

BRONSON CAPITAL MARKETS RESEARCH

As Forecasted: A Retrospective

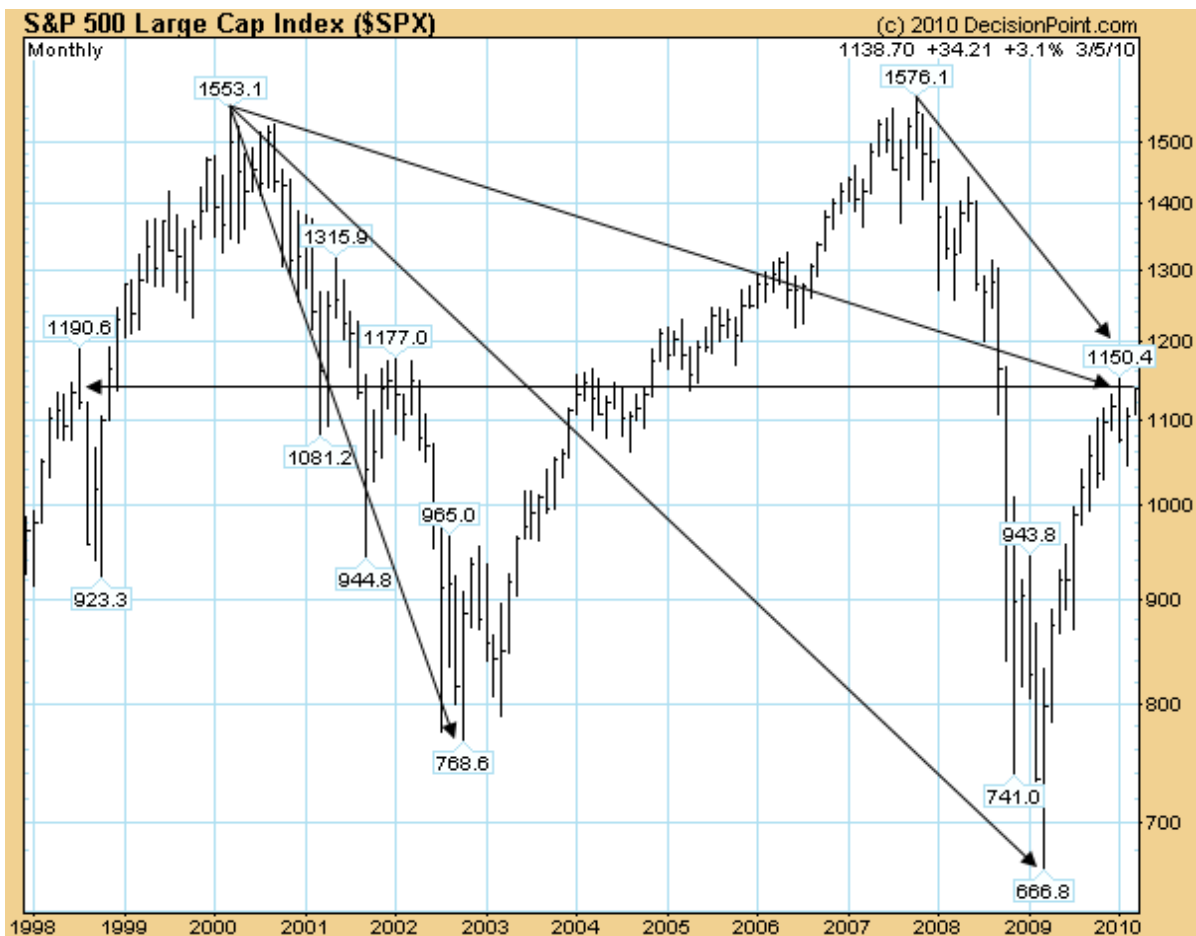
To bring you up to date with our latest expectations we open this retrospective with a copy of the latest commentary that one of our investment manager clients sent to their investment management accounts

MARCH 2010 MARKET COMMENTARY

- The U.S. economy is stalling prior to sliding back into a double-dip recession
- The latest employment figures confirm a double-dip recession is emerging
- The stock market's delayed reaction is typical in a Supercycle Winter (pages 46-47)

The U.S. stock market has essentially traded sideways over the past several months on volume that is persistently low, as buying abates. That the market could ever have risen to recent levels at all stands as testament to investors' renewed "irrational complacency" as they piled in, hoping despite all data to the contrary that a sustainable economic recovery and, therefore, a sustainable bull market might be underway. In our September/October 2009 commentary, we discussed the extremely poor quality of the market advance, which rose largely on the type of speculation that occurs only in rallies in ongoing Supercycle *Bear* Markets.¹ We noted in our Year-End 2009 commentary that speculative optimism about equities at that time was already at the highest level since the peak just before the 1987 Crash, which is an *extremely bearish*, contrarian indicator.

¹ A Supercycle Bear Market is the most severe combination of the several bear markets typical during a Supercycle Bear Market Period, running typically from the highest to lowest point in the Period. For example, during the previous Supercycle Bear Market Period from 1965-82, the Supercycle Bear Market lasted for the six years from the highest point in December 1968 to the lowest point in December 1974. [Revealing BAAC Supercycles](#)



The stock market is also at exactly the same level it was 17 months ago and at the same level it was in 1998, having erased all gains over nearly the past 12 years (see the horizontal arrow in the chart on page 1). The typical equities investor is still down 28% and 27% from the market highs in October 2007 and March 2000, respectively, as indicated by arrows in the chart. Over each of those same bear-market periods, our clients had *positive gains* in their portfolios and experienced maximum declines (drawdowns) that were less than one-sixth (compounded) of the 50% to 60% declines experienced by equities investors – that’s 80% *less risk!* We know of no investment manager with a better risk-adjusted performance over the past decade.²

Recent economic data (discussed further below) continue to confirm our view that the modest uptick in the economy in the second half of 2009, which was simply the predictable bounce that follows an unsustainably rapid rate of decline, would be short-lived, while the advance in the stock market would never be justified by the underlying economic fundamentals.

² Prior IF&M commentaries, which contain the record of IF&M’s past forecasts, are available upon request. It should not be assumed that forecasts made in the future will be accurate or will equal the accuracy of past forecasts. Nothing herein should be construed as a recommendation or performance forecast of a specific security.

In fact, as we discuss below, the economy will soon be heading back towards contraction precisely because of the *ongoing severity* of what is being called The Great Recession. Investors err in believing the government's massive intervention to end the banking crisis and to stimulate certain sectors of the economy will also end the business-cycle contraction. It won't. Recent economic data is proving once again that government intervention can somewhat mitigate the magnitude of a recession for a time, but only at the cost of making it ultimately more severe.

Headline-Reported GDP Overstates True Growth Almost 14 Fold!

The headline-reported GDP figure of 5.9% in the fourth quarter of 2009 both overstates economic strength and obscures how weak and unsustainable the rebound really is. GDP is the measure of the nation's total output of goods and services, but in this case it overstates the core business cycle portion by about 14 fold for two reasons: one is basically political hype and the other is a lack of understanding of the core business cycle, as we will explain.

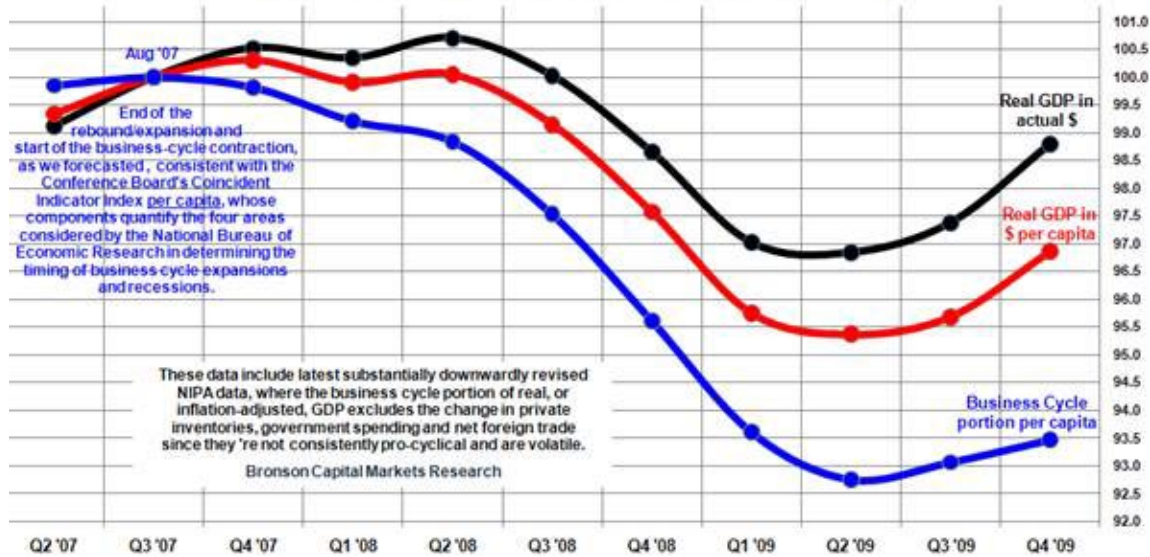
GDP reported by the government is one-quarter growth *annualized*, which means the figure implicitly suggests that growth in the next three quarters will be as strong. (This was [Kurt Richebacher's](#) biggest objections to U.S.-hyped GDP reporting.) Without such annualization, (compounded four times), fourth-quarter growth was just 1.45%. What's more, indications are that growth in the first quarter is not nearly as strong, consistent with our forecast that the predictable "pause" in recessionary conditions in the second half of last year would be temporary and that the economy would slide back into recession as this year progresses. More to the point, even in the fourth quarter, growth in the core business cycle portion of GDP directly relevant to the question of whether we're pulling out of a recession or not was only 1.7% annualized, or 0.36% not annualized – little improved after its steep decline.

Our updated chart of the business-cycle portion of gross domestic product (GDP), or what we are now referring to as the "U.S. core business cycle," visually makes it clear how very anemic the economic rebound has been, even with the 1.7% annualized growth in the fourth quarter. Bob Bronson, principal of Bronson Capital Markets Research, our investment strategist, adjusts GDP data by removing changes in private-sector inventories, government spending, and foreign trade to leave just the roughly 85% of GDP that is directly relevant to the true condition (phase) of the business cycle. This is more useful in assessing where we are in terms of the recession than headline-reported GDP, which is misleading because it both compounds the actual quarter's growth four fold, and it includes components that are counter-cyclical to the core business cycle. The phase is even more readily seen when the business-cycle portion of GDP is further adjusted for population or labor-force growth, since an economy not growing faster than its population or labor force is not growing.

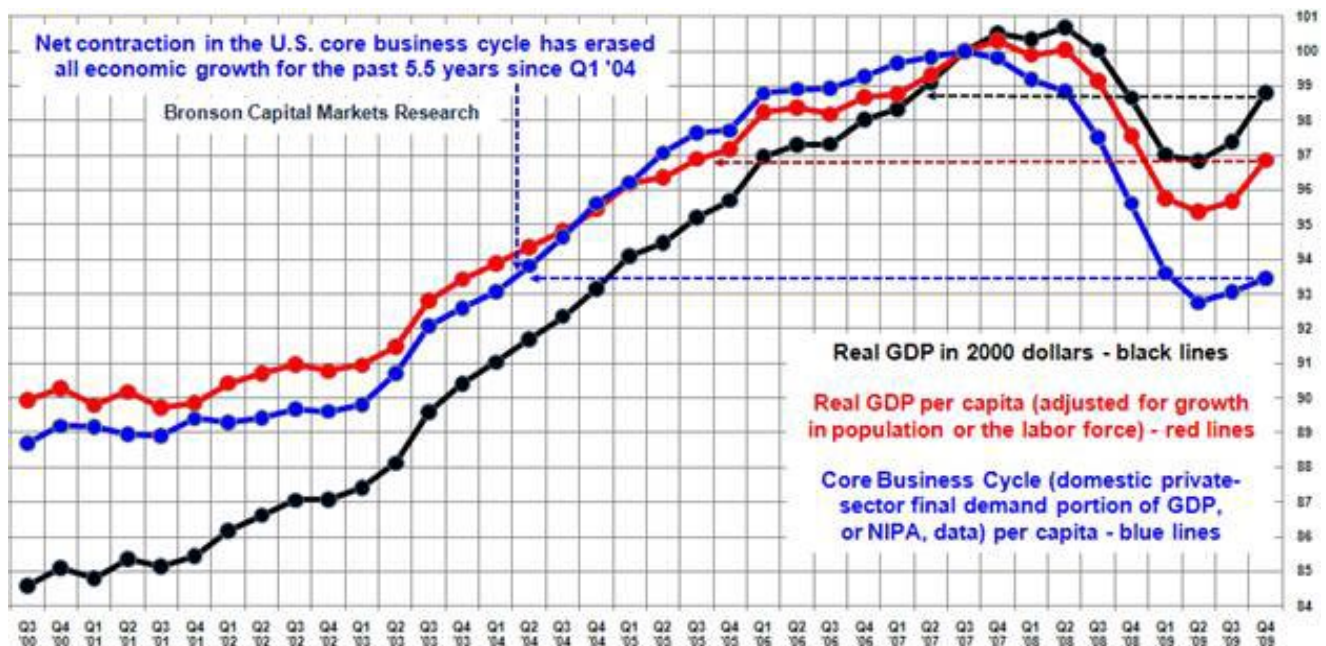
As the chart below shows, the improvement in the business-cycle portion of GDP per capita (the blue line) in the third and fourth quarters of 2009 was quite modest. It recovered just a small fraction (10%) of the 7.2% decline from its peak in the fourth quarter of 2007, which means that this measure of the economy is still down 6.5% from its peak, which is huge amount of damage in an economy the size of ours.

U.S. Core Business Cycle Only Grew 1.7% in Q4

with the past two-quarter knee-jerk rebound retracing only 10% of the prior seven-quarter contraction of 7.2% since its Q4 '07 peak



The next chart is a longer-term chart of the same data, which puts the severity of this recession and the minor rebound in even better perspective. It shows the anemic rebound, as measured by the business-cycle portion of GDP per capita (the blue line), that has followed the large contraction in the economy. The improvement in the fourth quarter was only slightly higher than in the third quarter, as we had expected (see our Year-End 2009 commentary), and we expect diminishing improvement in the current quarter, as the economy begins to slide back into recession. Notice that this measurement of the nation's economic activity in the fourth quarter of 2009 was at the same level as in the first quarter of 2004 (see the blue dotted line). This means that *over 5½ years of U.S. economic growth that was lost is not even close to being recovered.*



In our Year-End 2009 commentary, we discussed several other, widely-followed economic data series that further support our view that the economy is setting up for a return to recessionary conditions. Little has changed our assessment of that data in light of recent releases of that data. For example:

- Various metrics of the leading economic indicators are rolling over, the most important component of which – unemployment claims – is already worsening, as we discuss further below.
- Growth in personal income and spending, key barometers for consumer spending, are in the process of peaking –again
- Business spending still looks weak in the current quarter. Orders of nondefense capital goods excluding aircraft, which is a proxy for business spending, in the latest Q4 GDP report were revised down to minus 4.1% in January. See attached article, Exhibit A, by Robert Higgs, “No Recovery Until America Invests Again.”

With our ongoing analysis of economic data, we continue to expect that the growth rate of the rebound has been *decelerating* and that the business cycle is likely in the process of peaking in absolute terms, after which it will slide back into contraction, probably through the balance of 2010.

Our Continuing Expectation of Double Double-Dip Recessions

A dozen years ago, we issued our forecast of an ultimately deflationary Supercycle Bear Market Period³ (Supercycle Winter – see Exhibit A), which is characterized by typically three to four progressively more severe recessions, resulting primarily from excessive debt and leverage, which would be the worst series of economic contractions since The Great Depression in the 1930s during the previous Supercycle Winter.

The realization of this forecast is right on track. Following 10 years of uninterrupted economic expansion characteristic of a Supercycle Bull Market Period, we entered the current Supercycle Bear Market Period. In marked contrast, we are now facing the third of four, depending on how they are technically defined, economic contraction in the past 10 years.

The first recession of this Supercycle Period was in 2001, consistent with a forecast made in our April 2000 commentary that a recession would begin two to three quarters later. Though the recession was officially designated as just eight months long, our core business cycle work shows it had a 31-month duration, with recessionary conditions in that “jobless recovery” having actually dragged on into the first quarter of 2003, as seen in factors like durable goods (which

³ A Bronson Asset Allocation Cycles (BAAC) Supercycle Bear Market Period is a 12- to 20-year period of underperformance during which bear markets, anticipating economic recessions, as well as the recessions themselves typically are at least twice as frequent and twice as severe in magnitude and duration as during Supercycle Bull Market Periods. Such a period begins when the return on money market funds sustainably exceeds the total return on equities, especially when downside-volatility-risk is taken into account. Further details are found in our research paper, “Bronson Asset Allocation Cycles,” available on request. See Exhibit A.

includes all-important auto sales) and personal disposable income (which excludes transfer payments like welfare), which never fully recovered.⁴

By the time of our Year-End 2006 commentary, we were already giving advance warning of the next much more severe recession after having warned of The Great American Home-Equity Bust during the previous several years. In fact, based on his stock-market and economic cycle template (SMECT)⁵, Bob Bronson was forecasting the first of a devastating trio of upcoming recessions, [Are You Prepared for the First of Three Perfect Storms of Business Cycles](#) or “triple economic perfect storms,” which we correctly suggested well in advance would be *far more severe than average*:

“We are moving into a unique time frame, during which a negative convergence of all five [established business and economic] cycles [of differing durations] occurs – *not once, but three times* in the coming eight years. *The negative implications of this convergence should not be underestimated.*”

What is now being called The Great Recession was officially designated as having started in December 2007, some eight months after our warning, though we have previously discussed our view that recessionary conditions actually began several months earlier (in August). It was the severity of this business-cycle contraction that led to the implosion of the housing market and the financial instruments derived from it, which triggered the crippling global banking/financial crisis, the ripples of which are still being felt worldwide. The most recent example is Greece, which had extensively used credit default swaps,⁶ engineered mainly by Goldman Sachs, to hide problems resulting from their fiscal overspending. The potential sovereign bail-outs by and of

⁴ Though the National Bureau of Economic Research (NBER), the official recession-dating body, designated the 2001 recession as just eight months long, a more thorough application of the NBER’s own standards shows that recessionary conditions actually dragged on for 31 months of a “jobless recovery” into mid-2004, as clearly seen in the chart of the Conference Board’s widely followed coincident indicators index, which appeared most recently in our July/August 2009 commentary. The stock market continued to decline to new lows for 11 months after the official end of the recession, and the government subsequently released substantially downwardly revised economic data, both of which confirm an earlier start and later end to the recession than the official eight months.

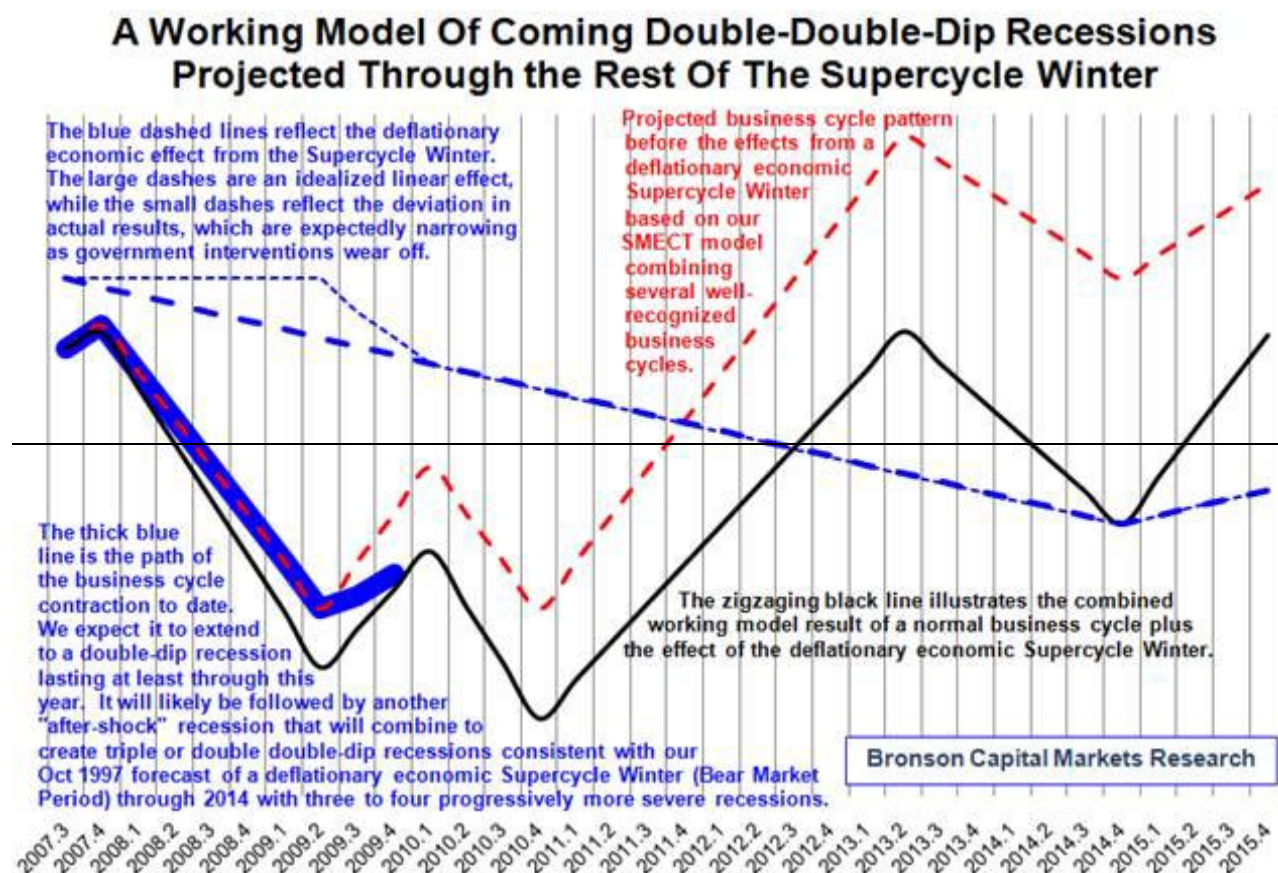
⁵ Bob Bronson, principal of Bronson Capital Markets Research, our investment strategist, has uniquely documented the relationship between business cycles and the stock market back to 1896. He has formalized these patterns in his Stock-Market and Economic Cycle Template (SMECT): [A Forecasting Model That Integrates Multiple Business and Stock Market Cycles](#) Expanding and refining the work of highly regarded economist Joseph Schumpeter (1883-1950), perhaps best known for his concept of growth through “creative destruction,” the template illustrates the integration of, and further supports the validity of, the recognized Kitchin, Juglar, Kuznets, and Kondratieff business (or economic) cycles, as well as further establishes the validity and pivotal importance of Bob’s Bronson Asset Allocation Cycle (BAAC) Supercycle, which Bob has long contended is the missing link between the Kuznets and Kondratieff cycles. Thus, this template is – as was Bob’s intention in designing it – representation of the most comprehensive chronology of the interrelationships between classical stock-market and business cycles. (See our May 2002 commentary for our more detailed discussion of SMECT).

⁶ A credit default swap (CDS) is a credit derivative contract between two counterparties. The buyer makes periodic payments (premium leg) to the seller, and in return receives a payoff (protection or default leg) if an underlying financial instrument defaults. CDS contracts have been compared with insurance because the buyer pays a premium and, in return, receives a sum of money if a specified event occurs. However, there are a number of differences between CDS and insurance. In a so-called naked CDS, which amounts to a purely speculative side bet, the buyer of the CDS does not need to own the underlying security or have an insurable interest. In fact, the buyer does not even have to suffer a loss from the default event. Naked CDSes, which comprise more than 80% of all CDSes, are ultimately a dangerous moral hazard for which the proverbial chickens have already come home to roost.

other sovereign nations, like Portugal, Ireland, Italy and Spain, as well as the potential bailout of some U.S. states, like California, New Jersey, and Michigan, are emerging as hot-button, too-big-to-fail issues.

Late last year, when investors were celebrating what they thought was a sustainable economic recovery and, therefore, an all-clear signal for the stock market, Bob was further refining his expectations for the timing of the recessions still remaining out of the three to four recessions forecasted by his SMECT model to occur during the current Supercycle Bear Market Period. Regardless of whether the imminent recession and the recession following it are viewed as the second dip of the past at least 19-month Great recession followed by a separate third, and final one, or as the third and fourth post-global financial crisis “after-shock” recessions, he is summing them up as “double double-dip recessions.”

The chart on page 7 shows Bob’s working model for the timing of them. The black zigzagging line illustrates the working-model result of modifying a normal business cycle with the effects of a deflationary Supercycle Bear Market Period. The thick blue line is the actual path of the current recession to date. Note that the rebound in the third and fourth quarters of 2009, as seen in the thick blue line, was actually weaker than would otherwise have been expected, as seen in the black line.



Keep in mind that the working model of a forecast is a work in progress, which will be further refined as data comes over time. Its primary purpose is to quantify the difference between how a forecaster views data and what the moody consensus view is on the same data. In this case, there is a big spread between Bob Bronson’s forecast of a slide back into recession and the consensus view of irrationally complacent investors, who have excessively bid up prices in the stock market in the hope that a sustainable recovery is underway. The bigger the gap, the

greater the profit potential there is in investments that will gain as investors collectively change their minds and close that gap, selling equities to be consistent with their new view.

What's important about an effective forecasting working model is not its absolute degree of accuracy, which is always being refined, but only that it is ultimately more accurate about the future than the current consensus. How much more accurate relates directly to the profit potential. Our clients are positioned in investments to take advantage of the large differential that presently exists on the future direction of the economy.

The Latest Employment Statistics Confirm A Double-Dip Recession Is Emerging

Employment is one of the most important factors in assessing where we are in the business cycle, and is of particular concern in forecasting which way the recession is now heading: into sustainable recovery or back into contraction.

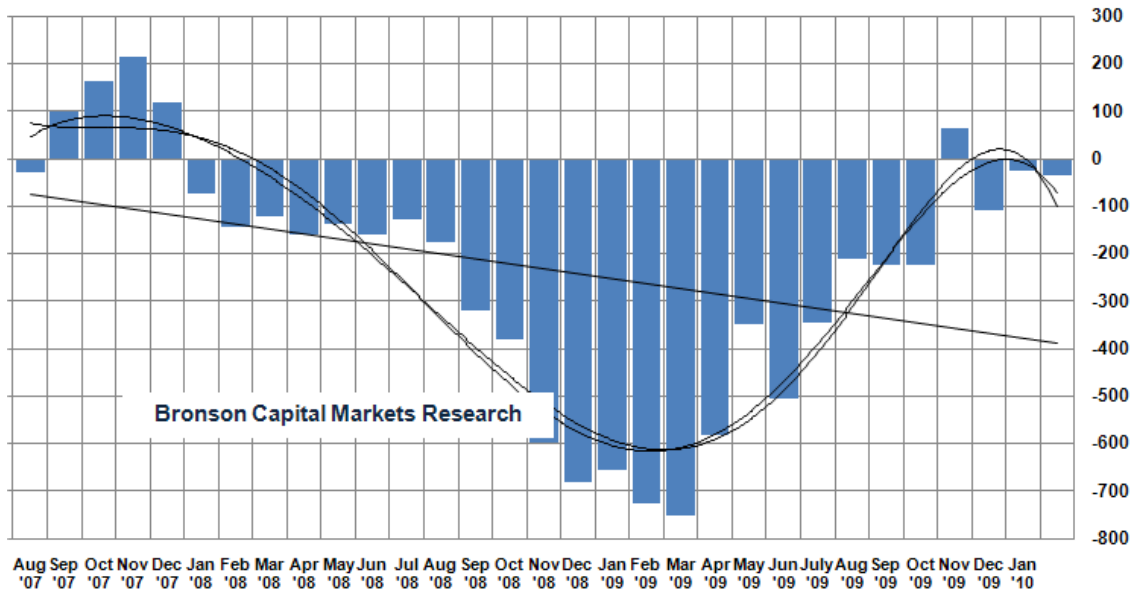
The latest employment statistics confirm not only that the rebound in the economy in the second half of 2009 is stalling, as we have been forecasting, but the data also provide strong support for our view that the first of two forecasted dips in what will become double double-dip recessions over the next several years is emerging. This imminent economic contraction, which will also be the first of the three "perfect storms" we have been forecasting, as discussed above, will be the third one in the past decade, regardless of whether it will officially be viewed as a second-dip in an ongoing recession or a separate, post-global financial crisis "after-shock" recession of its own. To see how close we are to it, we take a look here at two different employment data series: the first is nonfarm payrolls, a coincident economic indicator, and the second is unemployment claims, a leading economic indicator.

The trend in nonfarm payroll employment is the single most important component of the core business cycle. This measure of employment is a coincident economic indicator, which means it is a measure of business conditions that tends to change at approximately the same time and in the same direction as the whole economy. As such, it is one of the four components used by the National Bureau of Economic Research in determining (well after the fact) the starting and ending dates of recessions. Nonfarm payroll employment is one of two monthly surveys conducted by the Labor Department's Bureau of Labor Statistics, which asks 300,000 big nonfarm companies about payroll changes during the month.

From its low point in March 2009, monthly losses in nonfarm payrolls decreased in a series of "less bad" reports, as seen in the chart of the monthly changes in nonfarm payrolls on page 9. These reports were among the "green shoots" in economic data touted by the financial media as hoped-for "proof" that a sustainable economic recovery was developing.

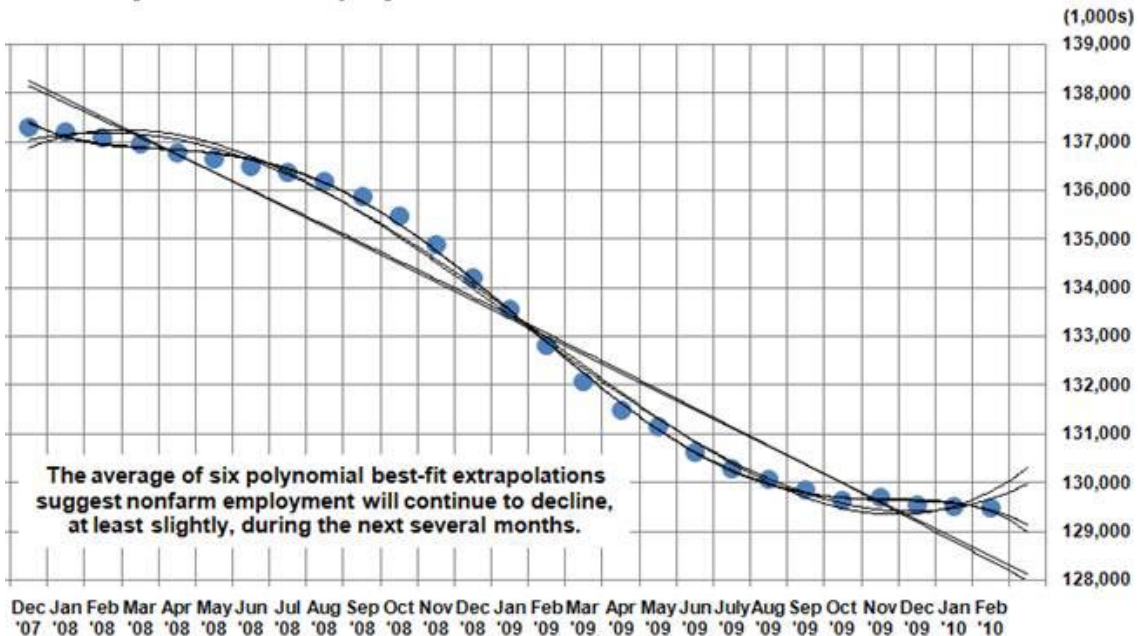
The chart on page 9 illustrates why employment can no longer be used to hype a recovery. Over the past three months (through February), the trend in payroll employment has changed from an uptrend to a flat or sideways trend, if not a new downtrend or continuation of the previous downtrend. That the data series is in the process of rolling over is indicated by the (curvilinear polynomial) best-fit lines. A best-fit line is the (straight or curved) line which gives the best approximation to a given set of data, taking all of the data equally into account. Simply put, the improving trend in employment is over.

Monthly Changes In Nonfarm Payrolls (thousands, SA)



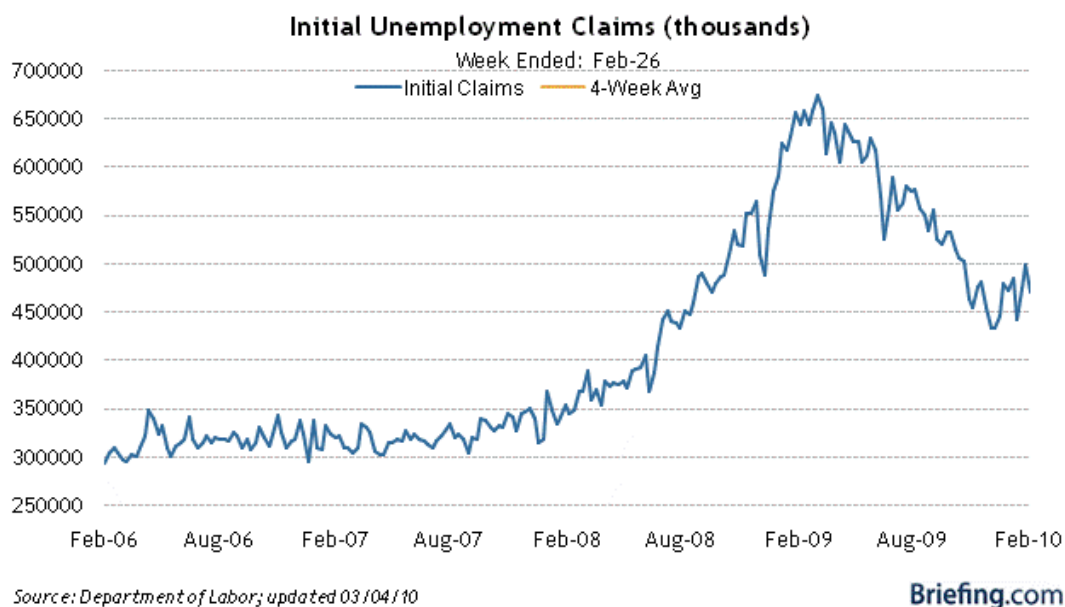
While the investment community tends to focus on monthly *changes* in employment, the actual *number* of employed workers makes the employment picture even clearer, as seen in the chart below. The number of workers has continued to trend lower. About 150,000 workers would need to be added to payrolls each month just to keep up with the net number of workers (age 16 and older) entering the work force, and even that would reflect no economic growth. When you look at the raw data in this chart, you can see that employment is not even close to being in an established uptrend, much less the sustainable uptrend that would be necessary to support a sustainable economic recovery. The six black best-fit lines associated with this data also show a two-to-one probability that employment will decline at least somewhat over the next several months.

Monthly Nonfarm Employment Since The Recession Started In Dec '07



Similar to nonfarm payroll employment's importance among *coincident* economic indicators, initial unemployment claims is the most important *leading* economic indicator. A leading economic indicator is a measure of business conditions that tends to lead the overall economy by an average of about two quarters (though the historical range has been from zero to more than four quarters). Jobless claims are one of the ten components of the widely followed leading economic index compiled by the Conference Board. It is reported weekly, instead of monthly like nonfarm payrolls.

New claims for unemployment benefits have risen over the past ten weeks, as seen in the chart below. The 40-week decline in new claims, starting from the weekly high on March 28, 2009 of 674,000 jobless claims, ended on December 26 with a low of 432,000 applying for unemployment benefits, and has now begun to rise. This clear reversal in the trend supports our view that employment, discussed above, will be worsening and taking the economy down with it. There is no chance that a sustainable recovery can be underway with payroll employment stagnant, trending sideways (*flat lining*) and possibly turning lower, while the number of unemployed workers is already on the rise – again.



Incidentally, in our July/August 2008 commentary, we discussed how the Bureau of Labor Statistics (BLS) calculates a total of six unemployment metrics (U-1 through U-6), with each progressively higher level showing a higher rate of unemployment. U-6, the most encompassing of the metrics, includes unemployed workers, part-time workers who can't find full-time work, and discouraged workers who have given up looking for work. At the time we wrote that 2008 commentary, which was before the start of the current recession had been officially announced, U-6 unemployment stood at 10.3%. We wrote:

“To place current unemployment in a further context, we note that during The Great Depression, annual unemployment reached a peak of about 25% in 1933. U-6 is the current BLS calculation most comparable to the calculation the government used back then. If U-6 rises from the current 10.3% to the 12% to 16% range during the current recession, which Bob Bronson’s analysis shows is very likely, then unemployment during this Supercycle Bear Market Period will be from one-half to as much as two-thirds as devastating as the peak level of unemployment during The Great Depression.”

You may be interested to know that U-6 did reach the 12% to 16% range. In fact, it has already been as high as 18% (January) so far in the current recession. This represents over 28 million American workers either unemployed, underemployed, or too discouraged to look for work.

As we have noted previously, employment has been in *a continuous recession since 2000*, having never fully recovered after the 2001 recession (or the recession from 2000-02, in our view). This continuous recession in employment is directly related to real (inflation-adjusted) personal disposable income, which *has not increased for some 10 years*. Combined with the negative wealth effect⁷ from declining home prices, the worsening jobs outlook will continue to cause consumers to cut back even more on their spending in order to pay down their still-excessive levels of debt – cutbacks to lower levels of spending that will last for years, if not become a permanent, new norm -- like living within your earned income means (not spending capital gains before they are actually realized - what a novel idea for baby boomers) -- and that is *not* currently priced into the stock market at all.

This lag in the stock market’s response to economic conditions is typical in Supercycle Bear Market Periods, and especially more devastating Supercycle Winter. In our July/August 2009 commentary, we discussed that during this Supercycle Bear Market Period, the stock market has actually lagged the economy by an average of two months. However, the lag has been appreciably longer at times, most notably at the end of the previous (2001) recession, when the stock market bottomed a full 11 months *after* the economy did. Our patience in waiting for the stock market to “catch down” to the economy should be well rewarded.

March 5, 2010

Anne V. Yates, President

Robert E. Bronson, III, Principal
Bronson Capital Markets Research

⁷ Negative wealth effect refers to the phenomenon of consumers spending less when they feel less wealthy – that is, when the value of their stocks and, even more importantly, their home equity has declined significantly.

Exhibit A

No Recovery Until America Invests Again

By Robert Higgs March 9, 2010

While most Americans are familiar with the broad ups and downs of the economy and the job market — the stuff of daily headlines — the deeper story of the continuing recession can be found buried in the statistical appendix to the 2010 report of the president's Council of Economic Advisers.

That story: a devastating decline in investment spending.

The government's data reveal that, contrary to popular belief, consumer spending held up fairly well during the recession, falling less than 2% from the fourth quarter of 2007 to the second quarter of '09.

Most of this decline was erased during the third and fourth quarters of 2009, so by the final quarter of last year real private consumption spending was less than 1% below its previous quarterly peak.

Although the drop in private consumption spending obviously contributed to the recession, the drop in private investment spending — primarily business purchases of structures, equipment, software and additions to inventories — was far more significant.

Gross private domestic investment peaked in 2006. Between the first quarter of that year and the second quarter of 2009, it fell precipitously, by nearly 34%.

During the second half of 2009, investment spending increased by only 10%, so that late last year it was still (when measured at an annual rate) running 29% below its early 2006 level.

This huge decline in investment spending portends an extended period of slow economic growth, lasting several years and perhaps longer. Worn-out equipment, obsolete software, ill-maintained structures and depleted inventories are not the stuff of which rapid, sustained economic growth is made.

The current investment drought does not simply reflect the housing bust that followed the residential investment boom that peaked in 2005. To be sure, real residential investment fell tremendously, by almost 53% from 2005 to 2009, with especially rapid declines the past three years. Yet real nonresidential investment also fell greatly last year, by 18% from its 2008 peak.

Even real investment in equipment and software — a category only loosely connected to the housing boom and bust — declined last year by 17% after occupying a high plateau during the preceding three years. Business firms have also fled from inventory

investment, trimming their holdings by an unprecedented \$125 billion in 2009 after lopping off \$35 billion in 2008.

Federal government spending, meanwhile, has raced ahead. From 2007 to 2009, government purchases of newly produced final goods and services — the federal government's "contribution" to GDP — increased by over 13% in constant dollars.

Unfortunately, while private investment is the engine of economic growth, government spending (despite what generations of Keynesian economists have asserted) is the brake. To understand this negative relationship, we need only scrutinize how the federal government's spending is determined: namely, by political processes devoid of economic rationality.

In this light, we can appreciate that enhanced government spending does not bulk up the economy, nor merely crowd out worthwhile private activity. Instead, it undercuts, penalizes and distorts everything that private parties attempt to do to create wealth. Ham-fisted government regulations and additional taxes are known killers of economic growth.

The investors' famine and the government's feast therefore are not merely coincidental, but causally connected.

Making matters worse, the explosion of the federal government's size, scope and power since mid-2008 has created enormous uncertainties among investors.

New taxes and higher rates of old taxes; potentially large burdens of compliance with new environmental and energy regulations and mandatory health care expenses; new, intrinsically arbitrary government oversight of systemic risks associated with virtually any type of business — all of these unsettling possibilities must give pause to anyone considering a long-term investment.

Investors now face regime uncertainty to an extent that few have experienced. To find anything comparable, one must go back to the 1930s and 1940s, when the menacing clouds of the New Deal and World War II darkened the economic horizon.

Unless Washington acts soon to resolve these uncertainties, from the cap-and-trade folly to the health care monstrosity, most investors will likely remain largely on the sidelines, consuming some of what would have been invested and protecting the remainder of their wealth in cash hoards and low-risk, low-return, short-term investments.

If this destructive stalemate persists much longer, Americans may have to write off another lost decade for much the same reason they suffered the first one during the 1930s.

- Higgs is senior fellow in political economy for the Independent Institute in Oakland, Calif., editor of the Independent Review and author of "Against Leviathan: Government Power and a Free Society."

A 12-Year Retrospective (through May 8, 2009)

By the time of our Year-End 2008 commentary, there was no longer any question that the U.S. was – and for months had been – in a recession. The official recession-dating organization, the National Bureau of Economic Research (NBER), had finally announced that the recession started in December 2007 according to their criteria,⁸ although an earlier date is certainly supported by analysis of broader data, as we also discuss below.

The calamitous economic and financial impact of the massive housing-market bust, homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities collapsing, venerable financial institutions careening towards insolvency, the global financial system grinding to a halt, businesses shuttering, unemployment rising, consumer confidence battered, and consumer spending plummeting has precipitated the most massive U.S. government intervention since the Great Depression in a desperate attempt to mitigate the damage.

As these economic realities sank in, investors increasingly abandoned the “irrational complacency” that had characterized investor sentiment over the past couple of years and sold more and more of their equity holdings. The decline in the stock market that had started at the final high in October 2007 accelerated to the downside in the second half of 2008 and into the recent March 6, 2009 low, nose-diving some 58% at the low to date.

In fact, not only was the entire overvaluation in stock prices during the “bull trap” from late 2004 through late 2007 more than completely erased (the red line in the chart below), consistent with our forecast during that time (see our further discussion below), but *all stock-market gains for the 12 years since early 1997 were wiped out* (the black line in the chart below). That is to say, investors lost – *not once, but twice* – all of their stock-market gains from the final three years of the mania (1997-2000) forward.

Thus, any investment manager who made *even \$1 of gain* for their equity investors during this time by correctly anticipating and positioning their investments to avoid – and better yet, *to profit from* – this stock-market decline *ranks among the top performers in the country*. To have done so with *relatively low risk* means the risk-adjusted performance is *even higher*.

⁸ According to the NBER’s website, “a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.”



At the same time the stock market made new lows, having declined 58% from its October 2007 high (as has the diversified equity portion of investors' portfolios), *all* of the client accounts of a registered investment adviser client of ours *made new highs*, using our research, forecasts, and individual account advice. Further, for the 9-year period from the March 2000 high, our research shows that well over 90% of investors lost money in equities, and of the remaining investors, well over 90% experienced interim portfolio declines (drawdowns) many times greater than -10%. In comparison, one of our investment adviser clients achieved positive, double-digit returns for *each* of their privately managed account clients using our advice and never exceeded their 10% drawdown target (excluding fees) in *any* client's account. We believe this puts that *risk-adjusted performance in the top 1%* over the past nine years.

There is tremendous significance for us in the fact that all stock-market gains were wiped out since 1997. That is exactly the year we called the start of a roughly 12- to 20-year period of essentially *no gains for stocks* we term a Supercycle Bear Market Period.⁹ Some 12 years later, *this forecast has proven true*. No other investment strategist in the world made this exact call. (See further discussion of this forecast below.)

⁹ A Bronson Asset Allocation Cycles (BAAC) Supercycle Bear Market Period is a 12- to 20-year period of underperformance during which bear markets, anticipating economic recessions, as well as the recessions themselves typically are at least twice as frequent and twice as severe in magnitude and duration as during Supercycle Bull Market Periods. Such a period begins when the return on money market funds sustainably exceeds the total return on equities, especially when downside-volatility-risk is taken into account. Further details are found in our research paper, "Bronson Asset Allocation Cycles," available on request.

We note that 1997 is exactly the year we called the start of a 12- to 20-year period of essentially no gains for stocks.

Some 12 years later, *this forecast has proven true.*

No other investment strategist in the world made this call.

The Three-Year “Bull Trap” Advance Completely Reversed

As we frequently discussed in our market commentaries, the stock market’s extended advance from the 2004 post-election, year-end bounce until late 2007 *was never justified by economic fundamentals*. The ultimate vindication of our view is that the entire three-year advance was wiped out in a matter of weeks. We had warned that the market advance, a classic, but lengthy “bull trap”¹⁰, which rose on the back of several years of rampant speculation, would eventually be *rapidly and more than completely wiped out* – and it was, as seen in the chart on the previous page.

That market advance was driven primarily by the apparently positive results of the *excessive leverage* used by both individuals and companies during that period – *especially by companies in the financial sector* – and was particularly evident in:

- the raging, unchecked speculation in the highly leveraged financial contracts known as derivatives,¹¹
- the leveraged and dysfunctional execution of stock buybacks,
- debt-leveraged mergers and acquisitions, especially private-equity deals, and
- the debt-leveraged housing-market bubble.

The so-called “strong earnings” of the period, which supposedly supported the stock-market advance, were fueled primarily by the highly profitable, but *highly speculative* creation and sale of derivatives. These financial-sector profits *were never going to be sustainable*.

In fact, it was *the unwinding of precisely these lucrative, but highly speculative financial instruments (derivatives)* that crippled or destroyed financial institutions around the world and led to the staggering string of events that required the most massive government (read: taxpayer) bailouts in history, brought the credit markets to a standstill and the global financial system close to collapse, and plunged the U.S. into a recession far more severe than any economic downturn since the Great Depression. (Further below we discuss our 1997 forecast of the implosion of derivatives.)

¹⁰ A bull trap is a period of modestly higher highs that lures investors back into the market, only to be followed by a resumption of the market decline. A bull trap is baited by investor emotion from hope, greed, or complacency, which leads investors to pile into the market despite all fundamental warning signs to the contrary.

¹¹ Derivatives are highly leveraged financial contracts whose values are tied to underlying stocks, bonds, commodities, currencies, or loans, or linked to specific events like changes in the weather or interest rates. They are widely used both as insurance against market losses and for leveraged speculation. They have the unintended consequence of linking – through increased correlation and heightened volatility – otherwise disparate capital markets, asset classes, and investment styles, especially when investors demand liquidity during extreme panic selling. See also footnote 8 on page 8.

The stock-market advance from late 2004 through late 2007 was never justified by the true condition of the economy or corporate profits. *The increasingly overpriced stocks of the period were not suitable for value investors.* The stock market has dropped by 58% since October 2007, as has the diversified equity portion of investors' portfolios, revealing the fact that their investment managers had a momentum-oriented – *not value-oriented* – investment style, *regardless of what was claimed*, and did little more than ride the market up, then ride it back down again.

**The stock-market advance from late 2004 through late 2007
was never justified by the true condition
of the economy or corporate profits.
*Stocks were not suitable for value investors.***

The Importance Of A Strong Conceptual Framework

We have long stressed the critical importance of investment managers having a deep, fundamental, and *unbiased* grasp of the economy and financial systems, with which to competently analyze and reasonably accurately anticipate significant changes in the capital markets. Without such a strong conceptual framework, we said that investment managers would be doomed to fail, *as they have now failed*, in rapidly and dynamically changing economic and market conditions about which they admit they are “confused.”

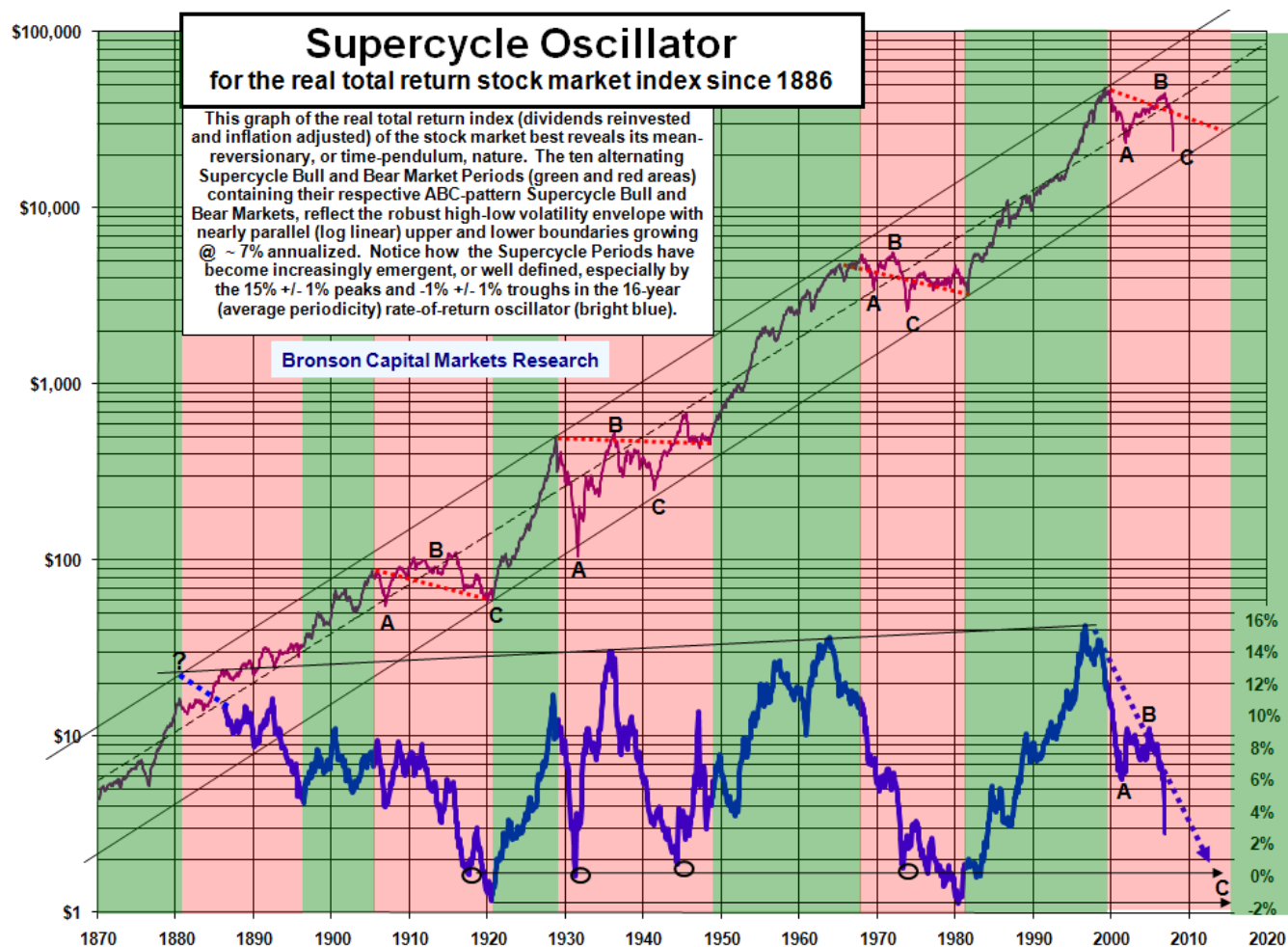
We approach the capital markets with just such a strong conceptual framework. We were one of the only investment strategists to conclude in the late 1990s, using both contemporaneous and historical data, that the nearly two-decade period of outsized stock-market gains dating from 1982 was approaching an end and *a 12- to 20-year period of essentially no net gain for the stock market* was in the process of arriving.

**Without such a strong conceptual framework,
we said investment managers would be doomed to fail,
as they have now failed,
in rapidly and dynamically changing conditions
about which they admit they are “confused.”**

In a landmark report we wrote in July 1997, entitled “The Case for the Third Supercycle Bear Market Period of This Century,” we summarized our stock-market outlook and detailed a large number of factors from our forecasting models¹² supporting it. We warned that during the coming Supercycle Bear Market Period, we could expect bruising bear-market declines, vastly increased market volatility, and overall stock-market returns that would *underperform no-risk* money market instruments, like U.S. Treasury bills.

¹² We use knowledge-based, “expert-system” forecasting models we developed over the past 41 years. They comprise more than 100 proprietary and conventional indicators that quantify four pairs of factor groups – monetary/economic, valuation/sentiment, political/social, and inter- and intra-market technical data – over nine time horizons, periodically re-optimized and re-weighted in light of dynamic market changes.

As the chart on the next page shows, our forecasts were right on the mark. It clearly shows the extended period of no net gain during the current Supercycle Bear Market Period, as well as previous ones, shaded in pink. As noted above, our Supercycle Bear Market Period expectation of a minimum of 12 years of no net gain in the stock market has now been met. The oscillator in the bottom panel shows that *the stock market's even longer, rolling 16-year rate of total return is also approaching 0%.*



**Our forecast of
a minimum of 12 years of
no net gain in the stock market
has now been met.**

Among other forecasts in that 1997 report that have particular relevance today:

- We originally forecasted that during the Supercycle Bear Market Period, “the U.S. stock market faces [an] enormous [decline] on the order of -67% (plus or minus 12%), at least twice the severity of the average bear market.”

The NASDAQ index already reached the low end of that target range when it dropped 78% during the 2000-02 decline. We believe substantial declines are still ahead for both the NASDAQ and S&P 500 indexes in the remainder of the current second downleg of the Supercycle Bear Market.

- In 1997 we wrote: “We will experience increasingly violent swings up and down in stock prices...until a final selling panic, involving global capital markets simultaneously.”

Investors have witnessed greatly increased volatility in the U.S. stock market, as well as synchronous moves across the global markets, in day-to-day trading and in the market trends and counter-trends over the past nine years. In 2008 alone, the U.S. stock market experienced the fifth and sixth largest percentage gains and four of the 20 largest percentage losses in stock-market history. We expect the greatest volatility – probably record high volatility – to occur in the final selling panic, which we believe is close at hand.

- More than a decade before the cumulative, unbridled speculation in derivatives caused the current credit crisis, we warned in our 1997 report:

“Investments are far more leveraged today than in 1929.... Investors can effectively borrow more than 99%...through derivatives. ... Rather than used as a hedge for defensive purposes, they are too often used aggressively to place speculative, leveraged bets on the direction of markets...We believe that the... trend-following strategy of ‘dynamic hedging’ popular today represents a greater meltdown risk than ‘portfolio insurance’ did in 1987 [leading up to the Crash] – more because of rollover illiquidity than counter-party failures.”

This is exactly what happened in the 2008 market meltdown of the derivatives known as “credit default swaps”¹³, which caused global credit markets to seize up and stock markets to go into tailspins worldwide.¹⁴

¹³ A credit default swap (CDS) is a credit derivative contract between two counterparties. The buyer makes periodic payments (premium leg) to the seller, and in return receives a payoff (protection or default leg) if an underlying financial instrument defaults. CDS contracts have been compared with insurance because the buyer pays a premium and, in return, receives a sum of money if a specified event occurs. However, there are a number of differences between CDS and insurance. In a so-called naked CDS, which amounts to a purely speculative side bet, the buyer of the CDS does not need to own the underlying security or have any insurable interest. In fact, the buyer does not even have to suffer a loss from the default event. Naked CDSes, which comprise some 86% of the \$29 trillion nominal amounts in CDSes, have finally been recognized by both regulators and legislators as a moral hazard, for which the proverbial chickens have already come home to roost.

¹⁴ More than 10 years ago we predicted that the misunderstanding and misuse of the correlation coefficient, used by all the correlation trading desks trading derivatives, would lead to a derivatives crash. Now some are claiming that is exactly what has happened. More on this fascinating subject is available upon request.

**In 1997, we warned that highly-leveraged derivatives –
which triggered the current credit crisis –
represented a greater meltdown risk than
“portfolio insurance” did in the 1987 Crash.**

- We also warned in our 1997 report:

“Americans are far more involved in derivatives than they realize. Their pension funds, mutual funds, insurance companies and banks have been using them many times more extensively than a decade or so ago. More than 50% of the profits of some major banks in recent years has come from their marketing and use of all types of derivatives. A Supercycle Bear Market is linked inextricably to a collapse in derivative trading volume – ...each [is partially] the cause and effect of the other.”

The confirmation of this forecast has been made painfully clear in the recent meltdown of credit default swaps, especially the naked credit default swaps (see footnote #8), and the impact of the failure of those derivatives on financial institutions and the credit markets.

- Concerning the economic contraction linked to the Supercycle Bear Market, we wrote: “Like the late 1920s and the mid-1960s, the coming stock-market decline will probably trigger a recession in the U.S., which in turn will trigger a contagion of additional international recessions due to the increased interdependency of world capital markets and economies.”

Following a recession in 2001,¹⁵ which was more shallow than average (having been cut short by the massive economic stimulus immediately following the 9/11 terrorist attacks), a second, far more severe recession, with far more widespread, global repercussions, is not only still unfolding, but is worsening at an ever greater rate. As we discuss further below, economists as a whole *completely missed* the magnitude of the economic deterioration, believing on the whole that the U.S. economy would either avoid a recession or experience a minor one lasting only a couple quarters.

Finally, we wrote in our 1997 report about several myths that had been popularized by Wall Street and the financial media during the stock-market mania of the late 1990s. These self-serving notions promoted the view that the way the stock market operates had *fundamentally changed*, that the bull market would *continue indefinitely* and that, therefore, investors could continue to buy and hold equities *without any concern*.

¹⁵ The last recession, which was designated as a eight-month recession in 2001 by the NBER, actually dragged on for 31 months, according to our more thorough application of *the NBER's own standards* for determining recessions, which are the factors the Conference Board uses in its coincident indicators index, adjusted for growth in population or the labor force. The chart of the Conference Board's index (see our First Quarter 2008 commentary) is clear as a bell in showing a 31-month recession. The NBER decided to stick with its initial determination of an eight-month recession even after the government issued *substantially lower* revisions to key economic data, and in spite of other miscalculations brought to their attention.

We wrote that these permabullish concepts would all be *indisputably disproven* during the Supercycle Bear Market Period – and, indeed, they have been. Among them, you will undoubtedly remember the following:

- Concerning the self-serving mantra “I’m in for the long haul” that Wall Street drummed into investors, we wrote: “Buy-and-hold is not an adequate long-term strategy for most investors. We expect that the coming [Supercycle] Bear Market will bring almost complete consensus on this point....”

Investors who have held stocks over the past 12 years are learning this painful lesson.

- Concerning economists’ promulgation of a permanently rising, New Era Economy: “One myth is that as long as we are in a ‘Goldilocks economy,’ with corporate profits rising moderately and with inflation and interest rates remaining low, the business expansion and the bull market will continue indefinitely.”¹⁶

Inflation and interest rates have remained low and gone even lower since we wrote this in 1997, but two business-cycle contractions, accompanied by plunging corporate profits, have occurred nevertheless since this notion held sway with economists.

**In 1997, we wrote that then-popular notions,
advancing the view the stock market would rise indefinitely,
would all be disproven – and they have been.**

- This one was very popular with financial planners: “Another myth...is that Baby Boomers’ retirement needs will guarantee cash inflows to mutual funds for years, thus fueling a continuous bull market.”

¹⁶ From the late 1990s through the stock-market high in March 2000, Wall Street inundated investors with bullishly-biased half-truths about the economy and stock market to give them a rationale for continuing to buy and hold overpriced stocks. Among the now-debunked nonsense circulating at the time was the notion that there was no longer any risk in owning stocks over bonds – no “risk premium” – because stocks had always outperformed bonds over periods of 10 to 15 years, so if investors would buy and hold stocks for 10 to 15 years or longer, the stock market could rise indefinitely. This notion was immortalized in a popular book of the time, entitled *Dow 36,000*, which ironically was published in late 1999 just before the dot.com bust and severe stock-market plunge that the authors argued would never happen again. Prior to the book’s publication, we made a bet with the lead co-author, economist Kevin Hassett, director of economic policy studies at the American Enterprise Institute. Hassett was only willing to bet that the stock market would grow at least 7% on average for the next 10 years – not that it would reach his Dow 36,000 target. We took the position that the risk premium had not permanently gone to zero, that it was highly cyclical over multiple time horizons, that its cyclicity is more important than earnings or the price-to-earnings (P/E) ratio in forecasting future stock-market performance, and that based on that knowledge, we were forecasting the stock market would have a 12- to 20-year period of essentially no net gain and heightened volatility that we call a Supercycle Bear Market Period (or half a Bronson Asset Allocation Cycle). We won the bet on April 2. Bronson Capital Markets Research – April 2009

As we more correctly forecasted, Baby Boomers have instead drastically cut back on their spending and begun to pay down debt in preparation for retirement. Instead of increasing, cash flows to mutual funds have *declined substantially*.

- In 1997, a particularly backward-looking theory of asset allocation was extremely popular with financial planners, about which we wrote:

“One final myth propelling the bull market is the so-called Efficient Frontier... The Efficient Frontier optimization...is dangerous to investors because, in effect, it overweights the relatively recent best-performing asset classes, which already have risen relatively strongly and which, therefore, will likely have greater losses during inevitable periods of market declines and/or underperformance... One could argue that the value investor should do the exact opposite of what the Efficient Frontier recommends.”

In retrospect, it is easy to see that investors *should* have done the exact opposite of what the Efficient Frontier recommended, just as we wrote. In the late 1990s, Efficient Frontier optimization dictated that investors’ asset allocation should be heavily weighted towards stocks, which had been the best-performing asset up to that time. Of course, *investors who followed this then-fashionable theory have sustained horrific losses*. That looking in the rearview mirror would fail during the current Supercycle Bear Market Period was an easy call for us.

Navigating A Supercycle Bear Market

Having correctly anticipated a 12- to 20-year period of essentially no net gain for the stock market, which we call a Supercycle Bear Market Period, we further laid out the path the stock market was likely to take during the period. In particular, we laid out the geometry of the most severe combination of bear markets of the period, the so-called Supercycle Bear Market, which typically runs from the highest to lowest point during the Period.

Supercycle Bear Markets have a down-up-down, ABC zigzag pattern, as seen earlier in the chart on page 7 and in the chart below of the current and two previous non-world war Supercycle Bear Markets, where their magnitudes and durations have been fractally rescaled (that is, equalized in magnitude and duration) in order to make the similarities of the patterns more apparent. The current Supercycle Bear Market (the bold bright blue line) has been overlaid on the two previous ones, showing that it is right on track. (The two world-war Supercycle Bear Markets, not shown here, have a similar down-up-down, ABC pattern.)

As you can see, the first downleg, or “mania bust” (A) is followed by an exuberant rebound phase, or “echo-mania”¹⁷ (B). Investors’ “irrational exuberance” during the original mania becomes “irrational complacency” during the echo-mania, as investors continue to buy stocks in the face of a deteriorating economy. The echo-mania rebound half the time hits slightly higher, record highs before reversing and declining again in the second, even more devastating

¹⁷ An echo-mania is the exuberant rebound phase between the first and second downlegs of a Supercycle Bear Market, in which the “irrational exuberance” of investors during the initial mania becomes “irrational complacency” during the echo-mania.

second downleg, or echo-mania bust (C), which is currently well underway and most probably not yet finished. That decline typically ends in a classic selling panic – what we more precisely call a “mass-correlation, hyper-volatility, illiquidity event,” or MCHVIE (pronounced mac-vee).

Without the defense spending fiscal stimulus of a World War the second and final downlegs have been much more similarly severe, following a more extended B trend, with ultimately much lower lows occurring much more sharply



The reason for the viciousness of the second, follow-on decline (C) in a Supercycle Bear Market is explained by reference to investor emotions. When investors, who think they learned a lesson from a previous, severe decline they never saw coming, find themselves again losing money in a second, brutal decline they never saw coming, they then – *and only then* – become completely disillusioned and bail out of their stocks *en masse*. This causes the second downleg of Supercycle Bear Markets to be particularly devastating, typically ending in a full-blown MCHVIE.

Investors who failed to understand this major stock-market correction not only suffered catastrophic losses, but further compounded those losses by buying back into the market much too soon.

Investors and investment managers who failed to understand the geometry of this major, once-in-a-generation stock-market correction not only suffered *catastrophic losses*, but further compounded those losses by *buying back into the market much too soon*. Characteristic of a Supercycle Bear Market, value investors who stepped in to buy stocks at any point during the mania bust, echo-mania rebound, or echo-mania bust have lost money on their investments, as can be seen in the chart on page 3.

The Rest Of The Supercycle Bear Market Period

In our landmark 1997 report, “The Case for the Third Supercycle Bear Market Period of the Century,” we laid out in broad strokes a number of key events that would occur during the period, and these events have been unfolding in the years since. While exact details could not be known in advance, recent events are no surprise to us. *The crises now emerging are just the specific manifestations of conditions we have been anticipating and warning about all along.* We have discussed and benchmarked many of these developments in the commentaries we send our clients. We continue to monitor events closely.

**The crises now emerging are just
the specific manifestations of conditions
we have been anticipating and warning about all along.**

Our analysis strongly points to a substantial further decline in the stock market, for which those following our advice are positioned to continue to profit. Further, we are prepared for the decline to end in a MCHVIE. We described a MCHVIE and how and why it develops in some detail in our March 2001 commentary.

In short, it is *an extraordinarily savage sell-off*, in which virtually all investment strategies become unprofitable, almost all asset classes decline sharply, and it all happens simultaneously across multiple capital markets. Its devastation is wreaked by the herding effect of massive numbers of panicked investors ultimately bailing out of any and all investments at any price *en masse* in rapidly declining markets. It is the ultimate selling panic that ends major bear markets.

We have already experienced shades of such a selling panic when the market declined between 7% and 8% in a single day on each of four different occasions in late 2008. The final selling panic will probably decline by a significantly greater magnitude.

Once we believe the bottom of this decline – the second downleg of the Supercycle Bear Market – has been reached, we will make major changes in our recommendations to position our clients to profit from the subsequent bull market. *The stock market at that point will meet our value-oriented criteria.* Since we can make money in both up and down markets, we can call the markets as we see them, recommending various asset classes only when they are *truly a value* and avoiding the kind of catastrophic losses investors have incurred by missing or ignoring the warning signs of major reversals in market trends.

As soon as we have made recommendations to position our clients for the subsequent

bull-market advance, we will actively be gauging the magnitude and duration of that bull market, aware that history shows it is likely to be *shorter and weaker* than average. This is because it will be a bull market in an ongoing Supercycle Bear Market Period that will include post-shock recession(s). Additionally, it will be a bull market that will be anticipating what we believe will be *a particularly sluggish economic recovery*, in which the growth in consumer and business spending – and, therefore, the growth in corporate profits – will be relatively weak.

From our study of Supercycles, we know we can expect at least one or two more bear markets during the remainder of the Supercycle Bear Market Period. The coming bear market(s) will likely be more severe than average, but of lesser magnitude and duration than the current Supercycle Bear Market, which is the most severe combination of bear markets during the overall, 12- to 20-year period of no net gain in the stock market. Each bear market will also likely lead to another business-cycle contraction, each of which is likely to be a more severe recession than average, as is also typical in Supercycle Bear Market Periods.

The Recession Continues To Accelerate To The Downside

In our commentaries over the past several years, we discussed the slowing growth of the U.S. economy in some detail. As we wrote concerning the leading economic indicators¹⁸ 18 months ago in our May/June 2007 commentary: “The foremost, ‘long-leading’ indicators turned down more than two years [earlier] and the ‘short-leading’ ones 14 months [earlier], suggesting *a recession is already in its early stages.*”

We went on to present charts of key economic components of U.S. gross domestic product (GDP) that were *already clearly in recession* at that time, including housing (actually all of private fixed investment¹⁹) and autos. While employment is not part of GDP, it is an important factor in determining the phase of the business cycle, and we demonstrated that it, too, was in recession (contraction). As discussed further on page 24, while other economists and investment strategists were still looking for a “soft landing” and continued “strong earnings,” we forecasted the 2007 peak and decline in corporate earnings, which is another very important business-cycle indicator that we use, but the NBER does not in its recession dating.

Finally, addressing a then-popular view among economists and on Wall Street that the U.S. would avoid recession by business spending offsetting the slowdown in consumer spending, we presented a chart that showed business-spending growth had been decelerating for two years and was then hovering around 0%. We wrote:

“There is no valid indication of any reacceleration. A continuing drop in business capital spending, combined with the continuing slowdown in consumer spending, supports our view that the economic contraction, now in the early stages, will be a particularly severe one.”

¹⁸ Leading economic indicators are comprised of various measures of business conditions that tend to lead the overall economy by an average of about two quarters, although the historical range has been mainly from zero to more than four quarters.

¹⁹ Private fixed investment is comprised of investment in residential (new houses) and nonresidential (commercial and industrial) structures and business equipment and software.

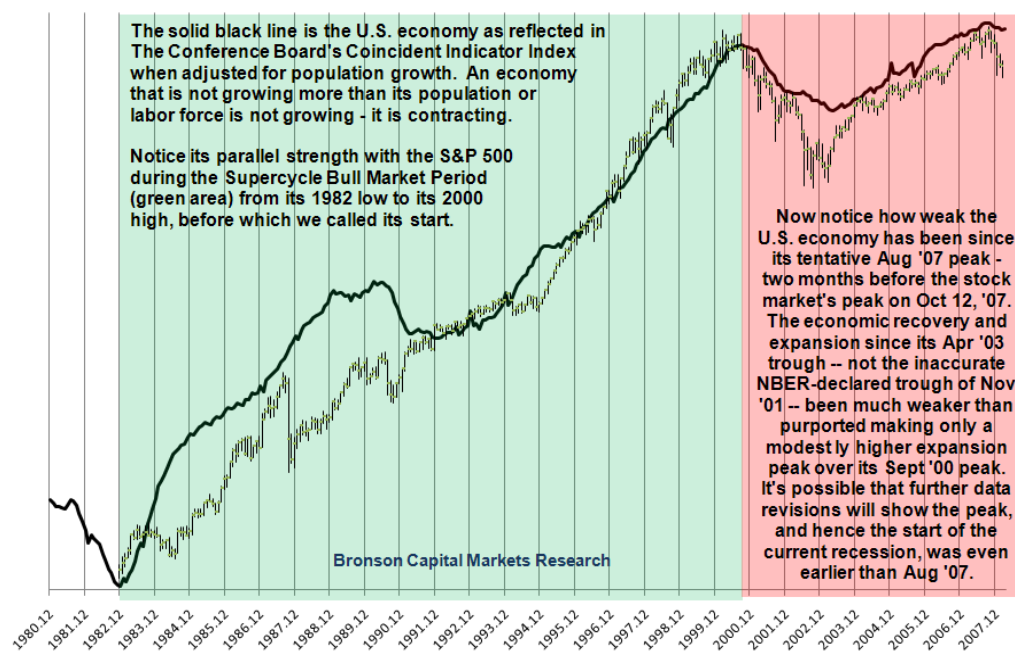
In our subsequent Summer 2007 commentary, we addressed the then-prevalent view among economists and investment strategists that higher growth in the global economy would prevent a U.S. recession. We wrote:

“This notion is also absurd. The rest of the world is simply not strong enough to boost our exports enough to offset the deepening slowdown in both U.S. consumer and business capital spending.... Far more importantly, *the U.S. is responsible for a good chunk of the growth [in the global economy]... Rather than bailing out a faltering U.S. economy, countries around the world will find *their own growth pulled down* along with the U.S. economy.*

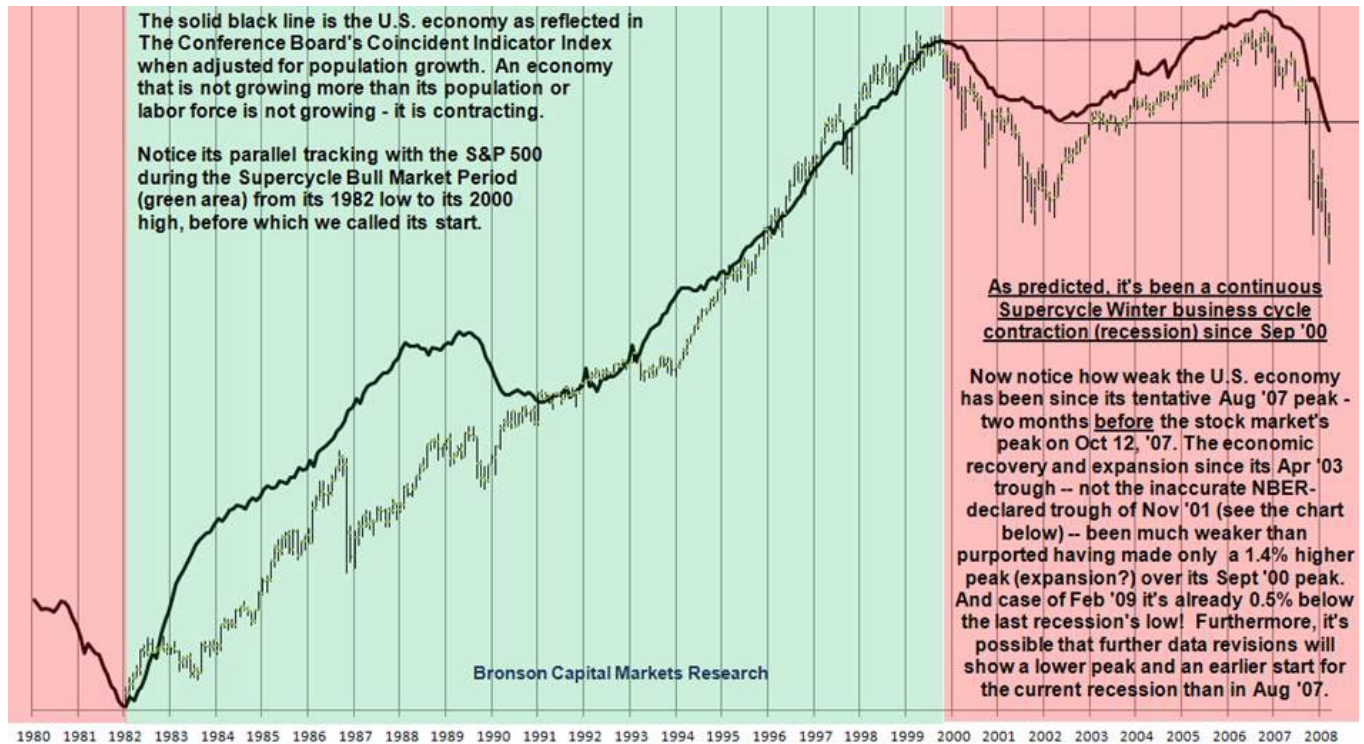
Of course, by now it is apparent that *the severe, synchronized global recession* we had been forecasting is well underway. Most of the major economies in the world are already in severe recession.

**In Summer 2007, we took the then-contrarian view:
“Rather than *bailing out* a faltering U.S. economy,
countries around the world will find their
own growth pulled down along with the U.S.**

By the time of our First Quarter 2008 commentary, we had transitioned from presentation of the *leading* to presentation of the *coincident* economic indicators. The top chart on the next page is from that commentary, showing that the Conference Board’s coincident indicator index (the solid black line in the chart), adjusted for population growth (or per capita), had peaked in August 2007 and had been declining since then. A per-capita adjustment eliminates growth in the population (or labor force) from the data because it is not reflective of true expansion or contraction in the business cycle. This was again clear confirmation to us that a recession was *already underway*.



In contrast, the consensus outlook of economists and investment managers all during this period was for continued slow growth – a “soft landing” – and *not a recession*. The chart has been updated below to show the continuing, very steep decline in the coincident indicator index, clearly showing that the business cycle is still *contracting rapidly* and is already deeper – more severe – than the previous recession, in further confirmation of our forecast.



With a per-capita adjustment, the peak in the index – and, therefore, a logical start of the recession – is August 2007. Without that adjustment, the nominal peak is October 2007. The National Bureau of Economic Research, using a more limited set of factors, decided the recession started in December 2007. We believe that the normal, periodic revisions of government economic data over the next several years, which will almost certainly continue to be *downward* revisions, will probably support an even earlier start.

No matter which of these starting dates one wants to use, the recession was clearly underway and worsening all through 2008. It is, then, a cautionary tale for investors that *economists and investment strategists as a whole completely misread the economy, grossly missed the start of the recession, and were totally unprepared for the predictable severity of its magnitude*, believing up until very recently that the economy would experience nothing more than a “soft landing” in 2007, and certainly no recession.

Economists and investment strategists as a whole completely misread the economy, believing until very recently that a recession would be avoided.

In fact, other professional prognosticators were so far off the mark that as recently as September 2008, when the recession had already been underway for nine months according to the NBER's reckoning and for 13 months by our determination, *fully one-third of economists surveyed still believed that the U.S. was neither in recession nor close to it!*²⁰

Keep that in mind the next time you hear economists and other financial pundits confidently state they see signs that the recession is bottoming. In fact, *there continues to be an acceleration to the downside* in a broad range of economic indicators, including gross domestic product²¹, corporate earnings, housing prices, auto sales, and employment, some of which we discuss further below. Taken together, the data confirm that the severe recession underway *has much further to go* before bottoming and that once it finally bottoms, with the extraordinary economic and financial damage occurring, the economy will be *extremely slow to recover*.

We believe investors are still too unrealistic and overly optimistic about the potential success of recent policy-maker interventions, even though they are the most massive U.S. government intervention since World War II by the U.S. Treasury Department, the Federal Reserve Board, and the U.S. Congress. We believe investors will eventually get fed up with intervention and its costs and will become increasingly more pessimistic about the future. This anticipated deterioration in investor sentiment further supports our view that the stock market will decline to *significantly lower lows* in this second downleg of the Supercycle Bear Market.

The Current Economic “Perfect Storm”

While the sheer ferocity of the recession has caught Americans – including professionals whose job it is to forecast them – by surprise, we forecasted this severity well in advance. In a section of our Year-End 2006 commentary entitled, “As Bad As It Gets: The Coming Economic ‘Perfect Storms’,” we wrote about the extremely ominous implications of the approaching and rare convergence of the downtrends of five significant economic and stock-market cycles.²²

We had previously presented (in our May 2002 commentary) a forecasting model we developed years ago, which integrated four widely-recognized business/economic cycles with the Bronson Asset Allocation Cycle, which measures the secular bull and bear stock-market periods we have quantified and identified as Supercycle Bull and Bear Market Periods. Our model not only explains the past interrelationship of all these cycles with a high degree of accuracy, which is a minimum condition for any meaningful model, but it also has been a useful tool in forecasting the future – and highly accurate in having forecasted the current economic meltdown.

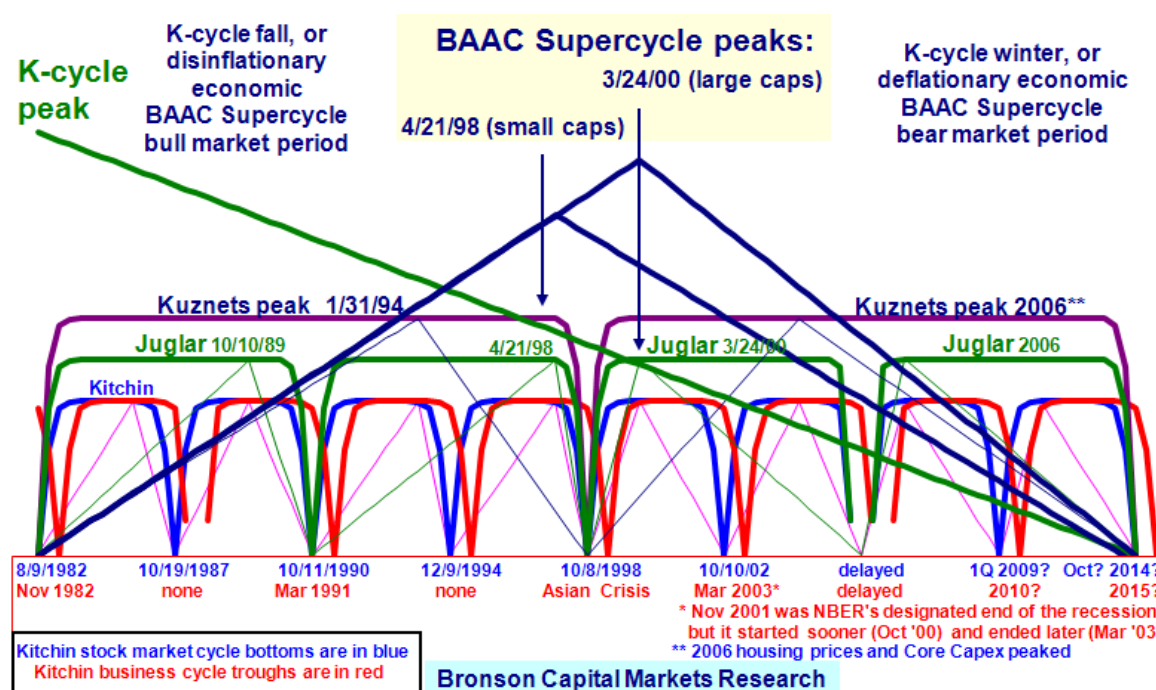
²⁰ The optimistic bias of economists was revealed in a recent study of the consensus forecasts of economists made in advance of 60 recessions around the world in the 1990s. It showed that economists failed 97% of the time to predict the coming contraction a year in advance, and on the rare occasions they did, they significantly underestimated the severity of the economic downturns. Many of the economists failed to foresee recessions that occurred as soon as two months later. In the present instance, the quarterly survey conducted by the National Association for Business Economics showed that fully one-third of U.S. economists failed to recognize a recession that had already been underway at least nine months.

²¹ Gross domestic product is the measure of the nation's total output of goods and services.

²² By “cycle” is meant one uptrend followed by one downtrend, or vice versa, not a fixed time period.

The chart below is a stylized illustration of this model, or Stock-Market and Economic Cycle Template (SMECT), which incorporates these five economic and stock-market cycles:

- the roughly three-generation (64-year) Kondratieff cycle of inflation and interest rates;
- the roughly 32-year Bronson Asset Allocation Cycle of stock-market over- and underperformance;
- the roughly 16-year Kuznets cycle of infrastructure development (now tracked by the National Income and Product Accounts – which Kuznets created in the late 1940s – as “private fixed investment” [see footnote #13]);
- the roughly 8-year Juglar cycle that reflects the true business cycle; and
- the 48-month Kitchin cycle, which originally reflected inventory cycles, but now more importantly reflects the coordination of the presidential election and stock-market cycles.²³



In our Year-End 2006 commentary, we again referred to this model, warning that the U.S. economy was entering a unique time frame, during which we would face the negative, synchronized, and compounded interactions of the *downtrending phases of all five of these cycles*, not once, but *three times* in the subsequent eight years through 2014.

²³ Kondratieff, Kuznets, Juglar, and Kitchin were all prominent economists. Kuznets won the Nobel prize in economics for his work. The fact that these economic cycles are not routinely referred to in present-day U.S. financial discourse in no way diminishes their ongoing importance.

- The Kondratieff cycle is in its deflationary economic phase: a severe recessionary period with declining interest rates and declining rates of inflation (disinflation) eventually becoming outright deflation, especially debt deflation, before its end around 2014.
- The Bronson Asset Allocation Cycle will remain in a Supercycle Bear Market Period until roughly 2014, during which time bear markets and the recessions they signal can be expected to be more frequent and severe than average.
- The Kuznets cycle, which includes residential housing, clearly peaked in 2005, has been in recession since then, and can be expected to decline into roughly 2014.
- The Juglar business cycle peaked in 2000 at the end of the previous expansion, experienced a recession, recovered, and now includes a second recession, after which the business cycle can be expected to recover and then decline again into roughly 2015-6.
- The Kitchin political/stock market cycle is in decline, and will likely rebound and cycle again two more times through roughly 2014.

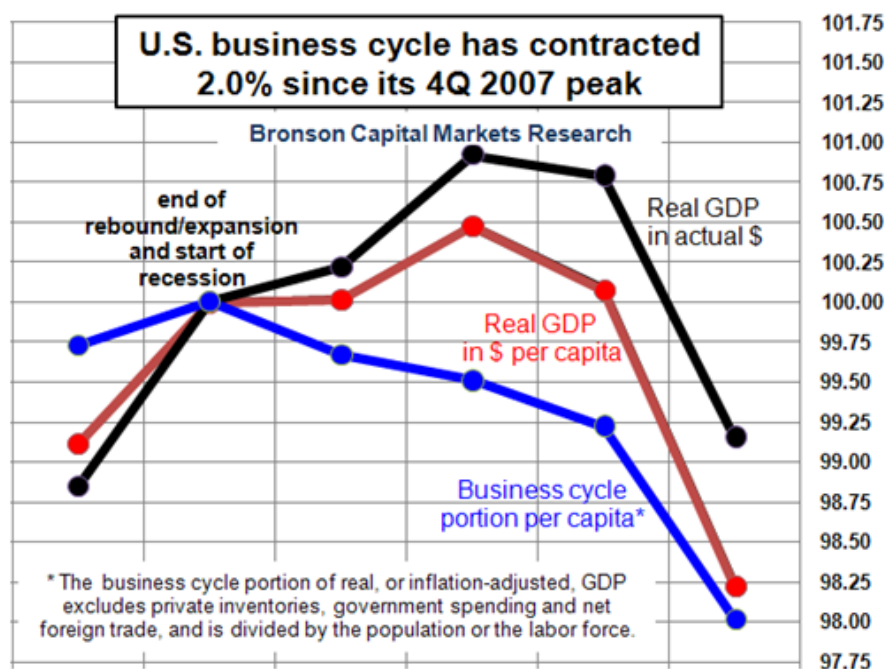
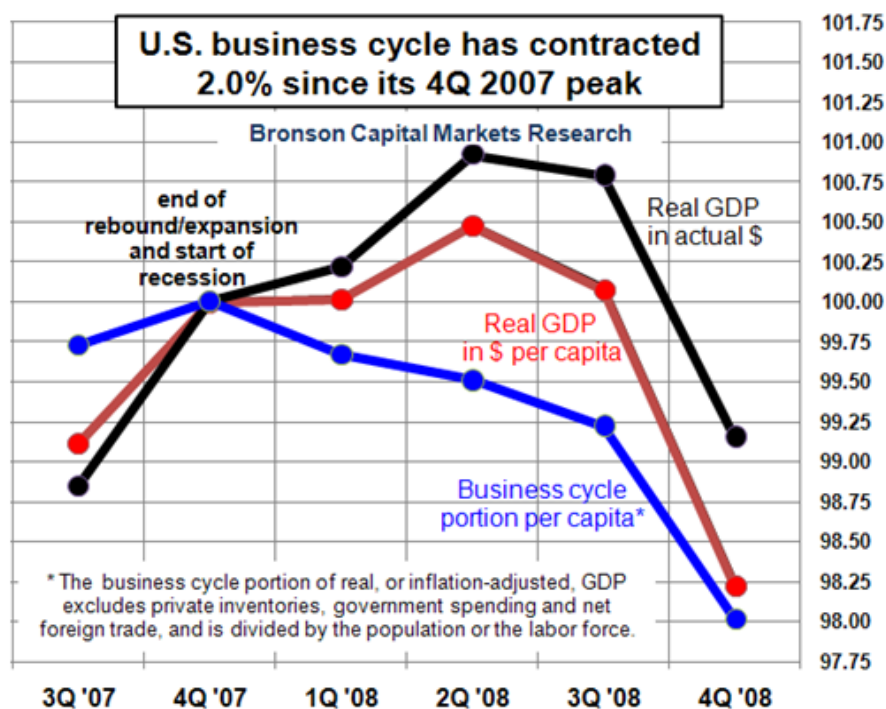
Clearly, a serious economic downturn is well underway and now widely recognized by the consensus, but the full extent of the current economic “perfect storm” has not yet been priced into the stock market. *The stock market will only bottom when this occurs.* For example, failed derivatives will have to be fully written off before the credit crisis ends; homeowners and homebuilders will have to lower their asking and selling prices even further and write off their losses before the housing bust will end; and so on. We anticipate a further, substantial stock-market decline will occur as investors finish this job.

**The full extent of the “perfect storm”
has not yet been priced into the stock market.
The stock market will only bottom when this occurs.**

GDP Continues To Accelerate Its Decline

The Commerce Department recently revised gross domestic product (GDP) downward for the fourth quarter of 2008. It shows the nation’s output of goods and services *declined at a 6.3% annual rate*, adjusted for inflation, from the previous quarter. It is clear confirmation that *the recession is accelerating*. Real GDP declined at the sharpest rate since 1982, while nominal GDP (no inflation adjustment) declined at the sharpest rate since 1958. The biggest hit to GDP came from the 4.3% annualized drop in consumer spending, the largest component of GDP. Business and residential investment also had large declines, and the deepening global recession took a toll on U.S. exports.

Removing inventory changes, government spending, and foreign trade leaves the portion of GDP directly relevant to the true condition (phase) of the business cycle. Further adjusting for population or labor force growth (because an economy not growing faster than its population or labor force is not expanding) results in the business-cycle portion of GDP per capita having fallen 2.0% from its peak in the fourth quarter of 2007, and down at a greater *and accelerating* 4.8% annualized rate during the fourth quarter of 2008, as seen in the chart on the next page. It is very similar to the Conference Board's index of coincident economic indicators (see the chart on page 16), as it should be.



The steep drop in the consumer and business spending portions of GDP and in the Conference Board's coincident indicators is consistent with our long-standing forecast, discussed in every commentary over the past several years, that the recession now underway would be global and much more severe. This is because, unlike the previous recession, which was caused primarily by a slowdown in business spending, this recession is the result of cutbacks in both business *and* consumer spending, and consumer spending alone at its peak comprised 72% of U.S. economic activity.

Corporate Earnings Are Still Declining Sharply, As Forecasted

In our Year-End 2006 commentary, we presented the top chart on page 23, which showed that corporate earnings, as measured on a Generally Accepted Accounting Principles (GAAP) earnings-per-share basis for the S&P 500 companies, were at the top of a reliable, 76-year-long, high-low volatility channel. Based on the months-long slowdown in the growth rate of earnings then underway, as well as other factors in our forecasting models, we wrote that earnings were “only a few quarters from peaking.”

While other economists and investment strategists at the beginning of 2007 were still looking for a “soft landing” and continued “strong earnings,” we forecasted a substantial drop in profits for that year:

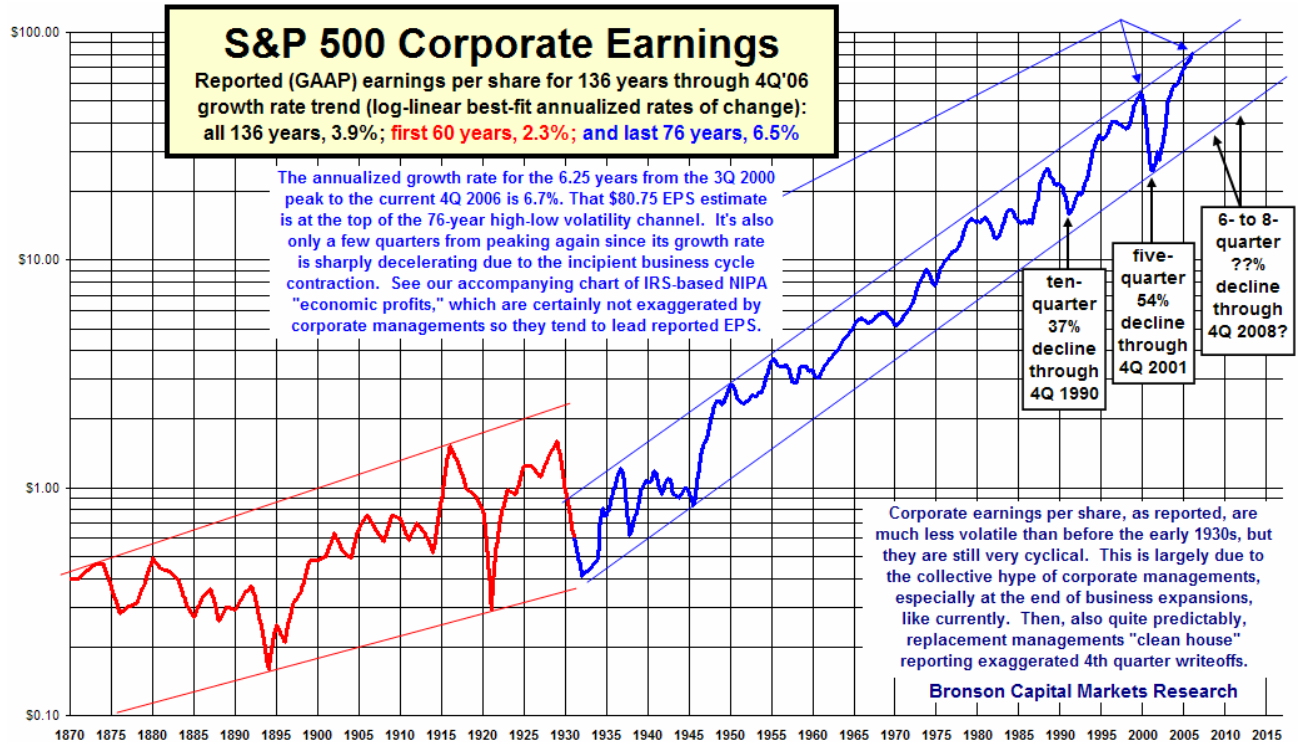
“From previous peaks at the top of the high-low volatility channel, earnings dropped 37% from 1988-90 and 54% from 2000-01. We are looking for *another significant decline in earnings to begin in 2007* as economic conditions deteriorate more rapidly.”

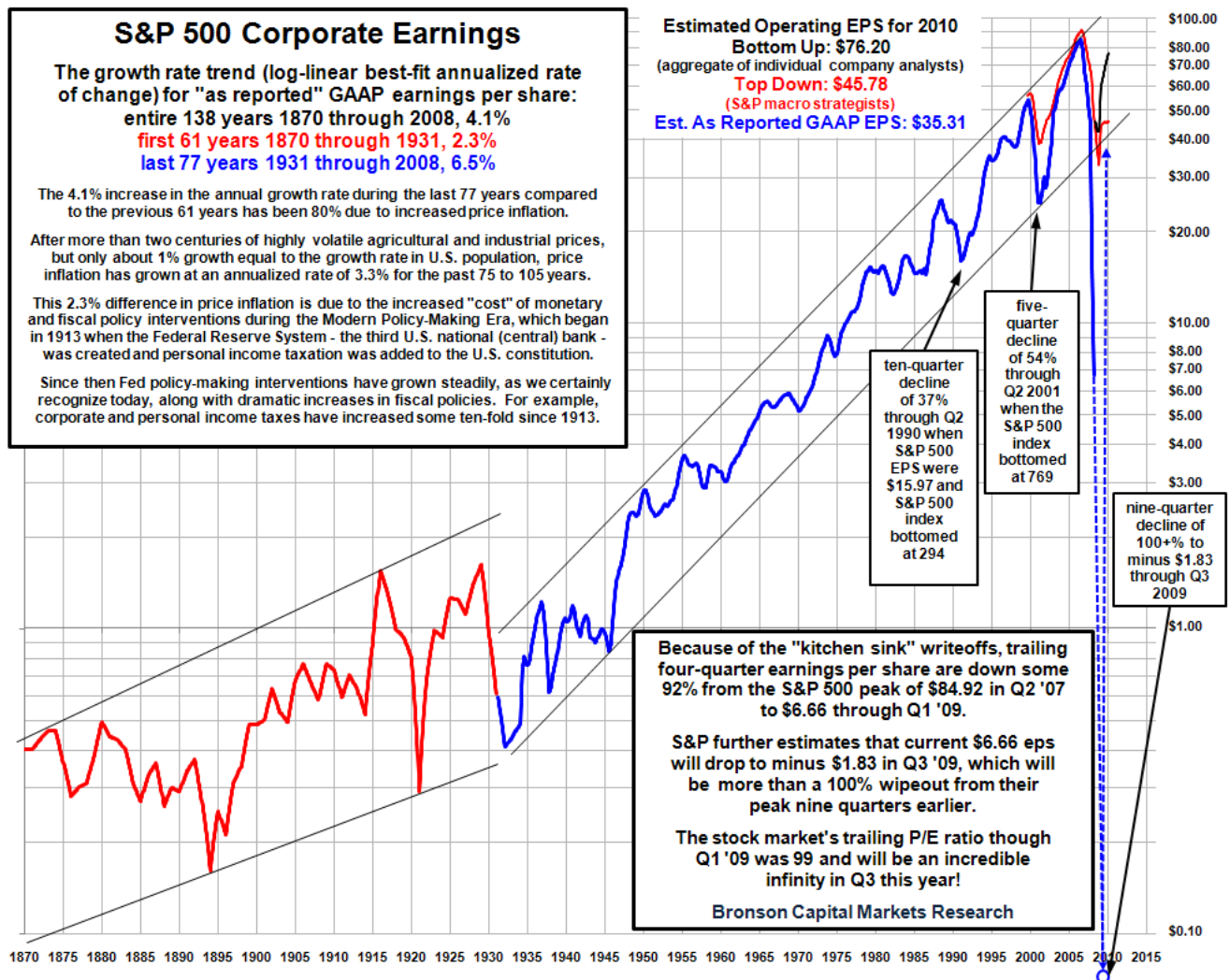
In fact, corporate earnings per share did peak two quarters later – in the second quarter of 2007 – and declined significantly the rest of the year, consistent with our forecast. Predictably, the recession started later the same year.

The following year, at the beginning of 2008, the consensus of economists and investment strategists was still for no worse than a short and shallow economic slowdown, with a recovery in earnings in the second half of the year. In contrast, in our First Quarter 2008 commentary, we forecasted a continuation of the decline in corporate earnings throughout 2008 and beyond, for a total decline of at least 40% to 50% over six to eight quarters from the second-quarter 2007 peak. *Our very much then-contrarian forecast has now proven true.*

Our updated chart at the bottom of page 23 shows earnings have continued to drop off a cliff, as it became abundantly clear that all the massive global intervention by governments and central banks could not stop the severe global recession from accelerating to the downside. Already, the huge “kitchen sink” write-offs in the fourth quarter of 2008 by corporate managements *hoping* to put their problems related to the recession and the credit crisis behind them caused widely-watched trailing four-quarter S&P 500 earnings per share to be *down a whopping 67%* from their peak in the second quarter of 2007. What's more, by the third quarter of this year, the drag on earnings from that dismal fourth quarter of 2008 will cause the trailing four-quarter S&P earnings per share to be *down by more than 100%!*

Trailing four-quarter S&P 500 earnings per share will be *down by more than 100%* by the third quarter of 2009 from their peak in the second quarter of 2007.





Long-Term Price-To-Earnings Ratios Are Still Declining Sharply

The most widely used measure of under- and over-valuation of stocks is the price of stocks in relation to corporate profits, or the price-to-earnings (P/E) ratio. In our research into Supercycles, we demonstrated that the market P/E ratio is *highly cyclical*, rising to an extreme high by the end of Supercycle *Bull* Market Periods, then falling to an extreme low by the end of Supercycle *Bear* Market Periods, as investors' appetite for the risk of owning stocks waxes and wanes over time.

It was relatively straightforward, therefore, for us to forecast that P/E ratios would drop to a level of extreme *undervaluation* from the level of extreme *overvaluation* at the market high in March 2000, when the smoothed²⁴ market P/E ratio of the S&P 500 reached 33 – by far the greatest *overvaluation* in U.S. stock-market history.

²⁴ The stock-market P/E ratios in this chart are 50% exponentially smoothed, which is similar to a three-year moving average. Smoothed market P/E ratios have predictive value for stock prices that non-smoothed P/E ratios do not. In our P/E Predictor Study I, we demonstrated that 50% exponential smoothing is the optimal way to evaluate market P/E ratios to get the strongest forecast of stock-market performance, which turns out to be over the subsequent 10 to 20 years in Supercycle Bull and Bear Market Periods.

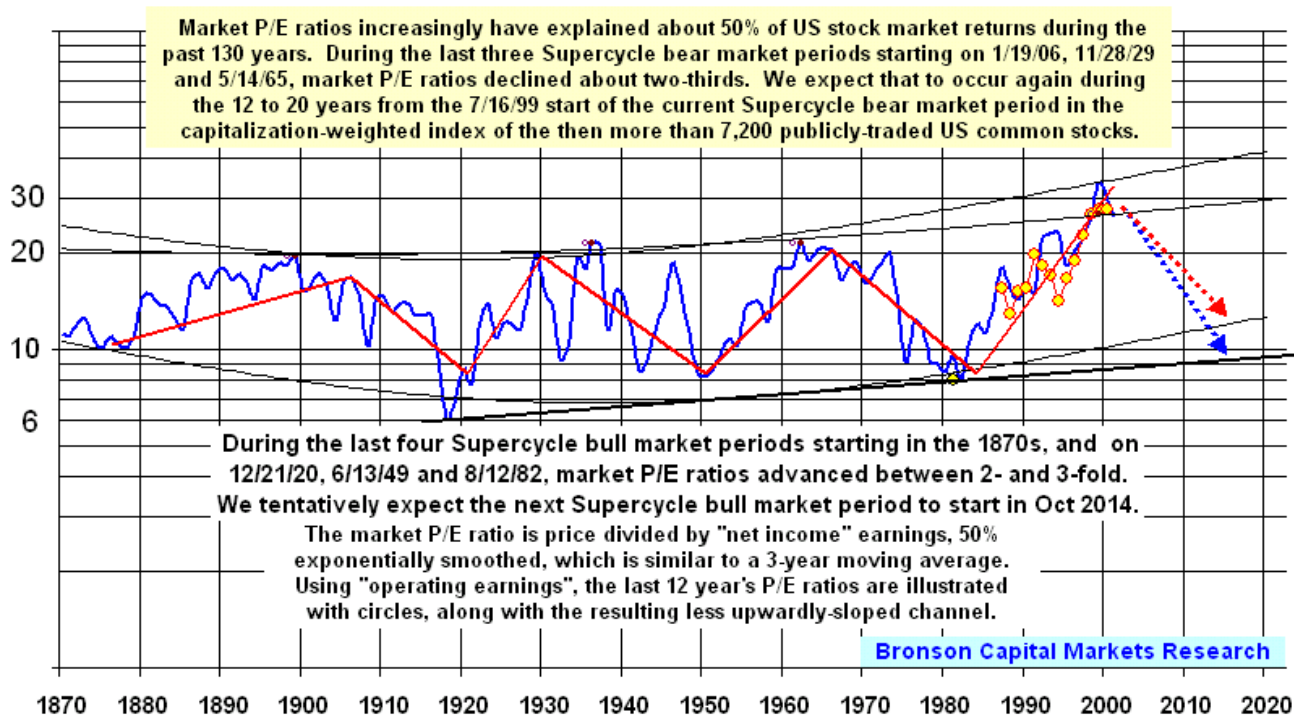
At the time of the market mania high, we wrote in our March 2000 commentary that overvalued stocks “do not return to normal levels on a smooth glide path by what is called ‘reversion to the mean.’ Instead, like a pendulum, valuations swing through the long-term mean to a level as proportionally undervalued as they were previously overvalued. We describe this as ‘reversion to the extreme.’”

Our long-standing forecast for P/E ratios, as found in our April 2001 commentary, has been “for P/E ratios to drop from record highs – a high of 33 for the S&P 500 – to *far below their long-term average of about 15* by the end of the current Supercycle Bear Market Period. For example, the P/E ratio for the S&P 500 at the end of the previous Supercycle bear market period was around 8.”

Our long-term chart of the channel in which properly smoothed P/E ratios have oscillated since 1870 first appeared in our November/December 2001 commentary, as reproduced again at the top of page 25. Note the blue dotted arrow pointing to an ultimate low for the (smoothed) stock-market P/E ratio of below 10.

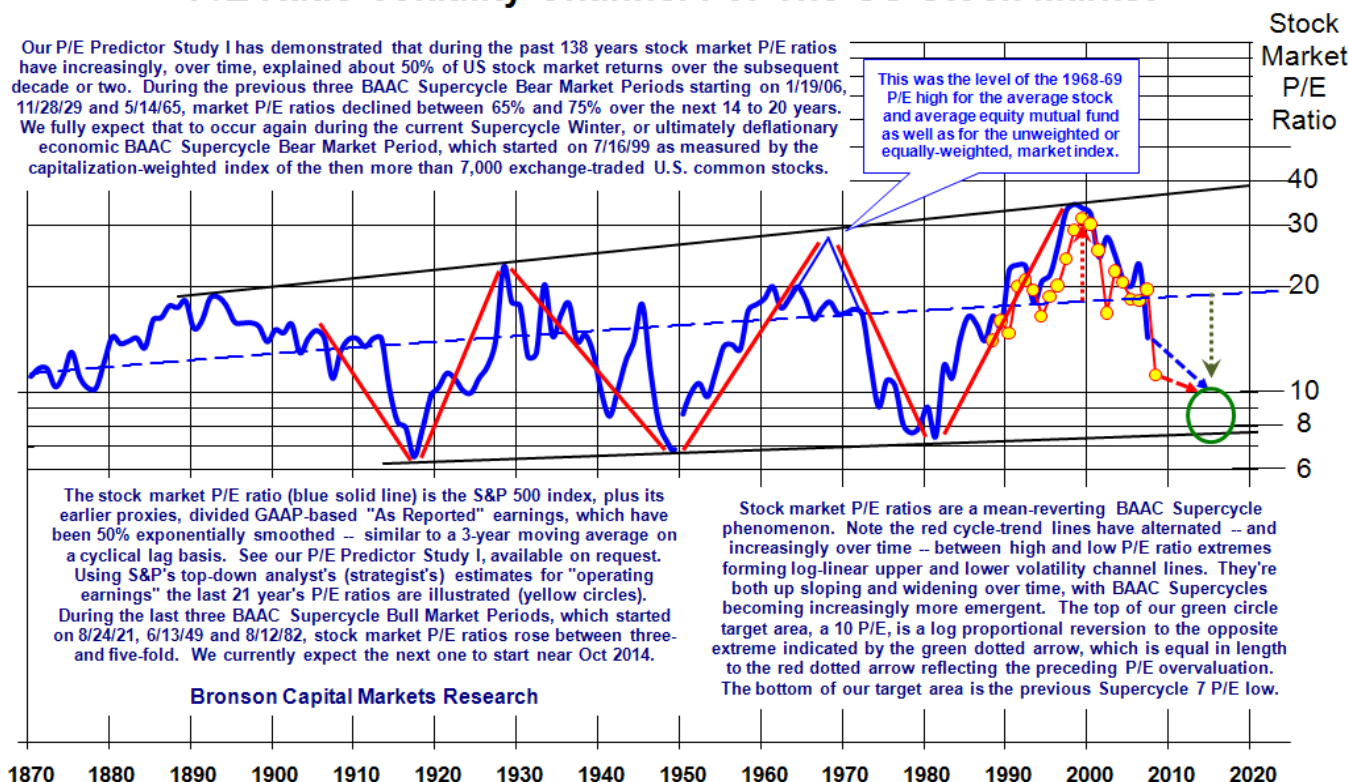
The market P/E ratio is highly cyclical, falling from an extreme high to an extreme low by the end of Supercycle Bear Market Periods.

US Stock Market P/E Ratio Volatility Channels



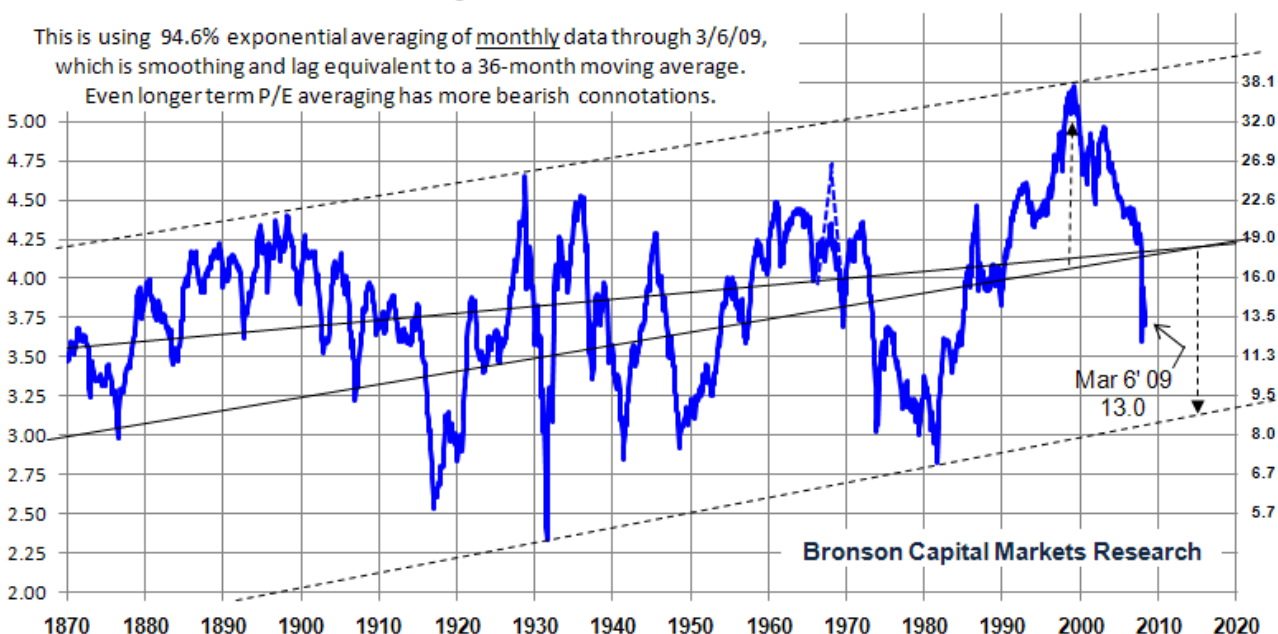
Now, compare these long-standing expectations with a current chart of the market P/E ratio below. The decline in the P/E ratio to extreme levels of undervaluation is well underway.

P/E Ratio Volatility Channel For The US Stock Market



The chart below shows more current, monthly data through March 2009. Notice that the market P/E ratio has already fallen well below its 139-year up trending average of 18 and has steepened its decline, well on its way to extreme levels of undervaluation and confirming our Supercycle forecast.

P/E Ratio Volatility Channel For The U.S. Stock Market



We have also pointed out frequently in our commentaries that while corporate earnings typically decelerate and eventually decline during the bear markets of Supercycle Bear Market Periods, *the devastating damage done to stock prices during the Period is due more to the collapse in P/E ratios than to lower corporate earnings.* The price of stocks (P) equals the price-to-earnings ratio (P/E) times earnings (E). With both P/E ratios and corporate earnings (E) still in sharp decline, the implications for stock prices (P) ahead is still quite negative.

The devastating damage done to stock prices during a Supercycle Bear Market Period is due more to the collapse in P/E ratios than to lower corporate earnings.

House Prices Continue To Decline Sharply, As Forecasted

Consistent with our long-standing expectation of a *deflationary trend* during the current Supercycle Bear Market Period, we have been forecasting what we have termed The Great American Home-Equity Bust since the summer of 2000 – long before housing analysts or economists had any thought of a housing bust. We were the first to warn that as home prices declined over a period of years, ultimately some *50% of American homeowners with mortgages would have their home equity completely wiped out* and would be upside-down on their mortgages (that is, owing more on the mortgage than the home is worth), creating an extraordinarily negative wealth effect²⁵ in the economy. And we stood virtually alone in expecting this to occur during a period of falling – not rising – interest rates. (See our further discussion below on pages 36-37.)

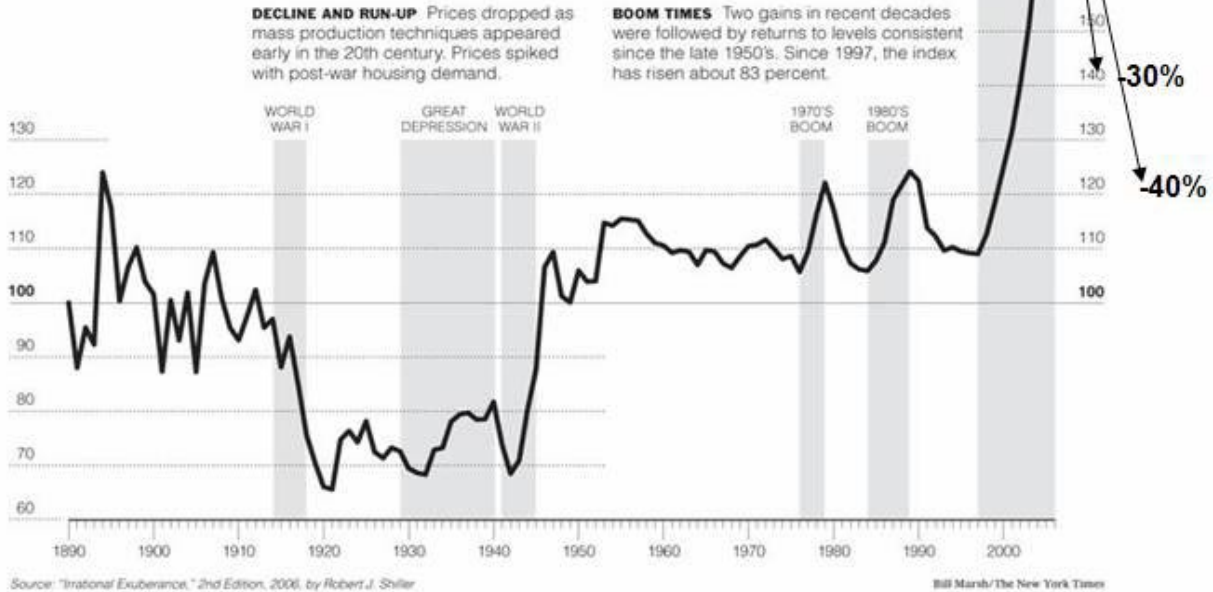
In our Summer 2006 commentary, we presented Yale economist Robert J. Shiller's chart of American home prices since 1890, adjusted for inflation (as reproduced here again below), which gave a long-term perspective to the recent housing bubble. To it, we added arrows to indicate our forecast of an ultimate decline in home prices of *at least* 20% to 40%, which would bring home prices back in line with more reasonable valuations.

²⁵ Negative wealth effect refers to the phenomenon of consumers spending less when they feel less wealthy – especially when the value of their stocks and/or real estate has declined significantly.

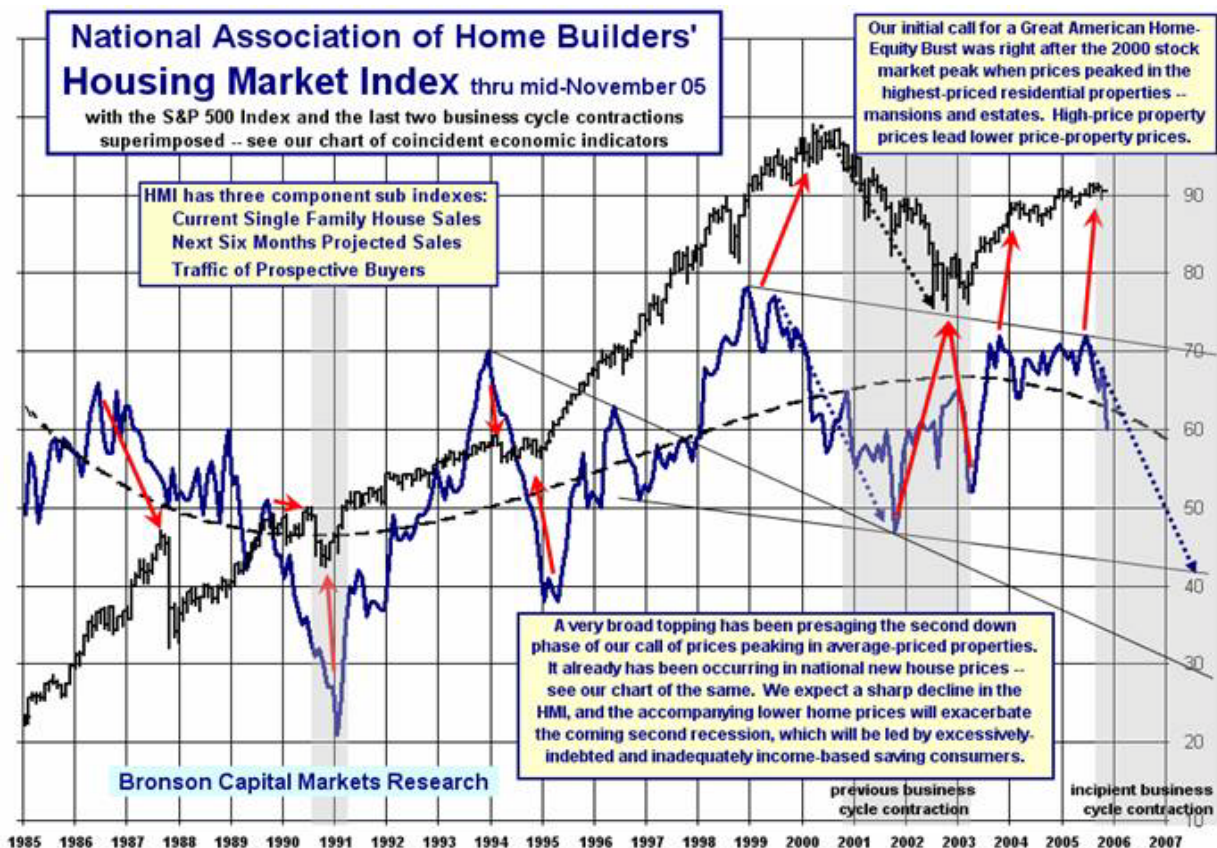
A History of Home Values

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

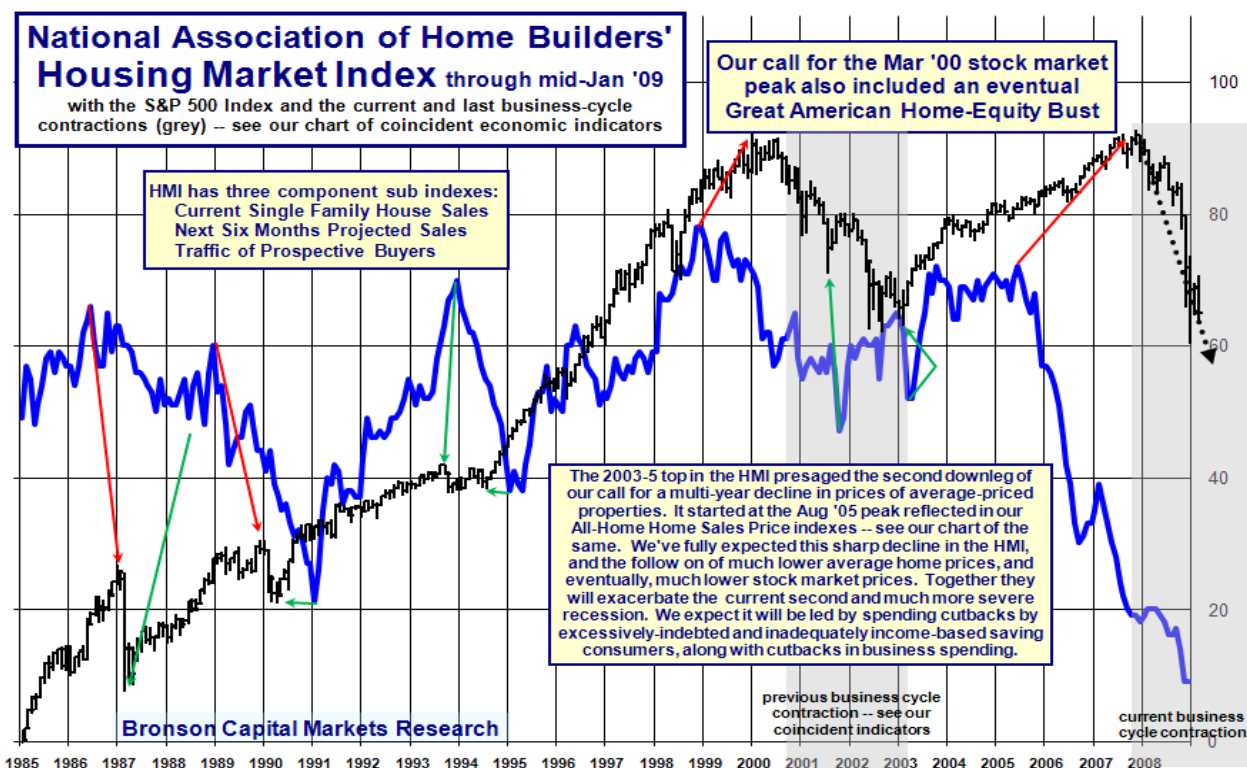
The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).



We also discussed in our November 2005 commentary the fact that homebuilders, who as “insiders” are a leading indicator for the overall housing industry, were becoming drastically more pessimistic, signaling *an impending plunge in home prices*. The chart below was our presentation at the time of the National Association of Home Builders’ (NAHB) housing market index (the blue line on the chart), along with our expectation that the index would plummet (the blue dotted arrow), with an ultimately devastating effect on the economy and stock market. Further, because the index has been *a very reliable leading indicator* for the stock market, we wrote that it also signaled *an upcoming steep decline* in the stock market (the black line in the chart).

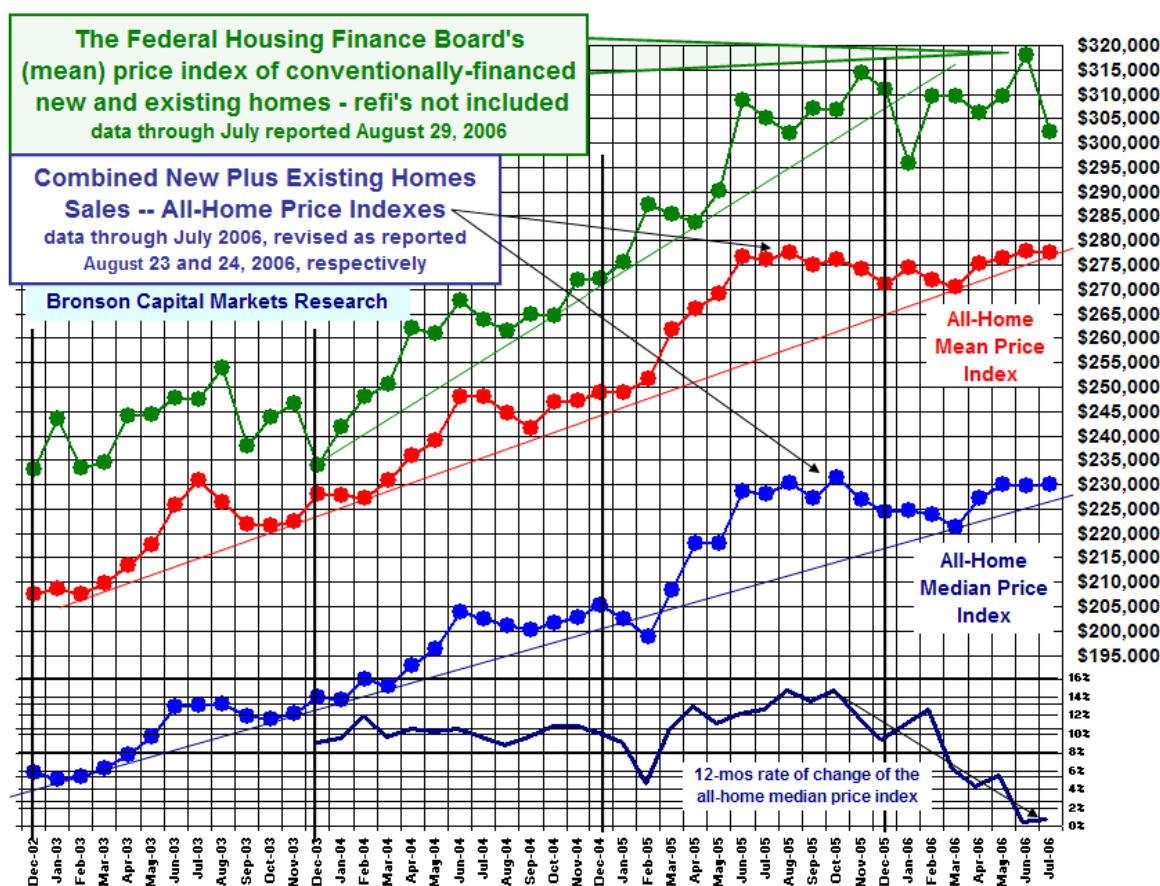


Comparing the chart above with the current chart of the NAHB data on the next page shows the accuracy of our forecast for both the housing market (the blue line) and the stock market (the black line).



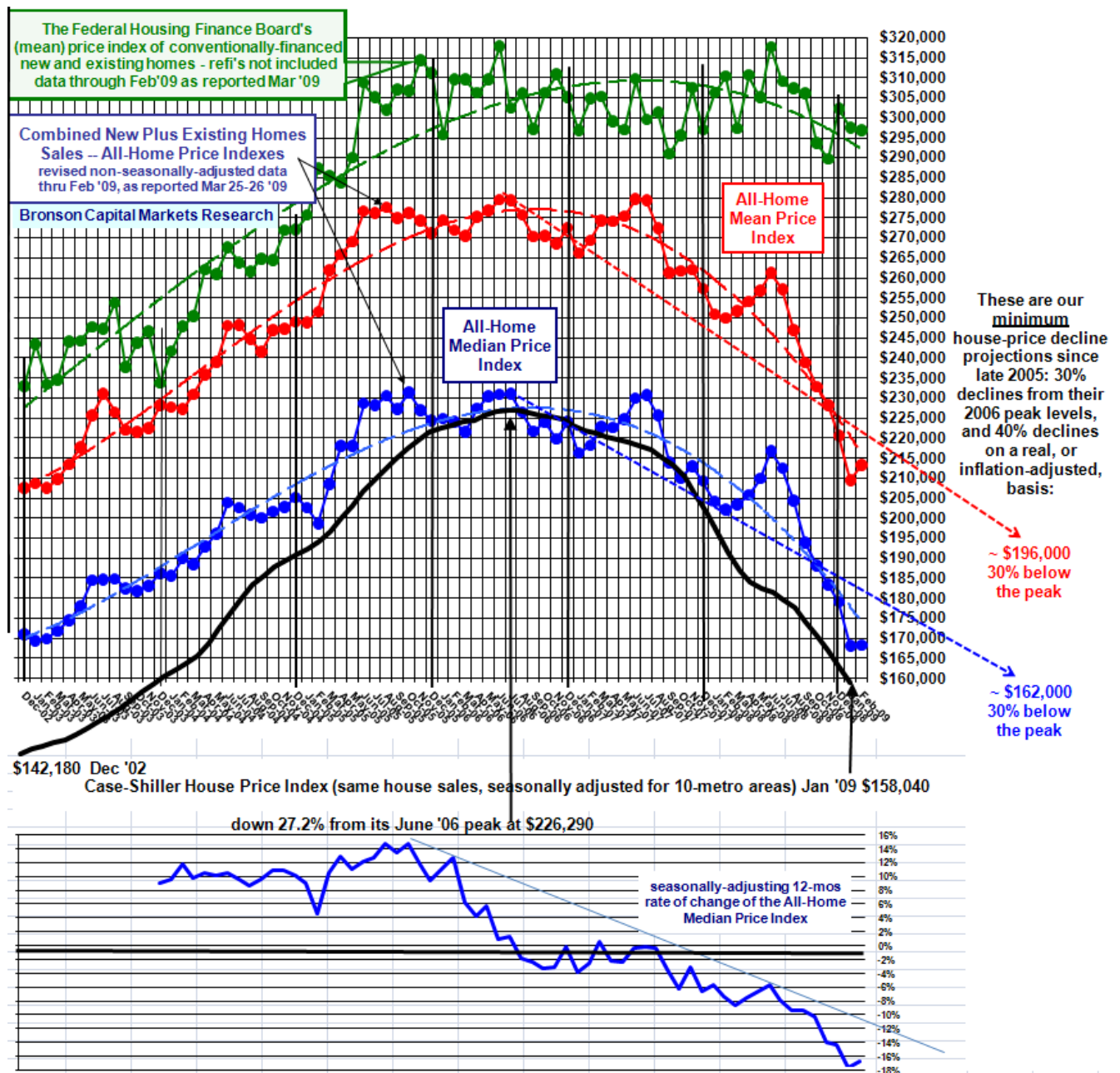
When we presented charts showing that the price of the median American home (new and existing) finally peaked in late 2005 and had started declining, the vast majority of economists and investment strategists were still in denial that there even was a housing bubble, believing instead that the housing sector of the economy would *continue to be strong and drive the economy*. In our view, a housing bust was underway.

By our Summer 2006 commentary, we had combined new and existing home sales prices into our own “all-home” price indexes, seen in the chart on the next page, showing that the median all-home price peaked in October 2005 (the bright blue dotted line) and that the growth rate of the median all-home price (the bright blue line in the bottom panel) had been plunging since then, suggesting that a much further, steeper decline in U.S. home prices was immediately ahead.



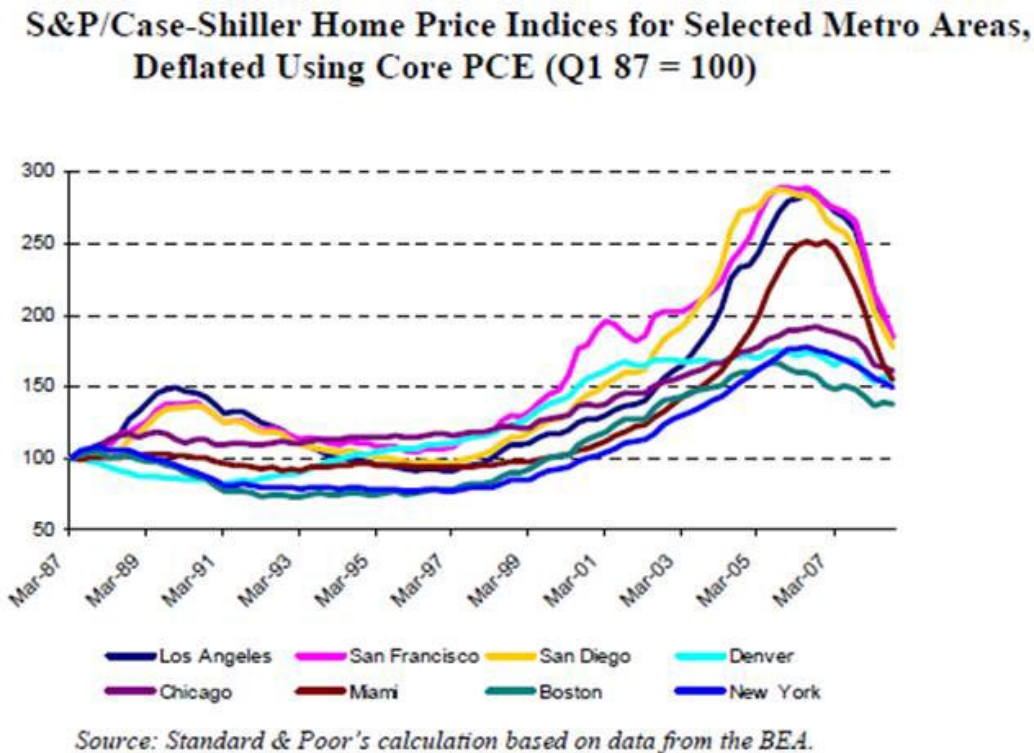
While the inevitability of a housing bust is perfectly clear with 20/20 hindsight, at the time we wrote this, the consensus among economists and investment strategists was that the decline in housing prices *had already bottomed and would recover in the second half of 2006*. Among the popular arguments used to support that view was the fact that the aggregate value of housing had not declined in any calendar year since the Great Depression, so it could not do so then.

As the current chart of the data on the next page shows, the consensus view was very wrong. *Home prices have already declined to our target range.* The bottom panel of the chart shows that the price of the median U.S. home has already *declined 27.2%* through February 2009. It has further been estimated that *more than 25%* of homeowners with mortgages currently owe more than their home is worth, which is well on the way to our forecast of 50%.



We expect a much further decline to come from the continuing downward pressure on prices from foreclosures, which are lowering comparable values for the whole neighborhood, and from inventory (both properties currently listed for sale and those that are pending) having to be cleared out before the bust is over.

Yale University economist Robert Shiller, a leading housing-market expert, concurs with our outlook on prices. In a recent interview, he noted that housing prices could not possibly be nearing a bottom because they are currently *accelerating to the downside*. The steepening decline in prices in several of his widely followed metro-area S&P/Case-Shiller home price indexes can be seen in the chart on the next page.



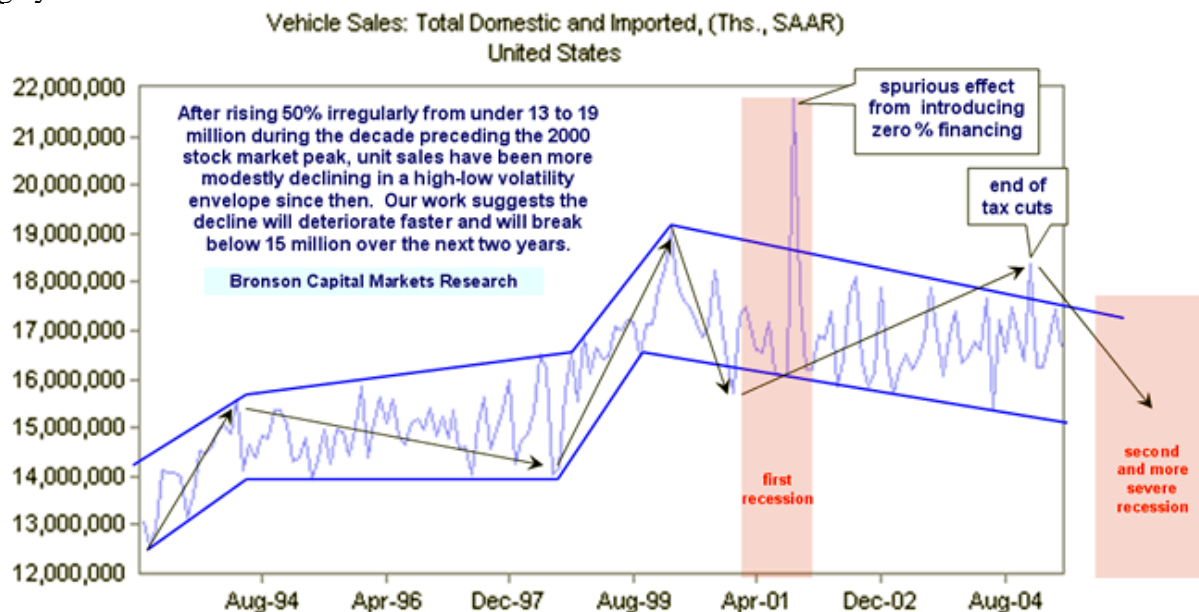
Auto Sales Gave Early Warning Of An Economic Calamity

Auto sales are the largest component of retail sales, which in turn is the largest component of consumer spending. Since World War II, the sales of autos, among the most expensive durable goods, have been a near-perfect barometer of economic activity, which is why we have been highlighting auto sales in our commentaries over the past several years.

In our May/June 2005 commentary, we presented the chart on the next page, with an arrow showing that we expected sales to decline significantly from the roughly 17,000,000 unit level at that time. Because *declining auto sales is one of the most reliable indicators of a recession* we also wrote: “Auto sales are signaling that consumer spending definitely is slowing, consistent with our view that the upcoming recession will be led primarily by overly-indebted consumers cutting back on their spending.”

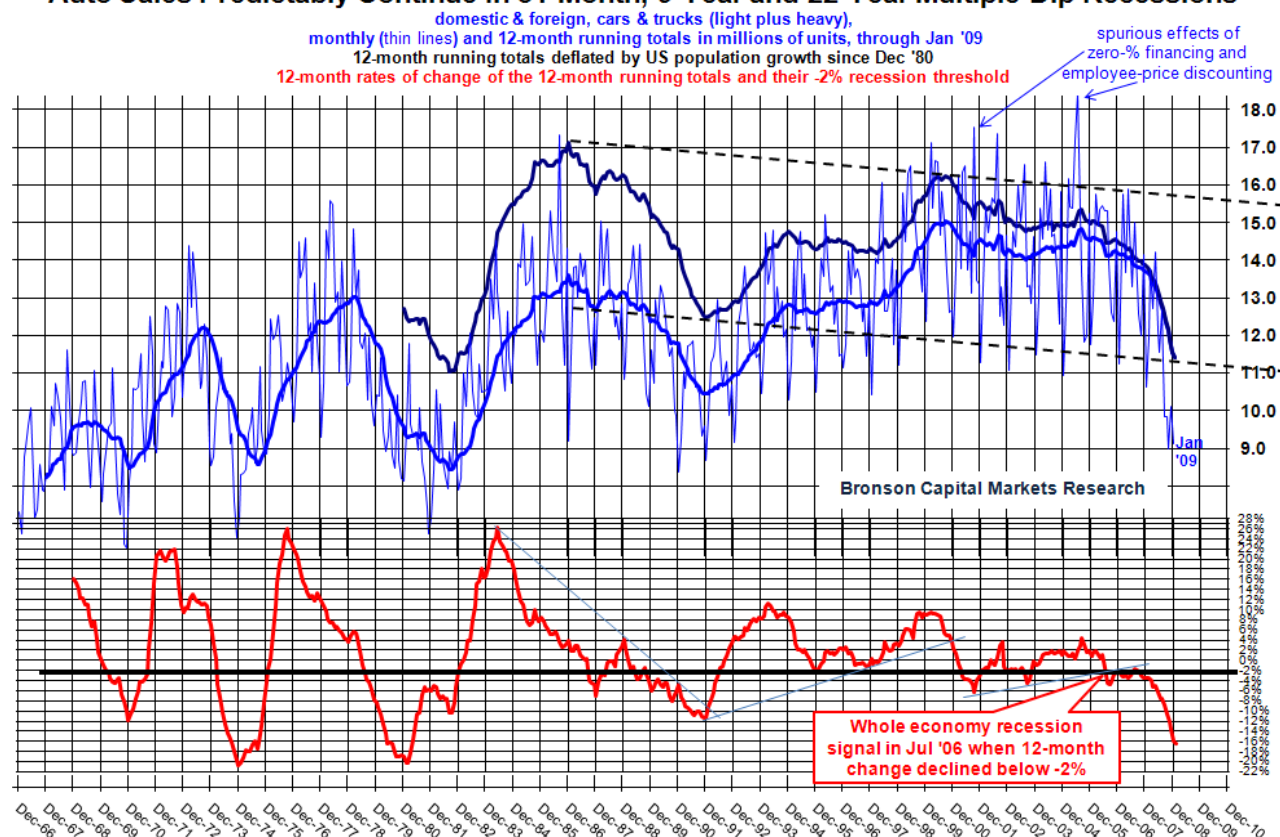
As we then noted in our Summer 2006 commentary, the -2% year-to-year growth rate reached at that time in dealer sales of new and used cars, parts, and service (adjusted for inflation) is the level that historically has signaled the U.S. economy is entering, or is already in, a recession, further supporting our expectations of recession.

Our forecasts have proven true. The chart of auto sales on the next page shows that monthly sales (the thin bright blue line) did drop from the roughly 17,000,000 units per year level at the time of our May/June 2005 commentary to around 9,000,000 units in January 2009. With the U.S. also having entered a recession, auto sales again proved to be a reliable early warning system.



Notice also that the rate of decline steepened sharply in the past year. This acceleration to the downside in sales suggests that the current decline in consumer spending and the current recession are *not* close to bottoming.

Auto Sales Predictably Continue In 31-Month, 9-Year and 22-Year Multiple-Dip Recessions



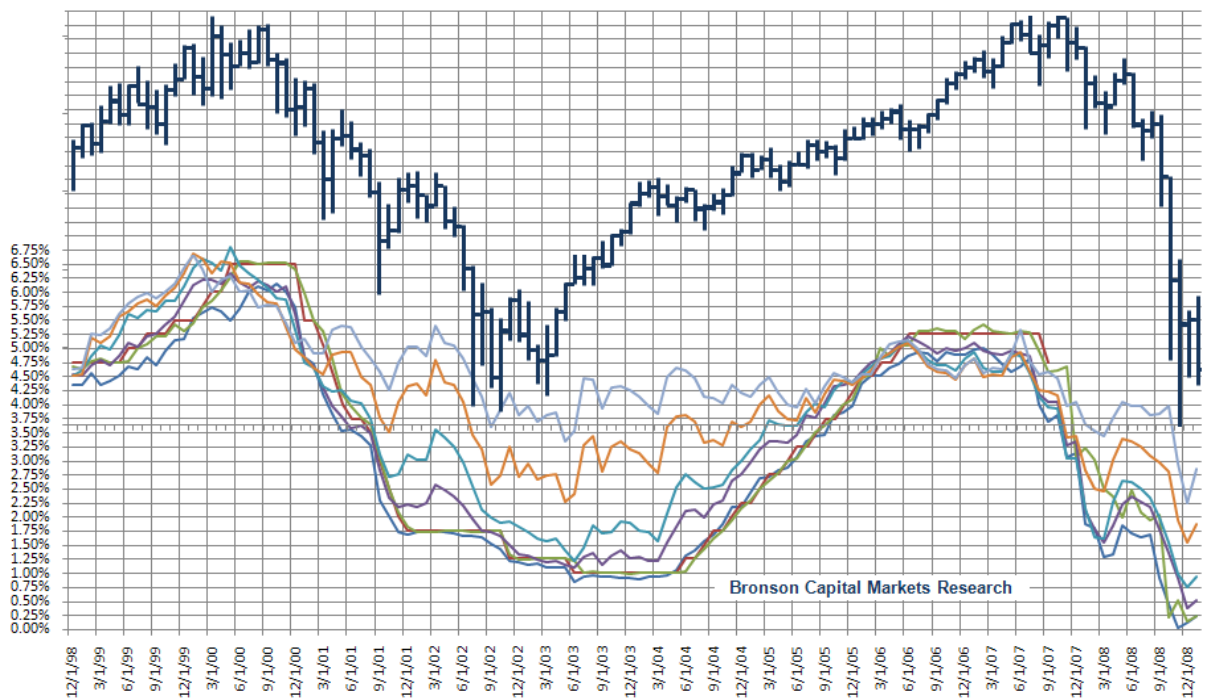
Our Forecast Of Sharply Lower Stock Prices Coupled With Drastically Lower Interest Rates Is Confirmed

Because lower interest rates are *generally* a stimulus for economic growth, and certainly were during the 1980s and 1990s, investors have erroneously come to believe that they *always* signal a stronger economy, higher corporate profits, and a rising stock market. However, in our landmark 1997 report, we wrote: “Low interest rates do not guarantee a stock market rise or prevent a decline. Interest rates lower than our current rates did not prevent bear markets in the 1930s, 1940s, 1950s and 1960s – and in particular, did not prevent the most devastating one in 1929-32.”

More recently, we discussed this point extensively in our October 2007 commentary, as the Federal Reserve Board was aggressively lowering interest rates. We wrote:

“The Fed’s recent, aggressive lowering of interest rates underscores the seriousness of the continuing weakness in the housing market and of the broadening of the incipient recession. It is also belated recognition that the banking system and credit markets are still under considerable strain from the ongoing defaults in the subprime and prime mortgage markets and from other related fallout. This alone should challenge investors’ belief that lower interest rates are always good for the stock market.”

We went on to explain: “As it happens, *during deflationary Supercycle Bear Market Periods, like the current one, interest rates and the stock market decline together overall – that is, they are positively correlated....*” Below is the chart presented at that time, now brought up to date, showing the close correlation during the current Supercycle Bear Market Period between the stock market (the dark blue line) and the long- and short-term U.S. Treasury rates plotted below it.



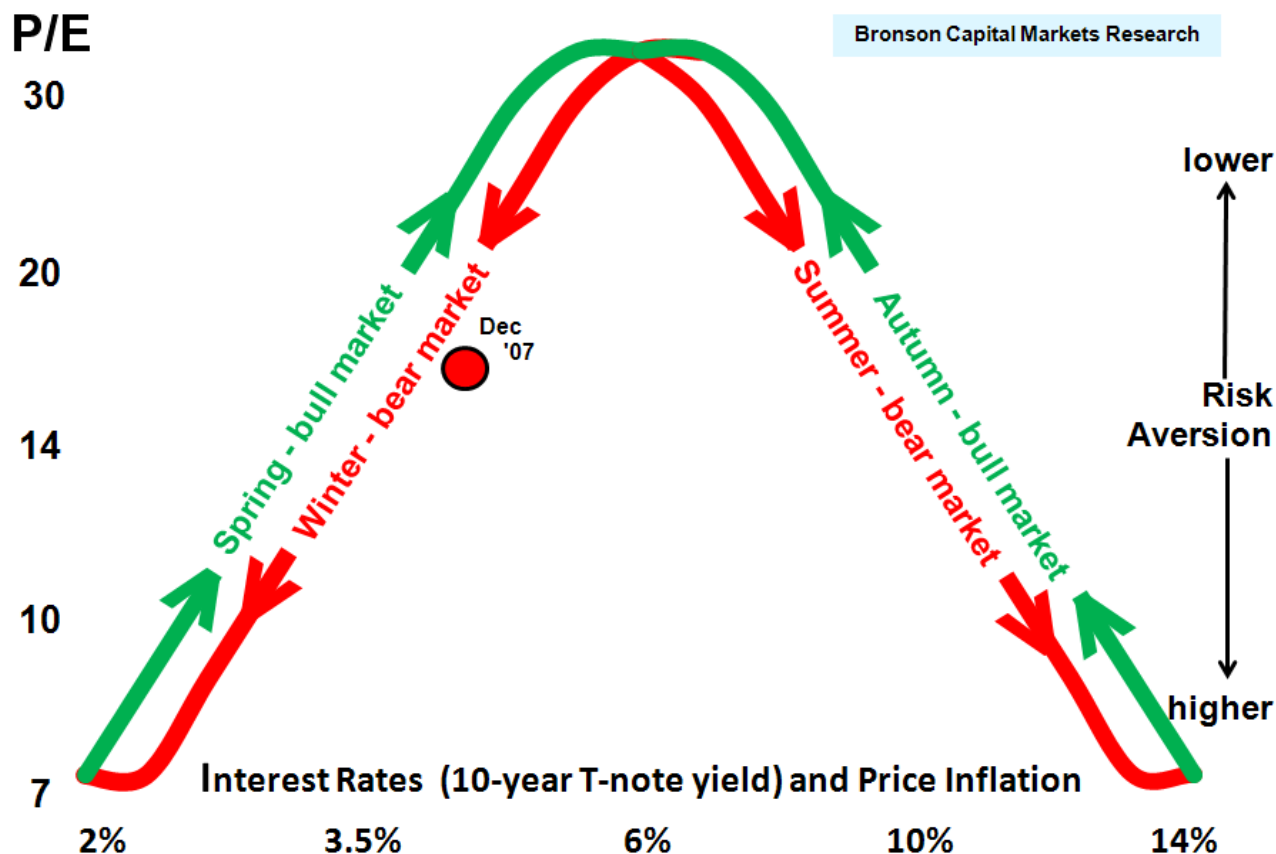
Finally, as we wrote in October 2007, which was the month in which the stock market peaked and began the current decline:

“Investors err when they believe that the relationship between interest rates and the stock market that existed during the previous Supercycle Bull Market Period [1982-2000] – that is, lower interest rates and higher stock prices (and P/Es)...will continue today. Just as the last investors into the stock market at the high in 2000 had the greatest losses, investors who jumped into the market in recent days, weeks, months, quarters, and even years will soon rue their decisions....”

In the 16 months since the chart above was first presented, interest rates have dropped significantly lower, while the stock market has already declined 58%, continuing to confirm the positive correlation between the two during a Supercycle Bear Market Period, as we correctly anticipated. And investors who continued to hold stocks *have* rued their decisions.

We developed the unique schematic and table below to explain the all-important relationships between the economic seasons of the Supercycles within Bronson Asset Allocation Cycles²⁶ and various fundamentals. Notice that falling interest rates -- that is, rising bond prices -- are *bearishly* correlated with the stock market's long term P/E ratio during ultimately deflationary economic Supercycle Winters, as is occurring currently. Very few investors (including professionals) understand that the stock market's long-term P/E ratio is *not positively correlated* with the net present value of cash flows (dividends and/or earnings) during Supercycle Winters and the Springs that follow, as is incorrectly taught in post-graduate college courses.

²⁶ A Bronson Asset Allocation Cycle (BAAC) is composed of one Supercycle Bull and one Supercycle Bear Market Period (defined in footnotes 1 and 3) in either order.



Supercycle Economic Seasons¹

<u>Fundamental</u>	<u>Spring</u>	<u>Summer</u>	<u>Autumn</u>	<u>Winter</u>
Economic Phase	reflationary	inflationary	disinflationary	deflationary
Recessions ²	less	more	less	more
Inflation and Interest Rates	rising	rising	falling	falling
Bond Market ³	bear	bear	bull	bull
Stock Market ³	bull	bear	bull	bear
Risk Aversion ⁴	decreasing	increasing	decreasing	increasing
P/E ratio ⁴	rising	falling	rising	falling
Bear markets ⁵	less	more	less	more

1. We have documented our discussions with others over many years who have used the terms K-Cycle, Kwave or Kondratieff Wave, with Season(s), and the like. Our decades long publishing record clearly establishes that we were the first to use these terms with Season(s), as well as the first to quantify them economically or otherwise fundamentally (Kondratieff and Schumpeter did not) or even technically. Most importantly, we were also the first to forecast their applicability to the secular period dating variously from the late 1990's through March 2000, depending on the metric under consideration. [As Forecasted – A 12-Year Retrospective](#) We more than welcome further inquiries.
2. The terms “more” and “less” refers to the combination of cyclical frequency and severity (duration times magnitude) – see SMECT: [A Forecasting Model That Integrates Multiple Business and Stock Market Cycles Since 1896](#)
3. The terms “bull” and “bear” refer to the over- and under-performance in Supercycle (secular) trends of excess total return compared to the risk-free return and other asset classes.
4. P/E ratio includes quantification of investor mood (animal spirits) – see our earnings-capitalization stock-market valuation model: [Quantifying and Forecasting an Equity Risk Factor](#)
5. See our quantification of the 33 most severe bear markets since 1895: Exhibit E in #2 above.

U.S. Dollar Continues To Decline Sharply From 2000, As Forecasted

We have written frequently in our Market Commentaries about our expectation of a long and substantial decline in the U.S. dollar. In July 2000, we wrote:

“The U.S. dollar reached its highest value against the value of its trading partners’ currencies in 1985. From that high, it declined more than 50% over the next 10 years to a low in April 1995..... We believe the five-year rally from that low, which retraced about 40% and now appears to be over, is an unsustainable rebound in an ongoing downtrend. While the dollar rallied sharply from 1995 into 1997, it has underperformed money market funds since then. We believe the dollar has peaked and is resuming its decline now.”

The chart below shows the accuracy of our 2000 forecast. The red arrow represents the linear best-fit line²⁷ of all the data since our forecast, which is consistent with our expectations.



²⁷ A best-fit line is the straight or curved line which gives the best approximation to a given set of data. Mathematically, it is the line that reduces the sum of the squared deviations of the actual data points from the line to the smallest amount.

In our July/August 2005 commentary, we detailed four key fundamental factors that we believe will continue to drive the dollar lower:

- the enormous U.S. trade deficit²⁸ and current account deficit,²⁹
- differentials in inflation-adjusted (real) interest rates,³⁰
- ongoing adjustments in purchasing power parity,³¹ and
- the rebalancing of central banks' portfolios to reduce their more than double over-ownership of the U.S. dollar relative to the United States' 30% share of global GDP (production).³²

In our opinion, these serious imbalances will continue to weigh on the exchange rate of the dollar for the foreseeable future. As these fundamental imbalances are corrected, the dollar can be expected to decline to substantially lower, all-time lows over the next several years.

The value of the dollar has become less certain in light of the huge budget and trade deficits that the U.S. has racked up in recent years, prompting foreign central bankers and monetary policymakers to consider changing the dollar as the only global reserve currency, a position it has held since the Bretton Woods Agreements were signed immediately following World War II. The success of the euro, which incorporated a number of currencies, is viewed as further impetus for the change.

Recently a U.N. panel has recommended the world replace the U.S. dollar as its reserve currency in favor of a basket of currencies. That is, instead of a single reserve currency, it would be a widely shared reserve currency. The European Union and China have indicated they would like their currencies, the euro and yuan respectively, to play a significant role in any basket of trading bloc-based currencies.

Meanwhile, Russia favors the creation of a new reserve currency to be issued by international financial institutions. Russia has already significantly reduced the share of the dollar in its reserves in recent years.

²⁸ The U.S. trade deficit is an economic form of debt owed to foreigners – the cumulative result of years of U.S. imports exceeding exports.

²⁹ The U.S. current account deficit is a measure of the excess of national spending over national income in the U.S. balance of payments, and is the broadest gauge of the nation's global trade.

³⁰ Higher real interest rates increase the demand for a currency because of the greater investment returns available. Notwithstanding the Federal Reserve Board's hikes in short-term rates, we believe that U.S. long-term interest rates will remain relatively low for years to come for various reasons.

³¹ Purchasing power parity (PPP) refers to the cost equivalency of goods and services between nations and their currencies. It is the single most important long-term factor in determining the relative exchange value of currencies, but it usually only comes into play when trade imbalances are being corrected, like now. Globalization has led to the offshoring of jobs by U.S. corporations seeking to stay competitive by employing cheaper foreign labor. This puts downward pressure on the exchange value of the U.S. dollar, the currency in which U.S. workers are paid, thus narrowing the huge differential in global wages. The labor PPP between high-cost American labor and low-cost Asian labor will take many years to fully adjust – that is, to find a stable differential, or equilibrium between them.

³² We believe that central banks rebalancing their portfolios will de-emphasize the dollar in favor of the euro, the Japanese yen, the Chinese yuan, emerging pan-Asian currencies, and even gold. Central banks are all the more likely to include the Chinese yuan in their portfolios, now that China has agreed to float their currency and likely will eventually establish parity with the Hong Kong dollar. We fully expect the rebalancing of central banks' portfolios ultimately to usher in a new global currency regime, effectively a Bretton Woods III, in which the U.S. eventually and formally recognizes the marketplace's substantial devaluation of the dollar as the reserve currency of the world.

These preliminary discussions are consistent with our view of a *significantly lower dollar*, which still remains in a long-term downtrend despite a rally in recent months that is likely over now, as seen in the chart on page 37. Those following our advice are well-positioned to continue to profit from this decline.

Bronson Capital Markets Research

May 8, 2009 SPX 929

Bob Bronson Wins A 10-Year Bet With The Author of *Dow 36,000*

From the late 1990s through the stock-market high in March 2000, Wall Street inundated investors with bullishly-biased half-truths about the economy and stock market to give them a rationale for continuing to buy and hold overpriced stocks.

Among the now-debunked nonsense circulating at the time was the notion that there was *no longer any risk in owning stocks* over bonds – no “risk premium” – because stocks had always outperformed bonds over periods of 10 to 15 years. So if investors were buying and holding stocks for 10 to 15 years or longer, the stock market could rise *indefinitely*.

This notion was immortalized in a popular book of the time, entitled *Dow 36,000*, which ironically was published in late 1999 just before the dot.com bust and severe stock-market plunge that the authors argued would never happen again. The book got worldwide attention and was discussed seriously in financial and academic circles and on the front page of *The Wall Street Journal*.

Prior to the book’s publication, Bob Bronson contacted the lead co-author, economist Kevin Hassett, director of economic policy studies at the American Enterprise Institute, to get a copy of his manuscript, which Hassett provided. After Bob read it, critiqued it, and discussed it with Hassett (and other economists, including Yale University economics professor Robert Shiller, best known at the time for having coined the phrase “irrational exuberance”), Bronson and Hassett made a wager.

Hassett was only willing to bet that the stock market would grow at least 7% on average for the next 10 years – not that it would reach his Dow 36,000 target. Bob took the position that the risk premium had *not* permanently gone to zero, that it was *highly cyclical* over multiple time horizons, that *its cyclicality is more important than earnings or the price-to-earnings (P/E) ratio in forecasting future stock-market performance*, and that based on this knowledge, Bob was forecasting a 12- to 20-year period of essentially *no net gain and heightened volatility* in the stock market that he calls a Supercycle Bear Market Period (or half a Bronson Asset Allocation Cycle^[1]).

The 10 years was up on April 2, and since over the ten years the S&P 500 Index declined 36%, or at an annual compounded rate of more than 4%, Bob has collected on the bet. Hassett sent him a bottle of one of the country’s finest reserve wines, the Caymus Special Select Cabernet Sauvignon. And Hassett says he wants to stay in closer contact with Bronson.

^[1] A Bronson Asset Allocation Cycle (BAAC) is composed of a Supercycle Bull and a Supercycle Bear Market Period.