

THE 'R' WORD

The question of whether we are going to have a 'soft landing' or a recession seems to have finally been answered. Goldilocks has been banished from Main Street and is rarely heard from on Wall Street these days. Now the debate is whether the economy is entering into a minor contraction, or a deep and prolonged recession. Yes, we have probably entered into a recession, though it won't be official for many months. How deep and how prolonged, no one can say for sure. In fact, we may come out of this cycle in record short time, so that it barely registers as a blip on the charts. What we do know is that some segments of the economy are having severe dislocations - real estate and financial services. Yet other segments are surging ahead - agriculture, exports, mining. So, as usual there are no absolutes and there are different shades of grey. The crucial issue for the next two quarters is not whether we're in a recession or a slow-down, but its severity and duration.

STOCKS

The low made on January 22 in the night session of the futures market - 1255 on the March S&P contract, was discounting the potential failure of the major bond insurers, continued bank write downs and panic selling on the part of European traders. When the Fed stepped in the next morning with a 75 basis point cut, it relieved those worries (albeit this may be only a temporary relief). We will likely see a lot more of this manic action in the months to come. The low briefly pierced the 200 week moving average and then made a 'key' reversal. This was the culmination of a 16.9% drop in 17 trading days - a substantial correction over a short time frame. Further, it marked a 19.2% drop from the October 11th high. These technical factors, the Fed's bold moves and the planned fiscal stimulus package along with new lending limits, gave the impetus for a strong rebound and created a trading opportunity off an important technical low.

A trading range should now commence with the S&P low of 1255 at the bottom of the range and the upper resistance around 1475. This is a notably wide range and more volatility lies ahead. Should either of these upper or lower levels be broken on a closing basis

with high volume, a new bull or bear cycle will follow. It is quite possible the range will be broken in a matter of weeks, but more likely we are going to be in this range for a few months. In either case, when this range is broken, expect a strong follow through, up or down. The macro, fundamental and technical factors which will determine the direction of the next major move have not yet been fully developed, but may be soon.

REAL ESTATE

The residential real estate market has been in a downward spiral since its peak in mid 2005, with over two years of declining sales, housing starts, and more recently, prices. The commercial real estate market (REITs) experienced a similar drop. The recent interest rate cuts (125 basis points in 8 days and 225 basis points since August 17th) are a direct attempt by the Fed to stop this slide. Just as the real estate boom was created by excessively easy monetary policy, which in turn boosted home construction and consumer spending, the Fed is trying to re-inflate the real estate market with the same type of easy money. This is not a good scenario for the inflation front. The recently proposed tax 'rebates' are an effort to stimulate consumers who have been spooked by losses in their

		Price Direction
S&P 500	1395.42	6
PHLX GOLD & SILVER INDEX	184.61	3
GOLD (February)	908.70/oz	4
SILVER (February)	16.82/oz	3
CRUDE OIL - WTI (March)	88.95/brl	5
10 YEAR U.S. TREASURY YIELD (March)	117.09	6
	Yield 3.59%	
30 YEAR U.S. TREASURY YIELD (March)	119.75	8
	Yield 4.31%	
3-6 month Price Direction		
Most Bullish - 1 Most Bearish - 10		
As of close 2-1-08		

home equity. Will it work? Not likely. But the proposed increased limits at Fannie Mae and Freddie Mac along with these lower rates just might hold back the flood waters enough to stabilize prices sometime in the Q2 or Q3 this year. Stable home prices could be sustained for a while, but it will take years to retrace the recent peaks. If the stabilization outcome is achieved, we may be able to escape a full blown deep recession. Regardless, much more damage will be done in the months to come - more write downs and more consumer debt problems are on the horizon (auto and credit cards). How much more of a beating can the financial system take without prolonged damage? How many times can the banks and brokers go to the sovereign wealth funds to shore up their balance sheets? The answers to these questions will determine the economic future of the US over the next 3 to 5 years, or longer.

COMMODITIES

Gold is in a major bull market. There are a number of factors that support the case that this run is far from over. Given the easy monetary policy and re-inflation that is being implemented to bail out the real estate market, tangible assets like precious metals, oil, and other natural resources are going to continue their upward bias. That being said, corrections are due and large swings are likely. Precious metal and mining stocks are undervalued with gold at current prices and they should be accumulated on dips. Agricultural prices are also going to continue to be beneficiaries of the inflationary environment. The simple fact that there are more people on the planet to feed and they have more money than ever before, adds fuel to this cycle. Corn, sugar and cotton are particularly attractive. One way to capitalize on the bull market in agriculture is to buy PowerShares DB Agriculture Fund (DBA).

INTEREST RATES

Short term Treasury securities will continue to stay low as long as the fed remains accommodative, but longer term bonds, particularly the 30 year Treasury is a opportunity for a short sale. The bonds are yielding 4.31 %, while inflation is not far from this level (not the published government inflation figures, but the 'real' levels, including food and energy). This gives these

bond holders close to zero 'real' return. The flight to quality over the past few months out of stocks and riskier credits has caused the 30 year Treasury to run up to unsustainable levels. The yield curve should steepen in inflationary environments. Add this to the weak dollar and the de-pegging of the dollar by many large US Treasury bond holders, and we have the potential for a severely over-bought condition. At the same time, we will see continued wide (or wider) spreads between government bonds and higher risk (junk) bonds.

INVESTMENT STRATEGY

The bull market has corrected. So far we can still call what we have seen since August a correction in a long term bull market. However, we may be entering a true bear market. A break of the January 22 low (S&P 1255) would signal that a bear market is in force, while a break above the 1475 resistance would signal a new phase of the bull market and a very powerful rally to substantially new highs could occur. The jury is still out. At this juncture, the odds seem to be about 60/40 in favor of the bear case. In the meantime, we will likely be range bound with substantial volatility. Buying dips and selling rallies, using stops, is one way to capitalize on this trading range. Good intermediate term opportunities in commodities and commodity stocks remain. For speculative short-term traders, short the 30 year Treasury bonds, with a 116.5 target price over the short run (use 121.5 as a stop). Longer term, buy the Rydex Inverse Long Term Government Bond Fund (RYJUX).

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