MARKET OUTLOOK

August 4, 2011

This is an important (all of them are, you know) outlook report.

Today the market dropped over 4.3%, bringing the Dow average back to where it was on January 1 of this year. Once again, a range-bound market has taken back what it had given. We have responded to this challenge by making focused and significant trades in approximately half of the stocks we hold, as well as a major percentage of the equity mutual funds. Most of our clients will be receiving sell confirms from Schwab over the next few days.

To us this market drop has major differences from those in the recent past:

- The Fed's quantitative easing program has ended (QE2), depriving the economy of an extra $100 Billion each month.

- One primary measure of America's economic pulse is Wal-Mart's increase or decrease in same-store sales. For the past nine quarters, the number has continued to fall, indicating that middle-America is less willing to spend.

- Americans' debt levels are falling. Paying off loans, not buying bigger houses or new cars, has transformed us into savers, paying down car-loans, credit cards, and mortgages.

- The US Gross Domestic Product (GDP), a measure of the country's total economic output, has sagged to less than 2% per year. Importantly, businesses can maintain a 2% growth rate through gains in productivity, without hiring back any laid-off workers. A 3% growth rate in the GDP would create the demand to add workers, but until those workers are added and getting paid, GDP will have a hard time growing to 3%. It becomes a chicken and egg conundrum.

- The antics of the US Congress up to the default date of August 2nd forced large businesses and banks to stockpile cash, as much as $60 Billion in some banks, for protection in the event they could not get further financing and Treasury Bond interest payments stopped flowing. Hoarding that money effectively shrank liquidity and put private enterprise on hold, with the risk that many of those projects will stay on hold indefinitely.

- As a result of less spending, higher saving, and fears about liquidity, housing prices continue to fall, shutting off home equity as a source of funds to spend.

- Europe continues to have severe difficulties with over-due debt from Greece, Ireland, and Portugal, with ripple effects impacting Italy and Spain. There simply is not enough money to satisfy all the demands. Current sovereign debt is in jeopardy, much of it held by European banks, which, in turn, owe money to US banks. In 2008 the US Federal Reserve Bank loaned significant amounts to those banks to get them through the meltdown. Although the loans have been repaid, there are clear doubts whether the Fed will be so accommodating if the need arises again.

So here we are! Now what?

We think that this current market slide is far from over. From the great majority of the economic data and opinions we have gathered, we expect that the stock market has another 15-25% to fall. Therefore…

Yesterday and today we have sold significant portions of <u>some</u> stock holdings. While in most cases we sold the entire position, some were trimmed by 25-50%.

We started the process last week, examining each stock for it's high and low price over the past five years, then making a guesstimate of how low the price could fall in the current environment. If that projected drop exceeded 20%, we sold. Many stocks, especially medical and pharmaceutical, as well as utilities, were spared, as were most international holdings.

Most of the equity mutual funds were either trimmed or sold entirely, for two reasons:

- We have spent the last three months reviewing all of the mutual funds we hold, comparing them to their peer groups, and most importantly, examining their behavior during the market drop of 2007-2009.
- Many funds are committed to maintaining at least 90% in their given area of focus, be it small cap value, large cap blend, etc. That approach was very costly during the market drop, with some well-respected and conservative funds losing more than 65% of their value.

Further, management changes and/or lower than average 5-year performance figures brought to light that other funds with more stable performance are available, as well as having greater discretion by the fund managers to exit and enter the market as they deem appropriate.

By moving that money out of the market, we 1) avoid any further downturn in the market, and 2) we add to our cash position to buy into better funds when the pricing reaches an attractive.

Please keep in mind that our decision to sell the companies we did is not a vote of no confidence in the companies. It is the macro-economic environment, coupled with the short-term irrational behavior of the markets that dictate this decision. There are simply too many structural obstacles present in the US and Western Europe economies to justify staying the course, holding on.

This decision marks the third time we have taken this action. In both 1999 and 2007 we began withdrawing assets from the stock market. In both instances our action led to far lower losses than the general market, while creating cash to invest that allowed us to regain those losses quite quickly, all while keeping our clients' portfolios risk level at least 20% lower than a fully invested strategy. In fact, even at the market bottom in 2009 we continued to hold nearly 20% in cash, and the current trades add to our ability to take advantage of what we fully expect to be a very good opportunity. MOST IMPORTANTLY, this strategy has been the chief reason we have been able to create a documented and audited record of superior portfolio growth over the past twelve years, not every year, but in any three year or more average.

Could we be wrong? Of course! We consider that every action has the potential of being a mistake. The primary question becomes: what is the little mistake? What is the big mistake?

If we sell and the market only falls a bit further or actually goes up 5-10%, then we have erred. But, if future conditions warrant it, we can quickly reacquire the same companies we sold, or even some better choices, especially in the mutual fund arena. That is a little mistake. On the other hand, if we do NOT sell, and the market continues to fall, which IS our expectation, we will have made a BIG mistake, one that our clients have clearly communicated as being the greater of two evils.

We anticipate that many of you will have questions or additional concerns. You can, of course, call us, but if you can wait just a bit, send us an e-mail and we will be able to return your call the same day, even if some of us have to order take-out and stay late. It's your money, and being available is our mandate. Send e-mails to rob@harvestcapitaladivsors.net, or chuck@harvestcapitaladvisor.net

All our best regards,

Rob and all the staff that has allowed us to react and respond quickly.