

## Commentary

by Ian Fraley

In the last issue of FCNOTES, ("Goldilocks and The Three Bears," May 31, 2006), we suggested that the "wall of worry" that bull markets love to climb was beginning to erode. Two of Wall Street's biggest bears, Richard Bernstein and Stephen Roach, had emerged from their caves, looked around, and decided that the forest didn't look so bad after all. We didn't like this development one bit, having written back in February 2004 that, "When gloomy strategists such as Richard Bernstein and Stephen Roach become bullish – or lose their jobs – there will be far more reason to worry about the next down-a-lot market than there is right now."<sup>1</sup>

This concern notwithstanding, it was our view that the bull market would continue through at least the end of this year, though perhaps not before the early summer sell-off turned into a full-fledged correction – which is exactly what happened. Our advice from the start was to ride it out. "Corrections are not uncommon, and the aggregate adverse impact of transaction costs, capital gains taxes, and the sheer difficulty of recognizing a bottom until long after it has occurred make trying to time corrections a losing strategy over the long run."<sup>2</sup>

The speed with which stocks rebounded last week should serve as an important reminder of how hard it is to spot a bottom in a correction, and thus why staying fully invested is the best course of action unless one's analysis points to the strong likelihood of a real bear market. In the space of just five days, the Dow Jones Industrial Average rose 2.7%, the S&P 500 gained 2.8%, and the Nasdaq Composite jumped 5.2% – the best week for the tech-heavy index since 2003.

What clues might one have seen in order to successfully reenter the market in time to catch this bounce? Perusing last week's headlines, we see much coverage of a terrorist plot to blow up U.S.-bound passenger planes (that doesn't sound bullish), the unfolding scandal over the dating of stock-option grants at numerous companies (that can't be good), the largest computer-related product recall in history (hard to put a positive spin on that), and a major consumer-confidence survey that plunged to the lowest level since the aftermath of Hurricane Katrina (yikes).

There was some good news as well, such as a couple of better-than-expected inflation reports and a modest decline in oil prices on hopes for a ceasefire in Lebanon. But on balance, last week wasn't much different from any other week during the past few years. Terrorist threats, corporate scandals, anxious consumers... no new news.

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## Market Indicators

	Current Reading	Level/Trend
<b>Earnings Yield Spread</b>	<b>1.04</b>	<b>5</b> ↑
<i>Calculated by dividing trailing 12-month S&amp;P 500 operating earnings by the price of the index and comparing the resulting earnings yield (E/P) to the 10-year Treasury note yield. We consider readings above 1.0 "very bullish" (5), between 0.0% and 1.0% "bullish" (4), between -1.5% and 0.0% "neutral" (3), between -1.5% and -2.5% "bearish" (2), and below -2.5% "very bearish" (1).</i>		
<b>Yield Curve Ratio</b>	<b>0.95</b>	<b>1</b> ↓
<i>Calculated by dividing the 10-year Treasury bond yield by the 3-month Treasury bill yield. We consider any reading above 2.5 "very bullish" (5), between 1.5 and 2.5 "bullish" (4), between 1.25 and 1.5 "neutral" (3), between 1.0 and 1.25 "bearish" (2), and below 1.0 (i.e., an inverted yield curve) "very bearish" (1).</i>		
<b>60-Day Put/Call Ratio</b>	<b>1.00</b>	<b>5</b> ↑
<i>The 60-day moving average of total put volume divided by call volume on the CBOE. We consider any reading of 0.85 or higher "very bullish" (5), between 0.75 and 0.85 "bullish" (4), between 0.60 and 0.75 "neutral" (3), between 0.50 and 0.60 "bearish" (2), and 0.50 or lower "very bearish" (1).</i>		
<b>Nasdaq Short Interest Ratio</b>	<b>3.90</b>	<b>5</b> ↑
<i>The number of trading days at 12-month average daily volume required to cover total shares sold short on the Nasdaq (data are seasonally normalized). We consider any reading above 2.8 "very bullish" (5), between 2.5 and 2.8 "bullish" (4), between 2.0 and 2.5 "neutral" (3), between 1.7 and 2.0 "bearish" (2), and below 1.7 "very bearish" (1).</i>		
<b>8-Week Insider Sell/Buy Ratio</b>	<b>2.67</b>	<b>3</b> ↑
<i>The 8-week average of total shares sold by insiders of companies traded on the NYSE, AMEX, and NASDAQ exchanges divided by total shares purchased by insiders. We consider any reading below 1.0 "very bullish" (5), between 1.0 and 2.0 "bullish" (4), between 2.0 and 3.0 "neutral" (3), between 3.0 and 5.0 "bearish" (2), and above 5.0 "very bearish" (1).</i>		
<b>UBS Index of Investor Optimism</b>	<b>55</b>	<b>4</b> ↑
<i>A monthly survey of approximately 800 randomly selected U.S. investors with total savings and investments of \$10,000 or more. We consider any reading below 30 "very bullish" (5), between 30 and 70 "bullish" (4), between 70 and 110 "neutral" (3), between 110 and 160 "bearish" (2), and above 160 "very bearish" (1).</i>		
<b>PULSE Panic/Euphoria Model</b>	<b>-0.75</b>	<b>5</b> ↑
<i>A composite measure of investor sentiment developed by Tobias Levkovich which includes margin debt balances, daily Nasdaq volume as a percentage of NYSE volume, retail money-market fund balances, the short-interest ratio between public investors and NYSE member firms, and several other indicators. We consider any reading below -0.3 "very bullish" (5), between -0.3 and 0 "bullish" (4), between 0 and 0.3 "neutral" (3), between 0.3 and 0.6 "bearish" (2), and above 0.6 "very bearish" (1).</i>		
<b>Bottom Line:</b> Investor sentiment has turned markedly negative since the start of the summer correction. The most striking readings have been seen in options trading, with the 60-day put/call ratio peaking at a stunning 1.06 at the end of July. With the exception of a slightly inverted yield curve, which bears watching, the data all point to a strong rebound in stock prices.		

So we have no idea why stocks rallied last week. It doesn't matter. What matters is remaining invested during bull markets and not allowing noise from the media to scare you out prematurely. Frankly, we don't even know if the correction is over yet. Historically, September is the worst month of the year for stocks (though there are certainly plenty of exceptions), and bottoming markets tend to be attracted to the month of October like moths to a flame. But again, it doesn't really matter if the correction has ended, or if one more shakeout is yet to come. The advice we gave you at the start of the correction remains unchanged: Keep your cool. This bull market has plenty of life left in it.

### Live Long and Prosper

Corrections are a lot like snowflakes; every one is a little bit different. And it is because of these differences that otherwise-rational "long-term investors" get rattled, wondering if years of hard-earned money invested in the stock market will prove to have been for not. Certainly this *can* happen, an unfortunate reality that too many reading this today know all too well from the 2000-02 stock market debacle. But bear markets of that magnitude and duration are once-in-a-lifetime events, probably because the tremendous excesses that lead to them are unlikely to recur so long as any of the folks who can remember the last one are still around.

To find a cyclical U.S. bear market as long and as devastating as 2000-02, one must go back 70 years to the 1930s. And prior to that? Another 60 years earlier, to the 1870s. Interestingly, the life expectancy of a young man in the 1870s who had made it to the age of thirty was around 60 years, and in 1929, the life expectancy of a thirty-something was around 70 years. With the life expectancy of the average American in his or her thirties now nearing 80 years, we won't be surprised if the next bear market to rival 2000-02 occurs somewhere around the year 2080, though by then we probably won't be around to see the telltale signs and sound the alarm – which is precisely the point.

Of course, bear markets of lesser magnitude occur on a much more regular basis – two or even three times a decade, depending on how one defines the term "bear." The rule-of-thumb used by Wall Street is any decline of 20% or more, but this definition ignores what in our view is the more devastating component of a bear market: *Time*. A sudden, sharp decline need not concern an investor if prices bounce back quickly. In the summer and fall of 1998, for example, the S&P 500 met Wall Street's technical definition of a bear, falling more than 22% from top to bottom, but the subsequent rally was so spectacular that by year-end, an investor who had simply owned an S&P 500 index fund for the entire year would have enjoyed a 28% profit. Even the Crash of 1987, which is regarded by most market historians as a bear market due to a wicked peak-to-valley decline of 34%, was in our view a simply a correction, albeit a very big one; for full-year

1987, the S&P 500 actually eked out a *positive* return of 5.3%, and in 1988 and 1989 the index returned 16.6% and 31.7%, respectively.

Anyone who panicked and bailed out of stocks during the declines of '98 and '87 likely did an enormous amount of damage to his or her long-term returns, and that highlights the crucial difference between a correction and a bear market – not the size of the drop, which can exceed 20% in either event, but the *time* it takes to travel from peak to valley and then back to new highs. Time is the one thing that no investor, no matter how wealthy, can buy more of, and that makes all the difference in the world.

To paraphrase a point made by Warren Buffett in his 1998 letter to shareholders, an investor who expects to be a net saver during the next five years should hope for *lower* stock prices during that period – after all, why would a prospective purchaser of anything want to see prices going up? (And yet just about everyone we know in his or her thirties or forties despairs when the stock market falls, a truly irrational response to being presented with the opportunity to get more for his or her money.) But for someone who is already retired and living off his or her investments, a bear market can be truly devastating, not just because the peak-to-valley decline in portfolio valuation is large – corrections can be large too, as we have seen – but because it will require many years thereafter to make back those losses, years the retiree simply does not have since he or she is already selling equities to pay for living expenses.

In theory then, an investor who is many years away from retirement shouldn't care very much about differentiating between bear markets and corrections so long as he or she is disciplined enough to invest new money on a consistent basis – an approach called "dollar-cost averaging." But as is often the case when it comes to asset allocation models, the mathematical theories fail to take into account the profound *psychological* changes experienced by investors during these market cycles.

Early in a new bull market, every hiccup causes near panic in investors who still remember all too well the pain of the previous decline. As a result, many rush to take profits at the first sign of trouble, while others adopt a "wait-and-see" attitude (i.e., they stop allocating money to stocks during the correction, missing out on the chance to put new cash to work at lower prices). But as stocks recover and make new highs, the regret and fear associated with the last bear market begins to fade and is slowly replaced by a different kind of regret and fear – the regret that they didn't buy more stocks when prices were lower and the fear that there won't be another great opportunity to do so again. In this way, bull markets slowly train investors to "buy the dips."

With every new correction and subsequent recovery,

investors become more convinced that the biggest risk is *not* buying on weakness, and when the bear market finally arrives, they are quick to jump in and snap up more shares of their favorite companies. This is enough to fuel a bear-market rally, but ultimately the gains falter and stock prices resume their decline. In the end, it is *time* that causes the most damage, as months of failed rallies and lower lows cause investors to believe that something has fundamentally changed – maybe stocks were great in the past, they think, but clearly they won't be in the future. And thus those who have held out hope the longest finally give up and sell, paving the way for the start of a new bull market.

### Concluding Thoughts

Regardless of whether we have in fact seen the bottom of the first real correction since the bull market took off in early 2003, our optimistic outlook for the year remains unchanged. Not only do we see little to justify a true bear market, nearly all of the fundamental underpinnings of the bull market that we have highlighted in past issues of *fcNOTES* remain intact, such as very low long-term interest rates (the 10-year Treasury note is back below 5%, somewhat to our surprise, we must confess) and accelerating M&A and buyback activity. What is more, a handful of our key indicators are actually *more* positive than at any other time in the past three years:

- Corporate insiders have taken advantage of the sliding market to acquire more shares in their own companies, with the Vicker's total eight-week sell/buy ratio having risen to its best level since the summer of 2003.

- A net 33% of global fund managers polled by Merrill Lynch are overweight cash, the highest level ever recorded by this survey.
- Short interest on the Nasdaq has surged back to the very extreme levels seen in the fall of 2005 (post-Katrina, a terrific time to load up on stocks).
- The 60-day put/call ratio, a measure of fear in the stock market, has risen above the 1.0 level for the first time ever, blowing past the previous record high.

These are all excellent signs that we are rapidly approaching a bottom, if we haven't seen it already. And perhaps most encouraging of all, economists have become strikingly pessimistic. The headlines from various economic research pieces last week speak for themselves. The latest market outlook from Charles Schwab: "Recession Watch." From RBS Greenwich Capital: "Stagflation bias and Fed fears". From High Frequency Economics: "LEI [leading economic indicators] not yet suggesting recession, but it is headed that way". And from Action Economics: "US confidence showing another headline freefall in August."<sup>3</sup>

Even Stephen Roach, whose sudden optimism in May was perhaps as good an indication as any that some kind of market decline was in the offing, has abandoned the forest and returned to his cave. Echoing the sentiments of so many others, Mr. Roach has decided that, "The recent vigour of global economic growth is a siren song.... There is a much better chance that global growth has peaked and the boom is about to fizzle."<sup>4</sup>

Don't bet on it.

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**Ian Fraley** CHIEF EXECUTIVE OFFICER  
ian@financiacapital.com

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**Stephen Brennan** CHIEF INVESTMENT OFFICER  
steve@financiacapital.com

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(Note: The "Sentiment Timeline" section of *fcNOTES* appears on the following pages as an appendix to this commentary.)

### Sentiment Timeline

#### Equity Markets & Sectors

"Your **cash** is no longer trash.... Investors are moving money into cash investments at a rapid pace. Money in retail certificates of deposit exceeded \$1 trillion earlier this year for the first time since 2001, according to Federal Reserve data, while deposits in savings accounts, including money-market deposit accounts, are now at record highs of \$3.6 trillion. Investors have also pumped \$171.2 billion into taxable money-market mutual funds over the past year, compared with outflows of \$117.4 billion the same period a year ago.... Year to date, \$29.25 billion of new cash has gone into money-market mutual funds, compared with the year-ago period when investors pulled out \$76.83 billion." *WSJ, 6/6*<sup>10</sup>

"The bears are becoming more strident as **[equity] market** jitters continue. Andy Xie [Morgan Stanley] says: 'The four-year global growth boom and three-year bull market may be over. Global financial markets look suspiciously like a pyramid game.'" *FT, 6/8*<sup>11</sup>

"Veteran **emerging-markets** investors say this selloff amounts to one of the toughest in recent memory. Some financial advisers and market strategists say it is time to scale back. That advice is a sharp turnabout in some cases from as recently as a few months ago, when many of the same advisers were encouraging boosting such allocations.... One thing is almost certain: Few investment advisers are pushing clients to boost their emerging-markets holdings right now." *WSJ, 6/9*<sup>12</sup>

"U.S. companies are spending record sums repurchasing their own stock, a move that could boost per-share earnings of many at a time when the **stock market** has been gyrating, often downward. The companies in the Standard & Poor's 500-stock index... plowed more than \$100 billion into their own shares in the first quarter, up more than 22% from a year earlier.... In the year ended March 31, they spent a record \$367 billion on so-called stock buybacks, an amount so large it could cover this year's Medicare budget." *WSJ, 6/12*<sup>13</sup>

"Fund managers are shifting assets into **cash** because of the turmoil in global financial markets, according to the latest Merrill Lynch monthly survey.... A net 29 per cent of managers said they were 'overweight' cash – one [of] the highest readings recorded – compared with 18 per cent in May." *FT, 6/14*<sup>14</sup>

"*Why It's a Good Time to Buy.* Recent market downturns are making **stocks** around the world attractive, in our view. At the same time, S&P analysts are raising their target prices for many issues." *Standard & Poor's, 6/14*<sup>15</sup>

"With **emerging markets** suffering a terrible beating the past few weeks, it's easy to forget why investors got excited about them again after their miserable 1990s performance.... Over the past few years, many of these countries have steered their economic ships in the right direction. They turned trade deficits into surpluses and paid down foreign debts. Foreign-exchange reserves at their central banks soared.... Only 10% of emerging markets were rated investment-grade credits in 1998. Now more than 50% are.... The economic backdrop suggests these economies should weather the most recent storm better than they did in the 1990s." *WSJ, 6/15*<sup>16</sup>

### Sentiment Timeline

#### Equity Markets & Sectors (continued)

"We could be facing a serious bear market, said Tim Middleton [Moneycentral].... That makes the timing ideal for a new breed of exchange-traded funds expected to launch by the end of the month, said Lawrence Carrel [Smartmoney].... These bear-market ETFs aim to produce the opposite return of certain indexes, such as the Dow or the S&P 500.... Even if the bear market itself is brief, said Christopher Davis [Morningstar], many experts such as Warren Buffett think that '**stocks** are headed for an extended period of underperformance.'" *The Week, 6/23*<sup>5</sup>

"Too many bubbles, too many potential busts – that's what's confusing the global financial markets these days.... **Stock prices** in India and Russia have roughly doubled in two years, with emerging markets such as Turkey, Indonesia, and Argentina not far behind.... How, then, should investors deal with this fundamental uncertainty? One option is to withdraw money from any risky market and shift it into safe havens such as money market funds." *BW, 6/26*<sup>6</sup>

"Bye bye, bull. Hello bear. The market decline that began in early May could well signal the end of one of the longest-running cyclical bull markets on record. That's the conclusion of some top market watchers.... Rising interest rates, inflationary pressures, a weakening dollar and a negative savings rate all have conspired to bring this latest bull market to an apparent close.... 'We are in a **bear market,**' asserts Paul Desmond [Lowry's Reports].... The current decline is especially dangerous because many investors appear unfazed by the bearish signals." *Barron's, 6/26*<sup>7</sup>

"Money managers have become more bullish on **large-capitalization value stocks** and have lost enthusiasm for small-cap shares, a shift in sentiment driven by expectations of a slowdown in the economy.... Fifty-four percent of managers favored U.S. large-cap value stocks, up from 36% in the previous quarter, the largest gain for any asset class in the two-year history of the Investment Manager Outlook, a quarterly survey by Russell Investment Group.... Bullishness for **small-cap growth stocks** declined to 27% from 57% in the preceding period – the largest quarter-to-quarter drop in the survey's history." *WSJ, 6/28*<sup>8</sup>

"Strike up the Wagner. It's time for the third and calamitous act of that epic, sprawling opera *Twilight of the Tech Gods*. It's been nearly four years since the curtain came down on the first act, when the Nasdaq plunged to 1108 and all seemed dire. The second act was not nearly as dramatic, with giants like Microsoft, Dell, and Intel scrambling to right themselves and take advantage of a changing landscape and lay plans for their resurgence. This year, it's growing increasingly clear that these companies are not heading for a resurgence, but a tragedy. If you had bought them four years ago when the Nasdaq was nearing the bottom of its trough, you'd have lost money on all three. Microsoft is down 4.7% over four years, Dell is down 4.6% and Intel is off 3.7%.... The **tech industry** may turn into a gerontocracy, guided by a bunch of graying old geezers, short on new ideas and big on indigestion – the way the Japanese consumer-electronics giants, which once ruled the tech world, have looked for the past 15 years." *TheStreet.com, 6/28*<sup>9</sup>

### Sentiment Timeline

#### Equity Markets & Sectors (continued)

"In the past five weeks, a net \$15.4bn has been withdrawn from **emerging market stocks** – almost 6 per cent of total assets.... This is the largest sum in any such period since it started tracking fund flows in 1995." FT, 6/28<sup>24</sup>

"Robert Shiller, the Yale professor and Irrational Exuberance author... keeps a monthly institutional-investor confidence measure.... It's quite simple, tallying the percentage of respondents who think the **Dow** will be higher in a year. The latest result, for May, showed 92.6% believing the Dow would be up in a year – the highest level since Shiller started the survey in 1989... When the market has been poised for a nice, lasting rally – as in October 2004 and October 2005 -- the Shiller index has been in the low 70s." Barron's, 7/3<sup>25</sup>

"The Case for a Major Bull Run in Japan. Despite a brutal quarter for **Japanese shares**, the outlook for the country keeps getting brighter.... To Russell Napier, a onetime Asia strategist at Hong Kong's CLSA Asia-Pacific Markets, who now consults for the firm, the growing evidence that deflation is fading makes now the right time to buy Japanese shares. In contrast, he doesn't like **U.S. equities**, because he sees the country headed into a prolonged battle with inflationary pressures." Barron's, 7/3<sup>26</sup>

"In more than seven years, since mid-1999, **blue-chip stocks** as a group haven't done more than move sideways – and most **technology stocks**, which suffered most in the long bear market, are languishing well below their records. Many analysts caution that any stock-market gains this year could be single-digit at best.... Some, especially technical analysts who chart market trends rather than analyzing fundamental business factors such as profits and sales, warn that the bull market, which began nearly four years ago, is getting old and extended, and that a bear market could be in the making. Even fundamental analysts who don't see a bear market on the horizon have been warning clients that, with the pace of profit gains slowing, the Dow industrials are likely to show no more than a single-digit percentage gain for the current year. That would follow a nearly flat year in 2005, when the industrial average fell 0.61%." WSJ, 7/3<sup>27</sup>

"'U.S. growth has peaked and global growth has peaked,' says Paul Erlichman [Brandywine]. Mr. Erlichman, who has reduced Brandywine's holdings in **emerging markets**, says he expects declines to continue into early 2007.... Allowing for a quiet summer, the rest of the global downturn could take place from August through October, says Abhijit Chakraborti [J.P. Morgan]. Mr. Chakraborti expects global markets to fall about 15% by year end and emerging markets to sink 30% to 40%, in what he says would be the 'sixth largest correction in history'." WSJ, 7/3<sup>28</sup>

"The risks still seem to lie in **emerging markets**, which are heavily dependent on global growth and on flows from trigger-happy investors. There is talk, for example, that some emerging market hedge funds may have to close after a poor May and June, meaning they will have to liquidate their holdings. Until the outlook for the global economy and interest rates becomes more clear, investors should be avoiding the riskiest assets." FT, 7/8<sup>29</sup>

### Sentiment Timeline

#### Equity Markets & Sectors (continued)

"Bigger the Better? Finally, It May Be.... That was the message at last week's Morningstar Investment Conference.... The tune: You have a better chance of making money by investing in less-racy investments than in the riskier fare like **emerging markets** and **small-company stocks** that have soared over the past five years.... Time and time again, stock pickers said the best opportunities seem to be in shares of the world's biggest 'quality' companies. In economic slowdowns, big companies' profits tend to hold up better than those of smaller ones that rely on fewer products and customers and have weaker balance sheets. And shares of many **large-caps** trade at their lowest price-to-earnings multiples in a decade.... 'Safe' investments may have finally gotten too cheap to resist." WSJ, 7/5<sup>17</sup>

"Retail investors have thrown buckets of money at **small cap** funds recently, using money they have removed from large cap funds. There have been outflows from **large cap growth** and large cap blend mutual funds over the past three years." FT, 7/8<sup>18</sup>

"With oil prices surging, financial markets gyrating and consumers turning cautious, the risks of recession are rising.... Stewart Pilette [Pilette Investment Management], said even fund managers who typically put their money into **technology stocks** and other traditionally high-growth areas, are loading up on **defensive stocks**. 'They've turned extremely cautious,' he said. Though Byron Wien [Pequot] said he doesn't see a recession coming, he said his firm has taken a more defensive posture amid the tensions in the Middle East, rising oil prices and slowing corporate earnings. 'Our job is to make money when we can and protect capital when we can't,' he said." WSJ, 7/15<sup>19</sup>

"Where the Market Will Be by 2007.... We asked four folks who seem to have starkly different opinions to tell us what lies ahead for the **[stock] market** in the next six months. Barry Freeman, a strategist at HPC Capital Management, is expecting the sell-off that began in May will take the market down 11% by yearend; Christopher Conkey of Evergreen Investments and Hugh Johnson of Johnson Illington Advisors see stocks continuing to climb higher. Meanwhile, Warren Bagatelle of Loeb Partners expects the market to tread water for the rest of the year." BW, 7/17<sup>20</sup>

"Is the bull market that began in 2002 over? We think it might be, which means the **[stock] market** could get worse before it gets better.... Our advice to clients can be summed up in a single word: caution." Charles Schwab, 7/2006<sup>21</sup>

"Little chance that **small-caps** can continue to run." IN, 7/17<sup>22</sup>

"Fund managers have become much more pessimistic about economic growth and corporate profits, and are lifting their cash holdings as risk aversion levels rise. One of the gloomiest monthly polls taken by Merrill Lynch found that a net 60 per cent of respondents expect the global economy to weaken during the next 12 months, the survey's highest ever reading. The figure was 5 per cent three months ago.... A net 31 per cent of institutional investors are overweight cash – the highest reading since the aftermath of the terrorist attacks in September 2001. **Risk appetite** has also deteriorated and is at its lowest level since the start of the 2003 Gulf War." FT, 7/19<sup>23</sup>

### Sentiment Timeline

#### Equity Markets & Sectors (continued)

"The American Association of Individual Investors had some good news for contrarian investors on Thursday: Its survey of **investor sentiment** was bearish for the 10th straight week, one of the longest stretches of investor gloom in the organization's history... Bearish sentiment rose to 58 percent in the AII's latest poll on Thursday, the highest level of pessimism over the past 10 weeks, compared with bullish sentiment among 24 percent of members. The last time bulls outnumbered bears was May 11, which was also the beginning of the latest correction." Atlanta Journal, 7/20<sup>35</sup>

"US institutional investors raised the amount of **international equities** in their portfolios by 72 per cent in the year to the end of February in a bid to boost their returns by venturing further afield." FT, 7/20<sup>36</sup>



Barron's, July 24, 2006

"*Time To Buy.* Based on factors ranging from skimpy valuations in some markets to excessive selling in others, **stocks** look ready to come back in many parts of the world, albeit bumpily... While there's risk that the global economic and political backdrop may worsen in coming months, there's also reason for bullishness on Wall Street." Barron's, 7/24<sup>37</sup>

"*Long Term, Tech Giants Offer Little.*" RealMoney.com, 7/24<sup>38</sup>

"There's no way around it: We are officially sliding back into a **tech bear market.**" TheStreet.com, 7/25<sup>39</sup>

"'The big problem for the market is the lack of confidence in the economic outlook,' said Al Goldman [AG Edwards]. 'The market doesn't know whether we are going to get a hard landing or a soft landing to the economy.' Mr Goldman said **US equities** were not in a bull or bear market but were in a 'turtle' mode – not moving very fast and mired in the mud of uncertainties. Mike Buchanan [Goldman Sachs] also warned that growth expectations embedded in US equity markets remained too high." FT, 7/26<sup>40</sup>

"*Once Highflying Tech Industry Reboots for Era of Slower Growth...* A raft of recent earnings reports suggests what some in the industry have long suspected: that the industry's markets are maturing and that slower growth may be here to stay, requiring a new business model and a new style of management... 'Tech has not anywhere near come back,' says Howard Silverblatt [S&P]. 'It's hard to call it a growth industry anymore.'" WSJ, 7/27<sup>41</sup>

### Sentiment Timeline

#### Equity Markets & Sectors (continued)

"*Time to cover your bases: Stocks aren't about to collapse, but they are risky. Now is the time to go on the defensive in your portfolio...* The market has more demons to exorcise. Persistent inflation jitters, despite occasional reassurance, prolong the concern that inflation fighters at the Federal Reserve will continue to boost interest rates. That, in turn, conjures up fear of an economic slowdown or even a recession... Don't be tempted to put more money into old winners because they're down. **Emerging markets** funds and shares of **homebuilders, commodity producers** and most **small-company stocks** aren't likely to continue leading the market... Instead, try **bigger companies** and **defensive stocks**, which can better withstand a tough market and a challenging economy." Kiplinger's, 8/2006<sup>30</sup>

"*Relax, He Only Looks Scary...* There are substantive reasons for the rise in investor anxiety besides the immediate crisis in the Middle East. High oil prices, resurgent inflation and rapidly climbing interest rates recall the stagflation of the 1970s. And a return to '70s-style valuations would depress stocks by 40% or more. Scary, indeed. But in my view, the pessimists are confusing short-term problems with far more damaging long-term trends. And that confusion is creating an opportunity to buy top-notch stocks at below-average prices... Today's greatest bargains are **giant growth and growth and income stocks**, many of which are at least 15% below their historical norms." Money, 8/2006<sup>31</sup>

"Managers of 'value' mutual funds can be a finicky bunch when it comes to investing, because their goal is to buy **stocks** on the cheap. A year ago, many were sitting on record piles of cash and saying that stocks were overvalued. Now, they appear to be diving back in. In recent months, some value-fund managers have started pouring cash back into the market." WSJ, 8/4<sup>32</sup>

"*Apocalyptic year for tech Horsemen.*" FT, 8/4<sup>33</sup>

"*How to Buy Foreign Shares...* A few major brokerage firms are starting to chip away at barriers like these. Last month, Charles Schwab Corp. cut prices on international-stock purchases for U.S. clients in some cases by more than 50%, putting them closer to their fees on U.S. stocks. Early next year, E\*Trade Financial Corp., the online brokerage firm, plans to expand its international service to let U.S. investors trade foreign stocks in local currencies for the first time in places including Japan, Canada, Hong Kong and European countries. Mutual-fund titan Fidelity Investments also is getting into the act. The company recently increased its brokerage division's customer-service staff to help deal with a fourfold increase in calls about international stocks... The goal of moves like these: cashing in on Americans' voracious appetite for overseas investments. For the past three years, international stocks have had better returns than their U.S. counterparts. That performance has caused a stampede as U.S. investors pour their money into foreign holdings. About \$200 billion in new money has moved into international stock funds since the beginning of 2004." WSJ, 8/12<sup>34</sup>

### Sentiment Timeline

#### Economy & Earnings

"There are fears among analysts that the Fed might end up raising borrowing costs too much and choke off **economic growth** in its efforts to fight inflation.... A poll conducted by UBS/Gallup showed that investor optimism had fallen to a new low for the year in June.... Six out of 10 investors fear that the Fed will raise interest rates too much." FT, 6/27<sup>51</sup>

"With oil prices surging, financial markets gyrating and consumers turning cautious, the risks of **recession** are rising.... This past week's fighting in the Middle East is shaking Wall Street's confidence.... A big worry is surging oil prices, which have contributed to several past recessions.... Even those who don't foresee recession expect a significant slowdown. 'I'm not bold enough to forecast a recession at this point,' said Paul Kasriel [Northern Trust]. 'But I do think that the economy has entered a very soft patch here.'" WSJ, 7/15<sup>52</sup>

"Fund managers have become much more pessimistic about economic growth and corporate profits, and are lifting their cash holdings as risk aversion levels rise. One of the gloomiest monthly polls taken by Merrill Lynch found that a net 60 per cent of respondents expect the **global economy** to weaken during the next 12 months, the survey's highest ever reading. The figure was 5 per cent three months ago." FT, 7/19<sup>53</sup>

"David Rosenberg, Merrill Lynch's North American economist... put out a note titled 'Revisiting Recession Risks,' where he put the odds of a **recession** at 40 percent." AP, 7/21<sup>54</sup>

"Once again, tensions in the Middle East have boiled over, this time between Israel and the Hezbollah in Lebanon, and worries about a wider involvement by Iran and Syria have tacked on yet another risk premium to the price of oil and thrown the financial markets for a loop. As a result, the **economic outlook** has come under a new cloud of uncertainty. Just when consumers and businesses seemed to be coping – if not so easily – with oil at \$70 per barrel, the concern now is oil at \$80 or more, and not one hurricane has even formed yet." BW, 7/31<sup>55</sup>

Fund managers are losing faith in the **global economy**. Nearly three-quarters of 213 global fund managers surveyed... said they expect the economy to be weaker over the next year, up from 61% when the same question was asked in June and from 40% in April." InvestmentNews, 8/7<sup>56</sup>

"**Recession Watch.**" Charles Schwab, 8/2006<sup>57</sup>

"The recent vigour of **global economic growth** is a siren song.... There is a much better chance that global growth has peaked and the boom is about to fizzle." FT, 8/14<sup>58</sup>

"**Danger ahead: why the US economic juggernaut may face a lower speed limit.**" FT, 8/18<sup>59</sup>

"Companies and institutional investors around the globe are holding record amounts of cash - an indication that they are growing more pessimistic over the outlook for future **economic and profits growth.**" FT, 8/21<sup>60</sup>

### Sentiment Timeline

#### Bonds, Interest Rates & Inflation

"Some Wall Street strategists are recommending that investors reduce their bond allocation in favor of cash over the short term. Last month Merrill Lynch & Co. U.S. Strategist Richard Bernstein raised his recommended allocations for cash and stocks, given concerns that inflationary pressures could hurt **bonds**. The firm says its recommended cash weighting of 20% is now the biggest since April 2003, compared with a typical allocation of 10%. PNC Financial Services Group Inc. Chief Investment Strategist Jeff Kleintop raised his cash allocation to 5% last November, while reducing bonds" WSJ, 6/6<sup>42</sup>

"The threat of **inflation** once more hangs heavy over the global economy.... There is no mistaking the swelling chorus of concern from monetary policymakers, financial markets and many of the world's most respected international financial institutions... [However], no one is expecting a sudden return to the bad old days of the 1970s. Inflation as a global phenomenon was gradually squeezed from advanced economies in the decade from 1985. This 'great disinflation' is expected to endure. But the concern is that the world's pivotal central banks may have to work harder than they have done for many years to ensure continued price stability." FT, 6/8<sup>43</sup>

"**Inflation Backs the Fed Into a Corner. Unruly price indexes will trigger higher interest rates and new risks.**" BW, 7/3<sup>44</sup>

"**Inflation: Two Reasons To Be Uneasy.**.... Most consumers feel inflation is higher. Indeed, alternative measures by regional Federal Reserve banks back up those perceptions." BW, 7/17<sup>45</sup>

"Is now the time to be bullish on **bonds**? Bill Gross [Pimco], the world's biggest bond managers, thinks it is. In his latest investment outlook note, Mr Gross last week declared an end to the US bear market in bonds." FT, 8/2<sup>46</sup>

#### Currencies & Other Markets

"**CalPERS' New Crusade: Commodities are where the hefty returns are, says investment chief Russell Read.**" BW, 6/5<sup>47</sup>

"One of the strongest consensus views is that the consensus is generally wrong. The widely held view that the **US dollar** will weaken further looks set to be the exception to that rule." FT, 6/6<sup>48</sup>

"Oil and precious-metals prices have lost momentum recently, but that isn't stopping exchange-traded fund providers from pressing forward with more commodity-related products. 'There's plenty of room for more **commodities,**' said Cliff Weber [American Stock Exchange].... The Amex's Mr. Weber noted pent-up demand for commodities ETFs as diversification tools and to hedge geopolitical risk." WSJ, 6/6<sup>49</sup>

"**Crude oil** inventories in the developed world rose to more than 1bn barrels at the end of April, their highest level in more than 20 years.... Oil inventories in the countries of the Organisation of Economic Co-operation and Development are even higher than the very high levels seen in 1998, which triggered a oil price collapse to \$10 as demand started to slow. However, the world is not facing an oil glut as it was eight years ago. Nowadays, global oil demand is far higher." FT, 6/14<sup>50</sup>

### Sentiment Timeline

#### Currencies & Other Markets (cont.)

"US **crude oil** inventories rose to their highest level in eight years... US commercial crude stockpiles rose 1.4m barrels to 347.1m barrels in the week ended June 16, its highest since May 1998, when US benchmark oil futures were trading at less than \$15 a barrel, about a fifth of current prices." FT, 6/22<sup>70</sup>

"Too many bubbles, too many potential busts... **Housing** markets are sky-high from Boston to Shanghai... If we learned anything in the boom and bust of the past decade, it's that the bottom can be further down than anyone expects... High Frequency Economics... is predicting a recession starting in the first quarter of 2007, largely because of a slump in housing sales." BW, 6/26<sup>71</sup>

"And then there's the Houdini of levitating currencies, the **U.S. dollar**, which many economists fear could tank at any moment because of massive trade deficits." BW, 6/26<sup>72</sup>

"Two Big Bets Against The **Buck**. Why Warren Buffett and Pimco's William Gross say a slide is inevitable." BW, 6/26<sup>73</sup>

"There appears to be a 21<sup>st</sup> century **gold** rush. Record amounts of money are being invested in the metal as investors and bankers take the view the prices will remain high until at least the end of the decade." FT, 6/28<sup>74</sup>

"Ninety-three percent of lenders in a survey expect a housing correction to result in **real estate** prices dropping 10% to 20% across the country." Financial Advisor, 6/2006<sup>75</sup>

"Until quite recently, **gold** has been the investment equivalent of Rip Van Winkle... All that changed late last year when, along with other long-dormant commodities, especially metals, precious and not so precious, gold came to life with a bang... The dizzying run-up, there's growing evidence, was no flash in the pan, but the beginning of what may well prove to be an extended bull market in gold... It seems like a good time to buy gold." Barron's, 7/3<sup>76</sup>

"Institutional money managers -- representing mutual funds, pensions and endowments -- have \$100 billion to \$120 billion in **commodities**, up from \$6 billion in 1999, with \$80 billion of that in index-based investments, estimates Barclays Capital. Several billion dollars has flowed into commodities indexes just in past few months, index operators say." WSJ, 7/3<sup>77</sup>

"There Goes the **Dollar**: The falling buck is worrying some pretty smart folks. But you can protect yourself." Money, 7/2006<sup>78</sup>

"**Dollar** Is Whipsawed, But Bears Stand Firm. Big dollar losses followed by some unexpected gains marked the second quarter, leaving the greenback weaker for the period. These gyrations did little to shake the belief of many analysts that the dollar is destined to weaken further." WSJ, 7/3<sup>79</sup>

"Prospering in the **Housing** Bust. The boom is probably dead. But you can still make good money during the downdraft." BW, 7/5<sup>80</sup>

### Sentiment Timeline

#### Currencies & Other Markets (cont.)

"**Crude oil** prices 'poised to reach new highs'... Frédéric Lasserre [Société Générale] said he believed the bull run on commodities was back and that with the hurricane season just around the corner, oil prices were due to set new records... He added: 'Additional geopolitical risk factors, and the forecast of an extremely active US hurricane season, will send crude through \$80 a barrel toward our technical target of \$83.' Kevin Norrish [Barclays] added: 'Risks continue to be skewed to the upside, given a wave of supportive fundamental global data as well as the approach of a watershed in the Iranian nuclear issue.'" FT, 7/5<sup>61</sup>

"Industry analysts said threats to **oil** supply from places as far apart as Iran and Nigeria continue even as demand for oil rises. A seasonal dip in oil demand during spring in the Northern Hemisphere is now over. Typically, demand starts rising in July as, often, do prices. 'You don't want to be caught short in a market like this,' said Roger Diwan [PFC Energy]." WSJ, 7/6<sup>62</sup>

"Oil's Well. The bullish case for **oil** remains intact -- despite recent energy share weakness." Registered Rep, 7/2006<sup>63</sup>

"With investors hoping that the Federal Reserve can stop raising U.S. interest rates some time this summer, and with governments in Europe and Asia sending signals that they will boost rates in the future, investors are starting to think the **dollar** could come under attack again... That's why many pros are looking for ways to invest abroad, and why they are looking for other ways to bet against the dollar as well." WSJ, 7/7<sup>64</sup>

"For **Oil**, Does \$80 a Barrel Loom? As Mideast Conflict Flares, Price Forecasts Are Revised; Long-Shot Bets Reach \$175." WSJ, 7/21<sup>65</sup>

"**Betting Against the Dollar**... The ever-canny Warren Buffett has taken huge bets against the dollar, both by shorting the currency in futures contracts and by buying foreign stocks. For a while last year the antidollar play looked dumb, but this year it looks clever." Forbes, 7/24<sup>66</sup>

"**Dollar** May Fall on Growth Worries. With the Fed and many economists having long talked about a slowdown in the U.S. economy, some investors are taking to heart the argument that slower expansion can counterbalance the recent uptick in consumer inflation. This bodes ill for the U.S. currency." WSJ, 7/31<sup>67</sup>

"As Data Point to Slowdown, **Housing** Market May Land Harder Than Economists Predict. Home prices in some parts of the country are falling. Builders are scaling back. Bubble or not, the biggest housing boom in recent U.S. history is coming to an end." WSJ, 8/7<sup>68</sup>

"The house party had to end eventually, even if sellers refuse to believe it. Many remain defiant to the point of delusion, demanding one more drink at the **housing** bar... The slowdown seems certain to take a toll on the economy." Time, 8/16<sup>69</sup>

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