

## Time for a Defensive Posture

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The stage is set. Housing prices keep falling, oil prices keep rising and the credit crunch in the financial sector continues to worsen. In my view, the odds of a recession are now better than 50/50, up from a 25% consensus estimate only a month ago. And, if you've heard me talk much about the economy over the years, you know I'm not one to venture a forecast.

Just today, two events occurred that reinforce my rare forecast: First, Merrill Lynch announced an additional \$2.5 billion in write-offs, raising the total to over \$8 billion. These huge hits to Merrill's earnings were due to risky mortgage-related securities that proved to be much more price-volatile than the company had guessed several years ago.

Second, the price for crude oil reached a record \$90 a barrel after a government report showed an unexpected drop in U.S. stockpiles. With the winter heating season just around the corner, this will definitely put a dent in consumers' wallets.

Merrill's write-offs are just the next shoe to drop in the still unfolding credit crisis involving sub-prime mortgages and the risky securities that Wall Street packages them into. A June 2007 Wall Street Journal survey found that by a three-to-one ratio, economists thought the worst of the housing bust was behind us. They were wrong. As banks and mortgage brokers continue to raise standards for granting mortgages, it will become harder and harder for some people to obtain financing. That will cause a further drop in housing prices, until some sort of equilibrium is reached, probably about 6 to 12 months from now.

The U.S. economy, however, tends to be quite resilient,

and there are some bright spots, e.g. employment is stable and retail sales have been strong. Plus, the Federal Reserve may jump in as soon as next week to further lower short-term interest rates, thereby possibly lessening the severity of a recession.

Just to be safe, however, I recommend that all clients consider authorizing me to sell some of their current stock funds, in order to buy the Hussman Strategic Growth fund at a weighting of 10% of the equity portion of your portfolio. So, for example, if your target asset allocation mix is 60% stocks, the rest bonds and cash, I recommend holding 6% of your entire portfolio in Hussman, more if you're particularly anxious.

Why Hussman? It's a very low-volatility fund that has achieved returns in the last recession, 2001-2002 of 14.67% and 14.02% respectively. That's 26% to 36% higher than the S&P 500 Index in those two awful years of recession and stock market drops.

Hussman is a contrarian fund that tends to zig when the stock market as a whole zags. That's a good thing to hold in a possibly recessionary environment. The fund uses a very distinctive strategy of analyzing price trends and trading volume, as well as stock valuation measures, to assess the general market climate and hence the attractiveness of stocks. When his assessment is overwhelmingly negative, as it is now, the fund hedges away from stocks.

Please email or call me to give me your go-ahead on this strategy or to discuss it further. I would like to make the change to your portfolio as soon as possible. Some of you already hold Hussman, so it may merely mean tweaking the amount, if that.