

## Third Quarter 2011



The recent sharp sell-off in stocks (*stocks have declined 10% so far YTD, and 14% since our last report on June 30<sup>th</sup>*) begs the question – has this been a severe correction that is nearly over, or is this the beginning of something more serious – a full-blown bear market that will depress prices considerably further?

**The answer depends completely on whether or not the economy is slipping back into a recession.**

The history of market corrections is this – when a correction has historically occurred in conjunction with an economy that is *not* sliding into recession the damage is usually contained (to declines of 20% or less) and short-lived (roughly three months in duration). This happened in 1966, 1987, 1994, 1998, and 2010 (although the decline in 1987 was more severe than 20%, the duration of the decline was only three months).

On the other hand, market downturns occurring when the economy is slipping into a recession have been far more serious. Recessionary bear markets have typically lasted roughly 18

months and losses have been severe (-48% in 1973-74, -49% in 2000 – 02 and, -57% in 2008 – 09).

So, given the dramatic difference between a normal “pause that refreshes” correction and a recessionary-driven bear market, having an opinion on economic outlook is very important. No. Make that having a *correct* opinion is very important.

One of the economists that I have the highest regard for is Dr. John Hussman. According to Hussman, it seems that the odds of a full blown recession imminently occurring are not insignificant. Hussman keeps a tally of financial and economic conditions that, *when observed simultaneously*, have historically reflected a unique *signature* of recessions. Furthermore, these measures have collectively shown a compromising deterioration *always and only* during, or immediately prior to recessions. These measures are suggesting that we are there now. So, while the observation of this data doesn't guarantee a recessionary outcome, to expect otherwise would have to rely on the hope that "this time it's different."

## **Current Allocation and Market Outlook**

The economic concerns discussed in the *2<sup>nd</sup> Quarter 2011 Market Letter* – a slowing global economy, anxieties about the fiscal health and viability of the euro-zone, Middle Eastern turmoil, the durability of China's economy, our own domestic political rancor and the budgetary constraints imposed on the U.S. by our \$65 trillion dollar debt burden - still remain. They are the culprits behind the recent market difficulties - the gifts that keep on giving.

**Outlook Cautious** - Our *Market Risk Model* changed its risk outlook from the formerly favorable posture that it had been registering for much of the last year to an unfavorable outlook for market risk several weeks ago. As a result, BCM portfolios were repositioned from late July and into early August, to adapt to the changing risk environment. We dramatically reduced our exposure to equities (stocks), and redeployed those funds into a number of other areas that we expect will weather a recessionary storm (should it occur) relatively unscathed, such as government and government agency bond funds. We continue to maintain an exposure to gold.

**It is our intention to hold this more conservative risk posture until our *Market Risk Model* indicates otherwise.**

As always, please let us know if any personal circumstances have changed that might necessitate a change in your investment strategy, or if you have any specific questions about how your account is managed.

Thank you so much for your continued trust and confidence.

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