ALVERY BARTLETT GROUP

MARKET COMMENTARY

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Still Overtly Bearish…

Prices as of January 27, 2010 Close	
30 Year Treasury Bonds (CBT)	118-09/32 4.56% Yield
Dow Jones Industrial Average	10236.16
S&P 500 Index	1097.50
Spot Crude Oil Futures	$73.68
Spot Natural Gas Futures	$5.32
Spot Gold Futures	$1086.90

Source: Bloomberg, LP

In our last market letter dated November 19, 2009, when the S&P 500 was at 1094, we propositioned that "if this rally continues we see two possible areas of significant resistance: 1150 to 1300 ". Now that the market has tested the 1150 area on three occasions and failed (1149.74 on Jan. 11, 1150.41 on Jan. 14, and 1150.45 on Jan. 19), it would be advisable to have a discussion about the nature of the next possible rally or decline. Our commentary in this letter holds that (for the sake of simplicity) we see three distinct possibilities with our bias increasing as we get to the last one.

The first would allow for a cooling off period of up to three months beneath the 1150, but not much lower than 920, then to be followed by a move to the higher resistance of 1300. This option would correspond to what seems to be the consensus view that there have been “economic green shoots” popping up and it is risky to be out of the market when virtually every central bank in the world has put their foot on the liquidity accelerator. This view holds that until all the latent buyers get back into the market the move up is incomplete. It comes close to assuming that our recovery is going to be comparable to most other post-war recoveries, albeit a bit lumpier when it comes to jobs and housing values.

The second would be more along the lines of the 1929-1943 Dow Jones/NASDAQ comparison of our last three market letters. This would also parallel the Japanese experience of the last 20 years, i.e. suggest a backing and filling, slowly deteriorating market price through 2012 with an inflation-adjusted new low price below the S&P 500 price of 666 reached in 2009. This seems to be supported best by the economic view that government has stopped the hemorrhaging of the economy, but with the prospect of higher taxes, increased regulation, and more government “solutions”, the US and some other developed countries are due for a period of economic lethargy.

The third option is that the markets in the U.S., Europe and Asia are more or less setting up for another 1929, 1987, or 2008-style crash. In this circumstance the decline could come sooner rather than later. The degree of the break would be anybody’s guess but something close to last year’s low of 666 (or even 550) on the S&P 500 seems plausible. If this were to happen it would really catch the consensus (which has been running at historic highs) off guard. The market could test the broader exchange limits and quickly disintegrate to a level of fear, which could justify a reasonable risk/reward purchase. This opinion is supported by the fundamental view that this is not your father’s garden variety recession and that deleveraging has longer to run. Those who would favor this position would probably focus on the lingering sovereign debt problems, which have yet to come to a conclusion. They might believe that governments, especially in the US, are in disarray.

This view holds that the warm fire in the asset fireplace is not the result of solid burning logs, but rather a constant stream of government-fed brush. Whether we think of this monetary and fiscal stimulus as a "sugar high" (as some have called it) or as my "brush fire", the worry remains: How will we continue to stay warm when the brush is taken out of the fire?

In general, it is probably fair to stand back and recognize that it took the developed world about forty years to get into this mess and if one assumes, as we do, that the party ended in 1998-2000, it could take another ten years or so to flush out all the excesses and correct the system. It is our belief that before this economic mess is more or less resolved, monetary policy will have to be rethought from the ground up. Fiscal and regulatory policies will have to be wrestled over. The American public will have to get in touch with Ben Franklin by growing more practical in their personal spending, and our government will have to reduce its spending as well so its debt can be mostly funded by its own citizenry. Asia may have to produce primarily for its own markets and reduce their dependence on selling to an unhealthy US consumer. It seems to us that this deleveraging, the newfound governmental monetary and fiscal policy restraint, and trade equilibrium will take time to develop. We are going to get to this place eventually; the only question is how long it will take before we make the tough and right decisions? If we choose the quick fix with what is wrong and/or to address our deflationary problems with the same failed prescriptions, we run the risk of very high inflation at the first sign of recovery. In our view, that would be the worst outcome. Yes, stock market prices and asset prices may rise, but on an inflation-adjusted basis, it will be very difficult to preserve wealth. In addition, the dislocation created by such inflation would not provide for a pleasant social and political outcome environment.

For the moment, we are concerned enough about this year and this last possible phase of deflation. We should now focus on the nature of the next stock market move and be comfortable that we can handle an unexpected decline, should there be one. The larger and longer term issue of inflation can be addressed after we discover the government's reaction to either the next rally or decline. I fear the government response to either will still result in inflationary pressures.

Sincerely,

Alvery A. Bartlett, Jr.