



Bull Bear Reviewsm with Michael J. Chapman, CFP



Provident Capital Management's Chief Investment Officer

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- **Risk managers will lead next 12 months performance**
- **Markets have Fed's attention**
- **Opportunity at hand**

Mahamed El-Enian, lead manager for the 34.9 billion Harvard Endowment fund, succinctly summed up the last 12 months' returns and where returns will likely come from over the next year. In a statement heard this morning on CNBC he said, "Last years leading returns came from investing in illiquid investments and applying massive amounts of leverage. The next 12 months leading returns will come from those managers good at risk management."

There has never been a better time to be with a firm, such as ours, whose focus is on risk management. We are constantly measuring the risk reward ratio of our asset allocation and we make adjustments accordingly.

The market finally has the fed's (as in Federal Reserve) attention. There will likely be a fed funds rate cut with in the next 30 days. However, that does not mean we have put in the final low for this correction. Jim Stack notes that after the first rate cut in 2001, it was still 20 months to a market bottom. I believe we are much closer in time to a low. As I

stated last week, we look for the indexes to trade sideways to higher into mid/late September and then down into late November.

Valuations are much lower today than in 2000 and 1998. Corporate cash flow levels are still very strong, and while the recent buy out frenzy may slow because of reduced liquidity, the irony is, because of the recent price decline, there are many corporations that are ripe for a takeover. This means we will continue to see corporate stock buy back and take over announcements.

In my opinion, the next several months will present great opportunities to position for a rising market in 2008 and 2009.

Having said that, be aware...there will be talk of recession and possibly even acknowledgement that we have entered into one by November. That is why I have left the inverted yield curve commentary in this letter and on the bear side of our ledger. Historically, once a recession is recognized it is time to buy.

On The Upside

According to Thomson Financial, 2006 was a record year for global merger and acquisition activity, hitting \$3.77 trillion and topping the record set in 2000 of \$3.44 trillion. This trend has continued in 2007, and it may set a private-

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SPX 1,450 NDX 1,909 DJI 13,120

Bull (up)

Bear (down)

Liquidity and Free Cash Flow

Commercials Net Long

Inverted Yield Curve

Housing Market Fall Out

Seasonals

Rising World Interest Rates

Major Cyclical low due late 4th quarter

equity record with \$115 billion in buyouts announced. For the year through May we are at \$315 billion in private equity buyouts (Thompson Financial). As discussed earlier, this trend continued through June and July but has slowed dramatically in August.

A recent *Fortune Magazine* article discussed the ten biggest private equity firms. By their calculations, these top ten firms have \$250 Billion in cash. They will borrow up to 10 times that amount in doing their deals (hence the term “leveraged buy out”), which means they have buying power of \$2.5 Trillion. You also have the phenomena of SWFs, which Morgan Stanley estimates contain 2.5 trillion dollars. This is adding tremendous **liquidity** to the market, thus driving it higher during good times and supporting it during sell offs.

The commercials bought into this sell off, pushing their net long positions to a record level. They don't often lose this game, but when they do it can create a hard fast sell off. I am leaving it on the bull side of the ledger with the caveat that it could be a catalyst for further downside.

On the Downside

From June of 2006 until late May of 2007, the 3-month T-Bill was yielding more than the 10- and 30-year bond rates. This is what is called an **inverted yield curve**, and it is an important “red flag.” This condition has resulted in a recession seven out of the last eight occurrences. There has not been a recession since 1950 that was not preceded by a 10- to 20-percent decline in the stock market. We have now had a 10 plus percent correction - will the recession follow?

The **housing market fallout** remains the wild card. What we know about the housing market cycles are that the average length of time from peak to trough is 27 months. This down move started in January of 2006 and therefore likely has another 12 months. In the past 40 years private residential construction has never contracted to this extent without triggering a recession. Housing inventories are at a 16-year high (8.9 months at the current rate of sales). Existing home sales in May fell .3%. Both new and existing home sales are down 10.6 percent versus year ago levels. Building activity is down 24% from year ago levels.

Jim Stack is doing a good job of tracking the unwinding of the housing bubble. Go to www.investech.com to find three great charts that tell the story. Jim updates these charts regularly. Go to www.lenderimplode.com to track the demise of the sub prime industry.

Seasonals are down from late August through early October.

Restrictive Monetary Policy by China's Central Bank could be a showstopper. China has a problem with speculation in its stock market. The central planners are aware of the problem and are trying to quell enthusiasm with higher interest rates and restrictive monetary policies. There will be some fall out worldwide when their market corrects.

The 3.3-year **cycle low** is due late in 2007 early 2008. This cycle low has marked many significant lows over the past twenty-five years including the 1987 crash low.

Your Bull Bear Review Analyst,

Michael J. Chapman, CFP

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