

Preliminary Defensive Moves Indicated November 20, 2009

Investment Strategy

Analytic Systems Corporation refined a model based on computer studies of the historical behavior of thousands of stocks and hundreds of economic time series to identify which variables and factors have the greatest impact on stock returns. The model developed in 1982 holds that past economic relationships have application to the future trends. This month's Sector Analysis Research has identified the specific industry groups which appear to be in a favorable position based on the current economic climate.

Equities:

Telecom and Commercial Banks are well positioned based on the current economic environment. An overweight among S&P groups is advised in Industrials and Financials. Market weights are advised in Consumer Staples, Energy, Health Care, Information Technology, Materials and Utilities. Underweighted is Consumer Discretionary. Consumer Staples was upgraded this month, Information Technology and Consumer Discretionary were downgraded.

Fixed Income:

Our view on long bonds based on current macroeconomic trends is neutral. We would rate the current duration environment as a 5 down from 6 last month. Our duration is scaled from 1 to 10, with 1 representing a maximum position in Long Treasuries and 10 representing a maximum position in short term debt.

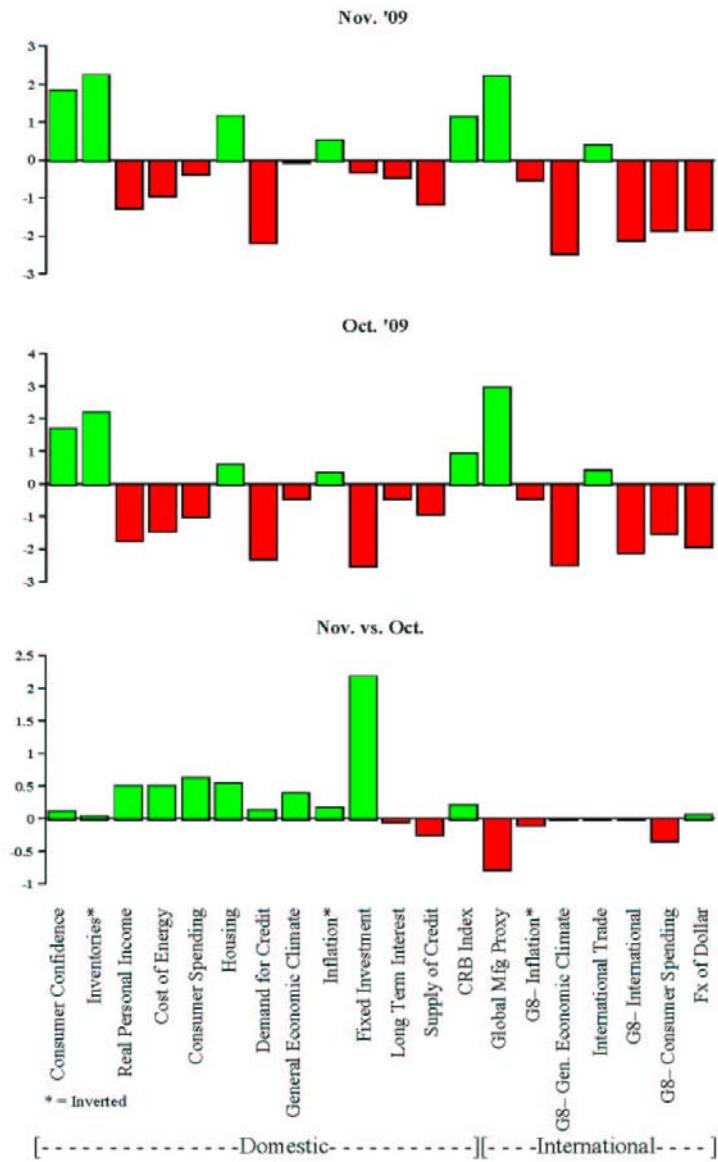
Hedge Funds:

We are long Industrials and Commercial Banks. On bonds we'd close out the small short position in the 10 year and small long position in the 10 year TIPs initiated last month.

Fact Forward Inferences:

Analytic Systems' approach to forecasting is fact-based, rooted in recent economic history and mathematically driven—incorporating new realities. The top bar graph on the following page shows the velocity (first derivative) of key areas of the US and G8 economies for November 2009, the middle shows the velocity for October 2009 and the bottom bar chart shows the acceleration or deceleration (second derivative) in trends that occurred in November 2009.

The following charts show fact based trends in ASC Economic factors as of November 2009 as compared to October 2009 and changes expressed in standard deviations around the norm, hereinafter referred to as “units.”



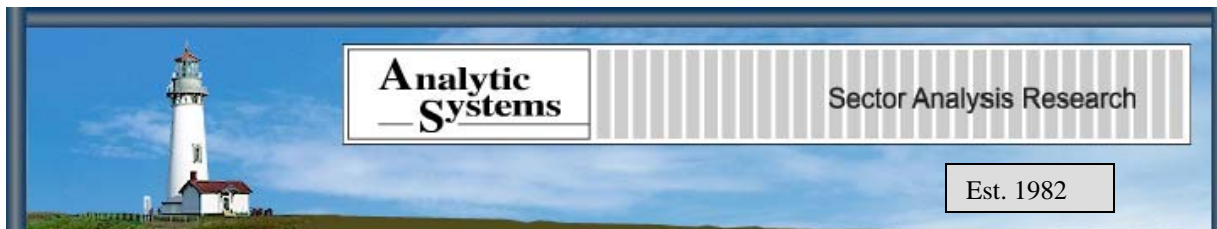
The model highlights the units that rose in November 2009	
Fixed Investment	2.19
Retail Sales	0.63
Housing	055
Cost of Energy *	051
The model highlights the units that fell in November 2009	
Global Mfg.	0.76
Fx US Dollar	0.29

* Inverted Factors

Analytic Systems’ Factor indicators of future activity suggest that the recovery in the US was aided significantly by a rebound in fixed investment. The recent pay downs in consumer installment credit continued at an uncomfortably high level of \$14 billion, up from \$10 billion last month but down from \$19-21 billion in previous months. Retail sales results were okay, up .2 % ex autos, helped by the downward restatement of Sep. 09’s drop of 1.5% to 2.3%. Excluding cash for clunkers and the housing tax credit, the consumer remains quite sluggish. Showing a sustained improvement in consumption appears necessary to keep the economy growing at a 3% plus rate in 2010. The overall latest score was 94.3 as compared to a restated 90.2 in October 2009.

Of the three scenarios we outlined last month, that of a sustained recovery and low inflation, a “w” with the current strength turning to weakness or a tsunami in which the Fed over stays and inflation picks up, last month’s data suggested that the odds of a “w” improved significantly. Consumers are not behaving as they usually do in the early stages of an economic recovery.

The outcome of a “w” shaped recovery is a distinct possibility. Consumers have been paying down debt and have increased savings from prior negative levels. Consumers have behaved differently during this recession, and so far in the recovery. There has been a loss of trust in government. There had been an assurance by Federal Reserve officials



that one does not have to save for a rainy day, because if the economy gets into trouble the Federal Reserve would come to the rescue. People could borrow and spend and not have to worry about being out of a job for long, because they could rely on the US government. In 2008, the US government broke that compact. A 100 year type of financial meltdown occurred and many were hurt very badly, a great deal are still suffering. Americans learned that we could not trust the government to protect them from highly leveraged enterprises that profited at the expense of the majority. Not trusting the government, they have begun to do what has been historically the responsible thing to do—save for a rainy day. The question that remains, is this a short term event or a change in behavior that is going to last for an extended period of time.

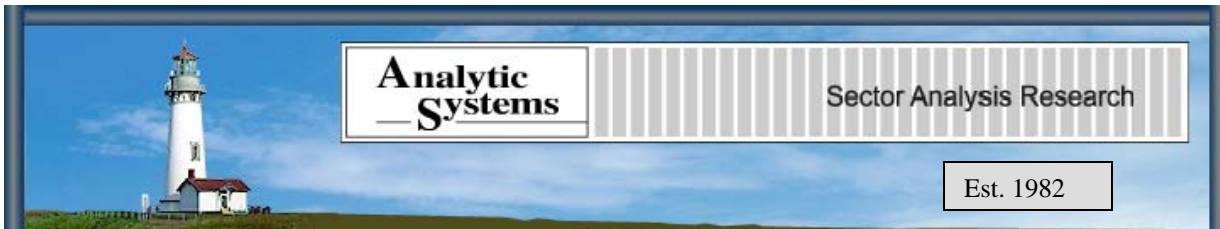
The question for investors is whether the perception or expectation of a “w” shaped recovery is likely whether or not a “w” actually occurs. For if there is a perception of a “w” then markets will discount a “w”, even if it does not occur. So, the likelihood of the perception of a “w” shaped recovery is great enough to take some defensive action.

If the perception of a “w” develops, then the safe haven value of the US dollar is likely to increase. In that case the US dollar could have a significant rebound. With strength in the US dollar, commodities are likely to be very weak, in particular since China has stockpiled all that it needs for the immediate future.

The CPI headline rate was up .3 % in October 2009 bringing the year over year rate to a negative .2 %. The core rate was up .2% leaving the year over year core rate at 1.7%. The Cleveland Fed’s median CPI was up .1%, resulting in a 1.5% year over year rate.

As a follow up to last month’s article, the reason the US is having to create asset bubbles is to maintain full employment when first Japan and then China have grabbed about 15% of the US’s goods producing employment. By extension the loss of goods producing employment has led to lower growth in real income and borrowing ability by US consumers, both of which reduce the ability of the consumers’ ability to spend. The growth in spending in the last cycle was illusory because it was financed by home equity extraction. Since the early 1970’s, the loss of 16% of the US goods producing employment has put a significant dent in the high paying blue collar jobs. The Federal Reserve in its attempt to maintain full employment, has had to err on the side of easing to stimulate the economy, creating bubbles that have been very disruptive.

Companies have found ways to keep up with demand with temporary workers, over time and extensive out sourcing to India and China. With China’s artificially cheap renminbi, the only foreign countries that are likely to be adversely affected on competitiveness by the weak US dollar are Europe and parts of Asia. It seems at every cycle, job creation takes longer and longer to reengage because American companies have found cheaper ways to meet demand without hiring expensive full time workers. It may take until 2011 when the current nascent recovery loses its label of a “jobless recovery”. The loss of jobs

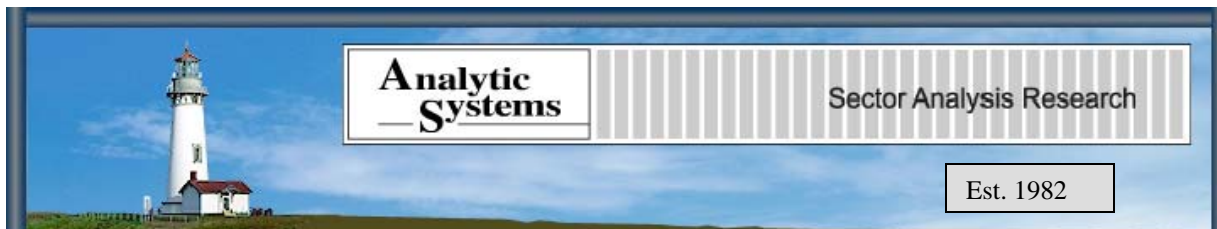


undermines the ability of Americans to consume enough to be the locomotive for the world economy. Recently, the areas of the US and G8 economies that has been the most robust have been exports. But, one might ask the question, export to whom. The emerging markets are growing quite rapidly but are not big enough to replace the European and American consumer. It would appear that the world economy is going to have to get by without depending on a profligate US consumer.

ASC industry group rankings were decidedly more defensive last month with a rise in the rank of utilities such as Regional Phones. Consumer Non-discretionary and Hospital Supply Drugs are also fairly highly ranked at 15 and 14 respectively. We are frequently asked why did the defensive industry groups move up in rank—what factor caused this? Well, the reason defensive groups are ranked highly is because of a pattern involving multiple factors that usually precedes a period of economic slowing. Labeling the current pattern follows from observing the following ASC Factors: (1) Depressed real income, (2) continued high level of job losses, (3) significant deleveraging by consumers, (4) lack of available credit, all of which are leading to weak consumption. In addition after the surge in the Federal Reserve's balance sheet during the panic in 2008, Supply of Credit has been decelerating. So the overall label would be something like a consumer that is unable or unwilling to spend commensurate with the strength of the recovery accompanied by tight money. How long these conditions last is the key question. With an improvement in residential real estate, the consumer should be getting a boost but has not yet responded. With higher equity prices, banks should start lending but so far have been reluctant to provide available credit. A lot of the money that the Fed has pumped into the system has gone into bank reserves that the banks are sitting on. For now it only seems prudent to steer ones portfolio toward more defensive groups and lighten up on some of the early cycle groups that have performed very well, until we get the all clear or a signal that conditions are worsening. This is the first time we have advocated a defensive posture since our optimistic stance in Dec. '08 which advised going with recovery type groups based on the prospect of a "v" shaped recovery.

Besides, in ASC's second deviation world, Supply of Credit is actually contracting at a moderate rate.

In a recent speech Federal Reserve Chairman Ben Bernanke suggested that while it is difficult to identify bubbles in the US and they are very disruptive, they need to be dealt with presumably with raising interest rates and a tightening of monetary policy. That was the policy that was used in economic cycles beginning in the 1960's. We've offered the view that bubbles should be reined in with a tighter fiscal policy which would yield tax revenue instead of a tightening by the Federal Reserve which causes recessions.



Below is a release issued by ASC in April 2008 advocating a better mix of monetary and fiscal policy.

Constrain a Bubble, Dodge a Bust

A radical approach to economic policy for a unique economic time

(**Hopkinton, NH**)- With the economy either already in or limping towards the first recession since 2001, an economic analyst in New Hampshire has a radical plan to moderate the economy's wild swinging from boom to bust. Though the economy has made headlines on its own merit for months, a Gallup poll in December 2007 indicated that economic issues could end up being more important in the 2008 presidential campaign than in any election since 1992. Clearly the three presidential candidates are looking for solutions as well.

Moffatt believes that there is a reasonable solution to the Federal deficit crisis, and further the dramatic swings of the economy from boom to bust. In short, Moffatt calls for policies that restrain an economic bubble on the way up; these same policies can help to sidestep the dramatic crashes, such as the one the country is experiencing today in the housing and credit markets. This solution, he says, is "politically neutral."

"The economy has been stimulated by increased government spending and tax cuts," Moffatt says. "During times of over-heating, however, Presidents and Congresses have shied away from raising taxes. Instead, they have relied on the Federal Reserve Bank to rein in the economy during periods of over-expansion through a tight monetary policy."

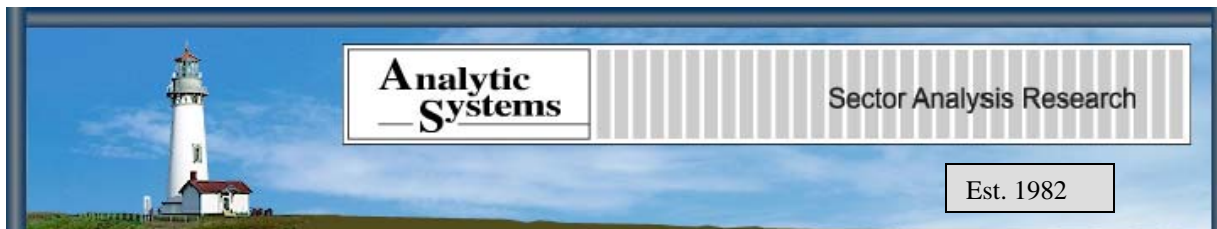
The problem with relying on the Federal Reserve Bank, Moffatt says, is that Congress is deadlocked, we have a lame-duck president and we're involved in a war that is being financed on credit. The country currently has a \$900 million trade deficit and a \$400 million budget deficit and this war will likely cost \$3 trillion.

While depending on the Fed may be more palatable than the periodic raising of taxes, it has, in effect, "institutionalized a structural bias towards deficits," Moffatt says.

"A structural solution to the deficit, which might attract bi-partisan support, would be simply to reverse the traditional use of fiscal and monetary policy," Moffatt says.

According to many analysts, including ASC's own model, the United States is experiencing the worst economic situation since the Great Depression.

In short, Moffatt's plan calls for economic policies that will generate an economic boom. Then, tax the boom. The taxes will harness the developing bubble which will then avert a dramatic bust. Both the rise and the fall get managed together.



“If the Fed is going to create bubbles, then let’s put them to good use,” Moffatt says. “Tax the bubble. Implement a tax on the people who are seeing the greatest increases in income. If you don’t tax the bubble, it bursts and all you have to do is look around to see the pain associated with a burst. We’ve never taxed a prosperous economy before.”

“Given the current, sluggish economic environment, it would be a mistake to assume that we can begin our revenue-rich fiscal policy at the present time,” Moffatt says. “But we can prepare for the opportunity. Just think what the result would have been if the 2000 dot-com bubble were taxed, or the current housing bubble. The bubbles would have been at least partially deflated by increased taxes and the bursting of them much less painful as well as the direct impact of Federal budget surpluses instead of the subsequent mounting deficits.”

In 1980, the country’s debt was \$800 billion. Today it is somewhere in the neighborhood of \$9 trillion, plus an additional \$51 trillion in Medicare and Medicaid. If every man, woman and child paid the government \$200,000, we fund Federal obligations, or we could implement a new policies and some new thinking to stop the debt spiral.

For information on Analytic Systems Corporation’s methodology and samples of past reports please visit our web site <http://www.asc-sector.com>.

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Analytic Systems Corp. 740 Broad Cove Rd. P O Box 496 Hopkinton, NH 03229. 603-746-6443 Email ascsector@comcast.net