

As the old Wall Street saying goes, “bear markets end with a bang and bull markets end with a whimper”. In other words, with a few notable exceptions like 1929 and 1987, bull markets rarely end on a cataclysmic event. Instead, they simply tend to run out of energy as the last of the potentially investable money gets sucked into the market, or they simply roll over under the weight of extreme overvaluation. By contrast, bear markets historically tend to end with a capitulatory selling climax (a “bang”), which shakes the last of the potential sellers out of the markets.

Unfortunately, no one rings a bell when a bear market reaches its lows, and watching economic and market fundamentals has historically proven counter-productive when trying to identify a market bottom, as the market historically reaches its lows long before the fundamental picture improves. Indeed, it is historically true that, if an investor were to wait until after clear signs of fundamental improvement to invest in the equity markets, they would have already missed a significant portion of the recovery (i.e. the next bull market).

The simple fact is that the securities (stocks, bonds, options and futures) and commodity (agricultural, metals, oil, coal, etc.) markets are discounting mechanisms that price in today the fundamental outlook that investors believe will exist six to nine months into the future. The current fundamentals are largely irrelevant aside from what impact they are likely to have on the future outlook. As such, the key to identifying a market bottom is not in determining when the current fundamentals have improved. Instead, the key rests in identifying the existence of one of two conditions. As you might assume from the above, the first is a state where there is a sustainable and growing level of confidence amongst investors that the fundamentals will be better in six to nine months. The second is a state of capitulation, where the fear level is so high that virtually every potential seller has already sold.

You will note that both of these requisites for a bear market low are based in sentiment. Unfortunately, fundamental analysis is a relatively poor gauge of investor sentiment. While it is clearly economic and market fundamentals that ultimately drive the direction and strength of the markets over the longer-term, fundamental data tends to be reactive rather than predictive over the near term. In other words, what fundamental news is already known is already reflected in market prices, and whatever fundamental news becomes newly known is something that investors simply react to. Fundamental data is rarely predictive in the short term.

Instead, measuring sentiment is the purview of technical analysis (which uses mathematical models and charting to analyze investor behavior, sentiment, valuation, momentum and a variety of other factors). Technical tools often provide some very useful and forward-looking insight into the near-term course for the markets. Indeed, in our experience, the usefulness of technical analysis increases notably during periods of extreme bullish or extreme bearish sentiment, as the daily action in the markets themselves appears to become increasingly technically-driven at extremes.

We consider this a sort of self-fulfilling prophecy. Technical analysis works better at extremes, so more and more investors rely upon it, and the markets therefore become more and more technically driven during those periods. With this in mind, the majority of this writing will concentrate on some of the more technical aspects of our analysis process. In addition, this report will be fairly short-term oriented, as opposed to featuring the more intermediate-term outlook that we have historically featured in these reports.

Importantly, we consider any attempt to try and invest at the initial reaction low as a waste of time. “V-shaped” or single bottoms are really quite rare. Markets almost always retest their lows at least once before they can make a sustained move higher. As a result, double (1 retest) and triple (2 retests) bottoms are much more common. Therefore, rather than trying to gauge whether or not a reaction low was sufficient to create a state of capitulation (a buying opportunity), it is normally much more productive to wait for a retest of the reaction lows. In other words, instead of investing on the initial reaction low, investors are normally better served by waiting for a successful retest of those lows.



A good example of this can be found during the last six months of the 2000 to 2002 bear market. The market experienced its reaction low on July 24, 2002 and successfully retested that low (around 776 on the S&P 500 Index) on October 9th and 10th. A final retest occurred on March 13th of 2003, but the fact that the final retest failed to even reach the previous lows confirmed the end of the bear market, and started a rally that almost doubled the value of equities over the following several years.

We had been operating under the premise that we might see a similar successful retest of the January and March 2008 lows last month, but the breach of those lows in July (top blue line of the chart on the following page) indicated that the bear market was still ongoing. In many regards, we

believe that at least a modest breach of the January/March lows was almost inevitable, as the establishment of a bear market bottom almost always requires capitulation (a loss of hope), and because it was very unlikely to have capitulation when such a major technical support level was close at hand. It would be like a drowning man giving up hope when a life preserver was in sight. Instead, it was only human nature (and our analysis was no exception) for investors to hold onto their investments in the hope that the January/March lows would hold, as was the case in 2002 and 2003.

Importantly, each of the lows illustrated on both charts represented a selling climax or capitulation low, as indicated by extremely high trading volume, a very negative advance/decline line, and extremes in bearish sentiment. We had a similar selling climax on July 15th of this year, which had many of the elements of a classic capitulation day. The huge decline on that day occurred with the highest trading volume for options in history and the second highest trading volume in equity shares (7.3 billion) in history. In addition, there was an eight-to-one negative advance/decline line (eight times as many stocks went down as went up) and panic selling (as indicated by the VIX “fear index” breaking above the all-important thirty reading).



Of almost equal importance, the markets rebounded strongly the following day on an almost equally impressive 6.5 billion shares traded and an eight-to-one positive advance decline line. This began a rally of almost 7% that has since failed twice in its attempt to break above the January/March lows, which now represent significant overhead resistance. Over recent days, the markets have again turned lower, and seem likely to re-test their July 15th lows.

Importantly, unlike the capitulation lows reached in 2002 and 2003, we are somewhat hesitant to give the normal amount of credibility to 2008's three capitulation lows, as each decline ended largely as a result of government intervention.

The January decline ended primarily as a result of the Federal Reserve cutting both the Federal Funds and Discount Rates by one and a quarter percent. The March decline ended largely due to a further three-quarter percent decline in these two rates, plus the government's brokering of the takeover of Bear Stearns by J.P. Morgan. The July decline ended chiefly as a result of the restrictions imposed on the naked short-selling (selling shares that you do not own or have not previously arranged to borrow) in eighteen of the country's largest financial services companies.

We tend to be very skeptical of government intervention in the capital markets (aside from steps intended to assure free markets), as such intervention normally just delays the inevitable. On some levels, we believe that the decline in equities might already be over if markets were unencumbered to simply find their own price levels.

In light of our skepticism regarding this rather constant government involvement in the capital markets, we are particularly inclined to wait for fairly substantial confirmation of a turn in the markets before dropping our relatively cautious stance.

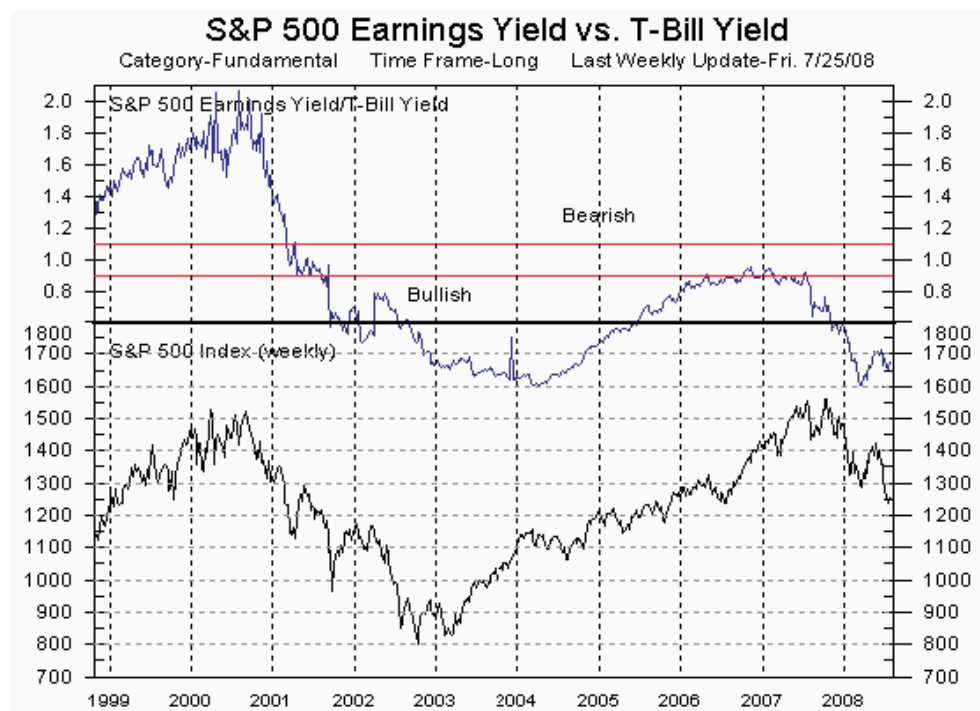
From a charting perspective, our analysis of the current market environment may almost seem overly simplistic (albeit we believe very utilitarian). If the market fails to drop below the July 15th lows around 1,200 to 1,215 on the S&P 500 (bottom blue line), we believe it reasonable to expect a rally that should continue to re-test (to the upside) the January/March lows (top blue line). If the market manages to break and stay above the lows established in January and March (top blue line), we would view this as quite bullish. In such an event, we would anticipate a rally of substance, and perhaps even an end to the bear market. By contrast, if the market breaches and stays below the July 15th lows, we will consider that quite bearish. Indeed, it would likely confirm an ongoing bear market.



In summary, from a charting perspective, we believe that there is no urgent need to try and anticipate the next move. We suspect that the market's future course will reveal itself based upon how the market reacts to these support and resistance levels. However, this is not to suggest that all technical indicators dictate such a wait and see approach. Indeed, many of the technical indicators, and particularly those measuring sentiment and valuation, are quite positive, and suggest that anyone with a minimum two to three-year time horizon could very profitably buy shares at today's very depressed prices.

Valuation: There are a great many tools by which degrees of market over-valuation and under-valuation are assessed. On the fundamental side, the most popular of these is the price-to-earnings ratio, which is presently only 14.22 on a forward-looking basis (a low to very modest valuation). On the technical side, there are valuation oscillators like stochastics, which have generated fairly convincing intermediate-term buy signals after emerging from deeply over-sold ranges. We have addressed each of these indicators in great detail over recent writings. As such, we would like to use the opportunity of this report to look at valuation from a slightly different perspective.

The following several charts blend together fundamental and technical analysis by taking fundamental concepts like earnings and dividend yield and converting them into valuation oscillators. The first illustrates the

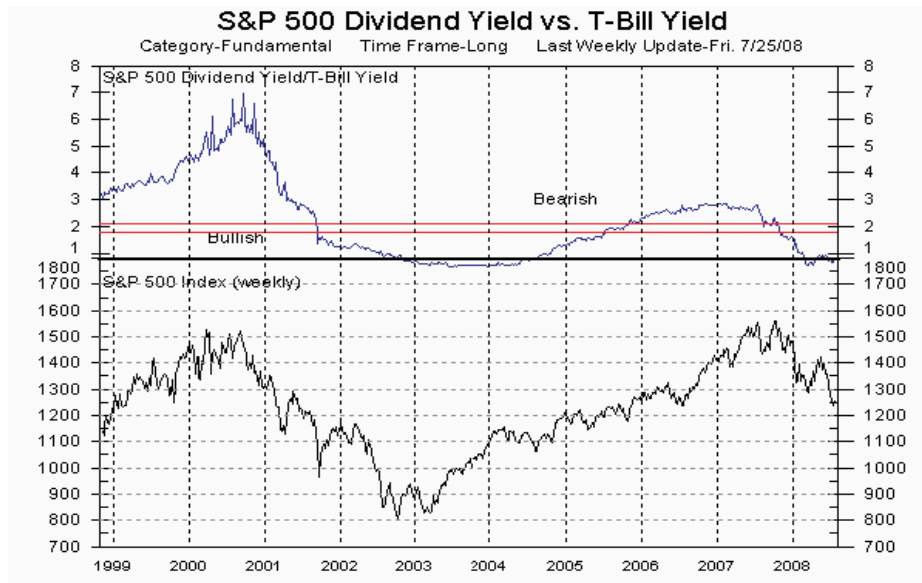


ratio of the S&P earnings yield divided by the yield on the Treasury bill. The earnings ratio is derived by dividing the index's earnings per share by the price per share (the inverse of the P/E multiple). When the earnings ratio is divided by the Treasury bill yield, it illustrates both the attractiveness of equities compared to debt instruments (a relative valuation) and the attractiveness of stocks on an absolute basis (due to the fact that stocks normally maintain higher prices relative to their earnings when interest rates are low). The bottom line is that, according to this well-respected valuation measure,

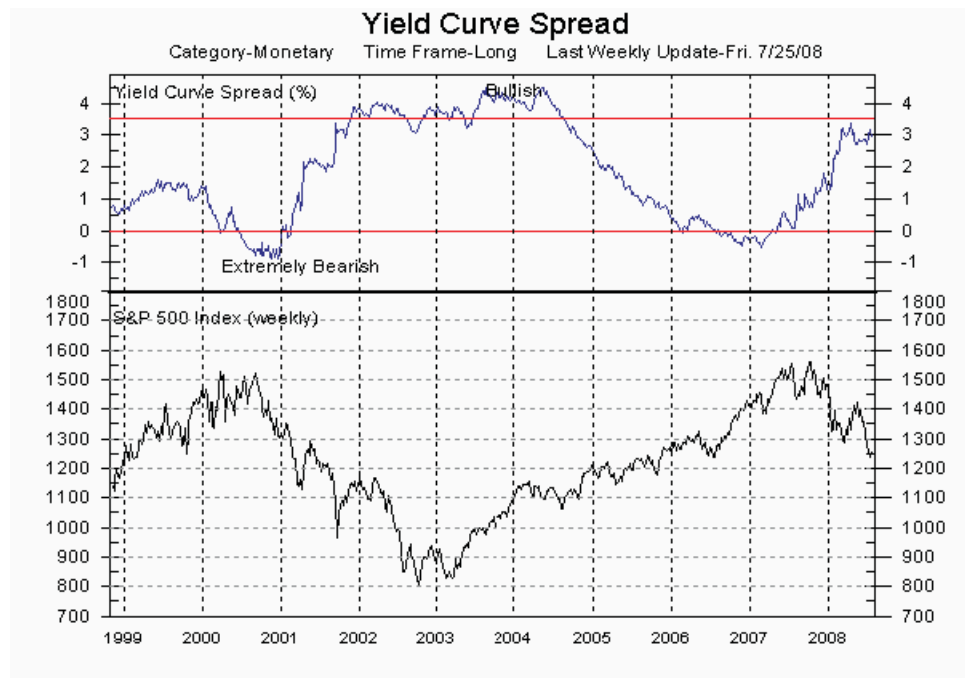
stocks are the most over-sold that they have been since 2003 & 2004 when equities were recovering from the 2000 to 2002 secular bear market (the beginning of a bull market that almost doubled equity prices).

This condition of extreme equity undervaluation is echoed in the following chart that represents a ratio of the S&P 500 dividend yield divided by the Treasury bill yield. Just as is the case with the above oscillator, this relationship illustrates that the equity markets are the most under-valued since the 2003 to early 2004 period. It also confirms that equities are inexpensive on both a growth and current income basis.





The next chart also examines interest rates as a means of determining equity valuation. However, instead of comparing equities to bonds, it compares yields on short-term debt to yields on long-term debt. The premise is that, when long-term rates increase relative to short-term rates (an upward sloping yield curve), the markets are predicting a future acceleration in economic growth, which should benefit equity earnings growth and therefore equity prices. While this indicator is not yet quite in the bullish range, it is quickly approaching that point. Of note, it is possible to also draw a bearish conclusion from this indicator, as it may be indicative of investor expectations of accelerating inflationary pressures, which would be a negative for both debt and equity instruments.

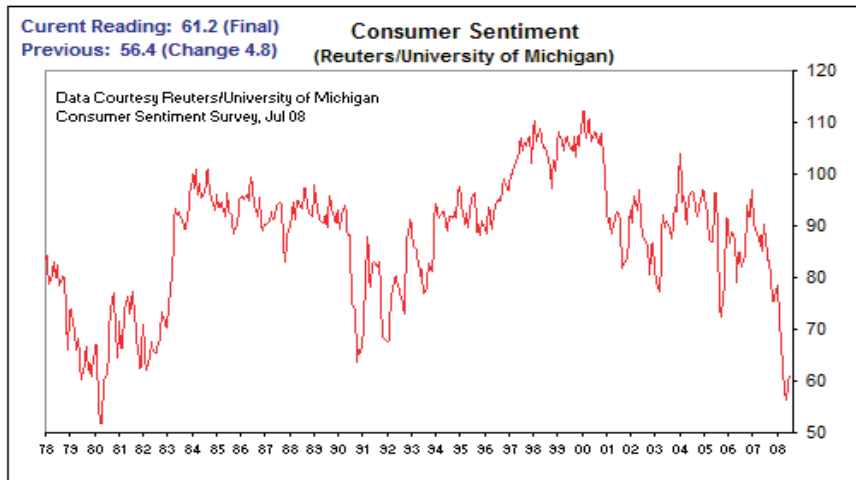


While these and many other indicators confirm that the equity markets are extremely under-valued at present, the level of pessimism that they reflect almost pales in comparison to the levels reflected in many of the major sentiment indexes. It is important to understand that these are contrarian indicators where bad is good and worse is even better. **The best buying opportunities in any asset class occur at the point of maximum pessimism.** As noted by the recently deceased and legendary money manager Sir John Templeton, “bull

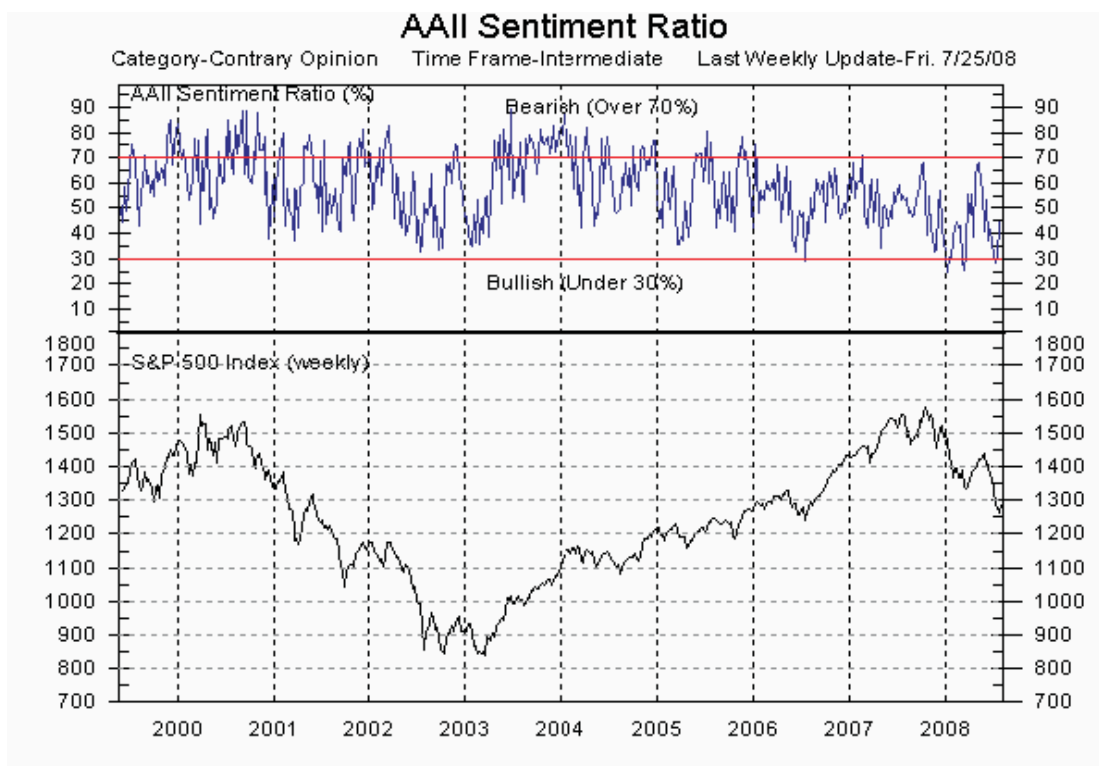
markets are born in despair, grow on pessimism, mature on optimism, and die in euphoria”.



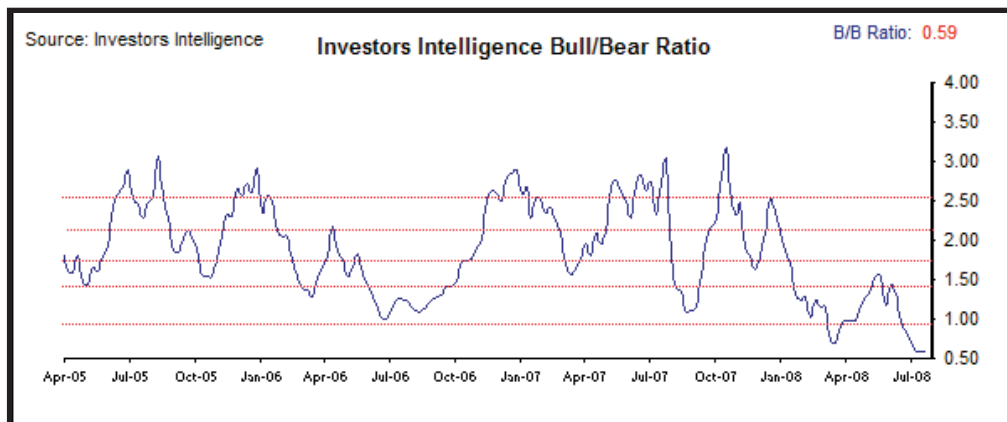
The first and most broad-based of the below measures of sentiment is the University of Michigan Consumer Sentiment Index, which is a monthly telephone survey that polls consumers on issues related to personal finance, their economic outlook, and their spending plans. You need to go back almost three decades to find the U.S. consumer in such a dour mood. At the risk of being redundant, the best buying opportunities in any asset class occur at the point of maximum pessimism!



The following two charts are perhaps even more insightful, as they address the sentiment of investors in particular. The first, the American Association of Individual Investors (AAII) Sentiment Ratio, measures the investment sentiment of its membership (150,000 individual, primarily non-professional investors). As such, it has historically been a useful gauge of the mindset of the non-professional investing public. At present, sentiment is just starting to recover from what has been the most depressed levels in many years. Indeed, during 2008, AAII's membership has been more bearish than they were at any point during the historic 2000 to 2002 bear market. Only time will tell if we are presently at the point of **maximum** pessimism. However, there is no doubt that we are certainly at levels of extreme pessimism.

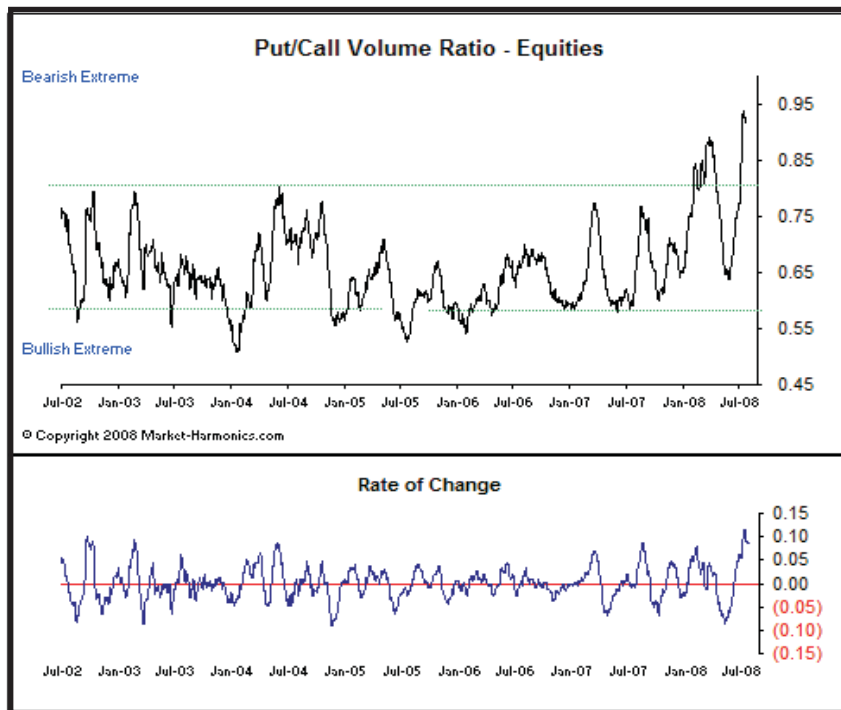


The next chart illustrates the Investors Intelligence Bull/Bear Ratio. Investors Intelligence categorizes each of 140 investment newsletter writers as bullish or bearish based upon the opinions expressed in their most recent reports. By dividing the number of bullish advisors by the number of bearish advisors you get the bull/bear ratio,



which has proven to be a very good measure of the sentiment of the professional investment community. Of note, even though this measures the sentiment of investment professionals, it is still a contrarian indicator. Indeed, the sentiment of professional investors has provided a contrarian tool that is almost as equally effective as is the AAll reading. As you can see from the graph, professional sentiment is the most bearish that it has been in years, which is another strong indication that the decline has already reached extremely over-sold levels.

The next and final sentiment chart is also specific to investors. However, rather than depend on investor and investment newsletter surveys, the put/call volume ratio measures the actual activity in the options markets. More specifically, it measures the amount of volume that is being invested in puts (which help protect a portfolio during a market decline) versus calls, which increase in value as the market appreciates. Investors are pumping historic levels of cash into protective options. While some of this surge may reflect a greater use of options in general, this provides yet another confirmation that sentiment is excessively bearish, which is, of course, bullish from a contrarian perspective.



Importantly, undervaluation alone is not normally sufficient to move market prices (much less the primary trend) higher. A positive change in trend normally requires a catalyst. In this case, with bearish sentiment being so well-embedded in the markets, it may take a very significant catalyst which, at present, is not readily identifiable. However, if we had to venture a guess as to the ultimate catalyst, we suspect that it may come from falling oil prices and reduced expectations for inflation. While a month certainly does not make a trend, it is notable that commodity prices, in general, experienced in July their worst monthly decline since 1980.





We continue to believe that the bear market in domestic equities is growing quite long in the tooth, and that we are starting to see some real signs of fundamental improvement in the financial services industry, which has, from the outset, been the epicenter of this crisis. Further, we do believe that fundamentals will be markedly better in six to nine

months, and that it is just a matter of time until a majority of investors start to reach the same conclusion. While we can only speculate about exactly when the turn will come, we are quite confident that the rebound should be very powerful based upon the current extremely bearish sentiment and very attractive valuations. In addition, we believe that the recovery is likely to accelerate very quickly in light of the near record level of short positions (which represent stock that will need to be bought back once the turn comes). In terms of sustainability, we have very high expectations for an extended recovery based upon the near-record levels of sideline cash that should ultimately return to the equity markets as the overwhelmingly bearish sentiment subsides.

We don't know yet what catalyst will ultimately turn the primary trend in equity prices higher, and we can only speculate (largely based on market history) exactly when the turn will come. However, we are very confident that, when it comes, it should be very rewarding. As noted by money manager Roger Engemann, "the market is like a train sitting on the tracks. You can see the direction it's heading, but you cannot dictate the time of departure."

