

March 1, 2010

Dear Clients and Friends,

As you know, last year was a difficult one, since I had misjudged the length and the strength of the rally from the March 2009 lows. The market finally topped on January 19, 2010 and since then, our accounts have been recovering as the market trend has changed.

Before discussing your progress year-to-date, I would like to review last year's inability to make sense out of the markets. What I would like to do is use Charles Biderman's analysis of the events that transpired in 2009. Charles Biderman is CEO of TrimTabs Investment Research:

Are Federal Reserve and U.S. Government Rigging Stock Market? We Have No Evidence They Are, but They Could Be. We Do Not Know (the) Source of Money That Pushed (the) Market Cap Up \$6+ Trillion since Mid-March.

The most positive economic development in 2009 was the stock market rally. Since the middle of March, the market cap of all U.S. stocks has soared more than \$6 trillion. The "wealth effect" of rising stock prices has soothed the nerves and boosted the net worth of the half of Americans who own stock.

We cannot identify the source of the new money that pushed stock prices up so far so fast. For the most part, the money did not come from the traditional players that provided money in the past:

- *Companies. Corporate America has been a huge net seller. The float of shares has ballooned \$133 billion since the start of April.*
- *Retail investor funds. Retail investors have hardly bought any U.S. equities. Bond funds, yes. U.S. equity funds, no. U.S. equity funds and ETFs have received just \$17 billion since the start of April. Over that same time frame bond mutual funds and ETFs received \$351 billion.*
- *Retail investor direct. We doubt retail investors were big direct purchasers of equities. Market volatility in this decade has been the highest since the 1930s, and we have no evidence retail investors were piling into individual stocks. Also, retail investor sentiment has been mostly neutral since the rally began.*
- *Foreign investors. Foreign investors have provided some buying power, purchasing \$109 billion in U.S. stocks from April through October. But we suspect foreign purchases slowed in November and December because the U.S. dollar was weakening.*
- *Hedge funds. We have no way to track in real time what hedge funds do, and they may well have shifted some assets into U.S. equities. But we doubt their buying power was enormous because they posted an outflow of \$12 billion from April through November.*
- *Pension funds. All the anecdotal evidence we have indicates that pension funds have not been making a huge asset allocation shift and have not moved more than about \$100 billion from bonds and cash into U.S. equities since the rally began.*

If the money to boost stock prices did not come from the traditional players, it had to have come from somewhere else.

What we do know is virtually all the gains in the market were made in the futures (overnight) market while daytime activities have been negative. In fact, there has been a high correlation between bad news that could adversely affect the market and massive futures activity before and after these adverse announcements.

Not only that, but the most gains were made in the worst performing sectors, such as the Banking Index, which rallied 178% from its March low, more than three times the market average. The sickest banks, such as Citigroup, which rallied 457% and Bank of America, which rallied 657% from low-to-high last year are known to be insolvent, even after the rally. Their behavior hasn't changed. The bailout has only increased the moral hazard of these companies. Keep in mind that they would not have been able to pay record bonuses to their executives last year if it hadn't been for the bailout money received from the Federal Reserve and the U.S. Treasury.

So, even though the "wealth effect" has soothed the nerves many a nervous investor, it has not given me any reason to feel more confident in the ultimate outcome. There are several reasons for this.

The first reason is that the Federal Reserve has been talking about an "exit strategy" since last fall. In October, it attempted a "reverse repo" auction to "retire" \$200 billion of toxic assets it had taken on as collateral to stabilize the banks. No one came, so the auction was quietly called off. Again in November, it tried to "retire" \$180 billion in a reverse repo. No one came again. I believe that the banks had "spent" the money and could not pay it back. *Instead, the Federal Reserve drew down the cash for the repo from public money market funds.*

The second reason is that the federal government dept is spiraling out of control. The markets are not large enough to absorb all of the new debt that our government is creating. Many of the treasury (debt) auctions are failing and it is suspected that the Federal Reserve is secretly buying up the debt. Sadly, we have already reached the point where we may not be able to pay it all back. Legislation may be coming soon that may require all retirement accounts to be invested in Federal Debt or annuities. These so-called annuities are being test-marketed as I write.

Third, there is a grassroots movement demanding transparency by the Federal Reserve. Many are writing their congresspersons and senators to demand that the Fed disclose who they are lending to and under what conditions. The secrecy surrounding the bailouts has got to stop.

Last, bear markets always have two installments. The second installment, which may have just begun, is usually longer or deeper than the first, or possibly even both. The first installment (the low in November 2008) was over thirteen months long. That means the earliest the current decline may end could be in March 2011. Cycle projections actually call for a potential bottom in the stock market in June, 2011.

On a positive note, everyone has heard about the projection of the Dow 36,000. I believe that it will happen, but only after all of the toxic debt has been washed out of our financial system. Not surprisingly, there are projections that most, if not all, of the sub-prime mortgages and alphabet soup derivations of toxic debt will be renegotiated, rolled over or repudiated by June, 2011. This will give our financial system a fresh start at rebuilding from the ground up if our government can stop its debt juggernaut. People will come out of this experience with a new savings ethic. Without the heavy weight of debt in our financial system, the markets may grow even faster than what we have experienced in the 90s.