

People always want to know where they are; they seek certainty. They ask if this is a new bull or only a bear market rally. In the world of investing there is no exact destination, time line or map. We do have some crude historic guidelines called business cycles, market cycles etc. that have been used for approximating our location. The financial meltdown has dominated the policy making of both the late Bush and early Obama administrations. Here is our update.

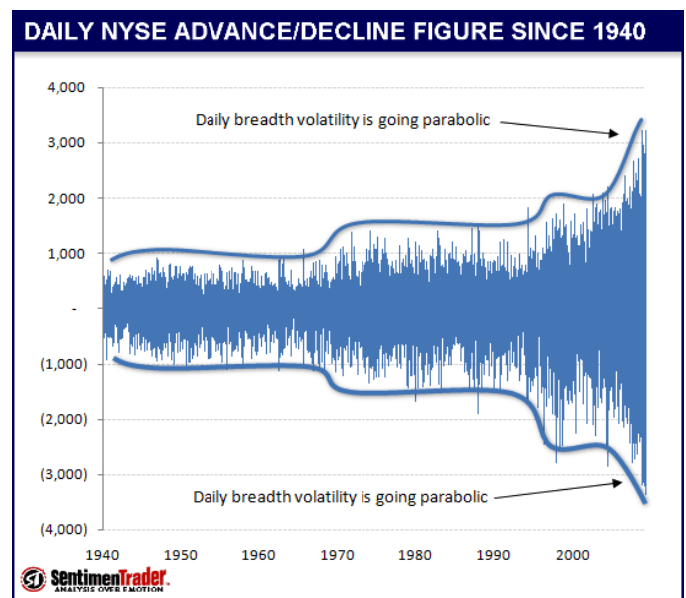
The problem with forecasting the financial markets is that we are all marching into the unknown facing backwards, and maps are of only minor help. Everyone wants to know where they are located, but no one really knows. History is what we have to work with so let's take a look at past bear markets.

S&P 500 Bear Market History							
		Number of Rallies					
Peak Date	Trough Date	# of Days	% Correction	>3%	>5%	>10%	>15%
09/07/29	6/1/32	812	-86.2	76	43	16	9
03/10/37	4/28/42	1545	-60.0	97	52	20	9
05/29/46	6/13/49	858	-29.6	36	18	4	2
08/02/56	10/21/57	307	-21.3	10	5	1	1
12/12/61	10/23/62	219	-26.4	8	3	1	
02/09/66	10/7/66	168	-22.2	5	2		
11/29/68	5/26/70	370	-36.1	11	4		
01/11/73	10/4/74	438	-48.2	25	12	2	
09/21/76	3/6/78	367	-19.4	9	4		
11/28/80	8/12/82	431	-27.1	16	8	2	
08/25/87	12/4/87	72	-33.5	5	3	2	
07/16/90	10/11/90	63	-19.9	2	1		
07/17/98	10/8/98	59	-19.2	5	3	2	
03/24/00	10/9/02	638	-49.1	45	22	6	3
10/09/07	3/9/09	358	-53.9	38	20	5	2
Average		447	-37	26	13	6	4
Median		367	-30	11	5	2	3

Above we see S&P data for bear markets showing the number of bear market rallies that took place before the final lows were made. Our current situation is highlighted, and it begs the most immediate question: Was the low on March 9th "the bottom", or was it an interim low? Truthfully we do not know. The bear markets of the 1950's were the result of inventory/ industrial/automobile cycles. The 1960's and 1970's had Vietnam and two oil embargoes. Since 1980 it has been all about interest rates and finance.

Of all industries, the computer age has affected finance the most. The interest rate led bear market of 1980-1982 was the first where bond prices were calculated on a computer not on a slide rule or estimated from a bond yield book. The market break of 1987 saw computer led program trading swamp the market as "Portfolio Insurance" (a form of stop loss order) collapsed. The 1987 bear market began the demise of the NYSE Specialist, and as computers have become ubiquitous to financial trading, the duration of market rallies and breaks is getting shorter and the amplitude larger.

S&P 500 Bear Market History							
		Average Duration of Rallies in Days					
Peak Date	Trough Date	# of Days	% Correction	>3%	>5%	>10%	>15%
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08/02/56	10/21/57	307	-21.3	12	21	61	99
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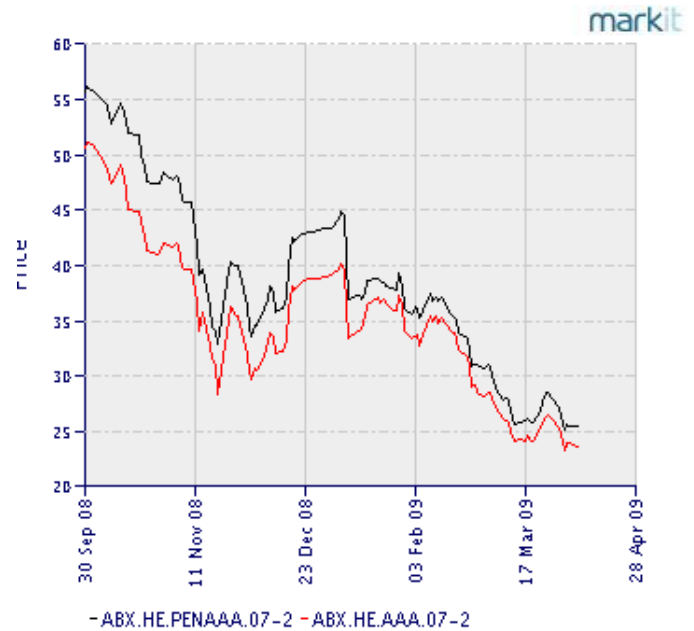


But look at the growing A/D volatility!

The financial industry is America's largest employer outside of government. The financial markets will not fully heal (in our opinion) until investors sense that they are making decisions based upon truth, will be protected by the rule of law and that the legal tender of the nation is a fair storehouse of wealth. The 22 acronym programs in place (so far) by the Federal Reserve and the Treasury are meant (in our opinion) to confuse the public as to the solvency of the banking system. Fortunately men of character are coming forward. This week in Barron's and last week with Bill Moyers William K. Black, the former senior regulator during the S&L crisis of the 1980's, who points out that both Bush and Obama administrations have been deliberately and consciously breaking the law in regards to insolvent banks. Mr. Black calls the Treasury stress test of the largest 19 banks a "Complete Sham". These are very strong words and a must read:

<http://www.pbs.org/moyers/journal/04032009/transcript3.html>

As the Second Quarter opens not only are the quality of banks' earnings being questioned, but also the nature of the Public Private Investment Partnership (PPIP) whereby the government offers 50% of whatever is recovered by private investors for approximately 6% as an equity stake in bundles of offered "toxic" loans from banks. This is really just transferring bad debts from one overleveraged bank to another overleveraged borrower. And of course the question is price. Banks cannot sell at market prices because they will book losses that will wipe out their stated capital. Likewise investors should not want to pay the prices on the banks books because they are unrealistically high. Many commentators are concluding that this will end up being a plan (ruse) to use public tax money to offer more bailout money to the five largest banks. The large banks with troubled loans are reportedly carrying them on their books around 90% of face value, yet we have market price evidence from Markit that shows real transactions.



Above are recent prices for 2007 vintage mortgage Asset Backed Securities still rated AAA, below AA prices. AA are selling for 25 and A and BBB are 3 cents on the dollar.



Since there is not yet clarity on the value or nature of the bank holdings in question, we conclude that this marvelous bounce from the March lows is in reality a bear market rally. From the charts on page one we see that such rallies can last a considerable amount of time and provide great returns.

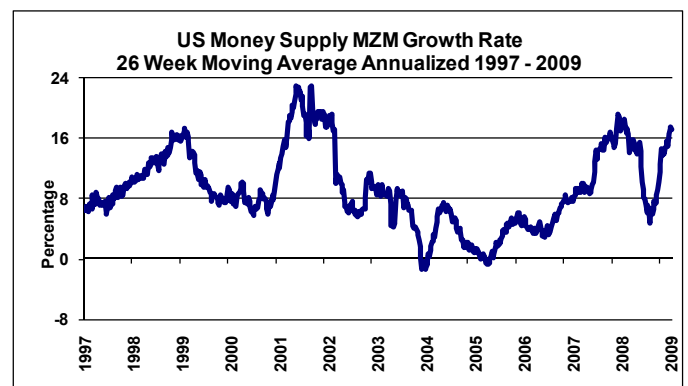
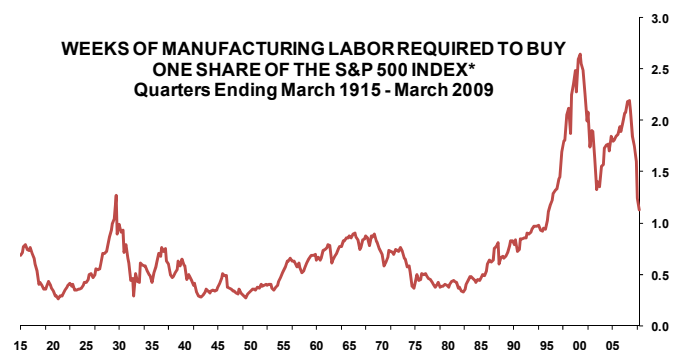
We believe that even if the March 9 lows on the DJIA and S&P 500 are the absolute bottom, the current bear market is far from over in time duration. It is very hard to believe that the greatest financial crisis since the melt down of the 1930's would produce the shortest bear market. In the Great Depression the world's financial architecture collapsed and was not fully repaired until the Bretton Woods Agreements of 1944 (15 years later). Now that the implied Bretton Woods II (whereby we buy low cost goods from Asia and they lend us the money to purchase them) has been shaken by the extreme abuse of credit by Wall Street, Main Street and Congress we have entered a period where the financial architecture of the world is again being challenged, and while it has not yet collapsed, the calls for its reform are becoming louder each day. The Russians have publically announced that their Central Bank is actively purchasing gold with the intent of achieving a 10% bullion anchor to their ruble. Russia holds the largest gas reserves in the world, but their oil production is in decline. It is only natural that they want to be paid in the hardest currency for their dwindling national treasure.

Two weeks ago China's Finance Minister Xie Xuren called for "a full scale reform of the global financial system to diversify international currencies, improve regulations and give developing countries a bigger say in economic decisions". His remarks came after central bank governor Zhou Xiaochuan's proposal of creating an international reserve currency. He recently stated "When the currency of one nation is used as the global reserve currency, there are constant conflicts between the single country's monetary policy goals and the needs of other countries". While the \$US was not specifically mentioned, it is clear that the Chinese are squirming over the long term prospects of paying for natural resources with their depreciating dollars. Concern about the long term implications of all major central banks engaging in a trade war centered around zero rate lending and Quantitative Easing (printing money) are growing.

Over the past weekend the head of the German Bundesbank Mr. Steinbrück said "I am concerned that the counter measures we are seeing around the world, financed by enormous amounts of debts, could be paving the road to the next crisis...We do not have a short-term inflation problem, but in the medium term we must start thinking about how to pull the billions we are pumping into our economies out of the system again. This will be a special challenge for central banks, including for the European Central Bank".

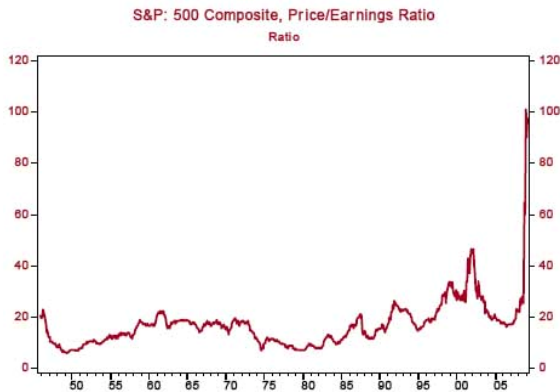
China is now the world's largest gold producer. Russia is a large gold producer and both are calling for monetary reform and the use of International Monetary Fund Special Drawing Rights (gold, actually) to be used in the settlement of international transactions. We believe that until these issues are resolved (after some world economic recovery) our investment in gold stocks will be handsomely rewarded. Until then we should look at historic markers for a clue to areas to invest in this bear rally.

First, a long perspective on where the Dow Jones Industrials stand relative to its affordability by the average skilled laborer. This shows that stocks are still expensive relative to wages.



Above we see that the money supply is growing briskly and that should be a bullish background for both the economy and the markets. But that money needs turnover or velocity to equate to rising business activity. We have not seen this yet but the market is hopeful. The S&P 500 earnings finished 2008 at \$49.51 per share in operating earnings, but after non-reoccurring items:

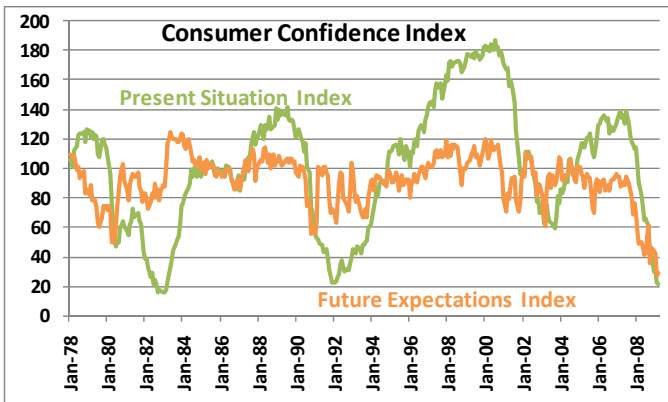
Did you know the P/E is 100x?



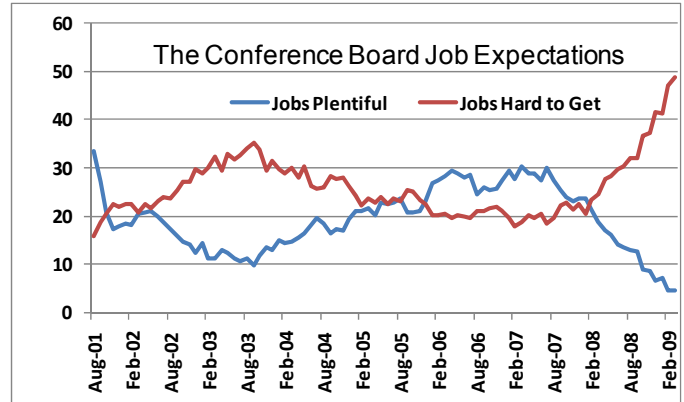
Source: Haver Analytics, Banc of America Securities-Merrill Lynch

Standard and Poor's boldly predicts that 2009 earnings will rise 24% to \$64.41 for a P/E ratio of 13.3 and another 24% in 2010 to \$76.08 or a P/E of 10.7. Where are these profits coming from?

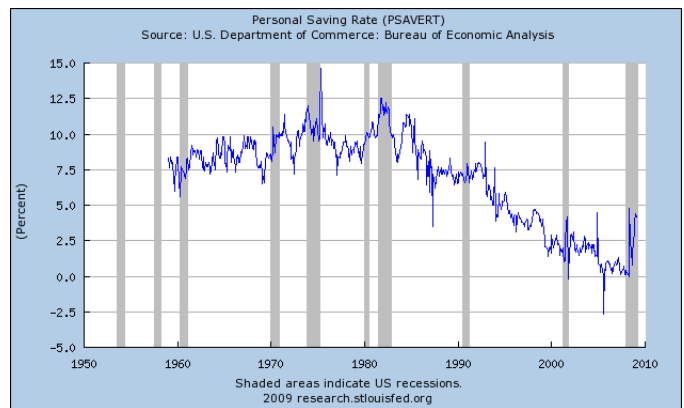
Looking at confidence as a leading indicator and spending 66% of GDP, we do not see any turn that would excite retail buying past bare necessities. Future expectations are the lowest on record, and to us it appears that a generational change has occurred with the outlook of the Baby Boom Generation. They have lost half of their financial assets and their homes have fallen in value. No more ATM from HELOC loans. Thrift is back.



The Conference Board's survey of the public's attitude towards finding jobs leads us to believe that with forecasts of unemployment heading as high as 11% spending caution will continue.

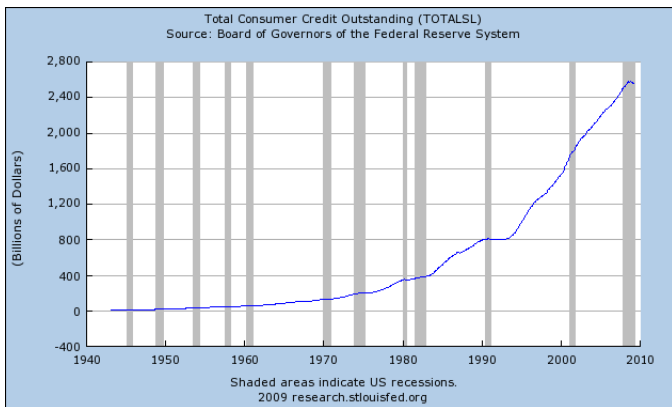


As expected, households started saving again in 2008, and we expect the thrift ethic to persist for some time to come.



Nearly \$500 billion per year of Home Equity withdrawal in 2005 and 2006 has now been completely reversed. How soon will it return to help consumption? Fed data indicates that household investments in financial assets was rising during those years, which is essentially buying on margin. Now that all financial assets have fallen considerably in value, the process is now in reverse and households are de-leveraging. In past recessions housing and financial assets were negatively correlated. This time it is different; there is no housing bubble to offset equity losses. Total assets of household and non-profits have dropped \$12.6 trillion since Q3 2007 with \$9.6 trillion of that in equity values. Home values are below loan values on over 20% of homes for the first time since the Great Depression.

Savings have returned to the 5% level as people realize that they cannot depend upon capital gains in their equity portfolios nor their homes for retirement income. Like The Great Depression, households are responding to this wealth destruction by de-leveraging through selling of equities, and the subsequent re-payment of debt. This causes consumption, the largest component of GDP, to stop rising, causing corporate revenue to fall, causing corporate profits and investment to fall etc., causing the Fed to openly fear a debt deflation. Note the first absolute credit decline in 2008 since WWII below.



Fed Chairman Ben Bernanke, a noted student of the Great Depression is keenly aware of the work done by the great economist Irving Fisher. Dr. Fisher analyzed the debt deflation of the 1930's and determined that there were nine steps in the debt deflation process:

- (1) Debt liquidation leads to distress selling and to
- (2) Contraction of deposit currency, as bank loans are paid off, and to a slowing down of velocity of circulation. This contraction of deposits and of their velocity, precipitated by distress selling, causes
- (3) A fall in the level of prices, in other words, as swelling of the dollar. Assuming, as above stated, that this fall of prices is not interfered with by reflation or otherwise, there must be
- (4) A still greater fall in the net worth's of business, precipitating bankruptcies and
- (5) A like fall in profits, which in a "capitalistic," that is, a private-profit,

society leads the concerns which are running at a loss to make

- (6) A reduction in output, in trade and employment of labor. These losses, bankruptcies and unemployment, lead to
- (7) Pessimism and loss of confidence, which in turn lead to
- (8) Hoarding and slowing down still more of the velocity of circulation. The above eight changes cause
- (9) Complicated disturbances in the rates of interest, in particular, a fall in the nominal, or money, rates and a rise in the real, or commodity, rates of interest.

Econometrica, 1933, Volume 1, p.342

Price deflation, in Fisher's sequence, is set off by the attempt to reduce debt outstanding by selling assets and paying down bank loans. This forces real (inflation adjusted) interest rates much higher thus destroying debtors. This is the nightmare that has caused our government to take actions not seen since the New Deal, as our central bank will not allow this to happen **at any cost**.

In 1933 when FDR took us off the gold standard the Fed printed us out of the depression as people spent the newly devalued money out of fear that it would devalue more over time. Debt deflation was stopped dead. GDP grew 30% from 1933 to 1938, unemployment fell from 25% to 15% and the Producer Price Index jumped 25% the first year and averaged 7% until 1938.

The nation next suffered a government led recession/depression as higher taxes, higher bank reserve requirements and reduced public spending enacted in 1937 re-ignited the debt deflation spiral that was only halted by World War II. As long as Ben Bernanke not Tim Geithner is the policy maker we can be assured that the mistakes of 1937 will not be repeated. Inflation is not their fear - it is their goal; we are forewarned and prepared.

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