

Commentary:

The Trend Tool: How It Works

During the past quarter I have had the opportunity to reread a good deal of the material that was prepared prior to the launch of the Trend Tool (TT) in 2000. Since that is almost a decade ago and since we've had such a tumultuous ride in the past 18-24 months, I felt it would be a good time to review the principles that apply. The run up in the equities markets in the past few weeks has generated a few calls asking when or whether we're planning to re-enter the equity markets. Hopefully the following explanation will serve the dual purpose of review and illumination of the investment process.

The main premise behind the Trend Tool is the old investment adage, "The Trend is Your Friend." It simply means to go along with the predominant trend in any given market. For example, when the stock market is going up and has proven itself it pays to be long, or invested, in stocks. When the direction changes, get out of the way, sell the stock or funds and sit on the sidelines in cash or money markets. With some minor differences and technical adjustments, the same premise holds for the fixed income markets (Governments/Corporate/Municipal Bonds).

At this juncture it might seem very simple and straightforward and in many ways it is. However, the complexity arises in identifying the trends, choosing

the right market sectors, the rate of change of each index and the relationships between them all. We have been fortunate in that Rusty left a good deal of background data, and that I had a reasonably good understanding of the process before beginning to use it, and that, of late the trends have been very well defined.

An example may be of help here. The TT automatically reviews 86 indices each Monday morning. The results are entered into a very large and complex spreadsheet which measures the rate of change over varying periods in each market sector (such as the S&P 500). Since the first week of March through the week ending April 17 the S&P 500, as well as most other equity indices, has risen in almost a straight line from the previous lows. In our system, that positive direction has evidenced itself by the TT giving long and buy signals for the shorter periods we measure. If the system was mechanical or computerized it would have bought indicated positions two weeks ago. This is what is often referred to as "program trading." However, the TT is not designed in this way. Actual trading requires the human element of judgment to make buy or sell decisions.

This is why we have not ventured into the markets. In this particular case, based on my belief that the current rally is going to be short lived and is not truly a turning point, I've held off moving back into equities. I would rather be wrong on the buy decision and leave something on the table than to move too quickly and be forced to take short term losses. My primary responsibility as an Investment Advisor is to preserve your Capital and to grow it at a reasonable rate. The

Commentary

(continued from page 1)

The past few weeks of market news have focused on positive surprises from the banking and financial industry in the face of higher unemployment, continued slow home sales and building, looming bankruptcy for one or more automakers, rising credit card and student loan delinquencies and numerous other reports that make it extremely difficult to credit the few earnings surprises as the true turning point in the economy, regardless of what the pundits say.

Fixed Income Markets

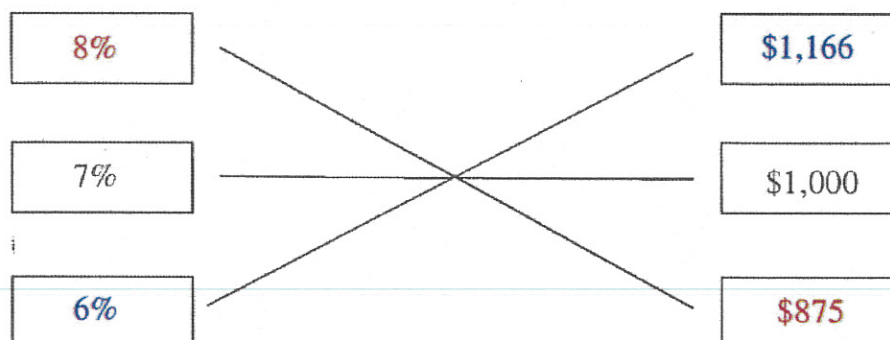
In many ways the TT utilizes the same computational methods and similar signals for the fixed income markets. The differences lie in the aspects of the sector that are measured. For fixed income sectors, both price movements and interest rate movements are measured. As my clients well know, the price of a bond moves inversely to the direction of interest rates. For instance, as in the diagram below, a ten-year bond with a face value of \$1000 and paying

an interest rate of 5% will increase in face value if market interest rates for a bond of the same maturity decrease to 4%.

Conversely, the face value will decline if the market rates rise to 6%. Therefore, the TT must track both price and interest rate movements to effectively monitor trends.

On page six of the last issue of *The Advisory* (Winter 2009), we described our outlook for the near to mid-term regarding interest rates and our likely moves within the fixed income sector. We are still holding in 1-3 year Treasuries and the Total Bond Market Index Funds. We will continue to monitor the direction of interest rates and price movements but have not yet seen a trend that would indicate that it is time to lengthen maturities to 3-7 or 7-10 years. We have bought Municipal Index Funds – both National and State specific – in selected situations.

Interest Rates vs. Bond Prices



Fighting Recklessness with Recklessness

(The following article is reprinted with permission of the author, John P. Hussman, PhD. The original article can be found at <http://www.hussmanfunds.com>)

By John P. Hussman, Ph.D

Last week saw a continuation of the impenetrably misguided policy response to this financial crisis, which seeks to address the downturn by encouraging more of what got us into this mess in the first place. The U.S. Treasury's toxic assets plan, for instance, looks to "leverage" public funds (with the FDIC providing the "6-to-1 leverage") in order to defend the bondholders of mismanaged financials who took excessive leverage. At the same time, the Treasury plans to limit the "competitive bidding" to a few hand-picked "managers" who will be encouraged to overpay thanks to put options granted at public expense. This is a recipe for the insolvency of the FDIC and an attempt to bail out bank bondholders using funds that have not even been allocated by Congress. The whole plan is a bureaucratic abuse of the FDIC's balance sheet, which exists to protect ordinary depositors, not bank bondholders.

On Thursday, the stock market cheered a move by the Financial Accounting Standards Board (FASB) to relax FAS-157 (the "mark-to-market" accounting rule), allowing nearly insolvent financial companies to use more discretion in the models they use to assess fair value. Of course, the irresponsibly rosy assumptions built into these models have been a large contributor to this near-insolvency, because they virtually ignored foreclosure risks.

Notably, the one thing policy-makers have *not* done is to address foreclosure abatement in any serious way. The only way to get through this crisis without enormous collateral damage to ordinary Americans is by restructuring mortgage obligations (ideally using property appreciation rights), restructuring the debt obligations of distressed financial companies (ideally by requiring bondholders to swap a portion of their

debt for equity), and abandoning the idea of using public funds to purchase un-restructurable mortgage debt ("toxic assets"). See *On the Urgency of Restructuring Bank and Mortgage Debt, and of Abandoning Toxic Asset Purchases*.

Look. You can play hot potato with the toxic assets all day long, and only outcome will be that the public will suffer the losses that would otherwise have been properly taken by the banks' own bondholders. You can tinker with the accounting rules all you want, and it won't make the banks solvent. It may improve "reported" earnings for a spell, but as investors who care about *the stream of future cash flows that will actually be delivered* to us over time, it is clear that modifying the accounting rules doesn't create value. It simply increases the likelihood that financial institutions will quietly go insolvent. I recognize that the accounting changes may reduce the immediate need for regulatory action, since banks will be able to pad their Tier 1 capital with false hope. But we have done nothing to abate foreclosures, and we are just about to begin a huge reset cycle for Alt-A's and option-ARMs. As the underlying mortgages go into foreclosure, it will ultimately become impossible to argue that the toxic assets would be worth much even in an "orderly transaction."

Meanwhile, in a bizarre convolution of reality reminiscent of Alice in Wonderland, the Financial Times reported last week: "US banks that have received government aid, including Citigroup, Goldman Sachs, Morgan Stanley and JPMorgan Chase, are considering buying toxic assets to be sold by rivals under the Treasury's \$1,000bn plan to revive the financial system." And why not? They can put up a few percent of their own money, and swap each other's toxic assets financed by a bewildered public suddenly bearing more than 90% of the downside risk. The "investors" in this happy "public-private partnership" keep half the upside while ordinary Americans take the downside off of their hands. Some partnership.

(continued)

Fighting Recklessness ***(continued from page 3)***

With regard to the economy, there is quite a bit of optimism that the recent market advance represents a forward-looking call that the economy will recover in the second half of the year. Indeed, some analysts have noted that year-over-year consumer spending has only declined very slightly, hailing this as evidence that economic concerns are overblown. The difficulty is that consumer spending has never declined on a year-over-year basis, except in this downturn, so that slight decline is actually the worst showing for consumer spending in the available data. Likewise, capacity utilization has plunged to levels seen only in 1974 and 1982, both which were accompanied by far deeper valuation extremes than at present.

I recognize that given the depth of the recent decline, it seems as if stocks must be at once-in-a-lifetime valuations. Unfortunately, this is an artifact of the previous level of overvaluation.

The depth of a bear market often has a loose relationship with the extent of the prior bull market (and particularly with the level of valuation of the prior bull), but there is very little relationship between the depth of a bear market and the subsequent bull.

If we assume that the long-term fundamentals of the economy have not been affected in any meaningful way by this economic downturn, then stocks are most likely priced to deliver long-term returns between 9-11% annually over the coming decade, with outlier possibilities of as much as 14% if the market ends the coming decade at historically overvalued levels, and as little as 4% if the market ends the coming decade at historically undervalued levels. Far from being once-in-a-lifetime values, prospective 10-year returns on the S&P 500 are not far from their historical norms here. Stocks are about fairly valued.

The only way that stocks could be considered ex-

tremely undervalued here is if we assume that the record profit margins of 2007 (based on record corporate leverage) are the norm, and will be quickly recovered. While we never rule out the potential for surprising strength or weakness in the markets or the economy, the assumption that profit margins will permanently recover to 2007 levels is equivalent to assuming that the past 18 months simply did not happen.

Still, given sufficient evidence of broad improvement in market action (which we take as a measure of risk tol-

erance and economic expectations), we wouldn't fight the combination of roughly fair values and a willingness of investors to bear risk. We've been carrying small "contingent" call option positions for a good portion of the recent advance. This helped to compensate for our low weightings in financials, homebuilders and other low-quality sectors that have enjoyed frantic short-covering.

Still, with only about 1% of as-

sets currently in those calls, our stance is still characterized as defensive here, as we are otherwise fully hedged. Again, we won't fight a broad improvement if it continues sufficiently, but if I were to make a guess, it would be that the potential downside in the S&P 500 from these levels could approach 30-40%. That is not a typo, and it is not a possibility that should be ruled out.

I have no idea how long investors will remain enthusiastic about trillion dollar band-aids and eroding the integrity of our accounting rules. I do know that at the end of the day, what matters is the *long-term stream of deliverable cash flows* that investors can actually expect to reach their hands. It's exactly that consideration that makes it clear that we will sink deeper into this crisis until we observe debt restructuring on a large scale. If we don't restructure the debt, the debt will fail, because for many borrowers, the cash flows aren't there, and it is not possible to service the debt on existing terms.

***"...for many borrowers,
the cash flows aren't
there, and it is not possible
to service the debt
on existing terms."***

FYI - The Official Word

On April 29, 2009, following its monthly meeting on monetary policy, the Federal Reserve released the following statement:

"Information received since the Federal Open Market Committee met in March indicates that the economy has continued to contract, though the pace of contraction appears to be somewhat slower. Household spending has shown signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Weak sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories, fixed investment, and staffing. Although the economic outlook has improved modestly since the March meeting, partly reflecting some easing of financial market conditions, economic activity is likely to remain weak for a time. Nonetheless, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability.

"In light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term. [i.e. possible deflation]

"In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to \$1.25 trillion of agency mortgage-backed securities and up to \$200 billion of agency debt by the end of the year. In addition, the Federal Reserve will buy up to \$300 billion of Treasury securities by autumn. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is facilitating the extension of credit to households and businesses and supporting the functioning of financial markets through a range of liquidity programs. The Committee will continue to carefully monitor the size and composition of the Federal Reserve's balance sheet in light of financial and economic developments."

Significant Indices for Year-to-Date 2009

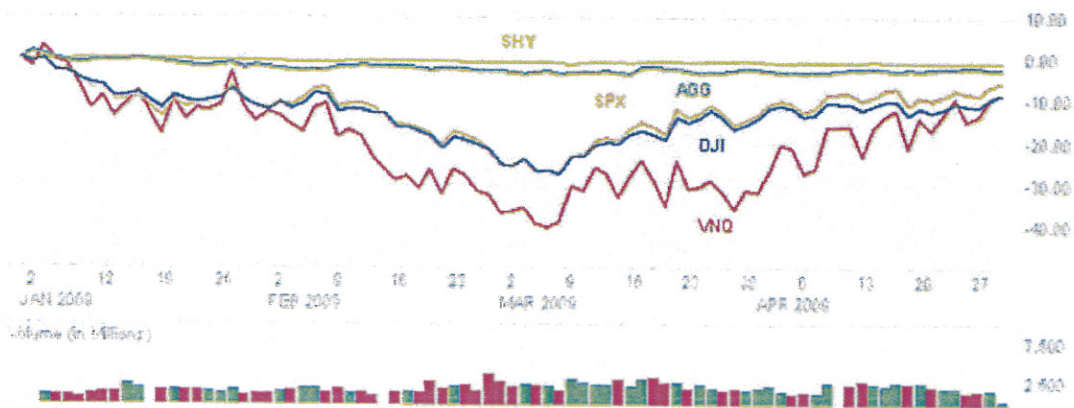


Chart from CNBC



The ADVISORY

is written by James P. McCauley, Jr. and staff
and is published by
Income & Asset Advisory, Inc.,
80 Business Park Drive,
Armonk, NY 10504
(914) 273-6800 FAX (914) 273-6806
e-mail jim@theadvisory.com
Copyright 2006 Income & Asset Advisory, Inc.

Market Activity

Market Indicator	Prices			Percent Changes	
	3/31/2008	12/31/2008	3/31/2009	Last Year	Last Quarter
1 Ounce of Gold (<i>London PM Fixing</i>)	934.25	843.50	924.00	-1.1%	9.5%
Technology Oriented Stocks (<i>NASDAQ Index</i>)	2261.18	1530.24	1545.20	-31.7%	1.0%
Small Company Stocks (<i>Russell 2000 Index</i>)	683.18	476.77	429.00	-37.2%	-10.0%
International, Global Stocks (<i>EAFE Index</i>)	2045.44	1210.76	1083.64	-47.0%	-10.5%
Large Company Stocks (<i>S&P 500 Index</i>)	1315.22	872.80	815.94	-38.0%	-6.5%
Higher Yielding Stocks (<i>DJ Utilities Index</i>)	473.43	359.43	331.27	-30.0%	-7.8%
High Yield Bonds (<i>M.L. High Yield Index</i>)	825.29	606.76	660.73	-19.9%	8.9%
Tax Free Municipal Bonds (<i>Bond Buyer Index</i>)	106 8/32	97 8/32	102 14/32	-3.6%	5.3%
Long Term US Gov't Bonds (<i>Lehman Index</i>)	1828.72	2109.97	1960.08	7.2%	-7.1%
Inflation (<i>Consumer Price Index</i>)	210.00	210.20	212.70	1.3%	1.2%

Source: Wall Street Journal, Barrons, and Yahoo Finance. All indices are unmanaged and not available for direct investment by the public. In addition, past performance is not indicative of future results.



Income & Asset Advisory, Inc is a financial planning and investment advisory firm. Information contained here is derived from sources believed to be reliable. Readers should not assume that either current or future recommendations will be profitable or will equal past performance. The Advisory does not render legal or tax advice. Readers should consult their own attorneys and accountants regarding legal or tax matters

*Advisory services offered through
Income and Assets Advisory Inc.*

Member FINRA and SIPC