

September lived up to its reputation as a cruel month for investors and left no doubt that a global bear market is in process. This is confirmed by a range of market indexes, the majority of which have declined in excess of 20%, the traditional bear market threshold (see table at right).

Investors are fleeing risk in response to a highly unstable economic and financial environment. Investor confidence today is as damaged as in the late 2008/early 2009 period. Investors perceive major risks - most importantly the likelihood of a new recession and the unresolved debt crises in Europe and the U.S. – and poor prospects for sustainable upside progress in risk assets. A recessionary outlook was confirmed last week by the *Economic Cycle Research Institute*, a private economic research group that is second to none in terms of forecasting the economic cycle. ECRI has a very strong track record, and is conservative about making recession calls. Last week, ECRI unequivocally rendered its recession verdict:

“This is a done deal. We are going into a recession. We’ve been very objective about getting to this point. A broad range - this is not based on any one indicator - this is based on dozens of indicators for the United States - there is a contagion among those forward looking indicators that we only see at the onset of a business cycle recession. These leading indicators have a certain pattern that they present in front of a recession, and that is what we are seeing now.

	Date of Bull Market High	Date of Bear Market Low (as of October 4)	Pct. Loss
U.S. Stocks			
Dow Jones Industrials	April 29	October 3	-16.8
Dow Jones Transports	July 7	October 3	-28.1 ←
Dow Jones Utilities	July 21	August 8	-11.4
S&P 500	April 29	October 3	-19.4
S&P 500 Equal Weighted	May 10	October 3	-23.2 ←
S&P MidCap 400	April 29	October 3	-26.6 ←
S&P SmallCap 600	July 7	October 3	-26.8 ←
Russell 2000	April 29	October 3	-29.6 ←
NASDAQ Composite	April 29	October 3	-18.7
Value Line Arithmetic	April 29	October 3	-27.5 ←
Russell 1000	April 29	October 3	-19.6
Russell 1000 Growth	July 7	October 3	-18.5
Russell 1000 Value	April 29	October 3	-22.3 ←
Russell 2000 Growth	April 29	October 3	-29.7 ←
Russell 2000 Value	April 29	October 3	-29.5 ←
S&P 500 High Beta Index	February 17	October 3	-40.5 ←
S&P 500 Low Volatility Index	May 19	August 8	-13.1
Morgan Stanley Cyclical	April 29	October 3	-34.8 ←
Morgan Stanley Consumer	May 19	August 10	-17.7
NYSE Financial Index	February 18	October 3	-32.8 ←
S&P 500 Sectors			
Consumer Discretionary	July 7	October 3	-18.6
Consumer Staples	May 19	August 10	-12.2
Energy	April 29	October 3	-28.4 ←
Financials	February 18	October 3	-34.3 ←
Health Care	May 18	August 10	-17.6
Industrials	April 29	October 3	-26.8 ←
Information Technology	February 17	August 19	-18.5
Materials	April 5	October 3	-29.4 ←
Telecom Services	May 31	August 8	-15.5
Utilities	May 17	August 8	-11.5
World Stocks (USD)			
MSCI AC World Index	May 2	October 4	-23.9 ←
MSCI AC World Ex USA	May 2	October 4	-28.5 ←
NYSE World Leaders Index	April 29	October 3	-23.3 ←
MSCI World Small Caps	April 29	October 3	-27.3 ←
MSCI EAFE	May 2	October 4	-27.6 ←
MSCI Emerging Markets	May 2	October 4	-31.1 ←

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Arrows highlight declines in excess of 20%.

"A recession is a process, and I think a lot of people don't understand that; they're looking for two negative quarters of GDP. But it is a process where sales disappoint, so production falls, employment falls, income falls, and then sales fall. That vicious circle has started. Our Leading Indexes are saying unequivocally this is a new recession."

ECRI's leading economic indicators have confirmed what the markets have been signaling since late July. A significant amount of recession risk is obviously already reflected in the financial markets, but it is a mistake to assume that markets have come close to fully discounting a new recession. The median recession-related bear market decline in the S&P 500 since 1945 is 30%. At present, the S&P 500 is 18% below its April 29th high.

Apart from a weakening economic backdrop, markets are vulnerable to the perpetual crisis environment in Europe, which is now in the acute phase. The structural flaw of the European Union is fully exposed, and the present situation of a monetary union without a fiscal or a political union has become untenable. Insolvent peripheral countries will either default and potentially exit the EU (and devalue back to their former currencies) or there must be fiscal union, or there will be debt monetization by the European Central Bank (ECB). Thus far, the ECB has been reluctant to follow the lead of the U.S. Federal Reserve and engage in large-scale quantitative easing (funding asset purchases with newly printed money). Absolutely no one knows how events in Europe will play out. It is futile to try to guess the shape or timing of the outcome. Meanwhile, global markets gyrate based upon the latest rumor.

In Europe and in the U.S., there are structural fiscal problems with no resolution in sight. Policy makers seem unable to do anything to inspire confidence. Instead, their actions and inactions have been mostly damaging to confidence. It increasingly appears as though crisis conditions are required to bring about a resolution. This has obvious negative implications for markets. Governments and central banks are intervening in the markets like we have never seen before, and investment decisions have become too dependent upon predicting the actions of policy makers. It is no wonder that investors are opting to hunker down in this environment and focus on preserving capital. There is little that gives one confidence to put capital at risk until the view of the future is clearer.

Investor psychology is deeply pessimistic and supportive of periodic bounces, but sentiment indicators are not as reliable a contrarian indicator in a bear market when the trend is down. Negative sentiment may prevent a collapse in prices, but not an eventual grind lower to the 950 - 1000 area on the S&P 500, which is my guess as to where this bear market could ultimately bottom out.

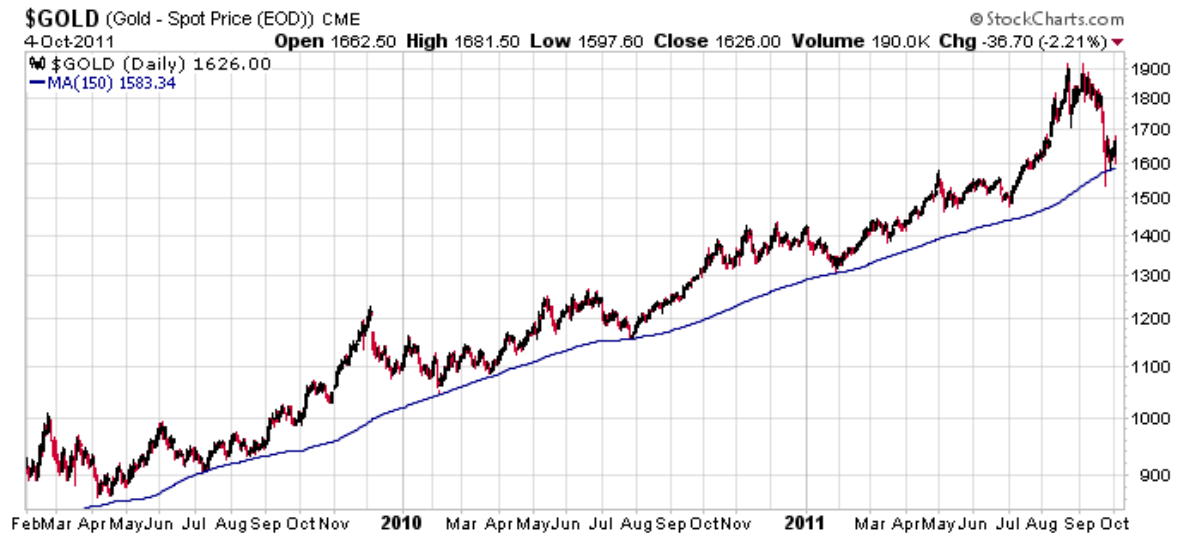
Market Comment

This projection would imply a peak-to-trough decline in the S&P 500 of around 30%, which is typical of recession-driven bear markets. At a price of 950 to 1000, the S&P 500 would be attractively priced, based on a multiple of normalized (cyclically-adjusted) earnings. At present, the normalized P/E ratio of the S&P 500 is still slightly higher than its long-term median, reflecting an essentially neutral valuation profile. A greater margin of safety is likely needed before a durable bottom can form.

Foreign stocks, broadly defined, are around 30% cheaper than the S&P 500 on the basis of normalized earnings. European stocks are over 40% cheaper than the S&P 500, due to obvious systemic risks there. The S&P 500 is more defensive than the broad foreign indexes due to its higher weightings in non-cyclical sectors such as healthcare and consumer staples, but this characteristic seems to be already reflected in current valuations. Notwithstanding the instinct to invest closer to home in an environment like this, investors should avoid indiscriminately selling foreign stocks at the expense of U.S. stocks.

Gold Back to Key Support Levels

After a parabolic ascent in July and August, the gold price has abruptly corrected over the past month back to key support at its longer-term trend-line. Since reaching a high of \$1,923/ounce on September 6, gold has dropped 16% to \$1,615/ounce.



The 150-day moving average, currently at \$1583 and indicated by the blue line in the chart above, has held every intermediate term correction in the gold market since the present set of policies were adopted in the wake of the 2008/2009 financial crisis.

Market Comment

Some investors have undoubtedly sold gold in recent weeks to offset (or take the sting out of) losses in other investments. Selling in gold has also been exacerbated by a series of margin increases at futures exchanges, which has flushed out leveraged speculators. Ownership of gold futures contracts at the COMEX exchange has dropped to its lowest level since May 2009, when gold was trading at around \$900/oz.

The current shake-out in gold feels severe due to the huge run-up that preceded it, but gold is still up 14% year to date and is on track for an 11th consecutive year of gains. Gold likely needs some additional time to stabilize and build a new base, but investors should treat this correction as an opportunity to accumulate gold and build exposure towards 10-15%, which seems appropriate in the present environment. Nothing has changed with the longer-term bullish case for gold, which is linked to the sovereign debt crisis and the devaluation of paper currencies. Barring a radical change of direction, these problems will be with us for years. Investment demand for gold as a safe haven is global. Investors in each of the major economic regions – the U.S., Europe, and Asia – are acquiring gold as a refuge from currency debasement and the debt crisis in the developed world.

The secular bull market in gold will likely end when we return to positive *real* short-term interest rates and implement credible measures to address our long-term fiscal imbalances. Neither of these events is on the horizon at present. In fact, the Fed has promised to hold short-term interest rates at 0% for two more years, and is doing everything in its power to create negative real yields on long-term bonds. The current 10-year Treasury yield of 1.87% is more than a percentage point below the year over year increase in the CPI.



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“By God, I remember when interest rates were interest rates.”

Asset Class Returns

Broad Equity Index Performance, Ranked by Year to Date Total Return						
Asset Class	Representative Index	September	Date	Through September 30, 2011		
				Year to	Annualized	
				1-year	3-year	5-year
U.S. Large Cap Stocks	S&P 500	-7.0%	-8.7%	1.1%	1.2%	-1.2%
U.S. Mid Cap Stocks	S&P MidCap 400	-10.6%	-13.0%	-1.3%	4.1%	2.2%
U.S. Small Cap Stocks	S&P SmallCap 600	-10.3%	-13.8%	0.2%	0.8%	0.3%
Foreign Large Cap Stocks	MSCI EAFE	-9.5%	-15.0%	-9.4%	-1.1%	-3.5%
Foreign Small Cap Stocks	MSCI EAFE Small Cap	-10.4%	-15.5%	-5.5%	5.6%	-1.9%
Emerging Markets Stocks	MSCI Emerging Markets	-14.6%	-21.9%	-16.2%	6.3%	4.9%

Fixed Income Index Performance, Ranked by Year to Date Total Return						
Asset Class	Representative Index	September	Date	Through September 30, 2011		
				Year to	Annualized	
				1-year	3-year	5-year
Inflation Protected Bonds	Barclays Capital U.S. Treasury TIPS	-0.2%	10.6%	9.9%	8.1%	7.1%
Municipal Bonds	S&P National Municipal Bond	1.2%	8.9%	3.9%	8.2%	n/a
Intermediate Term Treasuries	Barclays Capital 3-7 Year Treasury	0.1%	7.2%	4.7%	6.6%	n/a
Broad U.S. Bond Market	Barclays Capital U.S. Aggregate	0.7%	6.7%	5.3%	8.0%	6.5%
Intermediate Term Corporates	iBoxx \$ Liquid Investment Grade	-0.3%	6.4%	3.9%	13.0%	6.9%
Agency Mortgage Backed Bonds	Barclays Capital U.S. MBS	0.2%	5.3%	5.6%	7.0%	6.7%
Emerging Markets Bonds	JPMorgan EMBI Global Core	-4.2%	3.2%	1.0%	11.9%	n/a
Foreign Government Bonds	S&P/Citigroup Int'l Treasury	-5.4%	3.0%	0.4%	n/a	n/a
Short Term Corporates	Barclays Capital 1-3 Year U.S. Credit	-0.4%	1.4%	1.5%	6.2%	4.8%
Short Term Treasuries	Barclays Capital 1-3 Year Treasury	-0.1%	1.4%	1.2%	2.4%	3.9%
Foreign Gov't Bonds Short Term	S&P/Citigroup Int'l Treasury 1-3 Yr	-6.2%	0.4%	0.3%	n/a	n/a
T-Bills	Barclays Capital Short U.S. Treasury	0.0%	0.2%	0.3%	0.5%	2.0%
High Yield Corporates	iBoxx \$ Liquid High Yield	-3.7%	-1.9%	1.1%	10.4%	5.2%

Alternative Investments Index Performance, Ranked by Year to Date Total Return						
Asset Class	Representative Index	September	Date	Through September 30, 2011		
				Year to	Annualized	
				1-year	3-year	5-year
Gold	London Gold PM Fix Price	-10.7%	15.3%	24.0%	22.4%	22.0%
U.S. REITs	Dow Jones U.S. Real Estate	-10.8%	-6.8%	-0.3%	-1.7%	-3.5%
Diversified Commodities	Dow Jones-UBS	-14.7%	-13.6%	0.0%	-5.7%	-1.1%
Foreign Real Estate	S&P World Ex-US Property	-12.3%	-15.2%	-9.7%	1.8%	-4.9%
Natural Resources Stocks	S&P North America Nat. Resources	-16.7%	-18.9%	-1.6%	-0.7%	3.2%