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A Special Report September 1st, 2009 *Be Prepared*

Today, the Institute for Supply Management (ISM) announced that the Manufacturing Index, its gauge for manufacturing activity in the U.S. reached 52.9, the first “expansion” reading in eighteen months (ISM readings over 50 indicate *expansion*. Readings under 50 indicate *contraction*.). The National Association of Realtors announced that Pending Home Sales for July were up 3.2%, the sixth straight month of increased sales. Ford Motor Company announced its August car sales were up 17% from last year. (Interestingly, GM, a.k.a. “Government Motors” announced their sales for the same month were down by 20.2%.) The President came out and talked up the “positive economic news”, declaring that “we are on the path to economic recovery”.

In the face of all this (mostly) good news, the equity markets....fell?!!! The Dow Industrials lost 185.60 points (-1.96%), the S&P 500 Index fell by 22.58 points (-2.21%), and the NASDAQ Composite Index followed suit, dropping 40.17 points (-2.00%)

The talking heads on the financial networks have been jumping on the “recovery” bandwagon faster than they can “spin” their relatively recent predictions of death, doom, and destruction. Candidly, the crowd of suddenly bullish prognosticators makes me more than a bit nervous.

Are we in economic recovery? Statistically, the answer is probably ‘yes’. In reality, not so much.

Home prices are stabilizing, but they have been supported largely by the Government’s subsidy in the form of a First-Time Home Buyer’s Tax Credit (34% of last month’s sales were to First-Time Home Buyers.). Car sales were boosted by “Cash for Clunkers”, and while manufacturing may be bouncing off some incredible lows, Manufacturing Capacity Utilization is at a pitiful 68.5%, 12.4 percentage points off the 1972 – 2008 average levels (*Source: Federal Reserve Statistical Release; August 14, 2009*).

The risk to full economic recovery remains very real, and the markets may be beginning the process of making fools of the new bulls....once again.

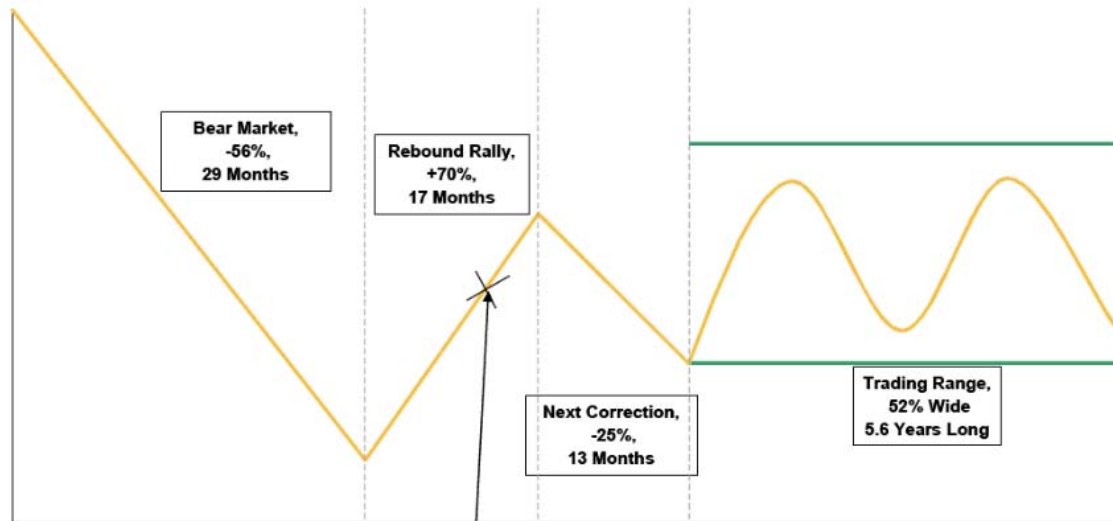
Investors breathing a sigh of relief following an impressive rally from the March lows, would be well advised to look beyond the media rhetoric, and keep in mind that the country is still facing some difficult challenges.

The drivers of economic expansion are Consumer Spending, Business Investment and Exports, are all extremely weak, and without the infusion of massive amounts of government spending, there would be little, if any growth in this economy.

In my opinion, our governmental leaders face a distressing conundrum. They can spend more money we don't actually have today to maintain what little artificial (i.e. government funded) stimulus the economy has, leading to unsustainable deficits a decade from now, *or*, show fiscal restraint (and responsibility, I would suggest) today, and face a "double-dip" recession in six months or so. Neither choice is particularly attractive, especially when we *know* that unemployment will continue to rise for some time, further depressing the consumer, and the next "wave" of housing foreclosures, scheduled to begin in early 2010, is also a virtual certainty, further depressing home values. Based upon the rhetoric coming out of Washington, it appears that expediency will triumph over responsibility, and we're likely to see a massive increase in government spending on health care and other programs, adding somewhere between \$9.3 trillion (Congressional Budget Office; March 2009) and \$12.3 trillion (the President's Office of Management and Budget) to our total Treasury debt. Incredibly, OMB projects that Treasury debt, as a percentage of Gross Domestic Product will grow from 40.8% for fiscal year 2008, to 70.1% in fiscal year 2019. It might as well be 100%, because ladies and gentlemen, the budgetary "math" simply doesn't work at 70% of GDP.

Now it shouldn't surprise you that my vote would be to take our medicine now, and avoid the larger calamity later, but also not surprisingly, I don't have a vote. Government officials tend to kick the can down the road, and take the course of least resistance whenever possible, so my guess is that unsustainable future deficits is something we should be preparing for.

That said, we are now more convinced than ever that we have been experiencing a "cyclical" bullish run-up in stock prices within a "secular" bear market. We need to be prepared for the next pull-back in equity prices, as history teaches us. My friends at Fortigent sent me a chart that Morgan Stanley's European Research group put together.



Source: Morgan Stanley, Europe Division, *The Big Picture*, Fortigent

A Special Report

Page 3 of 3

According to this chart, Morgan Stanley looked at 19 secular bear markets around the globe and found that the *average* rally from the bottom of a secular bear market decline is 71% over a span of 17 months. This is followed (on *average*) by a 25% correction, and then a period during which prices remain within an ensuing broad trading range for (an *average* of) 5.6 years. In 12 of the 18 equity bear markets studied, the reason behind the correction was a change in the interest rate cycle. A hike in the Fed funds rate in late 2010 or early 2011, as expected, may be the next catalyst for broad equity market weakness.

Whatever the reason for the subsequent decline this time, and whether or not this is an *average* cycle, the chart points out that we're well into the "average" recovery from a bear market bottom, and if there's another 5%, 10%, or even 20% more growth in equity prices to come before a reversal, we should be prepared for the inevitable decline.

This year has been a transition year, as we've moved toward a more defensive positioning with our clients, replacing buy and hold managers with others who advocate a defensive posture during these times, and have the defensive measures (i.e. "sell disciplines") to back them up. To our clients, I want to say, we're prepared, and don't worry. While we won't get out of the market at exactly the top, nor re-enter at exactly the bottom, we expect our managers to actively trade these broad cycles within this secular bear, advancing when possible, protecting when necessary. We have a strategy and we are executing on it. To readers who aren't currently positioned as such, I say, beware. Our economic difficulties are far from over. Let us know if we can be of help.

JRP

P.S. Also from my friends at Fortigent, comes this interesting quote:

"The American people will never knowingly adopt socialism. But, under the name of 'liberalism', they will adopt every fragment of the socialist program, until one day America will be a socialist nation, without knowing how it happened" – Norman Matoon Thomas (1884-1968, six time presidential candidate for the Socialist Party of America

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Alternative investments such as Managed Futures, Market Neutral Investments, Inflation Benefiting Investments, Private Equity and Trend Following, involve specific risks that may be greater than those associated with traditional investments and may have specific suitability requirements. You should consider the special risks with alternative investments including limited liquidity, tax considerations, potentially speculative investments strategies and different regulatory and reporting requirements before investing.