



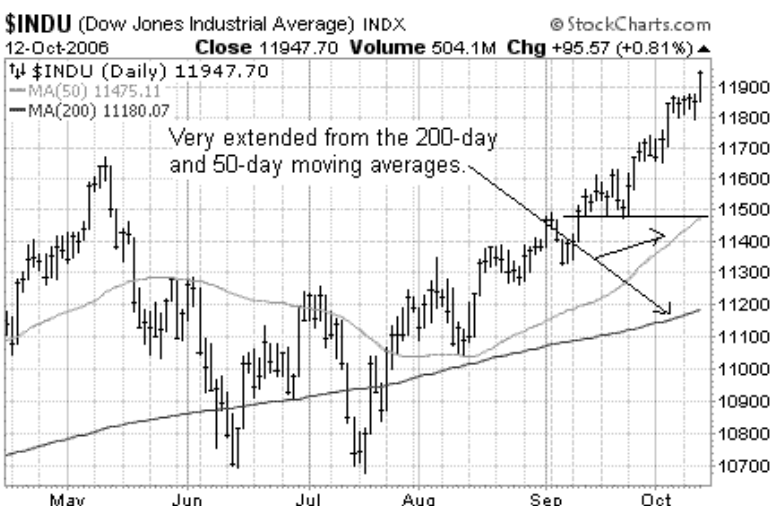
E-llumination October 13, 2006

Friday the 13th

First we get through August and September with “no runs, no drips, no errors” or as our colleague Richard Suttmeier observed, “no runs, no drips, no *terrors*”. Now we make it through Friday the 13th, and the markets are roaring. Here is a chart of the DJIA’s big run and CNBC is getting silly again, counting down the moments to the anticipated break through Dow 12,000.

It has been an impressive run up ‘till now. Particularly when you consider the fact that in July the DJIA was crashing from its high in May and was underwater for the year. Now CNBC can hardly wait for the new record high each day. And, we have no complaints either.

But we have been around this business a long time and we are keenly aware that no big move upward goes unaccompanied by at least short term movements downward. So it is probably time to start anticipating the inevitable correction.



Before we say another word we have to tell you that we believe the markets are healthy and that the correction we are anticipating should be an orderly one. We also believe that the markets will finish the year higher than they are today.

Whether we make it through 12,000 before or after the correction is anyone’s guess. That really isn’t the issue that we are concerned about in this newsletter. We are trying to tell you that corrections happen, and one is certainly due. What would please us is an orderly correction back to around 11500 for the DJIA. See the horizontal line on the chart that is above and to the right. 11500 is just north of the 50 day moving average, which currently stands at 11475.



The S&P 500 is no where near a record high; and that is one of the things that is bothering some pundits, regarding the overall health of the market. But its recent movement has emulated the DJIA quite closely. It too is probably overdue for a correction. One that takes the “\$SPX” back down to about

1310 would have to be considered “normal” or “orderly”, and hardly threatening to the current uptrend.

The NASDAQ Composite Index has been on a tear of its own. It has formed a perfect V formation and is now poised to match the May highs. See the horizontal line at the top of the chart. While there is no guarantee that the “\$COMPQ” will back off at the old high of 2375, it sure wouldn’t surprise us.



This chart is actually quite different from the first two. Note that the “\$COMPQ” has yet to move above the May highs. In other words, this part of the market hasn’t even gotten back to the May high; let alone approaching an all time high.

Other portions of the market lag even further behind the progress of the DJIA and the S&P 500. Here is the Philadelphia Semiconductor Index (“\$SOX”).



Look at how this index is lagging behind. Notice that it is nowhere near the old highs that took place in the spring of 2006. Since the “semi’s” make up a big part of the “\$COMPQ” this chart ought to help you understand why the “\$COMPQ” has yet to break above its May high. If you look at the chart closely you can see that this index actually peaked in February.

We are not showing you these charts to throw cold water on the advance of

the DJIA. We are showing them to you to help you understand that the current euphoria about the market is really limited to the large cap stocks that dominate the DJIA and the S&P 500.

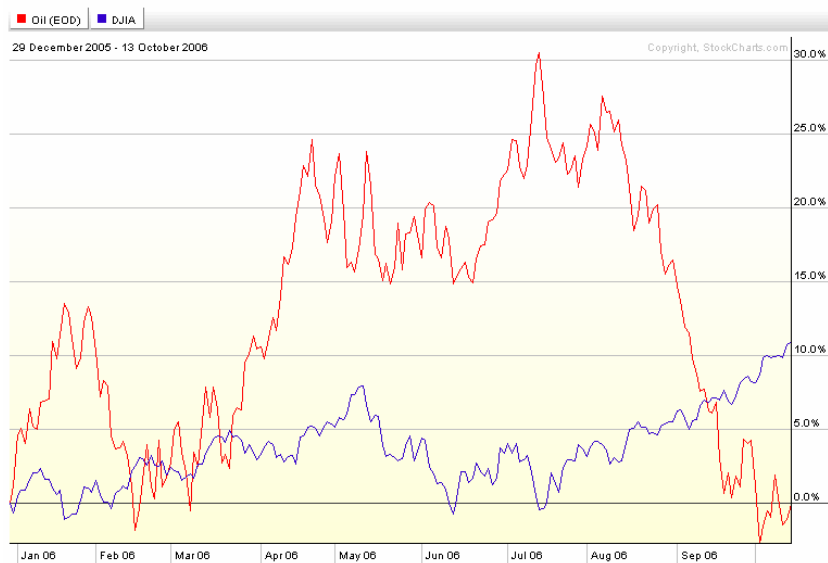


Here is the S&P 600 Small Cap index (\$SML). You can see that it is still well below the May high. Most small cap stocks have been lagging the performance of large cap stocks.

The same is true of “mid-caps”. Check out the chart on the following page. They are still climbing off the floor they

established in June and July. "Big money" has not flowed readily into small caps or mid caps recently. It is easier to understand the overall market by looking at a few charts like these. We are simply trying to explain that the current "bull" market has been selective. Not all sectors are participating to the extent that they are all setting records. On the other hand it is clear that all these averages have been moving up since the lows in July and August. Most years the last quarter belongs to smaller issues, especially mid-term years. Last week the NASDAQ rose 2.5%, the SP 500 1.2% and the Dow largest stocks were up 0.9%. It may be that the markets "correct" by rotation. That is that the "big" money starts to rotate back to mid and small caps while the large caps take a breather.

Our big "qualifier" on the prediction that the stock market is going higher is that oil prices can't turn around and head back up dramatically. They have to remain below \$62 per barrel for the remainder of the year, or this stock market rally could be seriously threatened. We have seen conflicting data on how much of the current rally has been based on the fall in oil prices. All we can tell you is that much of our own bullishness on stocks is related to the fall in energy prices. *Note: The first six charts in this newsletter are by Mark Manning's for RealMoney.com*



The picture at the left is worth a thousand words. The **RED line** is the price change of light suite crude oil during 2006. A little volatile, wouldn't you say? The **Blue line** is the price change in the Dow Jones Industrial Average. The inverse relationship is really easy to see. As oil prices rose; stock prices remained suppressed. As oil prices have fallen precipitously, stock prices have clearly gone up. Focus on the big move down in oil prices

since August and the big move up in stock prices. There is not much else to say; and frankly not much else has really changed in other economic conditions—except maybe a lot of rhetoric. *Note: chart by K&A using stockcharts.com*

Oil prices started to fall in July and accelerated downward in August. Forbes, for example, would now have us believe that "Peak Oil" theories which K&A has written about extensively are hogwash and that the world is about to be fully supplied with cheap oil—forever. Forbes recently ran a story in which it was represented that not only is there plenty of oil, but there is plenty of cheap oil—and that prices may retrench to the \$20 per barrel level. In our very considered and studied opinion, that is hogwash and it is simply not going to happen.

We have checked with every source we knew of and them some, to revisit our theories and concerns regarding rising oil prices and the long term decline in supply. We remain quite confident that the long term price trend is upward and the long term supply trend is downward. We are very confident that all the cheap oil is a thing of the past. Sorry, folks, but that is the way it is.

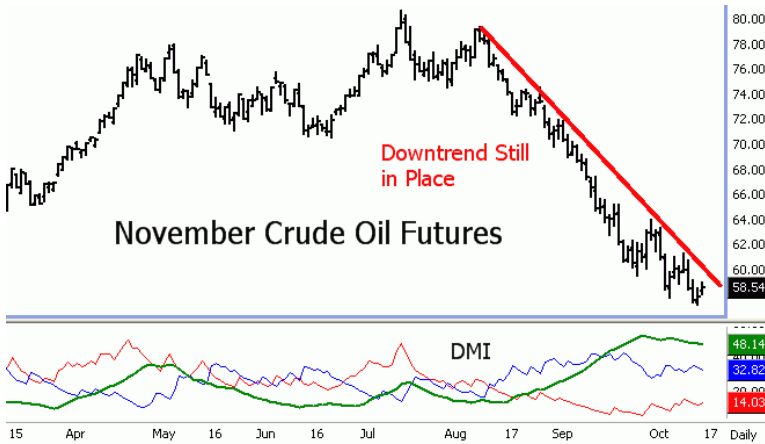
One of our favorite analysts of the oil patch is also confident about the path of prices and the historic nature of cheap oil. Chris Edmonds is a partner and managing director of research at

Pritchard Capital Partners, a New Orleans energy investment firm. He is based in Atlanta. Previously he was president of **Resource Dynamics LLC**, an Atlanta-based financial and corporate strategy consulting firm.

We recently interviewed Chris on our KVON radio show. Chris has been our guest multiple times and he is one of the most credible analysts we know following the oil patch. How do we know that? Because he is most often right.

Here is a quote from one of his recent columns, “Many cheap oil theorists point to the recent discovery by **Chevron, Devon, and Statoil** of the Jack field in deep waters in the Gulf of Mexico. Talk of 3 billion to 15 billion barrels of oil reserves in the area has excited those who are looking for reasons to jawbone oil prices lower.

I'm excited too, but I'm also realistic. Remember, it took \$40-plus oil for Chevron and its partners to even consider drilling these wells. It will take prices well above \$20 -- say \$45-plus -- for the trio of explorers to spend the billions necessary to develop the field. That's not to mention that, in a perfect world, production from Jack won't make it to market before the middle of the next decade?”



K&A believes that from here on-out \$45 should be considered “cheap oil” and we are hard pressed to figure out how prices will get that low. BUT, the current trend, as depicted to the left, is currently downward, and until that trend line is broken the trend is intact. *Note: Charts of oil and gold futures by Jim Yyckoff for RealMoney.com*

We also believe that oil is now in a broad trading range that could move all the way from \$50 on the downside to \$70 on the upside. The most likely case is that trading range could remain intact



for two years or more. Then the most likely case is that prices accelerate upward again. We will be discussing these probabilities at length in our 2007 forecast. Look for it in early January.

Gold is another commodity that started the year moving up, and is now moving down. The current trend line is extremely clear. This is the December gold futures contract. The downward trend

would be broken by a move above \$610. If that happened we might be interested in owning gold again—but not until the trend has shown clear evidence of a reversal.

On the other hand, “solid support” would be broken by a move below \$557.10, and would bring a move all the way back down to \$500 into the realm of possibility.

Another reason that we are currently out of the gold market is that gold often moves inversely to the U.S. dollar. The \$USD is going up. Until the dollar's trend changes we don't see much hope for gold's trend to gain serious upward momentum again.



Note: Chart annotation by K&A using stockcharts.com

You can see that the \$USD was dropping like a stone earlier this year. But that trend changed in May and has remained intact since. The \$USD is now probably "overbought" and could start to correct down to the blue trend line, but until that trend is broken the path of least resistance remains upward. A rising \$USD usually means falling \$GLD (gold). Don't be surprised by a short term bounce in gold, however, as the dollar works its way back down from 87 to 85. You could go long gold in here and short the dollar for a 2 or 3 percent gain on each side. But we'd prefer to see a clear trend break before getting too excited ourselves.

That is probably enough for today. As always there is much more we could write about. The investment themes are endless.

As long as we are prognosticating; how about if we take on the weather? I'm excited because ski season is coming!

Here is what the Old Farmer's Almanac says about the winter coming up in California, "**winter will be slightly cooler than normal near the coast and much cooler inland, on average.** Rainfall will be well above normal, with above-normal snowfall in the mountains. The most widespread snow will be in mid-January. The stormiest periods will be in mid- and late November and early and mid-February. The coldest periods will be in early December, mid-January, and mid- to late February. We're getting ready for a good ski season. I am not sure what the Almanac knows, but I hear that the squirrels in Lake Tahoe are busier laying in supplies this fall than they have been in years. That is good enough forecasting for me. I put my money (and skis) on the squirrels.

Have a great week.

Paul Krsek
For K&A Asset Management, LLC

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Sincerely,

Paul Krsek
Updated: October 15, 2006