



2005-CINV-00056

By Robert Boshnack, Chairman, Vision L.P. January 5, 2005

Our last year's special report, "Eye-Opening Stock Market Forecast and Analysis for 2004" proved right on target! Unlike many analysts who forecasted strong gains or big losses for the market in 2004, we took the middle ground. We cautioned investors not to expect returns anywhere near the 25% recorded by the Dow in 2003, but rather to expect a lack luster range bound market producing modest single digit returns closer to around 7%. The market proved us correct, trading in a relatively tight range, with the Dow finishing the year up 3%, at 10,783.

A Look at Our 2004 Forecast

"Stocks are a leading indicator; they tend to rise in *anticipation* of economic recoveries, not in response to them. They increase the most when earnings first recover. Historically speaking, the largest market gains tend to come at the start of an economic rebound, where the market "prices in" future earning gains. This is precisely what we believe happened in 2003. Most of the gains in last year's stock market are already factored in!"

"The key to the direction of the market will be interest rates. Historically most bear markets have been triggered by a reversal in interest rates. We feel that inflation is still low enough for the Federal Reserve Board to be accommodative in its monetary policy. Any interest rate increases, we believe, will not occur until the latter part of the year, and will be mild enough not to spook the markets and derail the economy. Historically, presidential election years have been positive for the stock market. We believe 2004 will prove true to form."

"We caution, however, not to expect returns anywhere near the generous 25% bestowed upon the Dow in 2003! Instead, we expect to see more modest returns, closer to 7%".

For a free copy of last year's report visit:

http://cta.visionlp.com/pdf/gen/2004%20stockforecast_CINV.pdf

History is Our Guide

As many of our readers know, we believe the history of the stock market can be a very important guide to its future direction. **We believe studying the history of the markets is of little use in forecasting day-to-day or short-term market movement, but extremely useful in helping forecast the market's intermediate-to long-term trend!** Why? History is created by the actions of people, and people have generally repeatedly reacted in a predictable fashion since modern civilization began! People don't change; only circumstances and events do!

With history as our guide we will present to you where we believe the stock market is now, and where it is headed in 2005 and beyond! Get ready to be enlightened!

Understanding the Big Picture

It is important investors realize that in 2000 we ended one of the biggest, speculative bull markets in history, where stocks rose to absurdly high levels that were nowhere near justified by their earnings. Secular bear markets have historically followed 'super-bull' markets.

The key to understanding the stock market is to realize the market moves in cycles. The current market is part of a secular bear market cycle that started five years ago in 2000. History has shown the bigger the boom cycle, the bigger the bust cycle and the longer it takes for the market to recover. We've seen this in the bull market cycles that peaked in 1901, 1929 and 1966. With regard to each of these cyclical peaks, annual returns afterwards, during the secular bear market cycle, averaged 1.9% to a negative 0.2% for a period of almost 20 years. In retrospect, when the bear market cycle began for each of these secular markets, few investors were aware or ever imagined a 20-year period of famine would ensue – one that would post average returns from a scant 1.9% to a negative 0.2%!

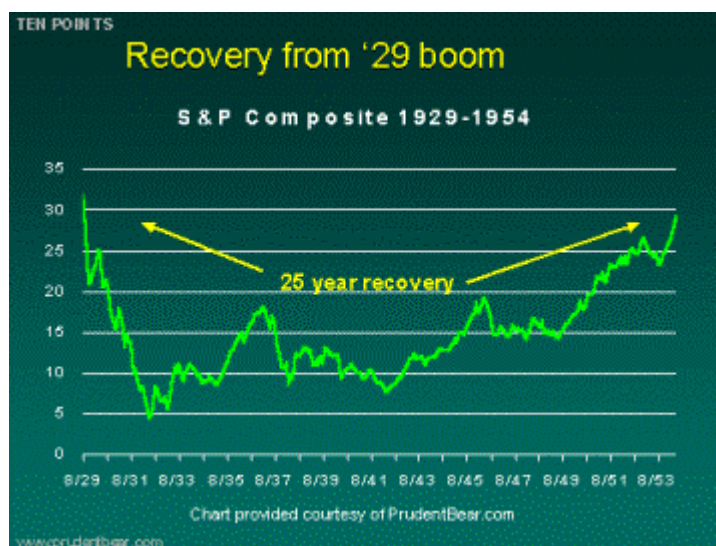
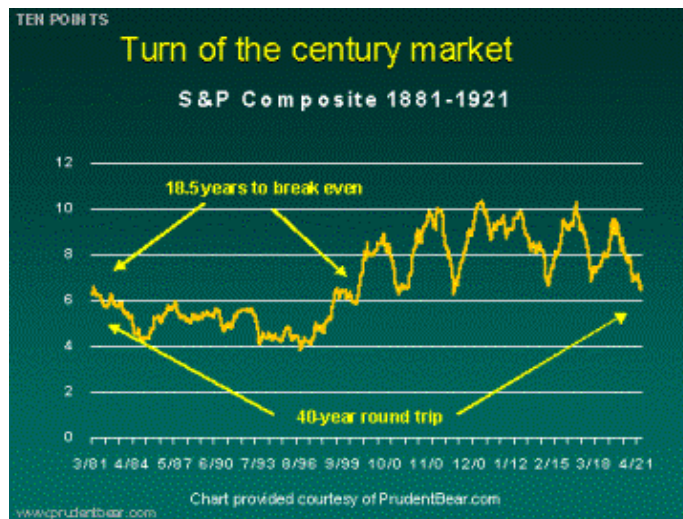
Why, we ask, should we assume the present market cycle will be any shorter than it was for each of the three bear market cycles described, especially in light of the fact that the bull market leading to *this* bear market was even stronger, more excessive and financially more damaging than all of its predecessors?

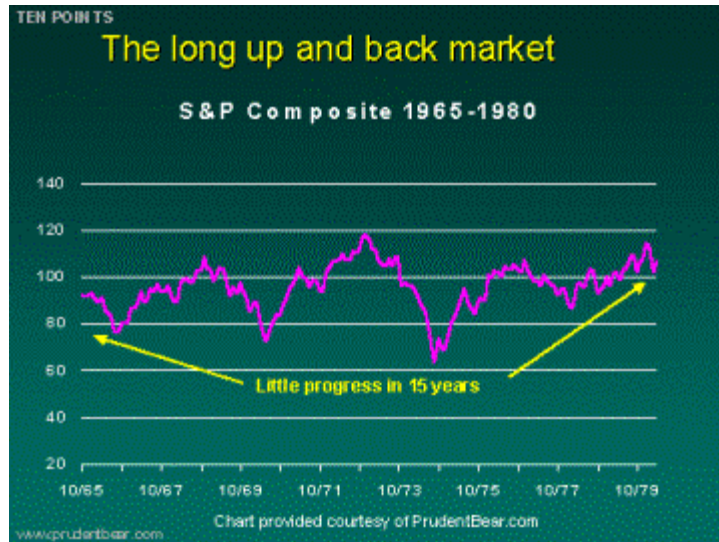
Based on our research, and compelling evidence we will disclose in this report, we believe in the strongest of terms we are in a long-term secular bear market cycle! Secular bear markets historically have averaged lackluster, flat returns over periods of 10 years and more, even with strong rallies and occasional big gains in some years. Fierce rallies are typical in secular bear markets. They serve to convince investors that the old bear market is over and a new bull market is on the way, eventually providing fuel for the next big decline, as disillusioned bulls exit the market. For example, during a

27-month span that began in April 1930, there were seven major market rallies. The average rise was 24%. Even with the rallies, it took the market 25 years to recover to its previous highs. **Similarly, we believe history will record the big gains the market experienced in 2003 as part of a secular bear market rally, which fizzled in 2004, and in which the bear market resumed in the later part 2005, or early 2006!**

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Secular bear markets, may go up and down, but essentially go nowhere over time. This is exactly what we are experiencing now! **Five years ago the Dow traded at 10,783; where it finished in 2004. The Dow's annual average return since the inception of our current secular bear market cycle in 2000, through the end of 2004 is only 0.8%: This is precisely in line with the historical annual average performance of the other secular bear markets previously mentioned!** In another five years we suspect the Dow will also be around current levels--but not without first retracing close to it's 2002 low before this secular bear market cycle is over!

Pictorial View of Secular Bear Markets





As you can see, a closer look at secular bear market historical cycles show long periods of stagnation and lackluster performance! From 1881 to 1921, a 40-year period, the market experienced little change. Once the market peaked in 1929, it wasn't until 1954, 25 years later that the market recovered to its 1929 highs. And for 15 years, from 1965 to 1980, the market made little progress! **Secular bear markets are the worst type of markets for investors because any gains usually are eroded and have a good chance of even turning into losses over time. Investors with a long-term buy-and-hold mentality may find themselves extremely disappointed in the coming years!**

Historical Support

There is ample historical data in support of our opinion that stocks are in a secular bear market and will under-perform for years to come:

John Mauldin, a well-respected financial newsletter editor notes, *“There has never been a time in history when the P/E ratios were in the range they are today, that 10 years later, investors in the broad stock market made a penny. None!”*

Yale professor Robert Shiller, who called the top of the market in his famous book, *“Irrational Exuberance”* supports Mauldin’s research. **According to Shiller, from today’s high P/E ratios, 10 years hence, there has never been a time when investors saw better returns than simply parking their money in a money market fund.**

In a Barron’s article, "After the Bubble," it was stated: "Nor does history offer any comfort to today’s stock investors.” **The last three stock-market manias that ended in 1901, 1929, and 1966-68 were followed by 15 to 20 years of anemic, average annual returns, ranging between 2% and 5%--or zero to a negative 1.8% after adjusting for inflation."**

*Further support comes from a fascinating study published in Michael Alexander's groundbreaking book, "Stock Cycles." Written during the first quarter of 2000, Alexander's propositions have accurately described the markets since then. **Alexander deftly points to the existence of certain long-term cycles, which are not random, and the probabilities of those repeating, he asserts, is very high.** The only statistically valid, non-random cycle Alexander could find is a 13-year cycle. Since 1800, he shows, there have been 15 alternating good and bad cycles of 13 years, from periods where stocks were undervalued to stretches where they were overvalued and back again. In his model, the year 2000 represented a 13-year peak. There is only a 3.9% probability that this pattern is random. In other words, **Alexander concludes, there is a 96.1% chance that the market topped in 2000 and will under-perform for an additional 10 years.** Investors in the stock market during the 95 years of bear market cycles achieved only a 0.3% annual average rate of return.*

The Specifics

Now that we've presented the stock market's "big picture," let's get to the particulars.

In order for any economic recovery to be lasting it must be self-generating and not created by artificial fiscal and monetary stimulus. A self-perpetuating recovery requires investment in capital expenditures, growth in both jobs and income and less reliance on debt. According to economic theorist Joseph Schumpeter, economic recoveries that are purely a consequence of fiscal and monetary stimulus must ultimately fail.

The market was propelled in 2003 by a fiscal and monetary steroid-like mix of tax cuts, highly accommodative monetary policy, record low interest rates and massive mortgage refinancing. These "market steroids" carried over into 2004 helping to underpin the market. However, enhancement drugs, as most of us have learned, provide short-term solutions for optimizing performance, but they also come with long-term consequences. Likewise, "market steroids" amount to no more than temporary band-aids, obscuring problems that can get even worse when the "band-aid" is removed.

The "steroid mix" has just about run its course, and unfortunately is not self-sustaining. There is now a preponderance of economic crosscurrents, which we believe will cause the stock market to change direction from sideways to down in the later part of 2005. These include record trade and budget deficits, a depreciating U.S. dollar, rising interest rates, high oil prices, record consumer debt and decelerating corporate profits.

Budget and Trade Deficit Concerns

At a conference in Frankfurt, Germany last November, Federal Reserve Board Chairman Allan Greenspan was uncharacteristically candid. He said, "It seems persuasive that, given the size of the U.S. current account deficit, a diminished appetite for adding to dollar balances must occur at some point."

Greenspan suggested an eventual desire by foreign investors to cut the risk of holding too many dollars may lead them away from U.S. assets or lead them to seek higher rates of return. He warned this would elevate the cost of financing of the U.S. current account deficit and renders it “increasingly less tenable.”

In effect, Greenspan was warning that if the government doesn't restrain deficits interest rates would have to rise. The government responded late last year by raising the debt ceiling by \$800 billion: Hardly the restraint Greenspan was calling for!

Concerning the ballooning U.S. trade deficit, Morgan Stanley's economist Steven Roach states what we believe to be an alarming, but accurate appraisal:

"The day will come when foreign investors simply say 'no' to this arrangement - refusing to fund America's consumption binge without getting a meaningful concession on the terms of financing. **That's when the dollar collapses, US interest rates soar and the stock market plunges.** Under such a crisis scenario, a US recession would be all but inevitable. Unfortunately, with America's current-account deficit now in the danger zone, that day of reckoning could well come sooner rather than later."

One can easily understand Roach's deficit concerns. According to respected newsletter editor, John Mauldin, the U.S. is now absorbing 83% of the world's savings to pay for its trade deficit. Foreigners now account for an alarming 40% of U.S. debt. The U.S. needs to pay \$1.5 billion dollars a day just to finance the debt! With the dollar plunging to record lows against the Euro and other currencies; foreigners are suffering huge exchange losses buying U.S. securities. Foreign buying of U.S. securities is already starting to decline. We expect the Fed to be forced to raise interest rates considerably more over time to continue to attract foreigners financing U.S. debt. Don't expect much buying from U.S. consumers; they are “tapped out” with the highest consumer debt, and lowest savings rate on record.

Depreciating Dollar, Inflation and Higher Interest Rates

Bill Gross, chief investment officer at California-based Pimco, with \$415 billion assets under management, said the handwriting is on the wall when it comes to a weaker dollar and higher interest rates.

"There's no doubt that the dollar is on the run and that higher U.S. interest rates are the inevitable consequence." Dollar depreciation leads to higher inflation and ultimately forces foreign creditors to question their rationale and indeed their sanity for continuing purchases of U.S. Treasuries, he added. We agree with Mr. Gross.

A depreciating dollar, inflation and higher interest rates are a lethal combination for the stock market, and the harbingers of recession.

Two widely followed inflation gauges are flashing warning signals. Near the end of last year Ned Davis Research's inflation model hit a 15-year high.

The Future Inflation Gauge from the Economic Cycle Institute is holding firm and shows no sign of weakening.

The ISM gauge (Institute for Supply Management) continues to hover near the highest levels in 25 years. This gauge measures on going pricing pressures in the manufacturing sector.

We expect any surprises in inflation to be to the upside in 2005!

Record Oil Prices

Adding to inflationary pressures is the highest oil prices in history. Higher oil prices are not only inflationary, but also take money out of consumer's pockets that could be spent on products that support the economy. According to Morgan Stanley's Roach, "Oil shocks like the one that may be developing, have an awfully perfect-and perfectly awful-track record. They are always followed by recession." Although oil prices declined from their \$55 barrel highs in 2004, we are still in the \$40 per barrel price range as 2005 begins. Sustained prices in the \$40 range are still significantly higher than in 2003, and way above historical averages!

Is Anyone Noticing?

We have had one of the biggest monetary and fiscal spending sprees over the past several years by the federal government in an attempt to spawn higher capital spending and hiring on the part of businesses; two essential ingredients for a healthily economy. While low interest rates, tax cuts, and mortgage refinancing had a positive effect on the economy in 2003 and 2004, the end of tax cuts, rising interest rates, and the slowing of mortgage refinancing were starting to show their effects towards the end of 2004, with a slowing of capital spending, less hiring and more firing.

At the end of 2004, it was reported in December that job cutting was the worst in 2 ½ years. Additionally the pace of job creation since the last recession in 2001 has been the slowest of any economic recovery in the U.S. since the Second World War!

With more people unemployed and less job creation, there is simply less money for consumers to spend to support businesses; which a record consumer low savings rate and debt load further compounds! Consumer borrowing and spending excesses of the past few years have grossly depleted the economy of available resources for a self-sustaining economy. A plummeting dollar does nothing at all to offset the profound structural shortfall of savings and capital formation. Rather, it fuels inflation. Consumer borrowing and spending excesses of the past few years have seriously compromised the ability of the consumer to support the economy going forward. **We expect that weaker than**

expected consumer spending will distinctly slow the U.S. economy in the later part of 2005.

Now that the tax cuts are no more, interest rates are rising, more jobs are being lost, corporate profits are decreasing, mortgage refinancing is waning, and business is slowing down spending, we see the “handwriting on the wall”: **the brakes are being put on the economy, and the market for now isn’t noticing!. Contrary to popular belief, we see the economy not nearly as strong as many predict in 2005.**

More Concerns

Historical Length of Bull Markets

Many investors who are not old enough to remember how the stock market traded before 1980 have a distorted view of how long bull markets should last. This is understandable since the bull market of 1982 and 1992 lasted 5 and 9.5 years respectively. We have experienced 16 bull markets over the past 55 years. The average peak in the 16 bull markets since 1932 was 2.6 years. The current secular bear market rally, which many refer to as a bull market, was 2.4 months old as of January 2005. This “bull market” is getting old, and approaching the historical peak of bull markets since 1932.

Historical Market Reaction after 5 Discount Rate Hikes

The Federal Reserve Board raised the discount rate 5 times in 2004. Since 1953, 6 and 12 months after the 5th discount rate increase 5 out of 6 times; the S&P 500 suffered losses! Six months after the last 5th discount rate hike will be in the later part of 2005, which coincides with the time we believe the market, may begin to experience difficulties.

Higher the Rise the Greater the Fall

Since the Dow bottomed in October 2002, it has rallied close to 50%, propelled by double-digit earnings. We see earnings decelerating more than the consensus, making the Dow highly susceptible to a substantial decline. The higher the rise the greater the fall!

Too Much Bullishness

An excellent contrary indicator to the direction of the market is extremes in investor sentiment. At the end of 2004, according to the American Association of Individual Investors (AII), their members recorded a 64% bullish reading. **This was one of the highest readings in the past decade, and not far from the 66% reading at the peak of the market’s Bubble in March 2000!**

2005 Forecast

We urge investors not to be led astray by the “herd’s” bullish forecasts for 2005! Don’t be fooled by appearances. The strength the market is exhibiting is a carry over from “market steroids” that are just about depleted. Stocks are a leading indicator; they tend to rise in *anticipation* of economic recovery and fall in anticipation of a recession. Without the “market steroids” previously mentioned under “Specifics” in this report underpinning the market, we believe the **on-going cumulative effect** of record budget deficits, a depreciating U.S. dollar, rising interest rates, high oil prices, loss of jobs, and rising inflation will be insurmountable, and push the U.S. economy into recession sometime in 2006. At some point in 2005, we expect investors to take off their rose-colored glasses and start to factor in the possibility of recession in 2006. **The anticipation of recession leading up to the actual occurrence historically has been the most financially damaging to the stock market. On average the stock market drops 43% during a recession: Sometimes more sometimes less.**

Increasing the probability of the bear market resuming in the later part of 2005 to the beginning of 2006, in addition to our “More Concerns”, is the post presidential election year cycle. Since 1953 there have been 13 presidential elections, not including the one that just passed. Bear markets ensued after 11 of the 13 elections. The average loss during these bear markets was in excess of 20%, and as high as almost 50%. **The majority of bear markets began in the first year after the presidential election—a period in which we now find ourselves.** The second greatest aggregation of bear markets started in the second year after their respective presidential elections, which would be 2006. This coincides with our forecast that the market will cross over to the bear sometime in the latter part of 2005 to early 2006! **(It is interesting to note the election year cycle, where the biggest gains in the stock market historically have come the year before the election, came to fruition with the Dow experiencing a 25% gain in 2003!)**

We see the bear market starting in the latter part of 2005 to no later than the beginning of 2006. Our forecast is for the Dow to end 2005 relatively flat, with a gain or loss in the range of 5%; with 2006 seeing possibly substantial losses, especially if a recession takes hold. However, be forewarned, that if inflation accelerates and interest rates rise quicker than expected the market could resume its bear cycle sooner than our forecast!

As you can see from “Pictorial View of Secular Bear Markets,” our forecast is in line with the historical patterns of other secular bear markets.

Our Advice: Act Don’t React!

We are now in the midst of a transitional period in which we strongly believe investors need to realign their portfolios; acting now instead of reacting afterwards to losses inflicted by a bear market. While the market may rise in the near term, we believe any profits will be meager and disappear before 2005 ends. We see the upside potential in the market under 5% with the downside significantly greater than the upside.

We believe we are now in a similar period to the super bull markets, which peaked in 1901, 1929 and 1966, where 20-year returns following *each* peak averaged only 1.9% to a negative 0.2%. Further, we expect the market will be in a sideways pattern with a downward bias for many years to come!

If one is to survive and prosper in the coming years, we strongly believe it is necessary to let facts and logic overcome one's emotions, realize we are in a long-term secular bear market and invest accordingly! The long-term historical average of the Dow Jones Industrial Average is around 7%. **Considering the disheartening long-term outlook for the market, we believe the wisest and most prudent thing an investor can do is to attempt to play it safe and place the majority of one's portfolio in historically safe, income producing investments that approximate the Dow's historical average. Our reasoning: Why try for speculative gains in the stock market when even assuming one is successful, in a secular bear market the gains probably won't be much more than one can achieve in less volatile and more comparatively safer income producing investments, like preferred stocks and tax free municipal bonds?**

Perhaps the most important question investors should be asking themselves: "Is my portfolio diversified with investments that are non-correlated to stocks, and that possess the potential to do well even if the stock market moves down or sideways?"

One of the least correlated investments to stocks is commodities. In fact, an important study, "The Time Variation in the Benefit of Managed Futures," published in the *Journal of Alternative Investments* concludes there are "statistically significant" risk reduction benefits by including managed futures in an overall portfolio. Additionally the study shows how managed futures' best performance periods were in periods of rising interest rates; a period we are in now! For more details on the conclusions drawn in the study, please visit <http://www.cta.visionlp.com/pdf/gen/powerfulStudy.pdf>. **You must keep in mind that futures and securities investments do not have the same risks. The risk of loss in futures trading is substantial, and it is not suitable for all investors.**

The End of One Bull Market and the Beginning of Another!

While we believe stocks are in a secular bear market, the long dormant commodities markets are now in the throes of a major bull market imbued with considerably more potential. While stock indices have languished, major commodity indices have made new highs. With the cycle for rising inflation and interest rates just starting to take hold, for suitable investors commodities are the place to be!

Over the last century, we have experienced only five bull markets in commodities, or one, on average, every 20-30 years. Growing inflation usually sparked the bull markets! Past performance is not indicative of future results.

The commodities that are receiving the lion's share of press include gold, crude oil, the US dollar and the Euro currency. However, a number of commodities remain near historic lows, presenting a potentially classic opportunity for investors. There are also

several investment strategies available to qualified investors that attempt to capitalize on the commodity markets, including the limited risk use of buying options. Consult your Vision affiliated broker for the commodities that look attractive and the investment strategies that are best suited for you!

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Please note: No matter how good any potential opportunities may be in the commodity markets, we still advise the majority of your portfolio be placed in relatively safe income producing investments, with the amount invested in commodities based on your suitability, the proportion of your portfolio dedicated to risk capital and your tolerance for risk.

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