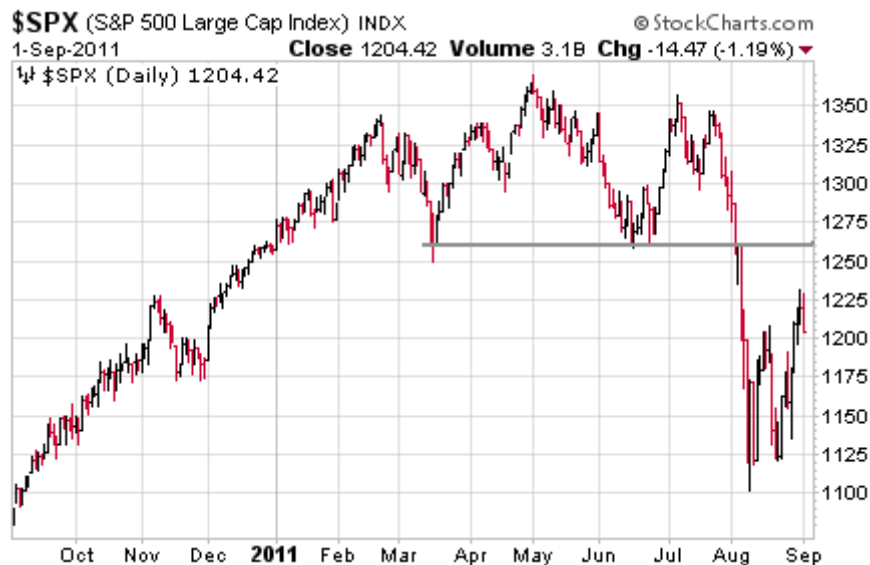


The stock market suffered a major technical breakdown in the waterfall decline that occurred between July 22 and August 9, in which the S&P 500 plunged 18%. Over the past two weeks, stocks have experienced a very typical relief rally from extremely oversold short-term conditions. At the close of September 1, the S&P 500 was priced at 1204, which is down 4% for 2011. The index is 12% below its May 2 high of 1370 and 9% above its August 9 low of 1101. Market action in September should tell us whether we are in a new bear market environment, or whether an intermediate-term bottom was registered in the panic selling in the first half of August. The 1250 – 1270 area on the S&P 500 poses major technical resistance.



Economic slowdown has arrived and it could be prolonged. Government has largely exhausted its ammunition to stimulate the economy (although more attempts appear forthcoming in September, particularly in light of the latest employment report, which showed no growth in payrolls in August). There is an extreme lack of confidence in our government policymakers and a deeper recognition about the magnitude of our financial problems. The Standard and Poor's downgrade of the country's credit was warranted and underscores how severely the U.S. financial balance sheet has deteriorated given the total federal debt is now at 100% of GDP and looks to be rising rapidly in the immediate years ahead. Until we begin to get our fiscal house in order, the economy will remain stagnant and markets will be prone to recurring crises. The reforms needed are unlikely to happen before the U.S. election in 2012, and may not happen after the election, given the current political climate.

On the monetary front, just when we thought policy could not become more extreme, the Federal Reserve announced on August 9 that short-term rates will remain at zero for two more years, until mid-2013. Chairman Bernanke then stated on August 26 that the Fed could introduce a new easing program following its September 21 meeting. The zero percent interest rate commitment is objectionable because it further debases the dollar and puts the Fed in a box if inflation becomes an even bigger problem than it is today. Moreover, it does nothing to boost confidence. In fact, it does the opposite by reinforcing perceptions of an unhealthy, unbalanced economy and desperate policymaking. Three of the ten voting members of the FOMC voted against the decision. As for a possible new round of quantitative easing of some form, that should be off the table for a host of reasons (e.g. CPI inflation running 3.6% year over year; the dollar trading at all-time lows; gold prices going through the roof). But evidently it is not. Fed policy is all about suppressing interest rates of all maturities to prop up the existing debt structure, and facilitating the expansion of debt, most particularly government debt.

Despite the recent decline, the stock market could still have significant downside risk. Corporate earnings have just begun to be pressured downward by the weaker global economic backdrop, and the economy may deteriorate further, particularly if a negative feedback loop from falling confidence and asset prices takes hold. The debt crisis is an issue that is not going away, particularly in Europe, which has the potential to roil markets this fall. If the bear market scenario turns out to be operative, I suspect the S&P 500 would find good support around the 1000 level, which represents a 17% decline from current levels and a 27% decline from the May 2 high of 1370. If we get down towards that level, stock valuations would be attractive on an absolute basis and compelling compared to bonds and cash, where interest rates are being systematically suppressed.

I am sympathetic to arguments from the bulls that stocks already look compelling on any sort of longer-term horizon (i.e. 5 years or more) compared to the pitiful opportunity set in the bond market, which has been massively distorted by government intervention. Of course, one would prefer stocks over bonds and cash if one had to make an investment today and hold it for the longer-term. But stocks can certainly go substantially lower in the near-term if recession becomes a reality, so it makes sense to retain a core position in quality stocks, but have significant dry powder. Moreover, until the country begins to get its debt problem under control, it is prudent to be mindful of possible worst case scenarios in the markets.

It is possible that recession fears are overdone and that the stock market has adequately discounted the economic slowdown. In this case, August 9 may have marked the final selling climax. We are open to this more bullish interpretation, but our investment approach is grounded in risk management, so we remain in a defensive posture. There are a lot of moving parts and very different scenarios that could play out in the markets, so we believe the best strategy is to give the current picture more time to develop.

Market Comment

With a gain of 11%, gold was the best performing asset class in August, demonstrating its value as a safe haven from the monetary risks emanating from the debt crisis. Leading up to its August 22 peak just above \$1900, gold had rallied \$400, or 25%, in the space of seven weeks. A series of gold-friendly events helped drive the rally, which was the strongest since late 2009. The debt crises in Europe and the U.S. intensified simultaneously with no progress in either case towards substantive resolution. The credit rating of the U.S. government, issuer of the world's reserve currency, was downgraded for the first time in its history. At the same time, the Fed promised negative real interest rates until 2013 and opened the door to additional quantitative easing. Not surprisingly, the price of gold went parabolic against that backdrop. It became very extended and needed a correction, which is what occurred. Gold dropped 9% over the course of three days. The correction was amplified by an increase in margin requirements from the Chicago Mercantile Exchange, which affected investors holding gold on margin in futures accounts.

Gold remains overbought on an intermediate term basis, but it is anyone's guess how deep or long-lasting the correction/consolidation will turn out to be. A break of last week's low of \$1750 would signal a deeper correction. The 150-day moving average at \$1550, which is indicated by the blue line in the chart below, 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. If we do get a deeper correction, I would be surprised if gold drops below \$1650. Investor demand from around the world is very strong. The macro backdrop remains bullish for gold, and recent events underscore its safe haven status. As long as the monetary and fiscal policies we now have in place continue, the gold bull market can be expected to continue.

