Churchill Management Group

Market Perspective

June 10, 2011

The Bull Market that began in 2009 is now two years and three months old. It is getting mature and showing signs of choppiness. Amid this backdrop which has the bad news being played up to an extreme by the free press, there is good news. Our indicators have not confirmed that we are in a Bear Market. In addition, our technical indicators are showing that in the near term, the recent pull back should at least have a significant bounce toward the highs. Our stocks and ETF's have held up well, though they have backed off during the recent correction. Of course, we will be watching our indicators closely and let them guide us to when and how much to cut back should they turn more negative.

Our top-down indicators remain mostly bullish. 1.) Fundamentally, interest rates remain low. However, with the world growing much closer, it is very concerning that the Central Banks in the emerging markets, especially China, are tightening to slow their growth rates. They are doing this because of potential inflation, excess manufacturing capacity and the building of too many homes. Also, the European countries, especially the PIIGS (Portugal, Ireland, Italy, Greece and Spain) have major deficits as well as other financial problems. How much the world's fundamental problems affect the American economy is yet to be seen. 2.) Technically, entering the current correction, both the breadth (advance/decline line) on the New York Stock Exchange and the number of new highs have confirmed the uptrend, leading us to believe the current pull back should NOT be a Bear Market. 3.) Our Sentiment indicators remain in a positive state (with the possible exception of the Equity Mutual Funds Liquid Assets Ratio Indicator on an all time low.) In sum, our experience tells us that unless all three of the Fundamental, Technical and Sentiment factors give bearish signals at the same time, a Bear Market should not happen.

For the very near term, our analysis indicates that this is a very normal correction. Of course, this can obviously change. A lot will be told once this market gets at least a relief rally from what is now a very oversold condition. The McClellan Oscillators, the Stochastics, and our set of Breadth-derived short term indicators are all now at oversold extremes. Of course, they can always stay oversold a little longer, but the typical end result is at least a bounce. A lot can be told about the market on that bounce. If it rallies weakly on light volume or fails at key levels of resistance, then our outlook could change. For now, though, our expectations are for a serious attempt at the highs.

SOME HISTORY ON THE UNWINDING OF A SECULAR BEAR:

The recent action of this "Cyclical Bull Market" against a "Secular Bear Market" background appears quite similar to the market action of the late 1930s in the latter phases of that Secular Bear. In some professional investment circles, this is known as the "1937 Scenario." A major part of Churchill Management Group's investment philosophy results from many decades of study into human behavior and how it affects the cycles of life and investments. Today's environment is a clear example of how history repeats itself.

In the latter phases of Cyclical Bull markets, the indices can become very volatile and the emotion surrounding the market moves can increase significantly. That was the case in the 1930s. When you look at the psychological part of life during the unwinding of the Great Depression in the 1930's and then compare the facts to today there are some economic similarities. Then:

1. In 1929 1% of the population owned 40% of the nation's wealth.
2. Individual worker productivity rises an astonishing 43% from 1919 to 1929 but the rewards were funneled to the top.
3. In 1930 after the crash, Herbert Hoover's Secretary of Treasury, Andrew Mellon, makes his famous statement "Liquidate labor, liquidate Real Estate…values will be adjusted, and enterprising people will pick up the wreck from less-competent people."
4. President Hoover's call for Protectionism – The Smoot-Hawley Tariff Bill passes Congress on June 17th, 1930.
5. By 1932 GNP falls by 13.4% and unemployment rises to 23.6%.
6. 40% of the banks in the United States failed.
7. The top income tax rate was raised from 25% to 63%.

No wonder our forefathers were scared out of their minds for the better part of a decade. We can imagine our forefather's anguish after the economic environment from the New Deal began to recover from the 1929 crash in the early part of the 1930's decade. That anguish had to increase significantly when the 1937, 1938 "recession" began (like our 2007, 2008 and 2009 recession.) Add to that, Japan invaded China in 1937 in a move to acquire bases in French Indo-China. Sadly of course, in 1939 Hitler invaded Czechoslovakia and Poland. Immediately, Britain and France declared war on Germany.

Understandably the investor psychological environment from 1937 to April 1942 was quite negative. The volume on the New York Stock Exchange dropped from an average of 5 million shares a day in 1929 to an average of 282 thousand by 1942. Of course, this horrible period is dramatically worse than the difficult period we have today!

We do know that our forefathers did not have television, the Internet, iPads, and the great tools we have today to stay informed as to what is going on.

THE CURRENT UNWINDING OF THE SECULAR BEAR

In 2011, we find that the free press often takes the negatives to an extreme. You can't go anywhere (and we at Churchill can not go to any Economic Conference) without hearing the gloom and doom played up by everyone. Among them:

1. Fears of deflation like the 1930's. With the blessing of productivity (computers, etc.) today, as well as competition from the emerging markets for our jobs, there is massive excess supply in many sectors. The internet and the cell phone, etc., have all brought the emerging markets into our world as many low end jobs, particularly in manufacturing, have been eliminated and will be gone for many years (will FDR's WPA program be repeated by the next administration so that millions of unemployed workers can be employed to carry out public work projects on the roads, freeways, etc.?)
2. The housing market had a bubble collapse. The massive number of homes in default and underwater are played up constantly.
3. The price of oil, and other commodities driven up primarily by the growth in the emerging markets, are acting as a significant tax on the American consumer especially at the low end economically.
4. As we stated above, Europe, with their attempt to keep the Euro countries together in one economic environment, has tremendous stress as the weaker countries like Greece, Italy, Spain, Ireland, and Portugal are finding their economic policies of socialism and budget deficits are a great fear for the economic environment.
5. As we stated above, China has started some economic tightening resulting from the beginnings of inflation caused by the great growth in their economy. Some economic experts are predicting a hard landing.
6. Japan, which has terrible underlying demographic issues, has been hurt terribly by the earthquake and tsunami. This has dramatically slowed down the manufacturing of a number of their products, like automobiles.
7. There are concerns on how the federal government will pay for the blessings of modern health care which has people living longer. The worry is that in order for Social Security and Medicare to be funded for a number of years down the road, inflation will pick up dramatically when the government is forced to print money.
8. Our Federal Reserve stimulating policy "QEII" is ending June 30th.

This is quite a list of alarming facts. And CNBC and all the other news broadcasts are alarming the American public and its consumers to the extreme, with all of these facts and their editorials. Fortunately, there is some good news to counter balance this negative psychology:

1. First and foremost, our financial leaders like Ben Bernanke, Chairman of the Federal Reserve Board, and the other Federal Reserve Board members, have

dramatically more knowledge and sophistication than the political and financial leaders of the 1920's and 1930's (thanks to modern technology.) For example, Ben Bernanke spent his college career studying how to stop the Great Depression (and deflation) of the 1930's and appears to have learned many lessons from the mistakes made then.

2. The Federal Reserve, the Administration, and Congress continue to provide an accommodating environment via both monetary and fiscal policy. Quantitative easing, TARP, and the American Recovery and Reinvestment Act of 2009 are all attempts at the same goal - to stimulate the economy. We believe that it is likely that if the economy does not take hold that a QEIII and other stimulus will be provided.
3. Corporations continue to improve their balance sheets and are flush with cash. In addition, valuations for many blue chips are now in the low double digits, not far from the single digit p/e's that define Secular Bottoms.

CONCLUSION

This doesn't mean that the next few years are likely to be a great opportunity to make money in the stock market, but it certainly won't be the severity economically that was seen during the 1937 to 1942 period. Even during that period, we know there were two really good buying opportunities if one follows disciplines to make sure that capital is not hurt badly during the down periods. (We saw the first buying opportunity in March of 2009.)

We know that the time to get a great return out of the Stock Market again is coming. If history repeats itself as we expect, it should come with the "buying opportunity of a lifetime" that we have referred to in the past. (Likely in just a few years when the investing public will be the most scared!) This coincides with the timing that many economic experts, such as Gary Shilling, foresee the housing bubble finally playing out.

In the mean time, the Cyclical Markets will need to be monitored closely for the time to protect as the Secular Bear finally unwinds. As we said in the beginning, right now we believe the market is in a correction and believe it has a high probability to bounce and test its highs. We recognize, though, that it is a very fluid situation and as soon as our indicators turn negative we will act swiftly to protect.

We will keep you informed.

CHURCHILL MANAGEMENT GROUP

** This report is meant to inform the reader of our current market opinion, which we, as professional money managers, use in our decision-making. It should be noted that stock market and bond market data are subject to varying interpretations and any one interpretation will not necessarily guarantee investment success. The information obtained from the sources specified herein and used as basis for our current market opinion is believed reliable, but we do not guarantee the accuracy of such information.
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