



ELUMINATION

February 3, 2008

WE LIVE IN AMAZING TIMES

On January 27th it looked like the U.S. stock market was headed for its worst January performance in history. The market rallied for a few days at the end of the month and January's close turned out to be the worst since 1990. It was a dubious start but certainly not as bad as an all time record drop. The S&P 500 was down 6.06% after being down as much as 12% (for 2008) during the month.

The cyclical bear market got ferocious quite fast. Which begs the questions, how bad it will get and how long will it last? Before we answer those questions we have to tell you that our six models hardly felt the claw of the bear market. That was thanks to our call to go to cash in November.



That call has now provided us with 4 minutes and 56 seconds of fame, and several new clients. We'd like to take this opportunity to welcome them to the K&A family and to say thank you for your confidence in us.

We suspect that many of our existing clients don't even know that on Wednesday, January 23, 2008 Paul Krsek, Chief Investment Officer of K&A, was interviewed by Alex Chadwick, host of *Day to Day* on **National Public Radio (NPR)**, discussing Krsek's approach to positioning client portfolios in advance of the recent market turbulence.

The **NPR** website features the following comment about the interview, "**With the recent market turmoil, many financial advisers are telling their clients to stay the course. But one company is doing the opposite: It's ditching all of its stock holdings. Paul Krsek, founder and managing member of K&A Asset Management in Napa, Calif., speaks with Alex Chadwick about his decision. Two months ago Krsek decided to liquidate his entire stock portfolio....**"

"Riding the ups and downs doesn't always work", Krsek insists.

"How long-term do you want to go? Today the markets trade 24-hours-a-day. Your gains can get taken away while you are asleep. If you are willing to just sit there and let the big boys whip you around, you are going to get burned," he says.

His clients are pleased with his bold decision, he says.

"I spent more time on the phone with thank-you calls than I have in a long time," he says.

You can hear the full interview with Paul on NPR at <http://www.npr.org/templates/story/story.php?storyId=18337977>

There is absolutely no question that the call was outstanding and it was done completely within the context of K&A's constant technical and quantitative market analysis. We run our models with three things in mind. We dampen volatility. We try to avoid losses and we are out to make money. If you are going to do those three things consistently you need to sell when your research is telling you to sell.

So how long and deep will the bear market be? Richard Russell, author of Dow Theory Letters, answers succinctly when he says, "No one knows how far stocks will fall in bear markets or how long the bear will last." It is really just that simple.

K&A doesn't know either, but we are never short of opinions based on our research. Our sense is that the market doesn't have all that far to fall. Even as stocks were collapsing our calculations indicated that the S&P 500 should find a bottom in a range from 1190 to 1220.

The market moved down to 1270 and turned around sharply. We are treating the current rally as a counter trend within the context of the bear market. The chart at right shows you what is currently happening.

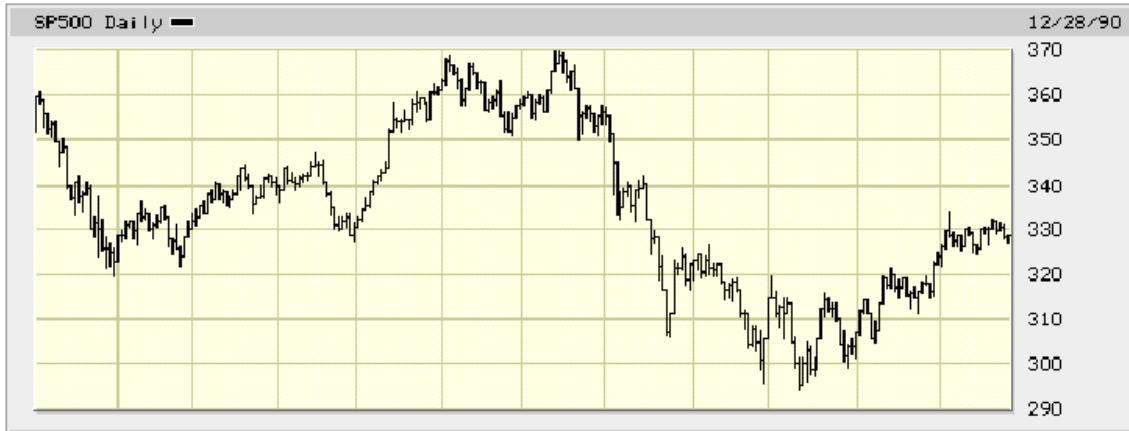


It is likely that this rally will stall somewhere in the 1400 to 1450 range, if not before. The most likely scenario is that the rally stalls and stocks take another leg down. Should the market rally back to about 1484 we'd say the cyclical bear market was short lived and declare it to be over. But we aren't counting on that.

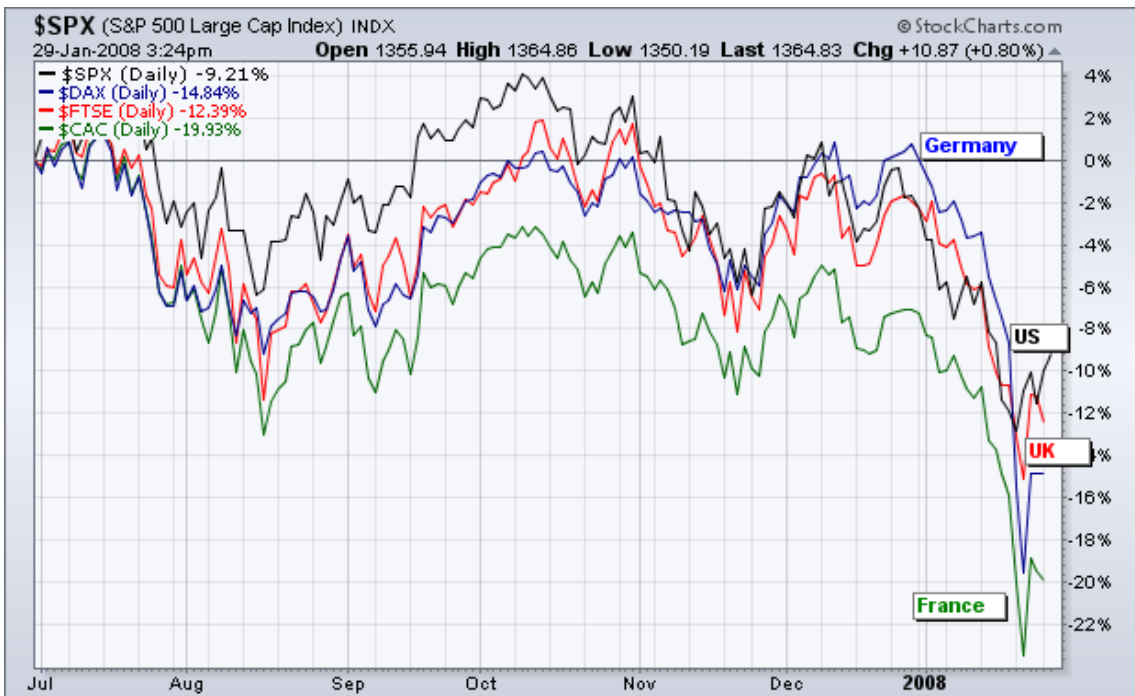
The most likely case is that this market will chop around for months. Barron's noted recently that "David Rosenberg of Merrill Lynch, who consistently comes up with some great stuff, points out, in the 2000-2002 bear market, there were no fewer than 16 rallies of at least 5% in the S&P, each lasting on average about a month, and no fewer than 35 bounces of 5% or more in the Nasdaq (which still managed to wind up losing nearly 80% of its value)."

Bear market rallies often look surprisingly strong based on the size of the move, but if you look behind the scenes you can see weak characteristics in the rally. One of those weak characteristics is that this rally has occurred despite fairly weak trading volume. That simply means that there doesn't seem to be a lot of conviction behind it.

If history can be our guide it might be interesting to check out what happened back in 1990? Here is a chart of the S&P 500 from 1990. The market collapsed in January; then slowly recovered into the spring, bolted upward into the summer and then faded for the rest of the year. Could it happen again? You bet. We'll know 12 months from now.

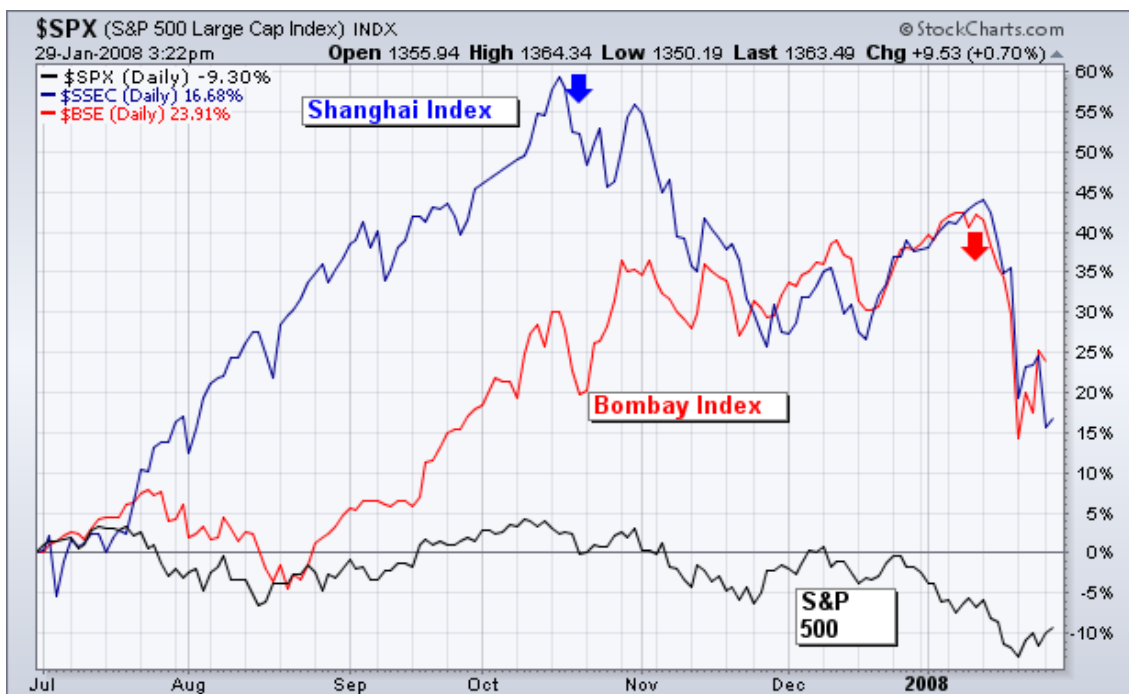


We also know this bear market is global. The chart below shows the S&P 500 (\$SPX), the \$DAX (Germany), the \$FTSE (England), and the \$CAC (France). If you look closely you will note that all three of these European markets fell more than the U.S. market.



Check out the chart on the next page that shows China and India are also experiencing collapses in their markets. It is ironic that international markets have suffered more than ours. The whole problem started here. We are exporting deflation to the world! (The chart above and the one below are by John Murphy at Stockcharts.com)

(See chart on next page)



Where does all this charting, analysis, and commentary leave us? In a bear market for stocks that might last a while, but in our opinion shouldn't get all that deep. This correction has provided just enough of a sell off that lots of stocks looked like good values to us over the past few weeks. Many seem cheap to us on a price-to-earnings basis. If you have been reading Ellumination for years you might be claspng your heart in shock right now. K&A saying that stocks look cheap! You'd have to dig deep in the archives to find the last time we said that.

We have recently been adding stocks back to all the models. Among them are stocks that we sold off in 2007 at prices that were much higher than we are buying them for now. In years past we have mentioned many of the stocks we own in the models in the context of these letters, but we will not be doing that in the future (starting now). Our policy, going forward, is that the models are proprietary and designed for the benefit of our clients who own them.

We noted with great interest that Microsoft has finally made the offer for Yahoo that we have been anticipating for two years. The shame of it is that we didn't participate in the pop that Yahoo stock got last week. The good news (from our point of view) is that we don't really care at this point. Microsoft made its move after Yahoo stock dropped to \$19 per share. Yahoo was \$33 in October! The Microsoft bid is for \$31, or LESS than the market valued Yahoo as recently as October 26, 2007. Parenthetically, does that answer any question you may have about why we sold all stocks in the models in October and November?

We will be using this bear market to reload on stocks; cautiously and over time. We are still heavily weighted to cash in all the models, but we are no longer at 97% cash as we were in 5 of the 6 models at the end of 2007. Hatteras had an allocation to municipal bonds then, and still does, so it never got to 97% cash.

There is a very old saying on Wall Street, "Buy low. Sell high!" We try to get that right as often as we can. Those who have been with us for many years know we don't always succeed. That is what stop-loss orders are for. But we get it right a lot more than the average bear (or bull); and that is why the models have been so successful.

We would like to comment on a few sectors and/or asset classes. Gold and energy (oil and gas) remain our two favorites.

If you have been a long time reader of Ellumination you know our position on gold. Its long term trend is up. We believe this bull market has several years to run and that we may be only half way through it relative to pricing of gold. We have admitted recently that our only regret about the gold holdings in the models is that we were too conservative and we don't own enough. During this past week we added more gold to 5 of the 6 models on short term weakness (The New World can't own gold).

Long time readers have been seeing our take on gold for over four years now. Here is another perspective that appeared in **Barron's** this weekend. This is an excerpt from an interview with *Joseph McNay, Chairman, Essex Investment Management* By SANDRA WARD.

The introduction to the interview is as follows:

NOT MUCH ESCAPES THE ATTENTION OF THIS wise and wily investor. Near visionary in his ability to identify trends and capitalize on them, Joseph McNay has made a lot of people and institutions wealthy in the 40-plus years he's been plying the investment trade. He manages more than \$3 billion at Essex Investment Management in Boston, a firm he founded, including its flagship long-short fund and a natural-resources fund. One of the all-time greats of growth investing, McNay is now pounding the table for, of all things, gold. Attention must be paid.



McNay: "In the past four or five years, the euro has gone from 82 cents to the dollar to \$1.48. That is all lost purchasing power in our currency. We are in a lose-lose situation. The decline in the value of our currency is directly inflationary: Lost purchasing power is inflation. The bigger risk is that, at some point, the large holders of U.S. dollars may decide they want a lot less of them, if any. This is a very challenging set of conditions for us.

Barron's: What does this mean for the market?

McNay: "We are going to have an even more narrowed and focused market than we had last year. Something the world is going to want now is a currency alternative. An investment I have felt positive about but now feel dramatically more positive about is gold. Gold

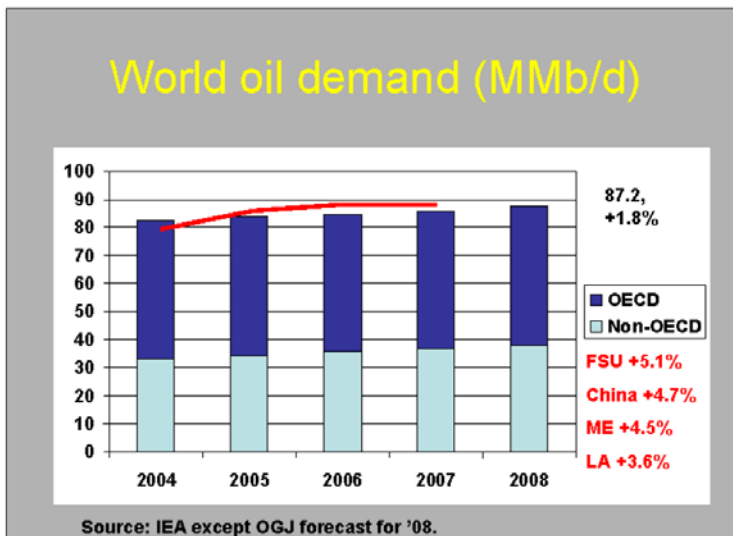
is probably the single most important investment that most of us can have a representation in."

We started buying gold when it cleared \$400 per ounce years ago. We recently bought again at just over \$900. We'd be happy to buy again on any near term weakness. We have been telling readers of Ellumination for years that gold is becoming the currency of choice.

The U.S. Dollar has been in secular decline for decades now. The chart on the previous page portrays its decline since 1982. We would expect any rallies in the dollar to be confined to the area between the two horizontal blue lines we have drawn on the chart. If the dollar rallies back to that area we would be shorting the dollar in anticipation of the next big leg down into uncharted low territory.

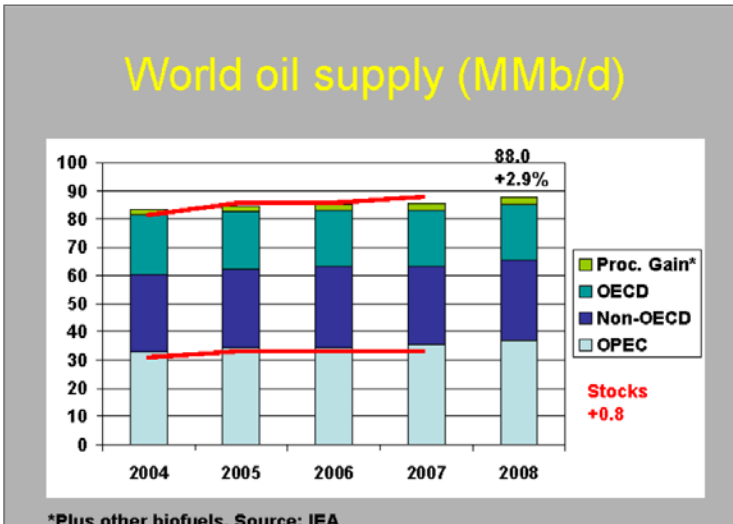
A comment on oil and gas

When we sold all the stocks in October and November the oil and gas stocks were sold too. Paul Krsek is on record in an interview with the San Francisco Chronicle during December 2007, that while he was glad he sold all the other stocks, he regretted selling the oil related stocks. They actually rallied significantly after we sold them. The good news is that most of them got caught in the sell off during January and oil and gas related stocks have been some of the first that we have bought back for the 5 models that can own them. (The New World can't own oil and gas stocks.)



The oil and gas journal released their forecasts for global oil supply and demand on January 28, 2007. Supplies and demand should be almost perfectly balanced during 2008. Demand is not growing as fast as in previous years due to the slowdown in the U.S. economy. New supply is very difficult to come by.

Demand is likely to grow no more than 1.8% this year to 87.2 million barrels per day. World oil supply is likely to grow no more than 2.9% and come in at 88 million barrels per day.



Your first reaction to those numbers should be the same as ours. Demand and supply are likely to be balanced in 2008, but there is no room for error, particularly on the supply side.

If there is an event that takes a significant amount of production off line during 2008 it is quite possible that we could see a significant price spike in oil. \$125 per barrel is hardly out of the question.

Bull markets turn to bear markets for a reason. It takes a catalyst. The current bear market in stocks was triggered by the financial crisis that started with "sub-prime loans". A second trigger that could lengthen and deepen this bear market is another price shock in oil. By that we mean a quick and sharp spike in prices. We do not expect that to happen, but we are on guard against it.

Natural gas supplies are more plentiful relative to current global demand. We are not expecting any significant movement in natural gas prices in 2008, but the bias should be to the upside, should any movement occur at all. The longer term bias is upward. Natural gas now trades in the \$7-\$8 range. We see \$1 of potential downside risk vs. \$7-\$8 dollars of upside potential over the next several years. That is why we recently added back two natural gas companies to the K&A models that can own them. The stocks that we are accumulating that are generally known as "oil" companies also have large natural gas exposure.

Looking forward

The good news at K&A is that so far 2008 is shaping up much as we thought it would. We expected stocks to be weak in the early part of the year. They have been, and we frankly don't know how long the weakness will last. But we are careful buyers of the dips in order to build back the equity allocation of the models. We are seeing some really cheap prices and we expect to see more before this is over. Getting out of equities was easy. We are convinced that the markets will not make it easy for us to get back in. We remain confident that we can do it profitably for the long haul.

We expected gold to be strong. It has been. Gold is now seriously overbought for the short term. It could pull back and we would be buyers on any dips. Gold most likely has another double in it before this secular bull market is over, years from now.

We expected that oil prices might dip, and they have. The short term dip in oil prices may not be over. We will be buyers on weakness. The long term path of both oil and gas prices are upward.

Long term readers of Ellumination know that we refer to the U.S. Federal Reserve Bank and the Treasury Department as the Plunge Protection Team (PPT). They have many allies and friends among the central bankers of the world. The PPT's behavior in January 2008 confirms for us that they are on the job and dedicated to avoiding a deep and prolonged global recession. The press pays all the attention it can to the fact that U.S. interest rates are declining. They pay absolutely no attention to the fact that broad U.S. money supply, formerly reported as M-3, is growing at its fastest rates in history. In 2007 the broad money supply of 18 of the world's largest 20 economies grew at rates greater than 10%. Central bankers and central governments around the world are making sure that consumers and producers alike have all the money supply they need to keep the global financial system liquid.

The only real question is whether U.S. bankers and financier's can continue to waste the money supply faster than the PPT can create it. It seems to be a horse race at this point. Don't get us on the topic of how stupid some of these companies have been. Don't get us on the topic of how much disdain we have for them.

The final thought for the day is a simple one. Everyone knows that you want to be a buyer when assets are on sale. They are on sale around the world today. We sold when the selling was good. We are currently net buyers today. But we are cautious and will try to buy constructively at the times we see prices and trends that we like. We are still sitting on lots of (your) cash and we intend to invest it wisely.

All the best,

Paul Krsek & Lee O'Dwyer
Portfolio Managers
For K&A Asset Management, LLC

Disclosure and Disclaimer: (updated February 3, 2008)

ELLUMINATION is the proprietary newsletter written for clients, friends, and affiliates of K&A Asset Management, LLC (K&A).

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.

ELLUMINATION does not represent the opinions of Fidelity, Fidelity Institutional Brokerage Group, NFS or anyone employed by Fidelity in any capacity. Neither Fidelity, Fidelity Institutional Brokerage Group, nor NFS, nor anyone employed by Fidelity in any capacity has participated in the creation of ELLUMINATION and they are not responsible for the contents or distribution of ELLUMINATION.

ELLUMINATION is written to provide general information to clients, friends, and affiliates. The contents of ELLUMINATION are not to be taken as individual investment advice. No investment decisions should be made based on the opinions or information offered in ELLUMINATION.

K&A does not represent that the information in ELLUMINATION is accurate or complete and it should not be relied upon as such. Opinions expressed herein are subject to change or modification without notice.

The investment portfolio models or management services mentioned in ELLUMINATION may or may not be available in some states, and they may not be suitable for all types of investors.

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-Illumination 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 Andreae 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.

This document is for information purposes only and it should not be regarded as an offer to sell or as a solicitation of an offer to buy any securities or other instruments mentioned in it.

Sincerely,

Paul Krsek
Updated: February 3, 2008

http://finance.yahoo.com/real-estate/article/104340/Housing-Meltdown;_ylt=AsUX0YnAX8XlhO1.XRO_wT1O7sMF