



## ELLUMINATION

July 31, 2008

### Follow up on Mid Year Report

---

In the 15 days since our Mid Year Report was released one could easily think that somehow we are now living in an alternative universe. Oil has moved down from \$147 (July 11<sup>th</sup>) to \$120. Natural gas has collapsed from near \$12 to \$9 and BankAmerica stock has moved up from \$18.44 to \$32 (and back down to \$29). It seems that every time I write a newsletter I mention some characteristic of the markets that is remarkable, or even unprecedented in history. The doubling of many banking stocks simply becomes the latest of those unprecedented events; as does the sudden collapse of oil and gas prices. To keep the rise in bank stocks in perspective however, one must remember that almost to a company they have merely risen from the ashes of one of the great collapses in history. The Financials Select SPDR (XLF) represents an index of banks and financial services companies. Since 2007 it has fallen all the way back to 2003 levels. The recent bounce hardly breaks the current bearish trend.

These markets are still truly fickle and still truly “hopeful”. On July 28<sup>th</sup> the markets swooned over 2% and Lee and I were in total agreement that we would wake up to a lower open on July 29<sup>th</sup> as the market digested the most recent news from Merrill-Lynch and a few negative earnings surprises. But overnight oil dropped another \$3 per barrel and that put a bid under the market. As I am drafting on the morning of the 29<sup>th</sup> it looks like the markets will gain back today everything they lost yesterday.

And that brings me to the point of this follow up to the Mid Year Report. The drop in oil prices is putting a bid under the market. Everyone who read our Mid Year Report knows that it was the gloomiest one I have ever written and that we were focused on our very negative view of the markets. We allowed that only ONE thing could change the dynamics of the markets.

“There is only one thing that could potentially provide significant relief to these markets and turn the tide. Oil prices have to drop dramatically. That is it.”

Well, oil prices are dropping dramatically, and so are natural gas prices. Oil has dropped about 18% in a matter of a few weeks and natural gas has dropped approximately 25%. All the major U.S. stock averages are UP roughly 3% over the past 15 days. The Dow Jones Transportation Index is up over 7



percent. Needless to say the transports are perceived as the biggest beneficiaries of the drop in oil and gas prices. The chart shows we were in oil prices on July 11<sup>th</sup> when oil peaked at \$147.90.

We can't take credit for "forecasting" a drop in oil and gas prices. We simply said that if they drop, that the dynamics of the market should change dramatically and they have.

We also focused a lot of attention on the work of the Fed, the U.S. Treasury Department, and what we call the Plunge Protection Team. We have applauded their work until now. We did make the comment in the last letter that, *"While we have been their cheerleaders to date we would prefer to see them step out of the way at this point and let the markets do what they will to cleanse and heal themselves."*

But we went on to say that:

*"It is possible that the markets will not melt down, as they should, because of PPT intervention. They are not likely to step out of the way. That would be contrary to everything they have been doing so far. Therefore our dire forecasts may not come to fruition—this time. The PPT could win this war with the markets and I could be guilty of writing my most pessimistic newsletter EVER, right at the bottom. But that bottom would be like the one in 2003. It would never have sold off enough to get us to the levels normally achieved at the REAL bottoms of bear markets, like the 1974 lows or the 1982 lows. Someday we will have to go there. That is for certain."*

Since July 15<sup>th</sup> the PPT, headed by Treasury Secretary Paulson, has announced the new "covered bonds" program that provides additional liquidity to the mortgage market. The Congress has passed the new Housing Bill. Senator Chris Dodd has been instrumental in writing the Housing Bill and he is quoted as saying, "

*"With one of every eight homes projected to enter foreclosure over the next five years, and the economy shedding jobs as the costs of energy, health care and food skyrocket, the American dream has become a nightmare for countless families across the country. Today, Congress did more than send a bill to the President - we sent a message to American families that help is on the way. In addition to providing urgently-needed relief to homeowners on the brink of losing their homes, this legislation will address our broader economic problems by helping to reform our housing sector and provide reassurances to our financial markets."*

Clearly the markets are responding affirmatively the dramatic drop in oil prices and to the continued intervention of the PPT.

K&A continues to believe that if it were not for the aggressive response of the PPT over the past several months that the markets would be at least 15-20% below current levels and that the economy would be in an official recession, and that the "Depression" word would be on many more lips. Our hats are off to the PPT.

## So what happens next?

---

Does all this mean that our gloomy outlook was overdone? Are we calling off the bear market? What are we doing to actually manage money?

I reiterate a statement I have made several times already, in writing and verbally since the release of the letter, *"The PPT could win this war with the markets and I could be guilty of writing my most pessimistic newsletter EVER, right at the bottom"*.

Based on two weeks of evidence that is exactly what happened. But two week's doesn't make a trend. Here is a little longer term look at the market. We keep telling you that "trends are trends" until they are broken. We have also explained, as best we can, that there are many interpretations of trends. Put our view of economic trends together with stock market trends and we can easily see the possibility that



today's (the 29<sup>th</sup>) rally aside, the direction is still down for equity markets. This is only one chart of one index in the whole world. It is the S&P 500 (SPX) and the trend is clearly down. This index is a leader right now in that many major indexes around the world are following its trend line. That means the direction of their movement is the same, even if the magnitude of their movement differs. If the SPX dropped into the 1180 range we would be much more comfortable, given our current economic outlook. If it collapsed to the 1080-1090 range we would be ecstatic and BACK UP THE TRUCK for the buying spree of the decade.

But it simply may not. If there is one thing that we are sure of it is that markets often don't do what you want them to do.

On the other hand, if the SPX cleared resistance above current levels and got back over 1275 we

would take that as a clearer signal that the PPT is winning its war against the mortgage and credit crunch and we would get more optimistic again. The same would be true at 11750 on the DJIA. **Particularly given what is happening with oil and gas prices. We still see oil and gas prices as the pivotal factor for the equity markets.**

If oil and gas prices continue to trend toward the \$110 to \$115 level the equity markets will continue to get bids and are likely to stop dropping and to reverse course. If "the friend" we alluded to in the Mid Year Report is right and prices retreat to the \$70 to \$90 range then the markets could really get buoyant again.

We mentioned in the Mid Year report that as oil prices clearly broke down that we might add the UltraShort Oil and Gas ProShare (DUG) to some of the models as a way to profit from the decline. We will not be doing that. While the trend is now down, we would consider shorting oil, or oil and gas stocks to be a high risk trade—and this is not the environment to be taking significant risks. One major hurricane sweeping through the Gulf of Mexico could end this downward trend in its tracks.

Oil prices are supposedly collapsing because of "demand destruction" caused by higher prices. What do you think happens as prices at the pump start to drop? DEMAND ACCELERATES AGAIN! We think that is a natural brake on continuously falling prices. Just as we said in the Mid Year Report that oil prices could not "grow to the sky", they are not now headed to zero either.

Yet oil and gas stocks are now getting pounded as if that will be the case.

We sold our last four oil and gas related holdings between June 25<sup>th</sup> and July 17<sup>th</sup>. Here is a table that describes the average prices we sold for and where the stocks stand now.

Company	Average Sale Price	Price on July 29th	Decline
---------	--------------------	--------------------	---------

Precision Drilling Trust	\$22.84	\$21.18	7.26%
XTO Energy	\$59.12	\$46.12	21.99%
Chesapeake Energy	\$60.69	\$46.87	22.77%
Anadarko Petroleum	\$73.61	\$56.99	22.58%

These are all stocks that are now discounting a lot of bad news and they are all terrific companies. We look forward to adding them back to the models at a future date.

Needless to say we are also constantly on the outlook for what sectors could lead this recovery. The entire market will not shift from bear to bull all at once. Certain sectors of the stock market will start to emerge as the leaders, and others will follow.

AS OF THIS WRITING THERE IS NO NEW LEADERSHIP IN THE MARKET. The energy stocks and commodity related stocks that led the market up have clearly broken down. Transports have bounced dramatically in the past two weeks, but that 'leadership' will disappear overnight if there is a new spike in oil prices. Biotech is making new highs and it could easily be said that is the new leader. Biotech is as fickle a market sector as I know of. The financials have clearly bounced, but are already in retreat again. **The bottom line is that the picture is still very cloudy and low risk trades and reliable entry points are hard to find.**

Having said that, there are stocks that seem dirt cheap in any market and we continue to monitor earnings calls and we are doing extensive fundamental research which we are coupling with our charting to find low risk opportunities. As the present time all the models are mostly in cash. We consider protection of capital to be the number one task at the present moment.

We made the following comment on bonds in the Mid Year Report:

*"For the next several months inflation is the major concern. That is clear. That is a function of money supply growth that we think will be slowing. Our worries to date regarding inflation have kept us from buying bonds. But the bond market the truly efficient market and it does not seem to be pricing in rising inflation. If indeed we are seeing the culmination of the global expansion of credit, and therefore possibly the slowing of money supply growth, deflation could be the next big "thing". Certainly deflation has hit real property. **Therefore bonds may represent better value than we have previously given them credit for.**"*

We no sooner had those words on paper than we received an update from NED DAVIS RESEARCH that money supply growth had COLLAPSED in the several weeks prior to the publication of the Mid Year Report. On July 28<sup>th</sup> NED DAVIS RESEARCH reported that their "bond enhancement model" had issued a buy signal.

NED DAVIS RESEARCH (NDR) IS ONE OF THE MAJOR OUTSIDE INDEPENDENT RESEARCH SERVICES THAT K&A USES. THEY ARE WORLD REKNOWNED.

The bottom line is that NDR is seeing the same trends in bonds that we are. Therefore we intend to add significantly to the bond allocations in all our models. **K&A clients will be seeing significant buys of corporate, agency, treasury or tax free municipal bonds in their accounts. Bond type and percentage allocation will vary from model to model, but all the models will be seeing an increased allocation to bonds.**

We were very bearish on bank stocks in the Mid Year Report. In the “Alternative Universe” that has emerged in just 15 days Wachovia and Merrill-Lynch have taken HUGE steps to bring themselves closer to the end of their write downs, balance sheet problems, etc. Each new round of disclosure by a major bank seems to be followed by dramatic action on the part of the banks CEO that heretofore they said would not be happening. The latest example is that John Thain, CEO of Merrill, was reporting only a couple of weeks ago that he would not be raising capital by issuing new stock that dilutes current shareholders. What did he do yesterday? He diluted his existing shareholders by selling new stock dirt cheap to a single “angel” investor. That is a two week turnaround folks. Remember this is an “alternative universe”.

K&A continues to rely on quantitative modeling using our VE (ValuEngine) Institutional software to determine target prices for all stocks, including the banks, before making investment decisions. Please remember that quantitative modeling is mathematical modeling. It relies on using past, present, and forecasted characteristics of companies to forecast a price of their stock over specific time periods. What we end up with in our quantitative models is a targeted rate of return and the probability of achieving that return over the specified period of time.

For an explanation of who VE is and how the modeling works you can go to <http://www.valuengine.com/pub/main?p=0>. Please bear in mind that K&A uses VE INSTITUTIONAL SOFTWARE which is not available on the VE website.

Our models show the following price targets for major financial stocks twelve months from now in July 2009:

Company	Current Price	Forecast Price	Project Loss
BankAmerica	30.36	26.29	-13.41%
Citigroup	17.9	8.62	-51.84%
Wells Fargo	29.73	27.07	-8.95%
Wachovia Bank	14.99	7.44	-50.37%
Goldman Sachs	179.23	169.7	-5.32%
JP Morgan	39.85	36.77	-7.73%
Morgan Stanley	35.75	33.77	-5.54%
AIG	25.13	22.03	-12.34%

The models are not “opinionated”. They rely on quantitative analysis. Needless to say the factors involved in that analysis can change. That is why we run screens on these stocks at least weekly. Until the risk/reward profile of the banks change dramatically we will not likely be buying them. If you do see us buying it is because our models finally show them to have a low risk/high reward profile, but not until then.

The Mid Year Report stated that *“it may be that the next stock market to do well will be Taiwan as China and Taiwan become peaceful partners. Taiwan could be the next boom market as it makes peace with China for the first time since I was born.”*

We still believe that to be true.

The Mid Year Report said, *“Despite all the negativity in this entire paper we are still bullish on oil, gold, some agricultural commodities, and some industrial metals—for the long haul. As I write gold is experiencing a bullish breakout from several months of price consolidation. We own gold in a couple of*

the models and we will be adding it to others. The odds of gold breaking above \$1000 per oz. seem absolute to us. Targets of as high as \$1400 seem reasonable.

The breakout failed and gold has now fallen back into a consolidation pattern.

You can see that on this chart of the gold bull market run since 2001. The current "consolidation" period is the one flagged near the top right of the chart. This is the third time since the bull market started that gold has consolidated.

At the present time K&A has turned neutral on gold and we have deleted it from the models. We are keenly aware that much of the rise in gold has been attributable to explosive money supply growth rates that we have commented on in many previous newsletters, and tied to the fall in the dollar. If indeed money supply growth rates are starting to shrink then it follows that gold may retreat and that the dollar may stabilize.

Therefore we are also moving from a bearish stance on the U.S. dollar to a neutral stance, particularly as it relates to the Euro.



**We're very confident that we have the capital base now that we need to go forward in 2008.**  
January 18, 2008.

**"...Today I can say that we will not need additional funds. These problems are behind us. We will not return to the market."** March 8, 2008

**"We have more capital than we need, so we can say to the market that we don't need more injections. We can confirm that we have tackled the problem."** March 16, 2008

John Thain learned the hard way that saying the same thing over and over won't necessarily make it come true. The truth is, Merrill was far from finished tapping the markets. Earlier this month, it raised \$8 billion by selling stakes in Bloomberg and Financial Data Services. And yesterday it announced plans to sell \$8.5 billion of new shares.

## **Difficult Times**

**7/30/2008 1:41 PM EDT**

This is one of the most complicated markets I can remember in my career. Many stocks are down and cheap with solid fundamentals. These usually represent attractive longs. Also, sentiment is as bad as it gets. That also usually means a bottom.

Yet fundamentally, things are deteriorating with the potential to get much worse. The uber bear case has a spreading global recession and still expensive stocks in the case of a global economic meltdown.

Therefore investors are shooting economically sensitive shares first and asking questions later. Bullet proof stories or defensive plays, ie expensive stocks are gaining at the expense of cheap ones. That makes life tricky for a deep value guy like myself.

I am limiting my bets in this type of market. I believe that the big bottom will come this fall on a deteriorating economy(no more rebate checks) and negative political sentiment from a democratic administration. In this environment, small/mid caps drop more than large caps, the VIX hits 35, and you hear "it's not too late to sell" from the talking heads on CNBC.

At that point, I hold my nose and buy like crazy and pray I am not too early. Til then I stay more defensive than not.

Position: none

### **Robert Marcin**

Robert Marcin is the founder and general partner of Defiance Asset Management. Formerly, Marcin was a partner at Miller, Anderson & Sherrerd and a managing director at **Morgan Stanley**, where he managed the MAS Value fund (currently Morgan Stanley Institutional Value). Send [Robert Marcin](#) an email.