Agile Investments
ETF PORTFOLIO MANAGEMENT

Monthly Market Review **August 1, 2010**

Stock investors got a much-needed reprieve last month. At the early July stock market lows, investor pessimism reached an extreme following a two-month barrage of bad news, including the European sovereign debt crisis, the "flash crash", a deteriorating economic outlook, the Gulf oil spill, and a 16% drop in the S&P 500 from its April peak. Several measures of investor sentiment registered bearish readings not seen since the crisis environment of late 2008/ early 2009. The VIX Fear Index spiked above 40 (Exhibit 1), and by the end of June, bears outnumbered bulls by a ratio of nearly three-to-one in the *American Association of Individual Investors* weekly survey.

With pessimism so thick, and markets highly oversold, it is not surprising that we saw a 6.9% S&P 500 rebound in July against an improved news backdrop of positive second quarter earnings reports and receding fears around the crises in Europe and the Gulf of Mexico. Currently, sentiment indicators suggest that the extreme investor pessimism that had built up in early July has largely dissipated. Accordingly, we rate the investor sentiment backdrop as a neutral factor as far as the near-term stock market outlook is concerned. If the May/June decline turns out to be just a severe correction, rather than a onset of a renewed bear market, then the VIX should continue to decline and break below the support level now being tested.

Exhibit 1

Market technicals have improved with the recent rally, and are now in a critical testing zone. The S&P 500 has broken above the trend line extending down from the April-May highs, but has yet to break above the June high (Exhibit 2). A sustained move above key resistance around 1125 in the S&P 500 would be a strong technical positive, and would break the bearish pattern of lower highs that has been in place for the past three months. The current trend of the market is inconclusive, so we will wait for further evidence to unfold in August to inform us whether recent improvement in the "tape" is truly significant (i.e. signaling that an important intermediate-term low was made in early July), or if the market has just relieved a severe oversold condition with a temporary rally back to the 200-day moving average.

Exhibit 2

The technical picture in foreign stocks, especially emerging markets stocks, is more encouraging. The emerging markets index did not confirm the technical breakdown to new lows that occurred in U.S. stocks a month ago, and in the July rally, emerging markets stocks have exceeded both the 200-day average and the previous rebound highs made in June and May (Exhibit 3). However, emerging markets stocks have had nearly a 90% directional correlation with U.S. stocks over the past year, so if U.S. stocks resume their decline, emerging markets stocks will fall as well.

Exhibit 3

We took defensive steps in our portfolios in recent months as a precaution against the risks of a renewed bear market and economic downturn. Although these risks appear to have diminished *somewhat* in the past month, they remain elevated, so we are taking a wait-and-see approach until the picture becomes clearer. It is premature to conclude that the economy is headed back into recession, but the odds of that outcome have increased markedly in recent months. The collapse in the 10-year Treasury yield to below 3% implies that recession risks have increased sharply (Exhibit 4).

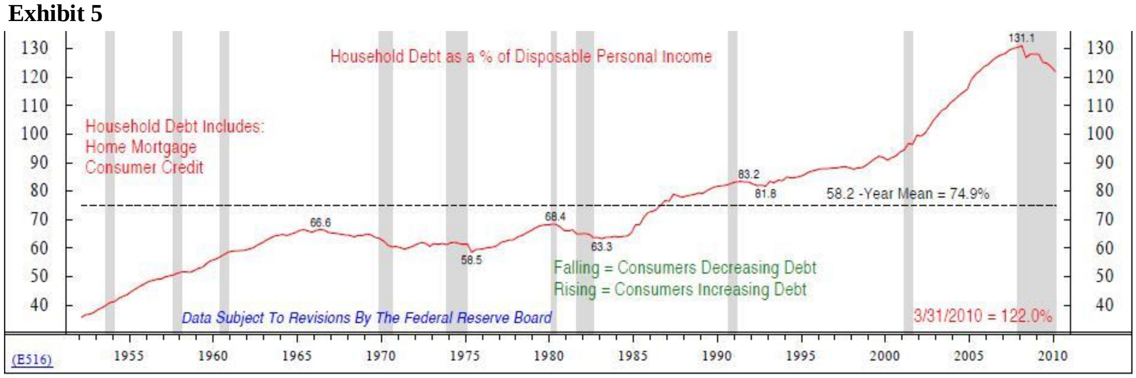
Exhibit 4

At this point, we would assign at least a 30% probability to the scenario of the economy falling back into recession over the next six to twelve months. Those odds are high enough to warrant a cautious investment posture, especially given our concerns about the secular risks emanating from the unresolved debt problem.

Secular risks remain high until the private sector debt bubble deflates considerably further, and government begins to get its fiscal house in order. Households have been moving in the right direction by increasing their savings rate, but household debt relative to disposable personal income is still very high, relative to history (Exhibit 5). We also have mind-boggling unresolved problems in the real estate sector, despite trillions of dollars of government support; one out of every 10 mortgages is delinquent, and a quarter of home-owners with mortgages owe more than their homes are worth.

As far as government debt is concerned, current deficits and debt levels are disturbing enough, but they pale in comparison to unfunded future liabilities, particularly healthcare entitlements. For the depressing details about this fiscal time bomb, refer to the bottom row of the real-time calculations presented on the U.S. Debt Clock web site. The anxiety, pessimism and risk-aversion that pervades the country and keeps businesses from hiring and investors from putting incremental savings into the stock market, is due to an awareness that (i) the bursting of an historic debt bubble is not fundamentally solved by simply shifting debt to the government, and (ii) painful adjustments of one form or another lie ahead because the government has made tens of trillions of dollars of promises that it can't possibly keep.

Exhibit 5



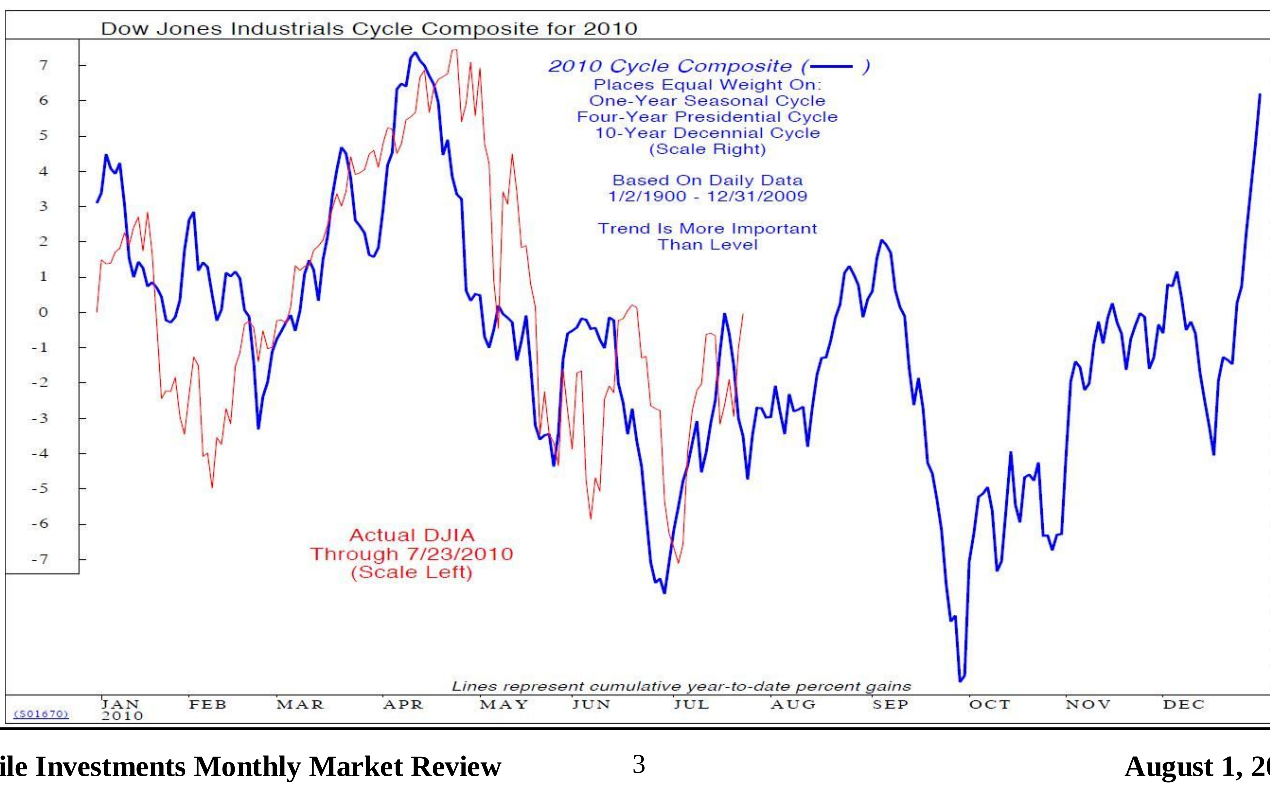
Apart from waiting for more clarity about the direction of the economy and public policy, we are cautioned to be patient by the *Ned Davis Research* time cycle composite, which has correlated very well with the movement of the stock market this year (Exhibit 6). The NDR composite gives equal weight to three cycle indicators that have had good predictive records – the One-Year Seasonal Cycle, the Four-Year Presidential Cycle, and the Decennial (10-year) Cycle.

From here, the model suggests perhaps a few more weeks of consolidation or marginal additional gains, but that the next move of significance is to the downside into the fall - and what figures to be a highly significant (and contentious) mid-term election – followed by a sharp rally into the end of the year.

In fixed income markets, decent longer-term value grows increasingly scarce, thanks in large part to the Fed's zero interest rate policy and its market intervention through quantitative easing. Here are two examples of the challenge bond investors face today. Last week, McDonald's issued nearly half a billion of 10-year bonds at 3.5%, a record low yield for a large batch of debt issued by a U.S. corporate borrower. According to one investor, "*I looked at McDonald's debt and felt the same as if I'd eaten five Big Macs in a row. It's a great company, but I don't need to own a low-A-rated corporate risk at 3.5%.*" Meanwhile, yields on top-rated, tax-exempt US municipal bonds have dropped to record lows. Triple A rated five-year tax-exempt muni bonds today yield 1.29%.

With values generally unattractive in the bond market, and with cash yielding nothing, doesn't this suggest that investors have nowhere to go but stocks? On an absolute basis (not relative to the distorted state of the fixed income markets), stocks are mildly overvalued relative to long-range historical averages, but valuations are reasonable enough that stocks are very likely to provide higher returns than investment-grade bonds over the next five years. However, we are in uncharted waters as a result of the debt problem. For now, we are going to maintain a cautious posture towards stocks (with a 45% allocation in our balanced portfolios), until the direction of the economy and government policy becomes clearer.

Exhibit 6



Broad Equity Index Performance, Ranked by Year to Date Total Return						
			Through July 31, 2010			
			Year to	Annualized		
Asset Class	Representative Index	July	Date	1-year	3-year	5-year
U.S. Mid Cap Stocks	S&P MidCap 400	6.9%	5.5%	23.0%	-2.7%	2.5%
U.S. Small Cap Stocks	S&P SmallCap 600	6.3%	5.4%	19.2%	-4.4%	0.9%
Emerging Markets Stocks	MSCI Emerging Markets	8.3%	1.7%	21.4%	-1.0%	13.0%
Foreign Small Cap Stocks	MSCI EAFE Small Cap	8.6%	0.9%	15.2%	-10.2%	1.9%
U.S. Large Cap Stocks	S&P 500	7.0%	-0.1%	13.9%	-7.2%	-0.2%
Foreign Large Cap Stocks	MSCI EAFE	9.5%	-5.0%	7.4%	-9.9%	2.1%

Fixed Income Index Performance, Ranked by Year to Date Total Return						
			Through July 31, 2010			
			Year to	Annualized		
Asset Class	Representative Index	July	Date	1-year	3-year	5-year
Intermediate Term Treasuries	Barclays Capital 7-10 Year Treasury	1.1%	10.6%	11.4%	9.8%	6.9%
Emerging Markets Bonds	JPMorgan EMBI Global Core	4.4%	10.1%	20.6%	n/a	n/a
Intermediate Term Corporates	iBoxx $ Liquid Investment Grade	2.1%	8.2%	14.7%	8.4%	5.9%
High Yield Corporates	iBoxx $ Liquid High Yield	3.7%	6.7%	19.5%	7.4%	n/a
Broad U.S. Bond Market	Barclays Capital U.S. Aggregate	1.1%	6.5%	9.6%	7.7%	6.0%
Agency Mortgage Backed Bonds	Barclays Capital U.S. MBS	0.9%	5.4%	7.9%	8.4%	6.5%
Municipal Bonds	S&P National Municipal Bond	1.3%	4.9%	9.3%	n/a	n/a
Inflation Protected Bonds	Barclays Capital U.S. Treasury TIPS	0.1%	4.6%	10.2%	7.0%	5.5%
Short Term Corporates	Barclays Capital 1-3 Year U.S. Credit	0.9%	3.1%	6.8%	5.9%	5.3%
Short Term Treasuries	Barclays Capital 1-3 Year Treasury	0.3%	2.2%	3.1%	4.6%	4.4%
T-Bills	Barclays Capital Short U.S. Treasury	0.0%	0.2%	0.3%	1.9%	3.0%
Foreign Government Bonds	S&P/Citigroup Int'l Treasury	5.9%	-0.9%	2.9%	n/a	n/a
Foreign Gov't Bonds Short Term	S&P/Citigroup Int'l Treasury 1-3 Yr	5.4%	-2.8%	0.3%	n/a	n/a

Alternative Investments Index Performance, Ranked by Year to Date Total Return						
				Through July 31, 2010		
			Year to	Annualized		
Asset Class	Representative Index	July	Date	1-year	3-year	5-year
U.S. REITs	Dow Jones U.S. Real Estate	9.6%	14.8%	50.5%	-5.1%	-0.6%
Gold	Comex Spot Gold	-5.1%	7.9%	26.4%	21.2%	22.4%
Foreign Real Estate	S&P World Ex-US Property	8.7%	-1.5%	13.5%	-12.7%	1.3%
Diversified Commodities	Dow Jones-UBS	6.8%	-3.5%	6.1%	-7.2%	0.2%
Natural Resources Stocks	S&P North America Nat. Resources	6.7%	-3.3%	14.1%	-5.1%	5.7%