

## **DouglasBradley LLC – 3<sup>rd</sup> Quarter 2008**

### **Quarterly Economic and Market Assessment**

#### DOMESTIC ECONOMY

- The derivatives problem on Wall Street has expanded to banks and caused the failure or takeover of national and regional banks. Washington Mutual failed on September 25<sup>th</sup>, the largest bank failure in history.
- The ability of companies and individuals to borrow has become constrained; hampering the economy.
- Due to the credit squeeze and slowing economic activity, unemployment has been steadily rising (and is expected to continue to increase).
- Money market accounts, once considered safe, were shaken when one of the oldest funds “broke the buck.”
- Home prices continue to fall. As a result, even more people have mortgages larger than their home’s value.

#### INTERNATIONAL ECONOMY

- Recently believed to have “decoupled” from economic events in the US, the international economy stumbled as the US faltered; supporting the belief that the world’s economies will forever be interconnected.
- The rapid decline in commodity and oil prices has severely impacted the economies in emerging countries, especially in South America, Eastern Europe, and Russia.

#### DOMESTIC STOCK MARKET

- The major US market indices continued the declines that started in the 2nd quarter of 2008 – essentially wiping out any gains earned over the past decade.
- Despite unprecedented intervention by the Fed and the Treasury, their actions have been ineffective in stemming the stock market decline.
- Fear levels in the stock market, as measured by the Volatility Index (VIX), are at all-time highs.
- Historically, stock prices are approaching values not seen in decades.

#### INTERNATIONAL STOCK MARKETS

- International stock markets have fallen in concert with the US market; in most cases, they have fallen farther.
- Japan’s stock market continued its 26-year decline, hitting lows not seen in decades.
- Many of the fastest growing and speculative stock markets (e.g., China, Singapore, emerging markets) have seen greater than 50% drops in stock prices

#### FIXED INCOME (BOND) MARKET

- Due to the weak (and weakening) economy, the Fed has been lowering the key government interest rates in an attempt to spark economic activity.
- Despite the Fed lowering key government-based interest rates, non-government (e.g., mortgage, credit card) rates are rising as lenders face increased risks of default and inflation in the future.
- The difference (“spread”) between the interest rate demanded by lenders for Treasury bonds vs. corporate bonds is historically large, suggesting there is a “flight to quality” and this is a very difficult time for companies to borrow to fund growth.

### **DouglasBradley’s View Looking Ahead**

- Global stock markets, including the US, have become “oversold” and now represent values not seen in decades. This suggests the 4<sup>th</sup> quarter could see a cyclical stock market rally with the potential for lower stock prices in 2009/2010.
- US companies with meaningful international sales exposure and strong balance sheets (e.g., manageable debt) should outperform those that do not.
- The decline in oil prices is acting as a tax rebate, putting much needed dollars back in consumer’s pockets.
- The rapid increase in the value of the US dollar relative to other currencies will reverse and continue its multi-year decline. To offset this, the government will need to pay higher interest rates to foreign lenders.
- Real estate prices in the US should reach their bottom by mid-2009, but it will take years for them to start to grow again in a meaningful way as the economy remains weak and interest rates are likely to rise.
- The US Fed and Treasury, along with the world’s other Central Bankers, will continue to identify and implement new stimulus programs to head off global deflation and stimulate new economic growth.

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## Quarterly Assessment and Discussion

### Discussion of Selected Portfolio Holdings

The third quarter of 2008, as we expected, saw a continuation of the overall decline in the stock market. This favored our “Protection” mutual fund positions such as the Prudent Bear Fund. Because of the volatility we saw, we actually successfully traded the Prudent Bear over the quarter. From our initial purchase, the fund ran-up substantially and became “over-bought” – in other words, the price ran up too-far, too fast. Recognizing that, we locked-in a profit. Then its price dropped substantially, becoming “over-sold”, so we bought it back.

But the major change in your portfolios in the third quarter was our re-entry into the gold company stocks. These are the stocks of companies that mine and process the gold ore that comes out of the ground. Gold and gold company stocks do well in certain types of economic environments – for instance, when inflation is moderate to high. We saw inflation begin to increase in the year 2000 and gold started its current “Super Bull Market” climb at that same time. We saw massive price appreciation in gold bullion and the gold stocks from 2000 to 2007. We owned gold stock mutual funds during this period.

We sold the gold stock funds in 2007 when they got overvalued and we got a signal from the unemotional methodology we follow. We had been waiting more than a year for a meaningful correction to buy them back. With gold stock prices down 40% from their highs and a “buy” signal from our methodology, we got that opportunity on September 11<sup>th</sup>.

For the typical client, we bought 15% each of two gold stock funds – US Global Gold and Precious Metals Fund (USERX) and US Global World Precious Minerals Fund (UNWPIX). At the prices at which we bought, we expect these funds to outperform the overall stock market over the next few years. We also knew when we purchased the funds that gold stocks can be volatile in the short term - but we believe that the potential long-term returns justify the short-term volatility.

Our research of what’s happened in the world economy and financial markets only reinforces our belief that: inflation will remain at moderate to high levels for several more years; and, gold and gold stocks will be the place to be for attractive investment returns. Here are some other drivers for higher gold and gold stock prices:

- Declining interest rates as a result of lower economic activity mean the opportunity cost of holding gold decreases (i.e., it makes it a more viable investment asset).
- The financial stimulus packages being implemented by governments around the world to support their weakening economies will likely cause inflation to continue to increase.
- In the US, to pay for the new spending, the government will need to do massive amounts of borrowing. This lowers the value of our currency relative to other country’s currencies and gold.
- Increased wealth in countries that have long valued gold, such as China and India, will mean increased demand for gold for jewelry and as a store of wealth.

As we discussed in our October 24<sup>th</sup> Investment Update, the deleveraging of hedge funds in October resulted in a big drop in all stocks – especially our gold stocks because these were the last assets the hedge funds wanted to sell to meet redemptions and loan repayments. But this economic aberration doesn’t change: the fundamental long-term reasoning for owning gold in our current financial environment; or, why it should outperform other investment assets in the years to come. We got great purchase prices at the time we bought, but of course the recent lows from October would have been even better. In the end, we believe we’ll be more than happy with how the gold stock funds perform.