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Serving Your Personal Investment Needs Since 2003

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INVESTMENT ADVISORY

The Market Direction – Where We Go Now

With regard to the direction of the stock market, it seems pretty clear that there will be another down move in prices.

The current retracement should go down to the 820 to 840 level in the S&P Index. At that point we will try to exercise the "Option A" investment trade that many of you have indicated you want to participate in. Perhaps in mid July this will happen.

Once this trade is done, it is likely that there will be a retest of the March lows, perhaps beginning in the late Fall. (Of course, there are no guarantees to these projections.) However, the risk to the economy is still great, and at some point, the stock market will discount this risk.

It is still too early to know if the economy will achieve sustainable growth. There are no indicators that will attest to this, and don't believe what the so-called pundits say. They do not know any more than you and I. ***Every aspect of our economy is in a state of flux. There is no predictability right now, only hope…..***

COMMENTS – THE ECONOMY AND THE STOCK MARKET

Today's Major Risk Scenarios

- Inflation
- Deflation
- Recession
- Depression
- Hyper-inflation

For the U.S. domestic system, there is a "tipping" point question that is probably the greatest concern for all of us today. That is, at what forward economic growth rate will government tax receipts pay down the heavy debt load that has been incurred during the last several years?

That target level is probably somewhere between 2% and 3% annual GDP growth.

What this means is that we need to see future economic growth rates that are historically high, to just pay off that debt, from a cash flow standpoint. Debt service and high levels of debt create volatility and high risk to the system's stability. It takes away any stability cushion that might be available in the case that some "upset" event might cause another huge cash requirement in order to support the system once again.

An investment portfolio management and design structure must take into account these most significant risks to the portfolio's stability and viability.

One particular concern: Most of our investment portfolios contain significant amounts of GNMA mutual fund shares, purchased as a holding place for money that is committed to stock market equity reinvestment, when the timing is appropriate. We need to be aware of the risk inherent in this investment and be able to protect the capital asset value of the GNMA mutual funds. If interest rates rise in the 10 year treasury, the price on these

funds will fall. The Federal Reserve is buying FNMA and FHLMC bonds (government guaranteed mortgaged backed securities (MBS) – including GNMA bonds) and these purchases have provided price support in the market place for these MBS assets.

We plan to sell these assets in order to reinvest into the stock market when our Model indicates it is time to buy. If interest rates rise, the value of these bond funds will fall. This is not a particular problem for those who bought last November and December. For our newer clients, however, we purchased these funds later and at higher price levels.

The July 8th 10-year U.S. Treasury auction eased our immediate concerns on this issue when the auction yield came in at 3.36% and by the end of the day, the interest rate was down to 3.3%. This is a lot lower than the 4% level that we experienced a few of weeks ago. An important guideline for the future is the 10-yr Treasury rate at 4%. Higher than 4% and we will want to exit our positions in the GNMA mutual funds in order to protect our investment. Rates above 4% would indicate that the economy is moving toward much higher levels of inflation.

There is not the same concern for the actual MBS securities, as compared to the GNMA mutual funds, because, for these assets we will get our money back at par (price = 100) over the years. The presumption is that these assets will not be sold. The yields on these assets are generally greater than 6%.

The path to the future is quite precariously balanced between deflation and inflation today, with the only desirable option for the future being an inflation rate of less than 3% and a real GDP growth rate at approximately the same level or 2-3% growth. This is a very narrow path to an acceptable future outcome. What are the chances that we will be able to navigate to this path? Probably not high! However, last November, that probability would have been zero! That in itself is encouraging!

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