Year End 2009 Commentary
January 29, 2010

Dear Clients and Friends,

In this commentary I summarize some of my thoughts with regard to the current condition of the stock market and the market for long-dated U.S. Treasury bonds. I hope you find my comments informative.

Bull Market Scorecard. Thirteen months ago, my fourth quarter 2008 commentary noted the following: "The bear market that began in October 2007 accelerated in intensity during the 3rd and 4th quarters of 2008. The declines of October and early November 2008 indicate the degree of intensity typically found during mature stages of bear markets. My own personal opinion is that the bear cycle is in the process of reaching its full maturity."

As it turned out, in the face of possible economic Armageddon and the complete destruction of the capitalist system as we knew it, the stock market made a major bottom on March 9, 2009, and rallied for the balance of 2009. Who would have thunk it? Economic catastrophe delayed until another day! So while I entitled the section of my January 3 2009 narrative "Bear Market Scorecard" and included a detailed discussion and analysis of the bear market that was in the process of winding up, we are now on the flipside of that discussion; hence the title above - "Bull Market Scorecard". So what has happened, and what is to be expected in 2010? See my comments below.

TECHNICAL, SENTIMENT AND TIMING CHARACTERISTICS OF TYPICAL BULL MARKETS/ CURRENT STATUS

Bull or Bear. A new bull market began on March 9, 2009.

Duration. Bull markets last, on average, 2–4 years. With the current bull market being 11 months old, it can be said that the bull move is still in its early stages. If the bull market were a human being with a life expectancy of 80 years, I would estimate that it is now about 30-35 years old.

Psychological Phases. Bull markets, like bear markets, can be divided into three psychological phases; the first phase being characterized by a high level of skepticism and disbelief by many market participants, both professional and non-professional investors alike.

Current Status. We are still in the late stages of psychological phase I and, as of the date of this writing, the level of disbelief is still high, but the movement to phase II is near.

Transition to Bull Phase II. This phase will introduce widespread *belief* in the rally, thereby signaling the progression of the bull move into phase II. The new found belief can be justified as economic conditions visibly improve. As an example I note the release of a strong GDP report (increase of 5.7% of GDP), an example of the type of report that could serve to increase confidence.

Phase II Decline. Psychological phase II should contain a substantial market decline that will convince many that the old bear market has returned. In reality, the decline is simply a case of the smart trader taking profits accumulated during the early stages of the bull market, as late-comers to the bull market take stock off their hands at elevated prices. The magnitude of the mid-bull market correction should fall within the range of 10-20% down in major market averages. One key observation here is that the phase II decline may provide the investor with a rough guidepost as to the ultimate length of the entire bull market from a timing standpoint. The end of the phase II decline might occur approximately midway through the entire bull market.

Initial Public Offerings. During the last months of the prior bear market I had noted that initial public offerings (IPOs) had completely vanished, symptomatic of late bear market behavior. IPOs have now begun to return to the marketplace. At some point, when IPOs become the central topic of conversation at cocktail parties, one should be on the lookout for an impending bull market top. We are not yet close to that point in time.

Market Internals. With a market correction in process during the 2nd half of January 2010, the advance-decline line (for operating companies only) has fallen from its peak in mid-January down below September 2009 levels. The relative severity of this decline, so far exhibiting higher intensity than prior minor corrections since March 9 2009, is possible evidence that the current decline could turn out to be the mid-bull market correction referenced above. The decline, if it should continue for any length of time, may carry the advance-decline line to a low enough level that will make it difficult to do more than recover that loss throughout the balance of the entire bull market.

Market Vitality. As the bull market advances, the move becomes less dynamic as time progresses. I think the comparison to the human life progression has validity. In the early months, the market advance was quite dynamic, defined as broad participation in virtually all market sectors, perhaps comparable to the sprinting ability of a teenager. Now, if the market has aged to the comparative age of a thirty-five year-old, the sprinting ability is still there, but imperceptibly declining. Perhaps the human experiences his first significant health issue in his 40s, just as the bull narket undergoes its first significant setback. But there is recovery from that point that sets up the balance of the bull market, just as in life.

Projected Angle of Ascent. If the experience of the March 2003 to October 2007 bull market is any guide, it could be that more than ½ of the total bull market gain, as measured by advances in major market indices, has already been seen. In March 2003, the stock market was deeply oversold following the severe 2000-2003 bear market. As a result, conditions in March 2003 were ripe for a new bull market, similar to conditions present in March 2009. And so, the market went on a tear for the balance of 2003 by gaining approximately 50%, slightly less than the percentage gains of 2009. From the close of 2003, through the bull market top in October 2007, the market managed to gain an additional 35% over a 3 3/4 year time period. While recognizing that history will not repeat in an exact way, I would at least conclude that the percentage rate of gains in major market averages experienced in 2009 will undoubtedly taper off.

Fundamental Backdrop. For the bull market to continue, it is necessary that economic conditions continue to improve. In the final analysis it is the earning and dividend-paying capacity of publicly traded companies that determine the value of the stock market taken as a whole. And it does appear that business conditions are improving from the almost unthinkably poor conditions that existed in the winter of 2008/09. The investor should maintain an open mind with regard to this subject, and be alert to the potential for reversals in business conditions.

Annual Pranks. I am a lucky man. I realize that. Every year I look forward to the annual prank played on me by my wife, Barb, and her partner-in-crime, Joyce. Every Thanksgiving vacation they play a trick on me at our favorite restaurant in downtown Naples, Pazzo's. I thought they would have trouble topping the pranks of the past two years – the 'Sandra Bullock look-alike' prank and the surprise that revolved around artificial enhancements of man's favorite female body part, 'nuff said. But I SO underestimated them! With the aid of a team of technical consultants (my friends) here in Columbus and advance preparations made with a Pazzo's barmaid, I was presented with fully framed photos of me and a couple of my old buddies – Ben Hogan and me strolling down the fairway at the 1946 US Open and Ted Williams and me at the 1948 All-Star game. I'm not sure how they are going to top that one, but I'm sure looking forward to Thanksgiving 2010 down in Naples.

Progress Report on US Treasury Securities. A new bear market in U.S. Treasuries began in early 2009 as the yield on the 30-year Treasury bond hit an all-time low of 2.5% in late 2008 and has since climbed by more than 2%. The math of the government's finances just doesn't add up in favor of U.S. Treasury securities. With U.S. budget deficits out of control (annual deficit estimates of more than a trillion dollars for as far as the eye can see), and mammoth deficits projected for most major developed countries of the world, the competition among governments to fund these deficits is intense, and promises to even further intensify in the years ahead. The solution is simple – spend less and raise more revenues. I do not think our government has the willpower to spend less, that's for sure. Nor do they have the willpower to raise revenues to any significant degree as this would prove to be too unpopular. So it is a problem without a practical solution. The result will be substantially higher rates for U.S. Treasury securities and commensurate decline in the value of those securities. I think we will see rates on long-dated U.S. Treasury bonds rising well into double digits before the bear market in bonds is over.

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Wishing you a happy and prosperous New Year!
John Hegler

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