# MARKET COMMENTARY

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## INTRODUCTION

| *Prices as of September 5, 2007 Close* | |
|---|---|
| 30 Year Treasury Bonds (CBT) | 112-16/32<br>4.77% Yield |
| Dow Jones Industrial Average | 13,305 |
| S&P 500 Index | 1472 |
| Oct. Crude Oil Futures | $75.92 |
| Oct. Natural Gas Futures | $5.80 |
| Dec. Gold Futures | $690.00 |

Enclosed are our two most recent market letters for your reference. Earlier letters are available upon request. Some of the market analysts we most respect are of the view that the recent 10% decline in U.S. equity markets (which they were not expecting) represents a wonderful buying opportunity. In our letter of March 28, 2007, we indicated several reasons why it would be realistic to expect a meaningful market decline following a high of 1535-1550 on the S&P 500. We are now suggesting that if the most recent decline has another leg down there is the possibility of a temporary overshoot, possibly reaching as far as 30% down from the high of 1556 on July 19, 2007. Therefore this may be a good time to reassess our opinion

## ANALYSIS

We still stick by our long-standing position that the equity markets are in a secular (18- year), rising but sideways pattern (upward slanting trading box), which started in 1998/2000 and could extend through 2016. Within this secular period, there could be two or three cyclical (1-5 years) bull and bear markets. The subtle distinction from our previous two market letters has to do with the potential magnitude of the current cyclical correction. It is our belief that if this market drop exceeds the current 10%, it could drop 30% from the high as opposed to the 20% we originally suggested. In addition, we are concerned that if such a decline occurs, it could happen soon, perhaps by the end of September or early October, but likely no later than year end

## COMMENTARY

Normally, we would prefer that a 20% or 30% market correction would not occur. We would hope that this current 10% correction would be another minor setback on the way to achieving the high end of our proposed secular trading box. Our fundamental belief is that the economy and its markets will probably do better in the long-run if they are allowed to naturally seek their own economic levels without overly zealous and politically influenced Federal Reserve intervention. The concerted efforts of the Federal Reserve and other central banks may have already succeeded in arresting this current decline at 10%. We will have to see what happens if and when the downward pressure resumes. When and to what degree the Fed responds will tell us a lot about the current downside objective and the long-term prospects for worldwide financial health. Bold or clumsy Federal Reserve rescue efforts could aggravate the already flawed decisions of the past.

Not "taking away the punch bowl" (the words of former Fed Chairman William McChesney Martin to describe the Federal Reserve's responsibility in times of exuberance) in 1997-98 allowed for the development of the stock market bubble. That bubble ended like all bubbles, in a crash - the crash of 2000-2002. In order to ameliorate the pain of the crash and to prevent feared deflation, the authorities at the Fed orchestrated a monetary bailout The massive liquidity created by that rescue ultimately led to other bubbles, most recently manifested in the U.S. residential real estate market. If there is another massive central bank driven liquidity infusion, there is no telling what liquidity excesses will develop in subsequent years; likely another mutable bubble and subsequent crash that may be too large for the Fed to fix without the cooperation and concerted efforts of all the primary world central banks. Every time the Fed intervenes to soften a market's landing, it also creates the unintended consequence of a "moral hazard". Why would the next generation of investors assume caution and care when they know the Fed provides such a high and wide safety net?