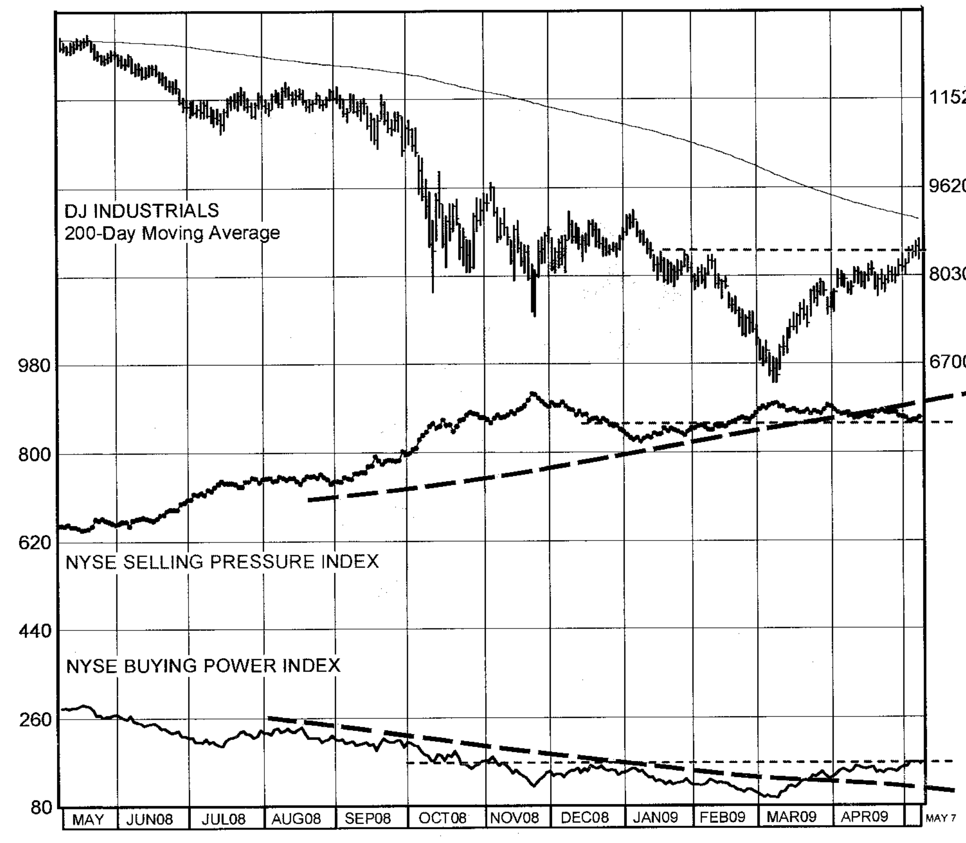
CAPITAL MARKET UPDATE

May 11, 2009

***SUMMARY AND CONCLUSION:** The Stock market closed lower for eight consecutive weeks, to a 13-year low, into the full moon lunar syzygy of March 10th. Then it began to rise. Today, in dramatic contrast, Stocks have closed higher for nine consecutive weeks, scoring the sharpest gain in seventy-six years, into the full moon lunar syzygy of May 8th. According to these indicants alone, the market has come full circle, and should be ready to decline. However, our other indicators are sufficiently robust to keep our Intermediate and Long Term equity models on their respective BUY signals of March 19th and March 27th. In the past, Intermediate Term signals typically lasted a few months, and the average Long Term signal lasted a few quarters. Given today's anomalous market dynamics, our models are likely to be less than normally stable; but position accounts have no obvious remedy but to follow the models. When these signals were originally given, we bought smaller than normal positions and/or we bought equity-substitutes such as Junk Bonds and Convertibles. The wisdom of this strategy is now being called into question, but we are not sure what, if anything, to do about it. Normally a 5-wave, 17-month 7700-point bear market such as we just had, might be expected to lead to a 3-wave, 3-month, 2900-point rally. So we should have higher to go in terms of price. In terms of time, there are two Cycle Dates and a Bradley Date in July, so the Stock market may be able to hold together into early summer. In terms of the wave count, we have no definitive opinion. We are still flat T-Bonds and long equity-like Bonds. We are also long Gold, Commodities and Forex.*

Stocks: We consider *Lowry's* one of the best tools for negotiating the Stock market. However, we use it not as a stand-alone model, but as part of an array. On a subjective basis we graded the data Positive in mid March. However, the experts at *Lowry's* have developed objective protocols for generating signals, and according to them, the data gave a Buy last Monday.



We still are not aggressively trading any of these markets.

Global Equities: On a relative basis, Emerging Markets and Asia ex-Japan are still the leaders. But on an absolute basis, Global bourses are joined at the hip with US stocks.

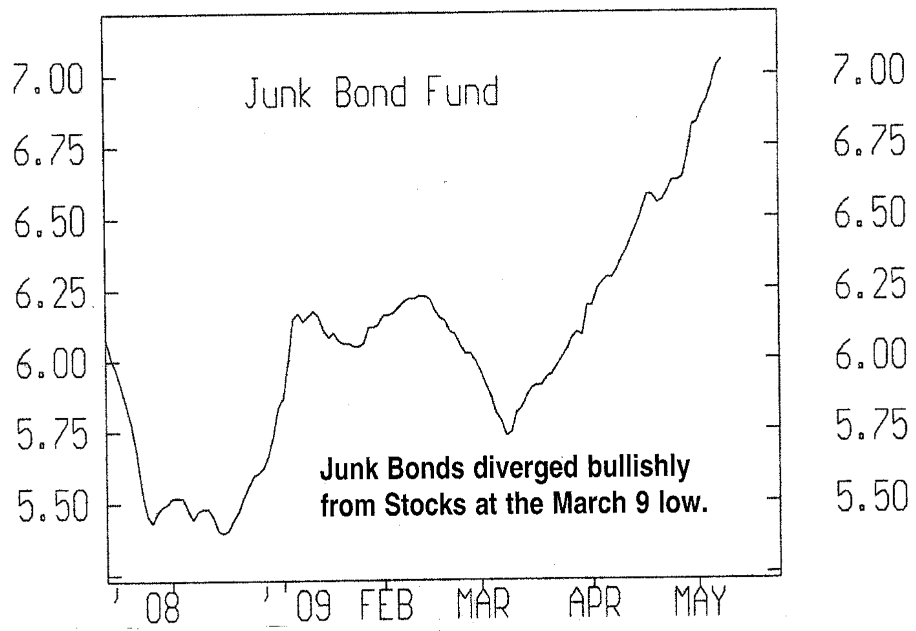
Bonds: Our three major Bond models have been consistently Negative (see summary page). These particular models address the Long T-Bond specifically, but in normal circumstances they can be used to manage long-term Bonds in general. However, these are not normal times. Typically investors buy Bonds to secure the interest income. And corporations issue Bonds when the cost of debt capital is less than rate of return of business enterprise. Lately, however, investors bought T-Bonds irrespective of the coupon in order to protect the market value of their portfolios. And businesses have sold Bonds irrespective of a steep yield curve, because short-term funding dried up. We think the long-term interest rate supercycle turned up in 2005 and will continue higher for at least a decade. The recent spike down to new lows on T-Bond yields was due to a counter-trend *force majeure.* The *Dow Jones Bond Average* presents a better picture of the long term direction of interest rates.

The *Bond Yield/Stock Yield Ratio* still favors Stocks over Bonds--and spread product over Treasuries. This trend is getting old and needs to correct, but that is not enough reason to re-allocate from equity to debt. Eight consecutive days in the same direction are extremely rare in most trading markets; but we have seen the *NYSE Bond Exchange* advance/decline move up thirty-some days-in-a-row. Junk Bonds are up 13 consecutive sessions, but market mechanisms within the Junk venue are such that this long streak does not yet constitute a Sell signal.

Gold: Our models are Positive, demanding some exposure here. We are retaining core holdings but are not aggressively long in trading accounts.

Commodities: We are finally making money on our Commodity trade, just as the market is getting overbought. But as long as everybody is worried about excess Crude Oil inventories we will try to stay long--"sell shortages, buy gluts" the old trading aphorism says.

The Dollar: We have been short the Dollar for two months, but the models are Mixed. We have no insight into this market at present and may exit.



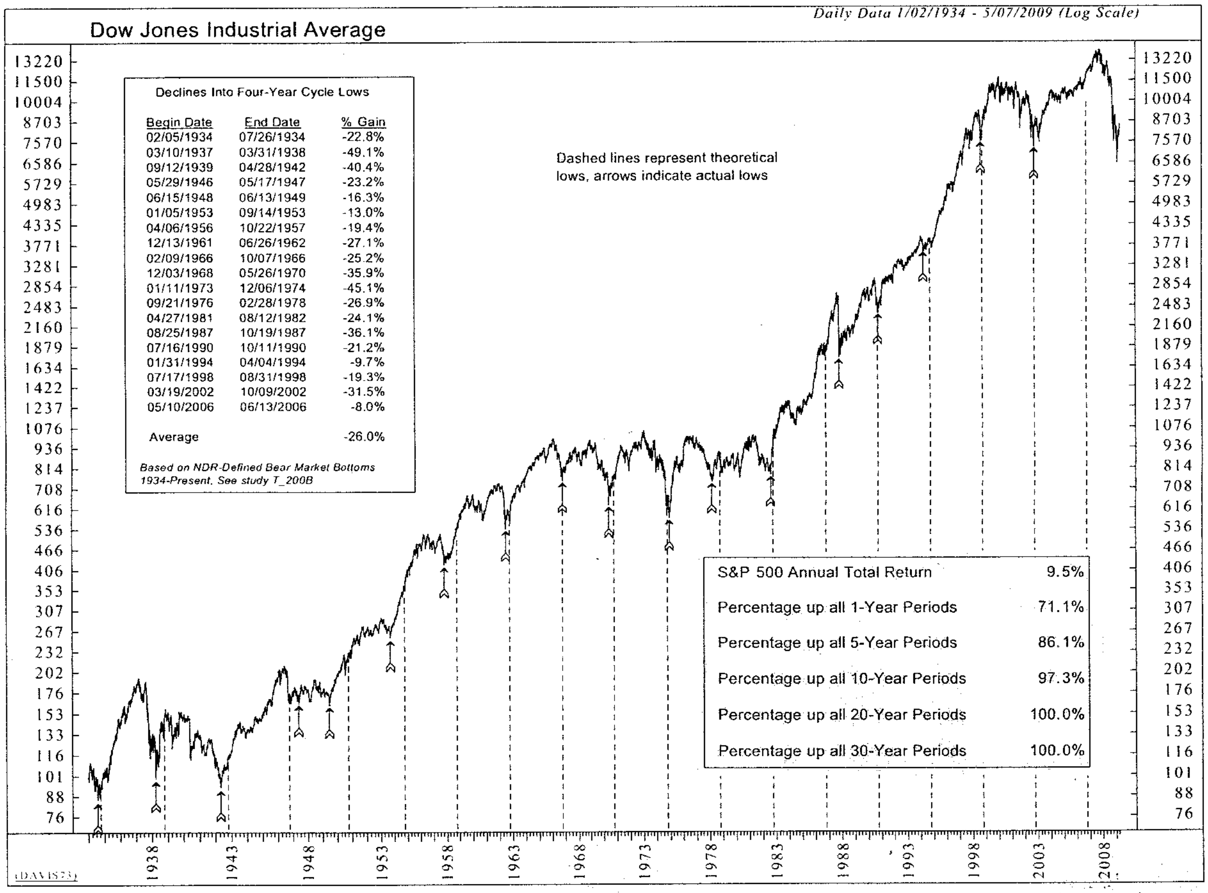
The arrows indicate the orthodox supercycle high in Bonds, low in long-term interest rates. Under this viewpoint, the 2008 spike up, by Treasuries alone, was a non-interest rate related aberration.

Stock Prices and the Supercycle

The chart below and the two tables thereon can be used to illustrate the respective appeals of two very different philosophies of Stock Market investing. The table at lower right shows that even after the horrid markets we have recently experienced, Stocks have still generated an average annual return of 9½% since 1926. Furthermore, investors who held for 10-year periods of time showed a net gain in 97.3% of the cases. And investors patient enough to hold for 20-year periods of time have enjoyed gains in 100% of the cases. This record suggests to many that a Buy-and-Hold approach is certainly an eminently appropriate investment strategy--if not <u>the</u> most successful strategy.

This same chart, however, also illustrates the appeal of "Market Timing," which is quite the opposite of a Buy-and-Hold strategy. Since 1934 there have been nineteen 4-year spans of time (demarcated by vertical dashed lines). Most of those quadrennial periods witnessed at least one significant decline, the average of which was -26%. Furthermore, *actual* Stock market lows (arrows) have come reasonably close to the *theoretic* 4-year cycle lows (dashes). The severity and the regularity of these declines suggest to some investors that, theoretically, anyway, Stock market returns can be *increased*, and Stock market risks can be *decreased*, by avoiding equities during the periodic bad times, such as illustrated here.

We feel that both views have merit, but *at certain times* Market Timing seems absolutely vital. This is why in early 1999 these pages warned that the Stock market was once again approaching one of its periodic sinking spells. However, what we foresaw at that time was not just a normal cyclic



Declines Into Four-Year Cycle Lows

Begin Date	End Date	% Gain
02/05/1934	07/26/1934	-22.8%
03/10/1937	03/31/1938	-49.1%
09/12/1939	04/28/1942	-40.4%
05/29/1946	05/17/1947	-23.2%
06/15/1948	06/13/1949	-16.3%
01/05/1953	09/14/1953	-13.0%
04/06/1956	10/22/1957	-19.4%
12/13/1961	06/26/1962	-27.1%
02/09/1966	10/07/1966	-25.2%
12/03/1968	05/26/1970	-35.9%
01/11/1973	12/06/1974	-45.1%
09/21/1976	02/28/1978	-26.9%
04/27/1981	08/12/1982	-24.1%
08/25/1987	10/19/1987	-36.1%
07/16/1990	10/11/1990	-21.2%
01/31/1994	04/04/1994	-9.7%
07/17/1998	08/31/1998	-19.3%
03/19/2002	10/09/2002	-31.5%
05/10/2006	06/13/2006	-8.0%
Average		-26.0%

Based on NDR-Defined Bear Market Bottoms 1934-Present. See study T_200B

S&P 500 Annual Total Return	9.5%
Percentage up all 1-Year Periods	71.1%
Percentage up all 5-Year Periods	86.1%
Percentage up all 10-Year Periods	97.3%
Percentage up all 20-Year Periods	100.0%
Percentage up all 30-Year Periods	100.0%

decline, such as those illustrated here, but rather a generational, or "supercycle," correction. There were a dozen relatively unconventional reasons we expected market discontinuities soon would present, which would be much more serious than what investors had come to consider normal. To follow up on that 1999 piece, in recent weeks we have proffered our current assessment of several of those dozen reasons. We summarize below:

Solar Activity: Various researchers have reported, based on evidence from 500 BC to the present, that human excitability and activity fluctuate with solar intensity as measured by sunspot activity. Wars, economic activity, bull markets, and favorable corp harvests tend to increase as sunspots increase. Conversely as the Sun becomes quiescent, global temperatures tend to fall, crop harvests become poorer, and the economy and financial markets suffer. The most recent solar cycle peaked in intensity in July 2000, and has declined dramatically into the present day. Some researchers now argue that on April 19th solar activity at last began a new cycle of *increasing* intensity. This conclusion is not unanimous, but <u>if</u> this is indeed the case, then the horrid Stock market decline from 2000 to 2009, should be giving way to a several year advance. That is the good news. The bad news is that the current 11-year sunspot cycle, *Cycle 23*, has generated the fewest sunspots in a century. The last six decades saw five of the ten most intense solar cycles on record. And the hyper-active Sun which characterized those years correlated with the most productive agriculture on record, the greatest economic advances ever, and the most intense bull markets in Stocks ever seen. But <u>if</u> the Sun *is* changing phase–and going into a century or so of relative quiescence--then periodic <u>bull markets in the future should be relatively modest affairs as compared to those of the 20th century</u>. (On the other hand, world wars should be much less likely in the 21st century than they were in the 20th).

Financial Engineering: During the great bull market from 1990 to 2000 or so, Financial Engineering, e.g., Mergers & Acquisitions, Share Buy-backs, LBOs and Private Equity deals, probably added some 6% or 7% a year to the total return from NYSE Stocks. Since such activity ended, the Stock market has dropped the "47%+" we predicted, so the worst effects <u>may</u> now be over. But the debt associated with previous deal activity could still constitute a headwind of sorts. Consequently, <u>the prevailing level of Stock returns over the next decade or so should be lower than it was during the deal days</u>.

Dividend Yields: There are thousands of stock market "indicators," and many investors and analysts assume that Dividends are just one among many. Such a dismissive attitude is inappropriate in our view because Dividends are <u>not</u> just an "indicator;" they are *one* of just *two* factors which constitute an investor's return. Historically, nearly half the total return from Stocks (9% annually) has come from the compounding of Dividends. Furthermore, over time *total returns are highly sensitive to <u>initial</u> <u>conditions</u>.* If one initiates stock market investment at a time when Dividend Yields are above normal, one's total return over time typically will be above normal.

Conversely, if one initiates his investment when yields are sub-normal, his long-term total return is likely to be sub-normal. Dividend Yields were at an historic low in 2000, making good returns from that point on highly unlikely. From their 2000 low to their 2009 high, Dividend Yields have tripled, making Stocks much more reasonable today than they have been in some time. But even after tripling, <u>Dividend Yields are *still* well below their 4¼% historic average, and hence will continue to work against high stock market total returns in the years immediately ahead</u>.

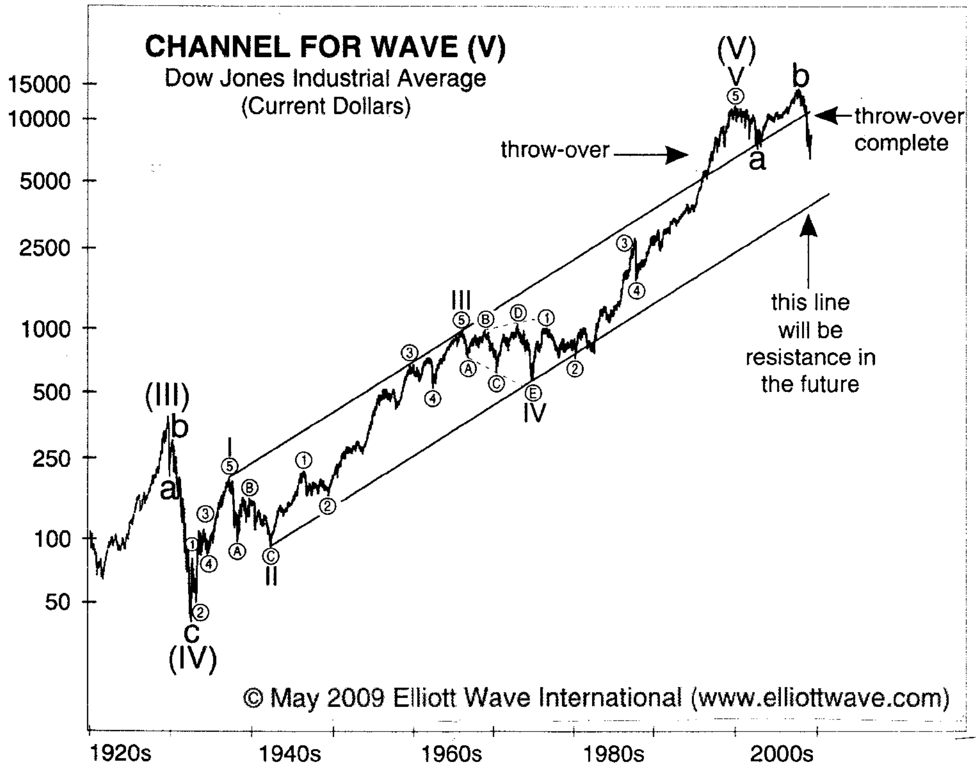
Stock Prices: As noted, the *Total Return* from a security, or market, consists of only *two* factors. One is the Dividends or Coupon payments the owner receives over time. The other is the difference between the Price *paid* for that security and the Price *realized* when it is sold. The outlook for Stock *<u>Prices</u>* is our theme for this week.

While the estimation of future Stock Market Dividends is difficult enough, predicting the *Price* of the Stock market through time is infinitely more difficult. The typical method used to forecast Stock prices is to try to forecast some supposedly more tangible, physical factor through time--such as Dividends or Earnings or Book Value or Sales or Discounted Net Free Cash Flow. When one or more of these "fundamental" factors have been estimated, then a relevant multiple is applied to the resultant data in order to estimate the future market *Price* of the subject security or market. Unfortunately, this method of prediction has a painfully flawed record. In fact, even in retrospect, these methodologies are totally "*time dependent*;" i.e., sometimes the *actual* Price data align with what theory suggests, but sometimes they deviate by 50% or 100% or 200% or more--rendering the laborious effort worse than worthless.

The one thing all the conventional--and failed--attempts at Stock Price prediction have in common is that they try to predict *Prices* on the basis of *something else*--something believed to be "real," such as "earnings" for example. There is one analytic discipline, however, that considers Prices themselves to be the ultimate reality. This discipline ignores all the "fundamental" factors that supposedly "cause" Price fluctuations, considering them to be distracting epiphenomena. This methodology is broadly known as "Chart Reading," the most refined and potentially successful form of which is expressed in *Elliott Wave Theory*.

Elliott theory assumes that Stock market Prices at all times follow one of a very limited number of precise, pre-defined patterns. By identifying which pattern the subject market is currently following--and then ascertaining that market's position within the posited pre-defined pattern--the skilled observer, ideally, can forecast the *subsequent* Price behavior of that market. While even skilled observers often will fail to predict prices precisely, Elliott theory has built-in self-correcting principles. Consequently, when an Elliott forecast goes wrong, it will not *stay* wrong, as many conventional protocols tend to do. Not being an expert in Elliott, we report here the probable future of Stock Prices as viewed by *Elliott Wave International*.

According to Elliott principles, a "*Five Wave Progress Pattern*" implies termination, or "completion." The chart below shows that in 2000 stock Prices hit their "*Fifth Wave*" peaks at "*Three Degrees of Trend*" simultaneously. More specifically: (1) The 5-wave rally off the 1974 low reached *its* completion; (2) It did so coincident with the 5-wave rally off the 1932 low reaching *its* completion; and (3) the 5-wave rally off of the 1784 low (not shown) simultaneously reached *its* natural terminus.

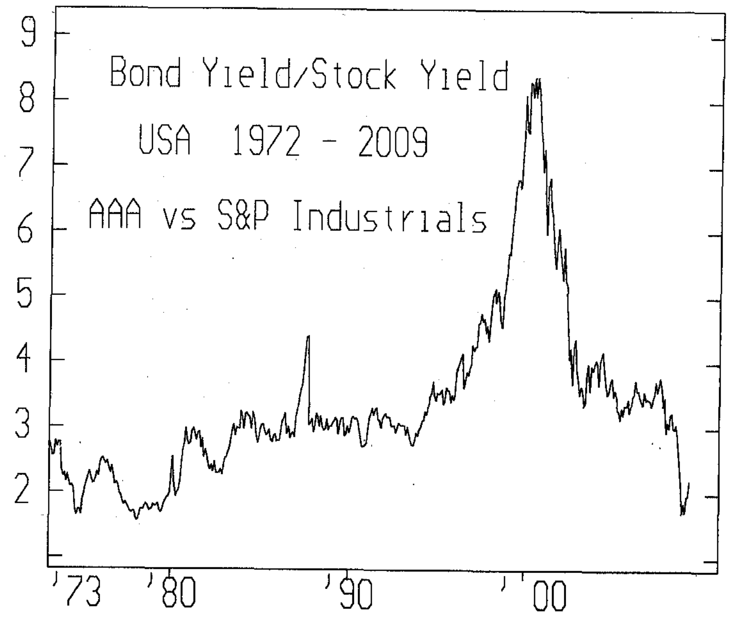


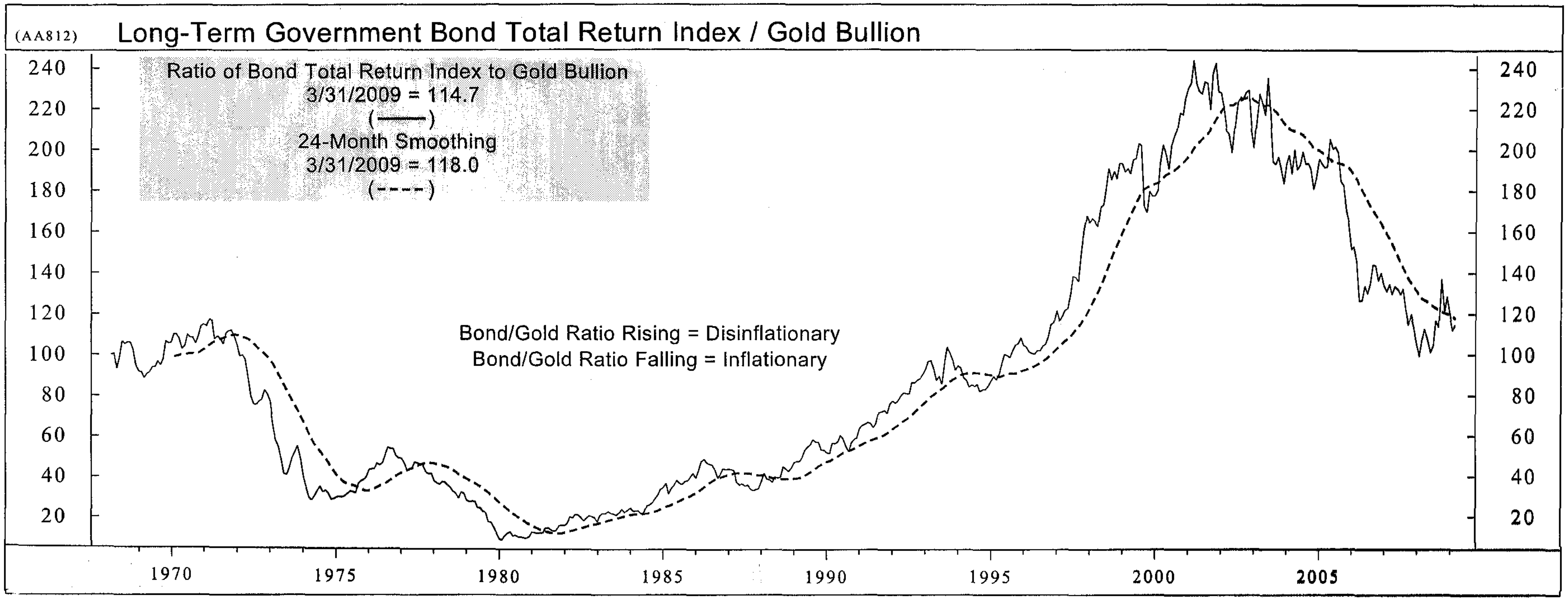
We do not know what the implications of 2000's triptych of *Fives* are *in detail*, but we do know *in general.* The fact that the 2000 peak completed the 5-wave advance off the 1974 low, implies that a decline from the 2000 high should *exceed* the biggest decline since 1974. And the fact that the 2000 peak also completed the 5-wave advance off the 1932 low implies that an ensuing decline should be the greatest decline since 1932. Both of these forecasts have now become *fait accompli*, as the *S&P 500* declined 56.8% into the close of March 6, 2009, thereby exceeding every other Stock market decline since 1974 and since 1932. Unfortunately, Elliott experts count the 2000 top as also marking the end of the 5-wave advance from the low of 1784. And the recent 56.8% Bear market decline has not exceeded the biggest decline since the 1784 low. The declines of 1835-1841 and of 1852-1857 and of 1929-1932 were all worse than our recent experience. Consequently, according to *Elliott*, after the current rally is done, another decline, below the March low is in prospect.

There is one obvious Stock Market dynamic that *can,* but not necessarily *will*, compromise virtually any long term forecast for Stock or Bond Prices. This dynamic has to do with the *unit of account* in which security Prices are denominated. In this country we are used to a *relatively* stable unit of account; viz., the U.S. Dollar. Other countries have not had the same experience. For example, the German Deutschmark, the French Franc, the Brazilian Real, the Mexican Peso, the Indian Rupee, the Chinese Yuan, the Russian Ruble, etc. *all* have been essentially wiped out one or more times during the last century or so. If the U.S. Dollar is ever similarly compromised--which may be a historic inevitability--*cetera paribus* Stock Prices would likely *rise,* since they represent a proportional ownership in certain Real Assets; e.g., property, plant, equipment, inventory, and the like. This "Real Asset" characteristic of equities should put a "lesser of evils" bid under Stock Prices, even in very poor economic circumstances. This was clearly the case in Weimar Germany, to mention just one of innumerable examples.

Currency values, or "exchange rates," constitute a potentially disruptive variable within the Capital and Commodity market equations. For long periods of time, measured in decades if not centuries, Currencies can be relatively well behaved, and of no material concern to investors. This is particularly the case with investors whose assets and liabilities are denominated in the same unit of account. But every now and then Currencies totally jump the track, and instead of "regressing to mean," as is their wont, they accelerate until various exchange rates among these *units of accounts* approach zero or infinity. At such times even portfolios whose assets and liabilities are denominated in the same Currency could be effectively destroyed--depending upon the "mix" of their assets. This is the case because such discontinuities affect various asset classes quite differently. "Real Assets," such as Commodities and Stocks and Real Estate will act quite differently from "Financial Assets," such as Cash and Bonds and Annuities. In order to avoid the potential disaster such a *force majeure* could cause, we must constantly monitor the Price of our assets, not just in *nominal* terms, but in *relative* terms as well; for example, Bonds relative to Stocks, Stocks relative to Gold, Gold relative to Bonds. That is the purpose of the *Bond Yield/Stock Yield Ratio* shown here often. That is also the purpose of the chart below showing *Dow Jones in Ounces of Gold*. Following this algorithm a portfolio would have been predominately in Stocks for most of the time from 1980 to 1999; and would have emphasized Gold since 1999. By constantly keeping our wherewithal in the strongest asset class we should be able to survive whatever happens to Stocks, Bonds, Commodities or Currencies. Such an approach worked in Weimar Germany, it worked in the Great Depression, it worked in Japan's "lost decade" and it has worked in the U.S. since the highs of 2000.

When the "*DJIA/Gold*" ratio pictured on the previous page is going up, stay in Stocks. When it is going down, stay in Gold. When the "*Bond Yield/Stock Yield*" ratio shown to the right is going up, stay in Stocks. When it is going down, stay in T-Bonds. When the "*Government Bond/Gold Bullion*" ratio shown below is going up, stay in T-Bonds. When it is going down, stay in Gold. Whether the subject ratio is going "up" or "down" must be mechanical, purely price-based determination. Tools such as Moving Averages, Point & Figure algorithms, MACDs and other similar protocols are appropriate to this task.





CAPITAL MARKET SUMMARY
As of May 10, 2009

MAJOR MODELS

Domestic Stocks	Long Term**	Positive**
	Intermediate Term**	Positive**
	Short Term**	Negative**
Gold Complex	(Short/Intermediate/Long Term)**	Positive/Positive/Positive**
U.S. Treasury Bonds	Long Term	Negative
	Intermediate Term	Negative
	Short Term**	Negative**
US Dollar	Long Term	Positive
	Intermediate Term**	Negative**
	Short Term**	Negative**
Commodities	Net of both models**	Positive**
Cycle Dates	Cycle Date July 7th/Bradley July 14th	

SUB-MODELS

NASDAQ-only Stocks	Positive
Small Cap-only Stocks	Positive
Energy Stocks	Positive
Global Developed Market Stocks	Positive
Global Emerging Market Stocks	Positive
Japanese Stocks	Positive
China Stocks	Positive
U.S. Real Estate	Positive
Global Government Bonds - Hedged	Positive
Global Government Bonds - Un-hedged	Positive
Emerging Market Bonds	Positive
Junk Bonds	Positive
Convertible Bonds	Positive
TIPS	Positive
ZEROS	Negative
Capital Market Class (dedicated portfolio)**	Stocks over Bonds over Cash
Domestic Style/Venue/Sector**	Mid Cap/Asia-Ex/Internet**
Bond Put/Call Ratio Level	Very Positive

**these models are currently unstable

Treasury Bonds have out-performed Stocks over the last 20 years--9.0% to 7.6% per year.