ALVERY BARTLETT GROUP

MARKET COMMENTARY

BY *ALVERY A. BARTLETT, JR.*

August 30, 2010

Our Rationale…Still Overtly Bearish

Prices as of August 30, 2010 Close	
30 Year Treasury Bonds (CBT)	135-23/32 3.875% Yield
Dow Jones Industrial Average	10009.73
S&P 500 Index	1048.92
Spot Crude Oil Futures	$74.25
Spot Natural Gas Futures	$3.842
Spot Gold Futures	$1237.80
Source: www.bloomberg.com	

I realize that in this price area the stock market seems, to many, to be fairly priced. Not as low as 666 on the S&P 500, which was made at the depth of the market panic in March of 2009 and not as high as it went in the recovery rally, which peaked at 1219 on April 26th. Many highly respected and more traditional money management firms hold the view that the markets, foreign and domestic, have settled into a reasonable trading range (a belief many held in 2008). They use words like "the market will muddle through" or "backing and filling", or "settling down into a new comfort zone awaiting a better day". Yet again, last week's S&P low of 1041 tested and bounced off important technical areas. Everything seems to be in balance – deceptively so!

As we see it, the stock market is trying to decide if what we are experiencing is a serious recession that is more or less in the vein of other post-war recessions or if it is something more like a depression. In fundamental terms there seems to be a standoff juxtaposing the following issues:

1. A recession, which has just ended vs. two back to back recessions.
2. A recession, which has just ended vs. a recession that never came to a conclusion and is continuing.
3. A recession, which has just ended vs. a recession that is to be followed by a double dip.
4. A President Bush recession vs. a President Obama recession.
5. Traditional remedies for government stimulus that will work as billed (albeit a tad slower) vs. remedies that in retrospect may have aggravated an already bad situation.
6. Monetary policy solutions that by text book thinking should work vs. Federal Reserve policy that has only managed to postpone and worsen the inevitable.
7. A wounded consumer who will moderate spending, but return wiser vs. a consumer who has changed for real and will dramatically increase savings at the expense of consumption.
8. An end to a tax venue that favors the rich vs. a tax system that punishes job creators and investors.
9. A weak regulatory regime that needs to be substantially tightened to reestablish order and confidence vs. a regulatory regime that has now gone wild and is hindering growth.
10. A resumption of government inspired moderate inflation vs. the deflation of a "liquidity trap" where government can't lead us to spend.

In short, it seems we are at an important crossroad. For the economist who is reading, it is an intellectual battle between John Maynard Keynes and Frederick Hayek. The intellectual argument espoused by the Keynesian school (selected by President Franklin Roosevelt) vs. the Austrian school of economics (which was rejected by Roosevelt) has been brewing for some 70+ years. Is the Keynesian approach, which facilitates a more politically progressive system the correct one, or is the free market (laisse faire), low tax option of the Austrian school more correct? Can the political establishment live with the status quo, or will it choose a hyper-Keynesian approach espoused by Paul Krugman, or will it choose the approach of the conservative/libertarian/objectivist movement? Even more interestingly, will we see all three being implemented at various times until a winner emerges? What we have here is a divided political establishment, a divided electorate, and a divided economic/investment community. Those representing the status quo, the left, and the right are now all wearing their war paint. They are eagerly awaiting the moment to pounce and say with confidence and some arrogance, "I told you so."

We are certainly living through one of the most exciting, frightening, and volatile times in recent American history. In our opinion, this is not just about a nasty recession, or Democrats vs. Republicans. There is much more going on here. The world is adjusting to some monumental changes:

1. Technology
2. Productivity growth
3. Excess debt
4. China's awakening from a centuries long slumber
5. India's arrival as an economic powerhouse
6. Real globalization on the international front

The world has recently witnessed the greatest migration of humanity to the city in history. In the United States we are demographically dealing with a maturing baby boomer at one end of the spectrum and the absorption of a younger Spanish speaking population at the other. This is big time stuff and it could end up being as significant as the Industrial Revolution or the Great World Wars.

It is my opinion that whatever emerges will differ radically from what we have known. For me it is only a question of whether the clear view of the future begins to emerge as soon as November 2010-March 2011 or something more like 2013-2014. In the meantime, we have no choice but to hang on for the ride. My guess is that it will continue to be a doozie. Many of the decisions about what direction we choose will ultimately not be made by us, but *for us*.

The invisible hand of Adam Smith will be slapping and pointing in ways we never dreamed of. After the dust settles, I firmly believe it will all be for the better. One of my previous employers was fond of saying two things that seem most appropriate, "This too will pass", and "Change equals opportunity". As I see it we have four challenges.

1. Preserve our capital as best we can (he who loses the least will define the winner)
2. Read the tea leaves properly (removing out biases as best we can)
3. Be prepared to go where the market takes us (different classes of assets and perhaps new structures)
4. Muster the gumption to act without waiting too long (if the train leaves the station can we really risk jumping on too late)

Let's conclude with what we discussed earlier. At the end of the first paragraph, we mentioned the deceptive nature of being in balance, referred to as equilibrium. In normal times, we could buy into that belief, but with so many mega cross currents we believe more in Black Swans and surprises. It is even risky to have faith in previously acceptable methods of analysis. In the past the economy drove employment, but now it seems to be the opposite. In the past, economic factors had a lot to say about the direction of the stock market. Now it seems the stock market may be more of an influence on the economy. I can still remember when low interest rates were a good thing, but now they are starting to scare the hell out of us. How bad must things be that we have interest rates near 0%? With globalization, 24-hour trading surprises happen mostly in the dark of night. Investors go to bed at night with a snake in the room and even during waking hours are no longer confident about what comes first, the Chicken or the Egg (as in the economy vs. employment, the direction of the stock market and the direction of interest rates). Investors got hurt in the 2000-2003 stock market crash, then after a modest 5 year recovery, they were hit again in 2008-2009. If the market collapses again, these investors will be 13 years older and 13 years closer to retirement. Their children don't have jobs, they can't sell their condo in Florida, and their house is worth 35-40% less. What do we think they will do if the market starts down again?

It is our view that this week is one of extreme risk not properly priced at equilibrium. Last week, the markets again tested important levels and bounced, but not yet enough to put distance between those levels and serious technical downside numbers. This leads us to the conclusion that if a meaningful break does come that it could be much faster and deeper than the pundits suggest. Cyclically, we are in a treacherous period for the bulls (Nov 2010-Mar 2011). Our guess is that the bears will have their way before the next lower-risk buying opportunity presents itself. As technically weak as the market appears however, we do not want to get religious about our opinion, especially with proactive governments prone to tinkering with billions of dollars in their war chests. If the market stages a meaningful advance, as stated in our previous market letters, the resistance zones are still S&P 1150+/- and 1300+/-.

So Now What?

Based on our world and market view, we continue to recommend investments backed by tangible, hard assets where we believe they can produce a steady stream of cash flow. This includes, but is not limited to Oil, Natural Gas, and Coal Royalties (all cash) and non-traded real estate investment trusts (REITs) with moderate leverage. We especially like proven and experienced managers of size who are creating new investment vehicles without legacy assets and where the sponsor has access to capital. As a current real estate or royalty buyer, the axiom holds true that "cash is king", but David Rosenberg recently reminded his readers that for *investors*, "cash, by the way, has not been king in Japan …for the past two decades — but what is king in a deflationary cycle is income".

We would be willing to purchase equities at a much lower PE multiple than at present, assuming the dividend yield was high enough (between 5-6%) to warrant dipping our toes in the stock market's water (for more information please see our market commentary letter dated 8-24-10, located at www.alveryb.com).

Gold has continued to confound us, and even though we concede the possibility of gold's continuing rise, we are still looking for deflationary forces to be at work in the very near term, which will hopefully give those of us who are extremely bullish on gold for the intermediate and long-terms a chance to jump in.

We see the possibility of 30-year Treasury Bonds moving to new historic highs. We do not agree with the consensus view that Treasuries are in a bubble, nor are we willing to make a long term investment given such low rates, even though we do understand that in a deflating economy interest rates, adjusted for deflation, may not be as low as they appear (real interest rates vs. nominal interest rates).

We continue to believe there is a possibility for the US Dollar index to reach 101 by early 2011, and the Euro and the US Dollar to approach parity.

Sincerely,

Alvery A. Bartlett, Jr.