



ELLUMINATION

April 1-2, 2008

DANCING ON THIN ICE

"If you are going to walk on thin ice, you might as well dance."

-- Author unknown

The title of this newsletter is pirated from a column written recently by Doug Kass, the general partner and investment manager of Seabreeze Partners Short LP and Seabreeze Partners Short Offshore Fund, Ltd. Doug also writes for RealMoney.com.

It captures the feeling we experienced all through Q1 of 2008. Right up to March 17th five of the seven models we manage were in the black for the year, despite the stock markets horrific performance. But when dancing on thin ice one might expect that it could break and it did. As of March 31st only one of the seven models is up for the year. That is our newest model, Pt. Reyes, which is designed to throw off income and preserve capital. Fresnel is down less than 1%. Hatteras and Mendocino are down just over 1%. Halifax is down just over 2%. Bonavista is down just over 3%. The New World, last year's big winner, is down over 5%. Stock markets are down A LOT, all around the world.

Country	ETF or Index	q1 return	
Brazil	EWZ	-4.55%	The U.S. bond market actually put in a slightly positive performance for Q1, but we do not expect that trend to continue throughout 2008. We think that the U.S. bond market will be the next one to tumble.
France	EWQ	-8.13%	
Russia	RSX	-8.66%	
USA	S&P 500	-9.88%	
England	EWU	-10.47%	
Germany	EWG	-11.05%	The irony is that the real damage was done to five of the models from March 17 th to March 19 th when gold, silver, oil and gas took big hits and those models went negative for the quarter. They are Hatteras, Mendocino,
South Africa	EZA	-12.97%	
China	FXI	-20.70%	

Halifax, Bonavista and Fresnel. We feel it is ironic because those are the asset classes that we have had the most faith in, and still do for the long haul. They are merely correcting and not collapsing. But they corrected at an inopportune moment. We will offer more constructive comment on the concept of correction rather than collapse later in this newsletter.

The working title of today's newsletter started out to be "The Long and the Short of It" which is a play on words related to the fact that we have been nimbly jumping back and forth between long and short equity positions all quarter long. On balance we are up nicely on our stock selections so far in 2008 even after all the trading and the stock market collapse.

If gold, silver, oil and gas had stayed at their highs for just another 2 weeks we would have been crowing about our quarterly results as all the models, except The New World, would have been in positive territory. But that is the world as we'd like it to have been, and not the world as it turned out to be!

So let's bear down and take a look at a very hard quarter and also discuss what we see happening as we move forward in 2008.

GETTING SOME PERSPECTIVE

The markets and the economy continue to defy imagination and description. What started out as a "subprime" mortgage crisis has now spread way beyond the confines of a sub-sector of the mortgage market. We now understand that we are dealing with a credit crisis of epic proportions and global dimensions. Comparisons are now being made with the economic era of World War II or the Great Depression to find crises of equal magnitude.

The size of the current crisis has been revealed incrementally. That is the case with most financial calamities. They usually don't form up over night. At K&A we have been discovering the breadth and depth of the problem right along with everyone else. We have been trading long and short relentlessly to stay ahead of the storm and to bring our models through this period successfully no matter how long it lasts.

We intend to use the rest of this quarterly report to bring you up to date on our actions and accomplishments during the Q1 of 2008 and to tell you what we see coming. But before we do all that let's establish that K&A isn't the only organization that thinks the current crisis is one of epic proportions. Check out the quotes below:

"The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the Second World War. The crisis will leave many casualties." --*Former US Federal Reserve chairman Alan Greenspan said in remarks published Monday, March 17, 2008*

"We are probably going to have one of the worst recessions we've had since the Second World War. It's not a good scene."—*Jim Rogers, Fortune Magazine interview on February 3, 2008*

"The Federal Reserve Board, battling Wall Street's biggest crisis since the Depression, slashed its key lending rate by 75 basis points Tuesday to jump-start the sagging economy and boost confidence in the U.S. financial system."—*Marketwatch.com, March 18, 2007*

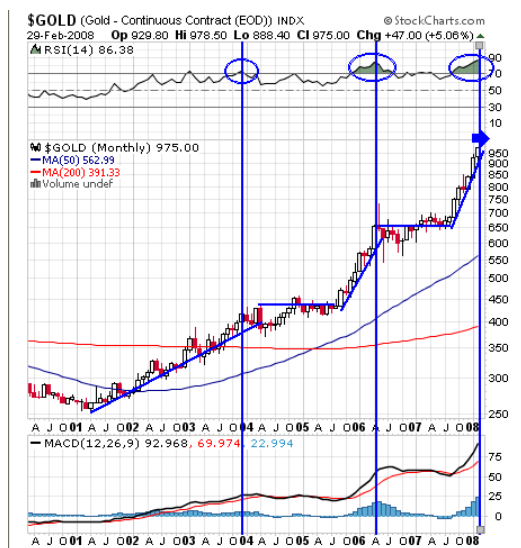
"Financial markets remain under considerable stress and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters."— *The Federal Reserve Bank comment from March 18, 2007*

The situation is dire and the full consequences are as yet unknown, but we deal in the world as it is, and we are looking for profits in the midst of this debacle, which has been brought to us by WALL STREET and some of their kissing' cousins in the real estate, mortgage banking and insurance businesses.

Here is a brief summary of the topics that we will be covering in the rest of this newsletter.

- 1) The long term path of gold, oil and gas prices are UP, as is also true for most other commodities that are in short supply.
- 2) The commodity bull market is not dead. In fact it is quite alive and well and we will be using near term weakness to add to the commodity related assets in our models.

- 3) The global economic growth story is still intact, despite what is going on in the U.S and the deflation we are exporting to the world.
- 4) The dollar will surely rally from time to time, but it is in a long term multi-decade decline that has not yet hit bottom.
- 5) The depth and duration of the current credit crisis are not yet quantifiable. Therefore substantial risk still exists in the equity markets, and particularly banking and financial industry stocks.
- 6) The Bernanke Fed is doing an excellent job of dealing with the credit crisis. They have been getting a little help from other central banks, and more help is on the way.
- 7) If the Fed was not so engaged and so effective the U.S. stock market would be at least 20 percent lower and confidence in the overall economy would probably have already shrunk to levels not seen since the early 1930's.
- 8) The divide between the “haves” and “have not's” in this country will continue to widen in coming years.
- 9) The economy is likely to experience pain related to the credit crisis for longer than most people think.
- 10) Wall Street, which is supposed to be the home of creators of wealth, has once again destroyed more wealth than it tends to create. And, they had many accomplices!



THE GOLD BULL MARKET IS NOT DEAD

This item is number one on our list of discussion points because no single event impacted five of the K&A models more than the sell-off in gold, silver and oil during the week of March 17-21. The sell off continued this week after an intervening rebound.

The models that were impacted are Hatteras, Mendocino, Halifax, Bonavista and Fresnel. We went from being profitable in them to being down in just a few short days. Fresnel lost over 5.5% of its value in three days alone. We own gold in the form of the StreetTRACKS Gold Shares ETF (symbol=GLD). It dropped 10.45% in three days. Oil and silver prices tumbled in the same three days and the K&A models took a licking. The “talking-heads” on CNBC

were declaring the bull market in gold, silver, industrial metals, agriculture, and oil and gas to be OVER. Larry Kudlow called it a “sea change”. Sorry Larry, it was a correction within a long term bull market. Corrections in the commodity markets tend to be swift and sometimes violent. This one is clearly no exception.

On March 3, 2008 we told you that, **“Gold remains a solid leader in 2008. We have drawn a chart for you that tracks gold’s entire move up since 2001. (Here is that same chart again.)**

It is very easy to see that so far there have been three major advances and two periods during which gold consolidated its gains by moving laterally for a number of months. You can also see that the periods of consolidation came at times that gold was extremely “over bought”. Look at the top of the chart where we have drawn three circles. They mark periods of extreme relative strength. It is clear that it was during these periods that gold began going through a period of consolidation. We are not expecting this time to be any different. Our best “guesstimate” is that

gold will reach \$1000 within days, pullback and consolidate for weeks or months, before making its next major move upward.”



That is EXACTLY what happened. Gold did pop up just over \$1000, just as we expected and then corrected. It should now stay in a consolidation phase for several weeks, or even months. The last two major consolidation periods lasted about 6 months. It may be no different this time. In fact gold could drop all the way back to \$581 per ounce and remain in its long term bull market trend. We don’t expect that to happen, but it might drop back to \$774 before this corrective phase is over. Therefore we have reduced our gold holdings by half in all the models. This is a similar tactic to our trading patterns during past corrections. We anticipate the next big move, whenever it starts, to take gold over \$1200.

“Outlook for Gold: Asian demand for food and energy hasn’t changed from a week ago, and the US money supply is still exploding at its fastest rate in history. Thus, the fundamentals for gold are still seen as bullish. The Bernanke Fed isn’t lifting interest rates anytime soon, and the US dollar could tumble again, as the Fed prepares a rate cut for April. That does not mean that gold can’t overshoot on the down-side, amid panic selling by nervous hedge fund traders. The gold

market is expected to find support at the upward sloping trend-line at either \$910/oz, or at longer term support at \$850/oz, the 1980 high, before recovering to \$1,000/oz.” Global Money Trends, March 21, 2008



THE OIL AND GAS BULL MARKET HAS YEARS TO RUN, BUT IT MAY CORRECT FIRST

Oil went through a similar violent corrective process, which we have also been expecting. In fact you may recall that earlier in March we actually took a short position in oil, which is a bet that prices would drop. There were specific conditions present, including seasonal supply and demand characteristics that led us to believe that oil prices might move back toward \$83-85. That trade lasted all of two days as oil prices shot up

right after we put the trade on and we were stopped out. Let me make a simple confession here—you can't time them all right!

Just as is the case with gold, the drop in oil prices has been short lived. It broke above \$110 and then collapsed to \$99. We are hesitant to short it again as we believe the inevitable path for both oil and natural gas prices are UP. Besides, any significant disruption in the supply chain, through terrorism, could spike oil prices to \$120-\$125 per barrel.

But just like gold, oil prices have come a long way and are now in a corrective phase. The models took a disproportionate hit because oil and gas related stocks took more of a hit than the commodities. We suspect that this is because the markets do not believe the correction in oil and gas prices is over. Frankly we don't either. The short term path of prices for oil may indeed be downward. \$98 a barrel is the current 50 day moving average. \$86 is the 200 day moving average. \$83.98 is the 50 week moving average. A correction back to any of these levels would make sense, and not disrupt the long term bull market in the slightest.

Al Gore has dibs on the title "An Inconvenient Truth", but I am going to borrow the phrase to make a point. The "inconvenient truth" about oil and gas is that no one is finding enough of the stuff to adequately replace what we are using. We have been telling you that for years, and NOTHING has changed in the last 90 days to change that condition. Companies that are potentially in the most trouble are the so called "oil majors" in the west. This would include the likes of ExxonMobil, ConocoPhillips, Chevron, etc.

We recently sold ConocoPhillips out of our models because they are readily admitting that they are having trouble replacing reserves at an adequate rate. We believe that many of the western oil companies are the equivalent of depleting annuities. By that we mean that their reserves are depleting faster than they can replace them. If that trend continues for too long the companies themselves will simply be forced out of business, or into other businesses. That is why you don't see the big western majors in our portfolios. ConocoPhillips was doing the best job, among the majors, of replenishing reserves and now even they are troubled.

We own companies that are more nimble, tend to be in natural gas production as well as oil, or foreign companies that have access to drilling areas that American companies tend to be locked out of. All of the companies that we own in the models are doing an excellent job of replacing reserves and therefore we expect them to be winners for the foreseeable future.

There are a lot of "talking heads" pointing to the fact that demand for oil has not increased in the U.S. during the past 12 months. They somehow manage to extrapolate that because U.S. demand is taking a breather that prices might drop dramatically. Hey, global demand is still growing and global supply is not growing as fast as global demand. You tell me what that should mean in terms of long term price movement. In the U.S. we have a tendency to place too much emphasis on our national statistics and ignore what global trends are telling us.

Think about this quote from **The Economist**, on March 15, 2008:

"Back in 1990 China consumed just 2.4 million barrels per day, leaving 400,000 barrels per day of its domestic production available for its oil firms to export. Now it guzzles over 7 million barrels per day, about half of which it has to import. The International Energy Agency thinks that by 2030 it will gulp 16.5 million barrels per day, of which 13.1 million will have to be bought abroad. That is more than the current total output of Saudi Arabia."

WE WILL BE USING CURRENT WEAKNESS IN COMMODITIES MARKETS TO DIVERSIFY INTO COMMODITIES WE DON'T OWN

It wasn't only gold, silver, oil and gas that took a pounding in mid-March and again this week. Other commodities got whacked as well including agricultural related products. We had missed a big portion of the move up in "ag" but within the context of the current correction we expect to see prices that offer us solid entry points. Just as we believe the path of prices is upward for the commodities we already own (gold, oil and gas), "ag" related assets have the same bright future ahead of them.

Temporarily they are going through a corrective phase that we intend to take advantage of.

THE GLOBAL ECONOMIC GROWTH STORY IS STILL INTACT

There is no question that the credit crisis in the U.S. has derailed stock markets around the world and threatens the banking industry in the U.S. and Europe. But the crisis does not alter in any way the long term global growth story that is impacting economies in Europe, Russia, China, Africa, Australia, the Middle East, and throughout Asia. We believe that economies around the world will continue to grow faster than the U.S. economy in 2008 and into 2009.

Just reflect a minute on this collection of quotes we found on the website of **The Prudent Investor** dated March 26, 2008. They certainly confirm our point of view.

The International Monetary Fund forecasts that, ***"despite the slower U.S. growth, the global economy will expand 4.1 percent this year, above the average 3.7 percent over the past quarter century. Emerging markets including China and India aren't only boosting world growth they're also creating new customers for other Asian exporters."***

"Over the past few years, China, India and the Middle East represented 47% of new global demand, while the US, Europe and Japan comprised 14%." According to Bloomberg.

"The Western slowdown is also welcome in China as it helps cooling off the red-hot economy." [Xinhuanet](#) reported last Monday. ***"Declining export growth, notably affected by the U.S. credit crunch, is likely to drag China's GDP growth down to 10.5 percent this year, still above official target of 8 percent"***, a leading university research paper said on Monday.

"China's booming exports are likely to see a sharp decline which will tame the 11.4 percent GDP growth last year to a slower 10.5 percent in 2008, against the backdrop of the subprime mortgage crisis and calming global economy", according to the research paper released by the Economic Research Institute of Renmin University. ***"This still leaves China with 10% more demand in everything and so far there are no signs why the Chinese Wirtschaftswunder should abate in 2009."***

"India's economic growth rate is expected to moderate to 7.8 per cent in 2008-09, mainly on account of a global slowdown", says the Economist Intelligence Unit (EIU), an arm of London-based magazine Economist. ***"The Indian economy, according to government estimates, is expected to grow at 8.7 per cent during 2007-08. Despite moderation in growth, India would continue to remain the second-fastest growing economy in Asia"***, said senior economist and Asia Editor of the EIU Anjalika Bardalai.

“As India lacks commodities and energy it can be safely expected that demand will grow accordingly. Commodity based economies will be among the few winners in 2008”, The Canadian Economic Press cites.

“Russia raised its forecasts for economic growth over 2008 to 7.1% from 6.7%”, Interfax news agency said on Tuesday citing government officials.

“The Asian tigers will see slower growth too, but there is not much to worry about. Thai economists see 4.5% GDP growth in 2008, off the original 6% target. Vietnam took back its growth expectations half a percentage point to a range of 8% to 8.5%”, reports the Guardian.

The Prudent Investor's Conclusion about all of this follows:

“All countries listed acknowledge that inflation may dent these projections further. The key for me is nevertheless the huge growth in domestic demand. Just think India, where Tata offers its Nano car for 100,000 or one lakh Rupees. As millions of it will be sold, I would not short metals and oil. And there is still room to sell billions of air-conditioners, laundry machines, LCD flat screens, PC's and whatever else you can think of that is a standard in the West but not the East.

Westerners in debt up to their eyeballs will be a less interesting market for Asian companies when they get run over by a domestic clientele that is eager to close the consumerism gap with the West. The East-West bifurcation in economic growth is further proof for my view that the center of economic power is accelerating its shift to Asia. Wasn't it Beijing where so many Western dignitaries went hat in hand since the beginning of the financial crisis last August?”

We find ourselves tempted to use the term “ironic” again, in the context of squaring our point of view about global growth, as illustrated above, with the pounding that many foreign stock markets have taken in Q1 of 2008. Economic growth is intact but global stock markets have tended to suffer more than the U.S. market. Here is our table again.

Country	ETF or Index	q1 return	
Brazil	EWZ	-4.55%	Before anyone jumps to any conclusions about any of these numbers we think they really support only one conclusion. Major markets around the world have dropped coincidentally with the drop in U.S. markets.
France	EWQ	-8.13%	
Russia	RSX	-8.66%	
USA	S&P 500	-9.88%	That shouldn't be surprising. We have told you in previous newsletters that all the major international markets tend to move in the same direction.
England	EWU	-10.47%	
Germany	EWG	-11.05%	
South Africa	EZA	-12.97%	
China	FXI	-20.70%	

It is the size, or magnitude, of their moves that tend to vary, not overall direction. That is important to remember when thinking about international diversification.

Below is a chart comparing recent trend of the S&P 500 (the red line) with indexes from France, the UK, South Africa, Russia, India, China (Shanghai) and Brazil (the purple line). They are all moving in the same direction. It is only the size of their moves that vary. You can see that with the exception of France, they had all moved up farther than the U.S. S&P 500. So it shouldn't be surprising that they came back down farther. That seems to be the working relationship. The notable exception has been Brazil which significantly outperformed in the bull market and has held up the best in the bear market.

WE HAVE RECENTLY BEGUN ADDING BACK POSITIONS RELATED TO THE BRAZIL MARKET TO MANY OF THE MODELS.

PerfChart (SPY,EWQ,EWU,EZA,RSX,\$BSE,\$SSEC,EWZ)
Interactive Performance Comparison Chart



Russia and China are also countries that we want to be invested in. We have also begun to add Russian equities, through ETF's to the models. China is likely to be next. We told you in our 2008 forecast that ***“China, Brazil and Russian stock markets will continue to lead global emerging markets. It is the common line of thinking in the West that the Chinese economy will soften after the Olympics. That is western bias, and not based on any fact. It won't happen.”*** Nothing has happened in the past 90 days to change our minds.

The Dollar Could Rally In the Short Term But the Long Term Trend Is Down

We fear sometimes that people may be tired of us pounding on the dollar. But we aren't the folks who have caused the problems that have debased the dollar. We are merely reporting the trend. Like many trends that we have already reported on in this letter there is likely to be a short term change. The dollar is likely to rise against a basket of currencies. Another possibility is that it could trend sideways for a while.

But the long term structural problems in the U.S. economy are well entrenched and the dollar must continue to adjust downward to continue compensating for the imbalances.

“The current crisis is not only the bust that follows the housing boom; it's basically the end of a 60-year period of continuing credit expansion based on the dollar as the reserve currency. Now the rest of the world is increasingly unwilling to accumulate dollars.” George Soros, January 2008

“If our current account deficit keeps running at present levels, the dollar I think is almost certain to be worth less five to ten years from now compared to other major currencies,” Warren Buffett, February 2008

“The US economy is heading for a recession that may be the worst ‘in a while’ and investors should sell the dollar as global currencies weaken. The dollar is going to be under duress for many years to come. It's going to be one of the worst recessions we've had in a while because we had so many excesses going into it. It's going to be bad for all of us as currencies come under more and more stress and we have more inflation in the world. The US and UK governments have been lying about inflation.” Jim Rogers, January 2008



“The yield on the US Treasury’s 2-year note is around 1.75%, or 50 basis points below the fed funds rate, telegraphing a quarter-point Fed rate cut to 2% in April. That could further weaken the US dollar, since it’s unlikely the Fed can reverse its rate cuts while home prices are sliding and banks are writing off toxic sub-prime mortgage debt. Still, the earliest signal of a bottom in the fed funds rate would be the moment the 2-year note yield crosses above the fed funds rate.” Global Money Trends, March 29, 2008

The other issue that faces the dollar is nationalism. There are countries all over the world that peg their currency to the dollar because they really had no choice at the time that policy was initiated. They were financially weak and we were strong. Now the trend has reversed and they tend to want more control over their own currency. Many of these countries are absorbing a combination punch from the U.S. right now. On the one hand we are exporting deflation of their asset values to them visa via our financial crises, and their participation through lending to our institutions and their stock ownership. On the other hand they keep having to devalue their own currencies to keep pace with ours and their inflation rates are exploding.

This is a vicious combination that brings together trading tactics related to interest rate movements currencies, countries and gold:

“When trading gold, one must also think globally. For instance, inflation in Saudi Arabia surged to a 27-year high of 8.7% in February as the world’s largest oil exporter and its Gulf Arab neighbors lowered interest rates to defend their archaic currency pegs to a tumbling US dollar. Saudi Arabia matched the Fed’s 75 basis point cut last week, along with the United Arab Emirates, Bahrain, and Qatar, where inflation is at 13.74 percent. The dollar peg is fuelling inflation by making some imports more expensive as the US currency sinks on global markets. Rents led the rise in Saudi inflation in February, surging 18%, followed by food costs which jumped 13 percent. Rate cuts by the Saudi central bank are fueling even faster inflation, by pegging bank deposits rate far below the local inflation rates. As a result, Persian Gulf sovereign funds, which control around \$2.5 trillion, might shift petro-dollars into gold on big dips. Inflation is also at multi-decade highs in China, Korea, Japan, and Europe. Global Money Trends, March 29, 2008

Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates collectively make up the 6 country Gulf Cooperation Council (GCC) and produce 20% of the world’s oil. The GCC is on record with its desire to eventually form a common currency, and decouple from the dollar. K&A believes this will be a long process that may involve a first step in which each country decouples its individual currency from the dollar. Kuwait has already done so.

The Chinese Renminbi is now officially decoupled from the dollar and the Chinese are increasingly conducting an open market currency policy. The Hong Kong dollar remains coupled to the U.S. dollar, but it is only a matter of time until that relationship ceases to exist.

There is still a formal peg between the Venezuelan Bolivar and the U.S. dollar but we have little doubt it will end.

There are other currencies that will compete on the global stage with the dollar as well. They are well known and include the Renminbi, the Yen, the Euro and even the Ruble. There is simply going to be less global demand for dollars over time. Reduced demand always lowers prices.

We have said many times that the transition from the dollar as the “reserve currency” of the world to a member of a group of reserve currencies will take decades. Those who keep rushing to call the bottom for the dollar should simply relax. It will take years. They should also not bet heavily on any sustainable rebound in the dollar.



The depth and duration of the current credit crisis are not yet quantifiable. Therefore substantial risk still exists in the equity markets, and particularly banking and financial industry stocks.

We are drafting this section of the newsletter on April 1st and the stock market is exploding upward as if it didn't have a care in the world. We are losing money today because we have big short exposure. For managers who are positioned like us this is not a fun day. The S&P 500 has rallied over 3% today and stands at 1366 at this moment. That just happens to be almost to the point where the two blue lines intersect inside the blue circle on the chart to the left. We calculate that cross to actually

be at 1372 today. If the market moves past that point in the slightest then those two declining trend lines are history. The next reasonable target on the upside is about at 1450, another 5.7% higher. Break that downward trend line and the BEAR MARKET is over.

On the other hand, if the rally today reverses and heads back down we could move all the way back to 1275 in a heartbeat. That is the anxiety of a bear market capsulated in two paragraphs. Frankly we can't tell you which way the trend will break. We can tell you that if we break above 1372 we will cease to hedge the models with short positions in equities, and our attempt to do so will have turned out to be a losing trade. On the other hand, all our models, with the exception of The New World, will have experienced maximum draw downs in this period of no greater than 3% and change. That is one heck of a lot less volatility than the market has experienced. From the top the S&P dropped over 18.5%. We will take a maximum draw down of roughly 3% in an 18.5% drop any day.

If the S&P 500 remains below 1372 (today's cross) we will maintain the short positions in anticipation that the rally will fail and the market could move all the way back down to test lows around 1275. If those lows don't hold our next downside target on the S&P 500 is 1225.

"It's April Fools' Day, but this is no joke: Traders are embracing massive write-downs from financial firms UBS and Deutsche Bank, National City's plans to sell itself, and Lehman's convertible offering as another sign the worst is over for financials. The problem with this line of thinking is that it's been tried repeatedly in the past year, with lousy results. Wasn't the third quarter supposed to be the "kitchen-sink quarter" for the financials, and then the fourth? The grim reality is that we seem no closer to the end of the write-down parade than we were six months ago. Goldman Sachs recently estimated Wall Street firms will ultimately write down as much as \$460 billion in credit losses, meaning the process isn't even halfway over yet. With so many traders eager to embrace the end of this crisis period, scant few are willing to acknowledge another harsh fact: The financial firms' blockbuster earnings of the prior five years were castles made of sand." Aaron Task, RealMoney.com, April 1, 2008

If the Fed was not so engaged and so effective the U.S. stock market would be at least 20 percent lower and confidence in the overall economy would probably have already shrunk to levels not seen since the early 1930's

He has been called Helicopter Ben, B-52 Ben and a whole lot of other names that are not so benign. He has been derided as an "academic", and an "amateur". He has been "behind the curve", "too late with too little". He doesn't understand the magnitude of the crisis. He should be fired and Paul Volcker brought back in his place.

So enough already! We don't agree with any of that. In fact Chairman Ben Bernanke gets a "10" in our book. He rates 5 stars. He'd rate a 99 if he were a vintage wine. The guy and his Federal Open Market Committee have done one heck of a job putting their fingers in every dike, fixing every leak in the system that has sprung. And Hank Paulson isn't so shabby either. Remember we call them the Plunge Protection Team and they are hard at work cleaning up the mess our bankers and investment bankers have made of our financial system.

How else do you explain rallies like the one that happened yesterday? Where else does the confidence come from to tack another 40 points on the S&P, raise the DJIA by 391 points and rally EVERY financial stock in the market on the day after UBS announces ANOTHER \$19 billion write down? When we went to bed Monday night the U.S. stock market futures were DOWN. UBS was set to open down 9% in Europe and look what happened today. This is nothing short of a miracle and you can thank Ben for it. The Fed is providing institutions the confidence that is needed to create rallies like Tuesdays. It is quite possible that this bear market will be one of the shortest in history. If that turns out to be the case we all need to tip our hats to Ben Bernanke.

If the Fed was not so engaged and so effective the U.S. stock market would be at least 20 percent lower and confidence in the overall economy would probably have already shrunk to levels not seen since the early 1930's. We have often wondered aloud here at K&A whether or not we would be able to recognize events that could trigger the next great depression. It is certainly clear that many did not back in 1929 or even in 1930-31 for that matter. Most banks, investment banks, individual citizens, cities, counties, states and nations simply rode it down to the bottom. There were very few winners in that era. We think that the current events related to the credit calamity, coupled with the squeeze from rising commodity costs, and stagnant wages could be the combination that pushes the economy into severe recession, or depression. That is why we have been so nervous about these markets and have been attempting to be short the markets even in the face of these incredibly powerful one or two day rallies. We have had faith in the Fed all along. The fact is that they are doing what they have to do. It is the bankers and investment bankers we don't trust. We still don't know if we are at a point of climactic disclosure from these banks. We tend to doubt it.

But risking that we might bore you or intrigue you let's take a little walk down memory lane so that we can firmly establish that the Fed has no choice at all but to inflate us out of the current crisis, which is exactly what they are doing.

IN December 2004 we wrote:

"Speaking of uncertainty, is there a real estate "bubble"? The highly respected UCLA Anderson Economic Forecast calls the current state of affairs "the bulked up Housing Bubble." On Sunday, December 12, 2004 the San Francisco Chronicle ran a major feature on California real estate which concluded there is no such thing as a bubble. How is that for definitive? We think it is time to be

incredibly selective when making real estate investments. The rise in home prices has strengthened personal balance sheets. But we observe that even as home prices have been rising, percentage equity has been falling. That is because there has been so much refinancing through which people are taking equity out of their homes and simply spending it. They are wasting their equity to maintain their standard of living!"

This ties right back to our worries about the American consumer running out of money. Right now the U.S. is borrowing from whoever will lend us money and we are going further and further into debt. That is true of the individuals and government entities alike.

The sheer size of the debt and the amount of capital that is required to fund it make us incredibly nervous. Right now it takes approximately 80 percent of the entire world's surplus of savings to buy U.S. Treasury Notes and Bonds EVERY SINGLE DAY to continue financing the U.S. deficits. If the debt continues to grow at present pace it will require 100 PERCENT OF THE WORLD'S SURPLUS SAVINGS WITHIN JUST A FEW YEARS! That CAN'T be done! Something has to change.

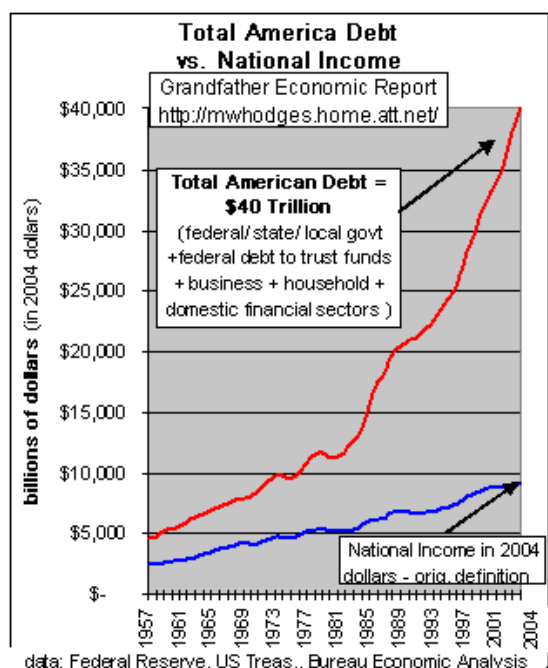
Note: It is a few years later and nothing has changed except that the situation is worse!

In January 2006 we wrote:

"We believe that during 2006 the Fed is going to fool you by making you focus on what they do with interest rates while they flood the globe with an increased supply of U.S. dollars. They can't afford a recession and will "error" towards favoring inflation.

Inflation is likely to go higher than the pundits currently expect, not related to the magnitude of movement of interest rates; but because the globe is being flooded with U.S. dollars.

We believe the fed is literally playing a game, but a very crucial and intricate game. While acting modestly restrictive on interest rates, they are flooding the market with dollars. They are going to make sure that despite rising energy prices, and despite the huge personal and government debt loads, there is all the liquidity individuals and institutions need to keep buying all the goods and services they need and want. The only problem with this policy is that we are not sure how this



gaming by the Fed eventually corrects itself. We are not sure what the final chapter in this story will be. We think the Fed may be up to the same tricks that the Arthur Burns Fed pulled in the early 1970's that led to the staggering inflation of the late 1970's and early 1980's.

If you are a discerning reader you have to be asking why the fed would risk such a thing. The answer is simple. The U.S. is carrying a staggering debt load and can simply not afford a recession. The chart, at the left, depicts the growth of total American debt vs. the growth in national income through 2004. You can see the problem. We are essentially a debt financed society. The chart does not even include the unfunded entitlements for Social Security, Medicare, Medicaid, various state government and local government

pensions, and unfunded private pensions. The U.S. simply does not have the economic flexibility to get through a mild recession. The next recession in this country is likely to be a hum dinger in which not only private entities will be declaring bankruptcy, but so might government entities. The Fed wants to avoid that scenario if at all possible.

Therefore 'inflating' our way out of this dilemma is the more palatable choice. The irony is that this time the Fed has allies that the Burns Fed didn't have. Today the oil producing nations are loaded with cash and that cash needs to go somewhere. Much of it is being recycled right back to the United States and is supplying our economy with much of the infusion of cash flow we need to keep the economy growing and to keep interest rates low. The same is true for China and India. They are selling us goods and essentially lending us back the money we need to keep buying from them. If only Arthur Burns had such friends; he would not have looked so bad in comparison to Paul Volker. And maybe Alan Greenspan would not be known as "the best Fed chief ever".

On another note, U.S. consumers are increasingly broke, but they are not telling and they will just keep borrowing—until they can't any more. That time is drawing much closer. However, the American consumer has proven much more resilient than we could ever have imagined. Debt loads are now staggering in many households. Rising real estate values have been the only thing keeping the American consumers balance sheets intact.

If real estate does collapse we are in for a major recession. Real wages are simply not growing fast enough to fuel additional personal and family consumption.

Unfortunately, the U.S. government is also broke and so are all the state and local governments and they will be looking EVERYWHERE to solve their problems."

The USA is in the same state today that it was during the "Roaring 1920's" when Will Rogers said, "This country is not prosperous. It's just got good credit. We live better and owe more money than anybody in the world."

And, with all that said, we have gone full circle, through some recent history and back to today. Real estate has collapsed. The consumer is broke. We now know that it was subprime lending that extended many consumers ability to survive financially for another two to four years beyond the time that we expected the recession to show up. The subprime lending provided a false lift to the economy that has now disappeared.

The federal government, our cities, states, counties are broke. By some estimates we now owe a collective \$66 Trillion. We are a great nation with Sovereign Debt, not a Sovereign Fund! We could spend the next 10 pages writing on this topic, but there is one simple plain truth here. The Fed and the U.S. government have two choices.. They could deflate our way out of this crisis, by taking us down the path of the next great depression. Or, they can inflate our way out of this mess, by papering the globe with cheap dollars—and that is EXACTLY the choice we knew they would make. That is exactly why the Fed is doing everything it is to avert deflation and depression. It is why the dollar is the sacrificial lamb. It is one of the

primary reasons we remain bullish on gold and oil for the long haul. It is one of the reasons that America is being seen more and more by the rest of the world as the real “3rd world”. We are becoming the source of cheap labor, cheap raw materials. It is a bit off topic, but we even export our top soil. How stupid is that?

We could be critical of a lot of things, but we won't. Our job is to make you money, not criticize, which takes us to our next theme.

The divide between the “haves” and “have not’s” in this country will continue to widen in coming years

At this point it is extremely critical that we make sure you understand our point of view. We believe that the overall economy may experience negative consequences from the current credit crisis for longer than others might expect. We also believe that the gap between the incomes and wealth of the investor class in this country and their wage-earning, non-investing counterparts is going to continue to get wider and wider. We actually believe that corporate America and businesses around the world should thrive right through this crisis.

That is one of the primary reasons that we have ventured back into some first class equity holdings. While on the one hand we firmly believe that up to 2 million families have been permanently removed from any chance of owning a home or accumulating wealth, PepsiCo is still going to thrive. Several dozen banks have damaged their balance sheets significantly. They have literally torn up significant wealth of their employees and shareholders, but Caterpillar is still going to thrive selling heavy equipment around the booming world. Several publicly traded home building companies probably have years ahead of them before they show profits that are anywhere near normalized, but UPS is still going to be delivering freight all around an increasingly wealthy and interconnected world. Several million baby-boomers might be postponing retirement because they failed to save enough, but Applied Materials, Nvidia, and Intel are likely to grow their high tech businesses selling products all around the world.

We have said many times and to many people, that if you are a member of what we call the investor class, you will do quite well through all of this. If you are not, your dreams of wealth through home ownership are probably dashed forever.

Wall Street, which is supposed to be the home of creators of wealth, has once again destroyed more wealth than it tends to create. And, they had many accomplishments!

If there is one question that we have gotten consistently over the last six months it would be, “Do you think it is time yet to buy _____. The (_____) is always occupied by the name of a bank or insurance company, as in Citigroup or AIG or Bear Stearns or UBS or Merrill Lynch or Washington Mutual, just to name a few. We haven't bought any of them yet and we probably won't for some time to come.

We have added one financial name to some of the models, but it is not an American company and it clearly has negligible exposure to any of this mess. The truth is that we simply do not trust the companies mentioned above, and many others not named, and we aren't likely to in the future despite turnover in the executive suite. This lack of trust didn't grow out of the current crisis. It has been developed over a 27 year span dating back to 1981 in which we have personally observed many of the best known financial institutions in America continuously making gross errors in judgment, waste the capital of their shareholders, and in many cases their account holders. Those listed above are simply a few of the current crop, and many of them have, in our opinion, been repeat offenders. We provide a short table

below which compares the stock price of some of these companies. We looked back at early April 1999 wondering what we would have to pay to own a share and then we noted the value as of April 1, 2008. It didn't surprise us that the prices of these stocks are flat to down over a period that spans almost an entire decade. All of these companies are bigger now. All are more diversified. They have simply built their businesses by wasting the capital of their shareholders. At least that is our strong opinion. Others may see it differently.

Company	Symbol	Stock Price	Stock Price
		4-Apr-99	1-Apr-08
Citigroup	C	34.33	23.84
AIG	AIG	67.20	47.11
Bear Stearns	BSC	47.26	10.85
Merrill Lynch	MER	49.06	46.02
Washington Mutual	WM	27.00	11.06

With this kind of investment performance why would you want to own them, even if you believed that the current crisis is well on its way to being cleared up? Let me pose a question to you. Do you think companies like this are going to have more opportunities to expand their business in the next 3 to 5 years or fewer? Do you think the puffed up earnings they reported over the past five years can be repeated, or are they likely to play ball like an aging baseball player busted for steroids and off the juice? We think the later. We think you can add several hundred U.S. based financial services and banking companies to the list of busted players off the juice. We think their prospects are dim and that buyers of these stocks on, April 1, 2008 are at risk of losing money over the next five years. Check back in five years to see if we are right.

We hear the people who are saying you have to buy these stocks because they are hated and dirt cheap and we shake our heads and say to ourselves, "You haven't learned anything have you?"

Summary and Conclusions

- It is easy to get really scared and really pessimistic during a bear market. We are neither. We are actually quite sanguine and very confident for K&A clients.
- We are disappointed that not all the models were up for the quarter we clearly delivered on our mandate to dampen volatility in the models and we are very confident that by the time 2008 ends people will look back on 1 to 3 percent draw downs for the quarter and breathe a sigh of relief, particularly compared to what has happened to many investors who are not K&A clients.
- All of our models have excellent prospects but our newest which is Pt. Reyes couldn't have been more timely and has proven to be the safer port during the current storm.
- The gold bull market is not over. We are in a corrective phase that we told you would happen and will shake out speculators. We expect to see \$1000 dollar gold again.
- The oil and gas bull market is not over. We are in a corrective phase that will shake out speculators. Global demand is increasing and global supply is not keeping up. The long term trend is for rising prices.
- The "ag" related commodities bull market is not over and we will be using weakness to step in and buy.
- The global growth story is intact and we will be using the current bear market to stage our models back into holdings in Russia, China and Brazil, as well as other foreign holdings.

- The U.S. dollar is likely to continue to weaken against competing global currencies for years to come. Many U.S. businesses and investment portfolios that are positioned properly will benefit from this trend.
- The depth and breadth of the current crisis is not quantifiable. People may be disappointed that it isn't over as quickly as some perceive and many hope.
- We can't yet discern a trend for the stock market in the short term. We are very much convinced that the market will make a definitive move and then we will know—we simply don't know which way that definitive move will break. We do know what technical market levels to look for in the search for longer term direction.
- The Fed is working their plan to inflate our way out of this crisis. We believe they will succeed and set up the economy for years of stronger inflation than we would have experienced otherwise. The stock market should rally on strong signs of their success.
- The Fed's success will not be a good thing for all people since wages will not keep up and real estate will not participate until excess inventories have been burned off around the country. The divide between the haves and have not's will continue to widen.
- We do not consider the "financials" to be good buys. They may have led the markets down. In the short term they may be the first to rise from the ashes, but their long term prospects are simply not good.
- We will therefore be looking to other areas to commit capital for the longer term. Candidates include natural resources and commodities, alternative energy, technology, food and beverage, transportation, and other businesses with heavy dependence on global trade for core earnings and cash flow.

Finally, one last thought: Where is the next bubble that will burst?

Would you believe the U.S. bond market? Yep! Coming soon to a portfolio near you. Unless, you are a K&A client, that is. Rising long term bond yields and falling long term bond prices. Brought to you by the Federal Reserve Bank of the United States of America, in cooperation with the Treasury Department. Support provided by the Executive Branch of the United States Government. Consultation and collaboration provided by the Bank of England, European Central Bank, Bank of Japan. Stunt work done by the banking community of the United States of America. Funding provided by the sovereign funds of various creditor nations who graciously keep buying our depreciating assets with all that money that they earned selling us goods and services we used to provide for ourselves.

All the best,

Paul Krsek and Lee O'Dwyer

Portfolio Managers

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Paul Krsek is the primary author of ELLUMINATION. While the views and representations found in the newsletter generally reflect the attitudes and opinions of the K&A Asset Management, LLC members and staff, Krsek often writes without editing and therefore is primarily responsible for the content and opinions contained in ELLUMINATION.

Effective February 1, 2008 Lee O'Dwyer has started to edit some portions of Ellumination. He also works closely with Krsek in the formation of investment policy so his influence is felt in the content of Ellumination.

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K&A manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

Krsek makes frequent reference to the model portfolios called Hatteras, Mendocino, Halifax, Bonavista, Fresnel and The New World. During 2005 Paul Krsek was appointed Chief Investment Officer of K&A, and as such is responsible to make all trading and management decisions for all client accounts which are being managed according to a specific portfolio model. A description of each of our models can be found on our website at <http://www.kaassets.com/choices.htm>.

As of July 3, 2007 Lee O'Dwyer joined K&A as a portfolio manager. Paul Krsek and Lee O'Dwyer frequently discuss investment ideas, model portfolio strategies and the investment policies of K&A. But when it comes to the implementation of those policies Krsek is primarily responsible to manage the accounts that fit into each model portfolio description. He generally makes all final investment and trading decisions relative to those accounts that are considered to be "modeled." However, in Krsek's absence O'Dwyer does have the authority to trade all client accounts. He has been actively trading accounts in the various models since joining K&A. Krsek and O'Dwyer are striving to reach a point in the management of the portfolios where they are likely to share more equal authority over the models. O'Dwyer has proven to be an excellent addition to the management team and is already having significant influence over the models.

Not all accounts managed by K&A are "modeled" accounts. We strongly urge our clients to understand which model, if any, are being used to manage their accounts.

Much of the content of Ellumination does not apply to K&A clients who are not invested through the models.

From time to time K&A receives requests from clients to purchase securities that are not included in the model portfolio to which they are assigned. Effective May 24, 2006 K&A has encouraged clients to hold such securities in a separate account for the client. Because K&A is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

K&A makes every effort to exclude securities that are 'requested by the client' from the modeled portfolio accounts.

The investment objectives of various accounts and models may be substantially different from one another. Therefore topics or investments mentioned in E-llumination may or may not apply to specific managed accounts and/or models.

Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at K&A.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek or Andrae and to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

The assets held in managed accounts at K&A Asset Management, LLC may include stocks, bonds, cash, commodities, foreign exchange or mutual funds or exchange traded funds (ETF's), money market accounts or limited partnerships that represent the same. They are subject to market fluctuation and the potential for losses. The assets are not insured. The value and income produced by these investment products may fluctuate, so that an investor may get back less than they initially invested.

The portfolio managers at K&A Asset Management, LLC do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the six model accounts in this newsletter. These accounts are "models" and do not represent the actual results accruing to individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their quarterly reports prepared using Centerpiece.

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Sincerely,

Paul Krsek

Updated: February 3, 2008