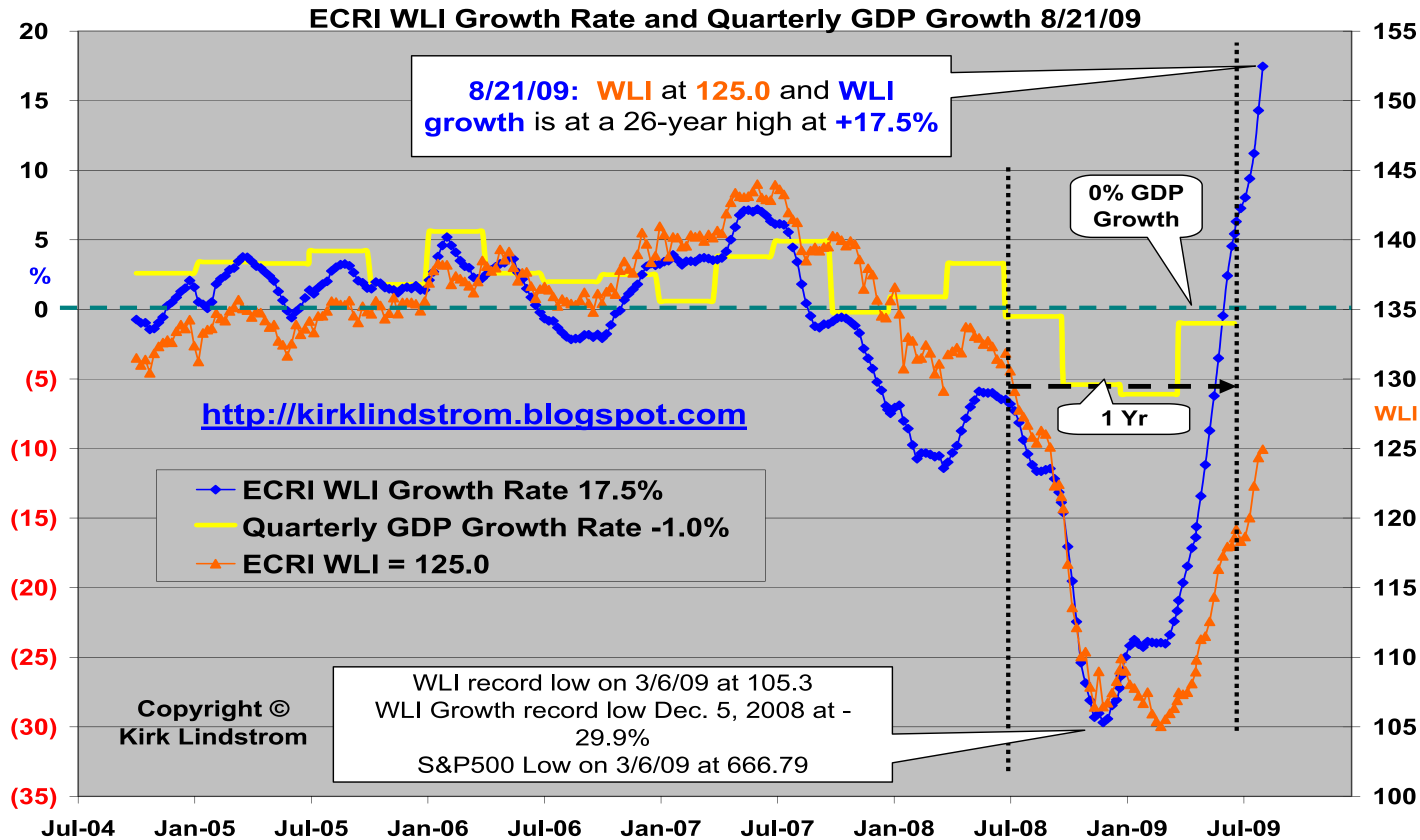
8/21/09: ECRI's[4] Weekly Leading Index (WLI) update: (From http://www.businesscycle.com with permission).

The index's annualized growth rate reached 17.5%, the highest yearly growth rate since the week to July 29, 1983, when it was 17.8%. Lakshman Achuthan, managing director at ECR said that he "expects the recovery to take hold at a stronger pace than any the U.S. has seen since the early 1980s." http://www.businesscycle.com/news/press/1540/



8/24/09: ECRI's U.S. Future Inflation Gauge (FIG) is at 7-month high!: (From August 7, 2009 Press Release)

- "The index has now risen from a 51-year low in March to a seven month high, due to "somewhat pronounced, pervasive and persistent advances in the USFIG and its components,," said Lakshman Achuthan, managing director at ECRI.
- "The implication, if the FIG keeps rising, is that the Fed's exit strategy (raise rates) may come into play sooner rather than later."

8/24/09 Inflation: The Consumer Price Index (CPI) for All Urban Consumers (CPI-U) decreased 0.2% in July, before seasonal adjustment. **The index is down 2.1% (Deflation!) from last year.** CPI-U peaked in August 2008 at 5.4% over August 2007. Getting low (or zero) returns in CDs, Treasuries, TIPS and iBonds are not so bad when real inflation is a negative number but I bet this is at or near a cyclical low and we'll soon start to see signs of inflation. If you wanted to buy TIPS or their funds, now is probably a great time.

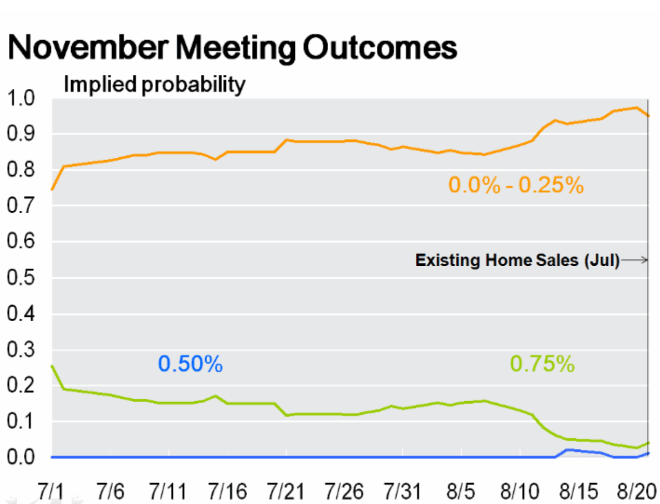


Chart courtesy of Federal Reserve Bank of Cleveland

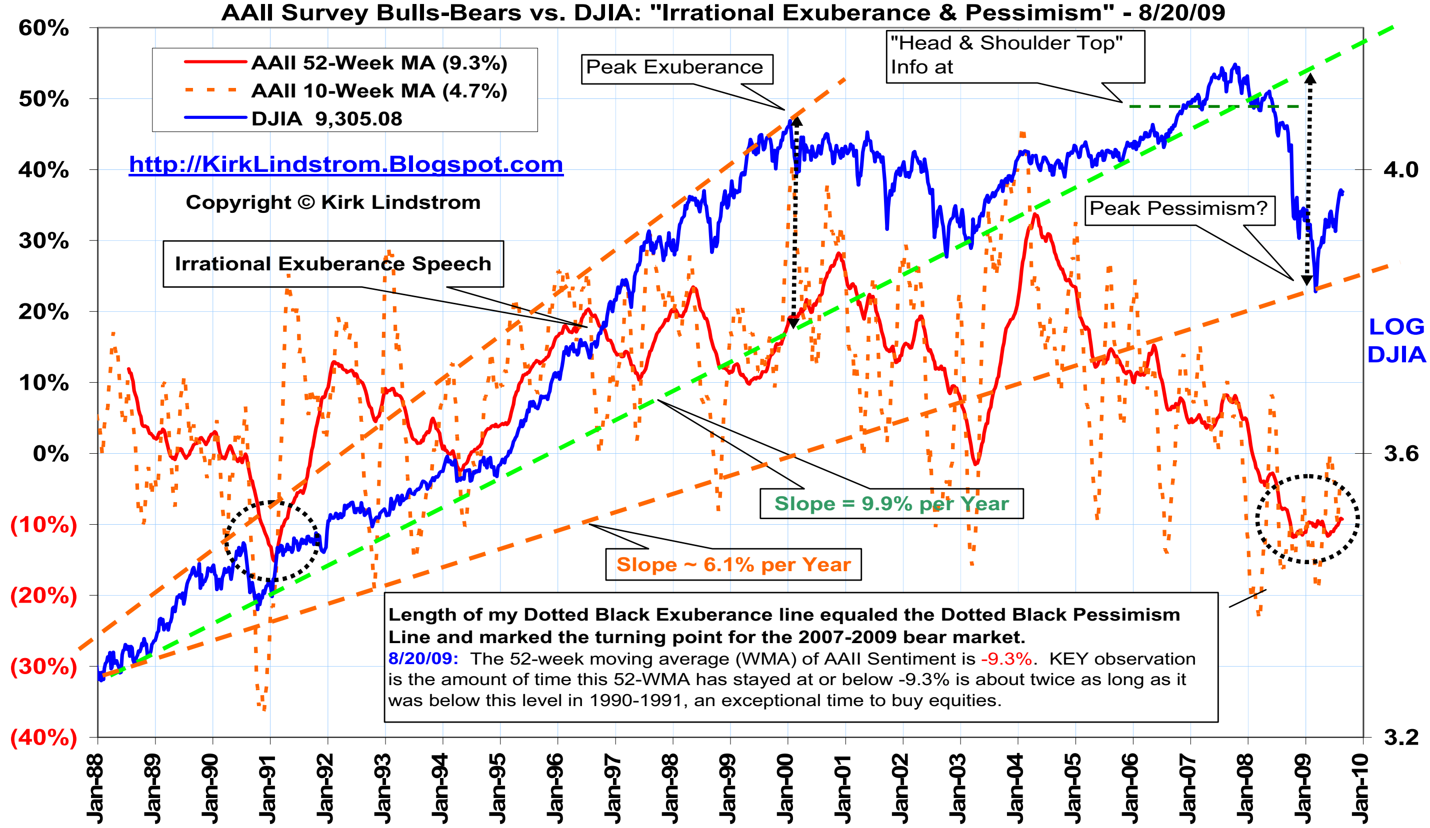
The Federal Reserve open market committee (FOMC) left rates unchanged at 0 to 0.25% after their August 11-12meeting. They said, "Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability. The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time."

The FOMC next meets Sept. 22-23. The odds are about 99% that they keep rates at 0.0% to 0.25 in Sept. with about a 5% chance they will start to raise rates by 0.25% to 0.50% at their November 22-23 meeting.

ECRI's FIG turned up strongly (higher commodity prices, etc) but it is still very negative. A dangerous deflationary economic spiral into an abyss is off the table now as we wait for the economy to recover and a healthy, moderate rate of inflation to resume.

[4] ECRI stands for Economic Cycle Research Institute. News Releases at http://www.businesscycle.com/news/

8/20/09 Sentiment Update: Remember, typically I do not "approve" of trying to time the markets except for a very small part of our explore portfolio in an attempt to get better prices when asset allocation already says to buy or sell. This could change at an extreme.



I first posted this chart showing peak pessimism reached the same level of peak exuberance in my March 19, 2009 newsletter, just 10 days after the market bottomed. For new subscribers, this is some of what I wrote:

> The AAII chart above shows a dashed green line for a 9.9% annual return since Jan 1988. This line was the "support level" for the DJIA until early 2008, about 20 years. I show two dotted black lines with arrows marking distance from this green line as "peak exuberance" and "peak pessimism." I point that out to show that, when measured as distance from a long-term return of about 10%, the low set about a week ago was about as pessimistic at the low before the rally as it was overly optimistic at the top in 2000. If the market was a rubber band, this would be the perfect "snap-back" level to return to trend of about 10% a year.
>
> I also show "Head and Shoulder Top" that I posted on this chart over a year ago as a personal reminder to remain cautious. It clearly was a top and the market exceeded the "minimum target" of about DJIA 9,000. .
>
> Finally, back in 1988 you could buy a 30-yr Treasury Bond that paid about 8% a year interest so the DJIA has under performed it by about 2% a year for the last 20 years, a very, very rare occurrence. **Regression to the mean plus pessimism greater than peak optimism suggests we are due for a very large rally** after investors realize Treasury bills paying a few percent at best will not keep up with inflation.

It took the DOW about 3 years to fall from peak exuberance to the green trend line. It could easily take just as long to reach that line again but from a point of peak pessimism. We could easily remain in a secular bear market where we do not make a new high for years, but I believe there is significant money to be made as the market recovers to trend from the trillions of dollars on the sidelines returning to the markets. Note that the last three bear markets began (1998, 2000 & 2007) just after new highs for the 52-wk moving average (WMA) of AAII. People as a whole are so bearish now that I'd not be surprised if the markets rally to undo most of their declines in a year or two. We COULD get a "higher high" for the 52-WMA just before the markets enter another major bear market.

Market Timing Disclaimer: No sentiment indicator, or any indicator for that matter, is 100% reliable. I look at sentiment as head winds and tail winds. When sentiment is terrible, then it acts like a tail wind for your returns where you could see further declines, **but long term, it is best to be buying when most others are selling**. Likewise, if we see sentiment get too bullish, then I would consider lowering my portfolio asset allocation. **It seldom pays to be buying stocks when EVERYONE is talking about stocks and how much money they are making at cocktail parties**.

In addition, I am not market timing but for a small portion of my explore portfolio. **I use market-timing indicators to tell me it is a good time to buy so I can add to positions when the market is down and thus help me overcome my fear to rebalance back to my target asset allocation**. Likewise, when the market-timing indicators are saying to sell, they usually come when the markets are high where I want to be taking profits. **The market timing indicators at market highs help me get over my greed and take profits**. Now and then, I may make an asset allocation adjustment based on the Fed Model saying the market is over or under valued. Some call that market timing, but I have stayed pretty close to 70:30 equities-fixed for many years despite the Fed model.

Effects of Inflation on Buying Power: How Inflation Erodes the Purchasing Power of $100

Annual Inflation Rate	2%	3%	4%
After 10 Years	$82	$74	$66
After 20 Years	$67	$54	$44
After 30 Years	$55	$40	$29

Modern Portfolio Theory (MPT) and Monte Carlo simulation indicates that a balanced portfolio with 50% in equities and 50% in US Treasuries should allow a 4% takeout a year for 30 years with a 98% chance of not outliving your money. A portfolio 100% in fixed income might be enough to live on today, but in 30 years of three percent inflation, it could have 40% of its buying power.

A 50:50 "balanced portfolio" should give you nearly all your retirement income from dividends and interest while net asset value gains of the stock market half, when rebalanced once a year, give you inflation protection.

For example, consider $100,000 today invested in GNMA funds paying about 5% a year. That gives you $5,000 a year to live on per $100,000 invested. If you need $50,000 a year to live on you would need $1,000,000 in GNMAs in today's dollars. In 30 years of 3% average inflation, that $50,000 could lose 60% of its buying power and leave you with the equivalent of only $20,000 in today's dollars!

I tend to like "120% in the market less your age" as a maximum allocation to equities. The equities are there for inflation protection so any money in TIPS or IBonds can further reduce this. For example, someone 70 years old could be 30% equities, 10% TIPS, 10% IBonds and 50% Total Bond (or GNMA) and have a wonderful portfolio as far as I am concerned. If you want to put 6% into my newsletter Explore Portfolio to try and increase your return, then you could be 28% equities (in my core index funds), 9% TIPS, 9% I Bonds, 48% Total Bond and 6% in my explore portfolio (which has some overlap in all the categories which is why I took a bit out of each.)

Long term, most but the biggest bears expect economies to grow so seldom is it wise to deviate from the above asset allocation. If you were able to accurately forecast a recession or depression well in advance, then moving some or all of a portfolio to fixed income ahead of time would make great sense, especially if you could get back into equities at a lower level.

The only reason I would deviate from your target asset allocation is if the Fed Model says the market is over valued as it did in 1999 and 2000. In 1998, my newsletter portfolio was 100% in equities. By January 2000 my portfolio was 17% in fixed income with 6% in a strip zero fund to give it "bond leverage." The strips did well and my overall portfolio only lost about 10% combined in 2000 and 2001, 12% better than the market. At the start of 2002 when the NASDAQ lost 38%, I had my portfolio about 30% fixed income and limited my losses to about what the S&P500 lost while the NASDAQ lost 38%. Then, as the market bottomed and valuations looked good, I added beta to my portfolio to get more bang for the buck. Since the end of 2002, I have greatly out performed the markets while only having 70% of my portfolio exposed to equities. Knowing what I learned from the last bear market, if I see over valuations again, I'll reduce my explore portfolio beta and increase my fixed income allocation even more, perhaps as much as ten or twenty percent. Academics call this "valuation based allocation" and is not considered market timing. Dr. Ed Yardeni uses the Fed Model to set his asset allocation as high as 90:10 in times of under valuation. At the top in 2000, he had his allocation at 30:70, recognizing valuation can catch up with stock prices so he always keeps some in the market.

More on Inflation: Inflation is not a problem as long as your income goes up to match it. If you retire and fund your retirement from the interest on CDs before you get 30 years of 3% inflation, then you might not have enough money because your principal doesn't go up with inflation thus you would lose 60% of your money's buying power.

Lets say you want to retire and have $100,000 a year in retirement income. Remember you will have no kids college to fund, your house may be paid off, etc. so $100,000 a year would be comfortable. How would you make sure you keep that $100,000 a year income adjusted for 3% per year inflation? What about 4 or 5% inflation? These are questions I have helped people answer for themselves using spreadsheets and articles about retirement portfolio management including safe withdrawal rates.

On Active Management, (explore portfolios or funds)

> *"Actively managed mutual funds? Yes. But only if they are run by managers who own their own firms, who follow distinctive philosophies, and who invest for the long term, without benchmark hugging. (Don't be disappointed if the managed fund loses to the index fund in at least one year of every three!)"*
> John C. Bogle in "The Little Book of Common Sense Investing", Chapter 18
> http://www.amazon.com/exec/obidos/ASIN/0470102101/kirklindstrom

On Market Timing

> *"The idea that a bell rings to signal when investors should get into or out of the stock market is simply not credible. After nearly fifty years in this business, I do not know of anybody who has done it successfully and consistently. I don't even know anybody who knows anybody who has done it successfully and consistently. Yet market timing appears to be increasingly embraced by mutual fund investors and the professional managers of fund portfolios alike."*
> John C. Bogle in "Common Sense on Mutual Funds", pg 20
> http://www.amazon.com/exec/obidos/ASIN/0471392286/kirklindstrom

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