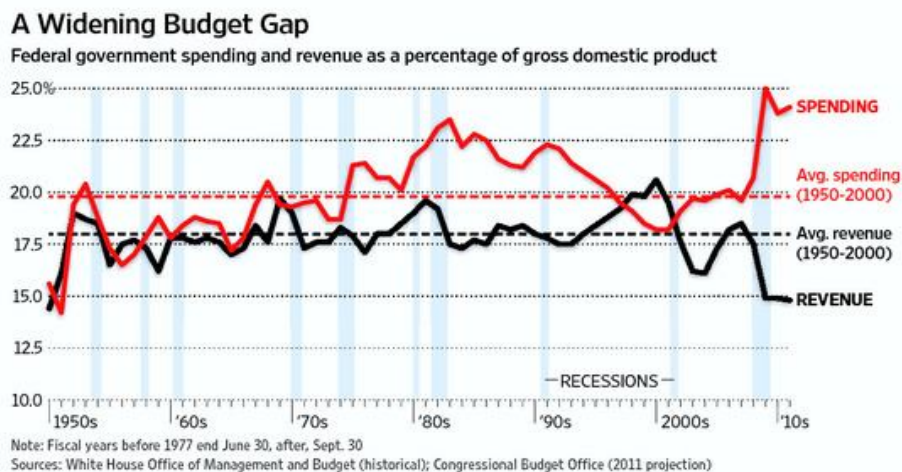


Last month, we wrote that our defensive investment posture is largely driven by our assessment that the global economy is slowing at a time when policy-makers have exhausted, or nearly exhausted, their stimulus. We argued that the stock market was not priced for an economic slowdown and was therefore vulnerable on the downside. Recent developments have supported this view. The stock market sell-off over the past two weeks has been more a function of a string of dismal U.S. economic data than the drama and incompetence in Washington. If the debt ceiling issue was the primary reason for the recent 5% drop in the S&P 500, the yield on the 10-year Treasury bond would not have concurrently dropped nearly a quarter of a percentage point to 2.75% - a new 2011 low.

Treasury bonds have rallied because recent economic reports have been consistently disappointing, and reflect an economy that is hardly growing (despite trillion dollar annual federal deficits). The respected *Economic Cycle Research Institute (ECRI)* has concluded that a cyclical slowdown will persist at least through the end of 2011, and ECRI is not ruling out a new recession in 2012. With the economic backdrop already fragile, it certainly does not help matters that the fiasco in Washington has engendered further doubts about the ability of the U.S government to function effectively. It is clear that the country is a long way from having the political will to take the necessary actions to deal with our fiscal crisis. Our problem, of course, is much larger than the current debt outstanding. We have a \$60 trillion net present value liability burden from our three major entitlement programs (Medicare, Medicaid, and Social Security), which is over four times our GDP. Yet Democrats don't want to touch Medicare, Medicaid and Social Security. For their part, Republicans want no tax increases, even though federal tax revenue as a percentage of GDP is running at 60 year lows:



## Market Comment

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Standard and Poor's recently said it would downgrade the U.S. credit rating within the next three months if it didn't see a \$4 trillion deficit reduction package. The \$2.4 trillion (over ten years) deficit-cutting deal about to be inked falls well short of that figure, so a downgrade seems probable. Even though one could argue that the rating agencies lost their credibility in the last financial crisis, a downgrade in the credit rating of the world's largest economy should not be taken lightly. The Treasury market at the moment is unfazed by the prospect of a downgrade, but it is impossible to predict how markets will react if and when a downgrade actually takes place. Such a development certainly has the potential to create turmoil in the markets, and at a minimum can be expected to tighten financial conditions.

Our portfolio management focus in recent months has been on protecting capital. The jury is still out, but evidence is accumulating that the cyclical bull market that began in March 2009 has ended. Prices remain within the trading range of 1260 to 1360 on the S&P 500 that has been in effect for 2011 (see chart below). What has changed in the past several weeks is that we have seen two more failures at resistance at the top end of this range, and prices are now testing key support in the 1260 area. If the S&P 500 breaks this support, we would anticipate a drop to the next major support level at 1225, where a relief rally could then be expected. A break of the first line of support, however, would seem to indicate that the 2011 stock market highs are in place. A wildcard for the stock market over the balance of the year is whether the Fed decides to undertake another round of money printing, which would inflate stock prices in nominal terms. We will have to deal with that scenario if and when it arises.



## Market Comment

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One bull market that is very much intact is gold, which moved to new all-time highs in July. Gold may pull back in the short-term in the wake of signed legislation to increase the debt ceiling. However, an increase in the debt ceiling is long-term bullish for gold because it paves the way for more monetary inflation. Gold remains an essential portfolio hedge against the debasement of paper currencies and the ongoing sovereign debt crisis. Gold has been the leading asset class for nearly ten years, yet is still remarkably under-owned in the portfolios of most institutional and individual investors. Longer-term, the risk/reward in gold remains very favorable, but in the shorter-term it is challenging. This is typical for the strongest bull markets, which provide few easy entry points. Gold's current price of \$1625 is \$160, or nearly 11%, above its 150-day moving average at \$1465, which has contained every intermediate-term correction in gold over the past two years (see chart below). A more attractive entry point for gold accumulation would arise in the event of a \$75 correction to the 1550 level.

