No Pain, No Gain, No Pain

The U.S. and global stock markets put on the performance of a lifetime yesterday ramping up 10% or more across the board. We did not participate in the rally as we own no stocks. That is what I mean by “no pain, no gain”. We didn’t participate in the “pain” as stocks collapsed in September and October. Neither did we feel the “gain” on the day of the 10% rally. That rally was simply too much, too fast, and it gave back a little today. Stock market futures are down tonight, pointing to a lower open in the morning, so it is quite possible we give back more tomorrow—therefore “more pain”. (believe it or not, I wrote that paragraph ½ hour ago. Now the futures are pointing to a mixed open in the morning with some averages up and some down. Rational-hardly!)

It would make sense “to give some back” as the magnitude of the rally made no sense—at least the second half of it. Giving back half would be about right, and we won’t feel that “pain” tomorrow if it happens.

Asia is all down tonight so we shall see what tomorrow brings.

After today’s close the S&P 500 is down approximately 11.5% for October after falling over 8% in September. Could the markets be lower again tomorrow night? It looks that way right now, but we shall see. You can’t take a bathroom break during all of this without missing a 100 point move. Amazing stuff!

Yesterday’s rally has clearly changed lots of perceptions about where these markets are headed in the short term. On Friday the world was being priced to go out of existence. Today all is well. We think reality lies somewhere in the middles. Our take is as follows:

1) The washout on Friday should be the low for 2008. We do not expect to see those intraday lows again during the remainder of this year.

   We do expect the markets to sell off and challenge their CLOSING lows from Friday. That simply means that we would expect any near term downturn in prices to hold at roughly 8500 to 8600 on the DJIA, around 900 on the S&P 500, and about 1270 on the Nasdaq 100. If the major averages moved back to test those areas we would likely be aggressive buyers of stocks, trying to set up for a year-end rally. This doesn’t mean that we have switched from bearish to bullish. It does mean that we think some stocks are **RIDICULOUSLY CHEAP**, and that we are finally at an inflection point that will allow them to move up in price over the course of the next several weeks.

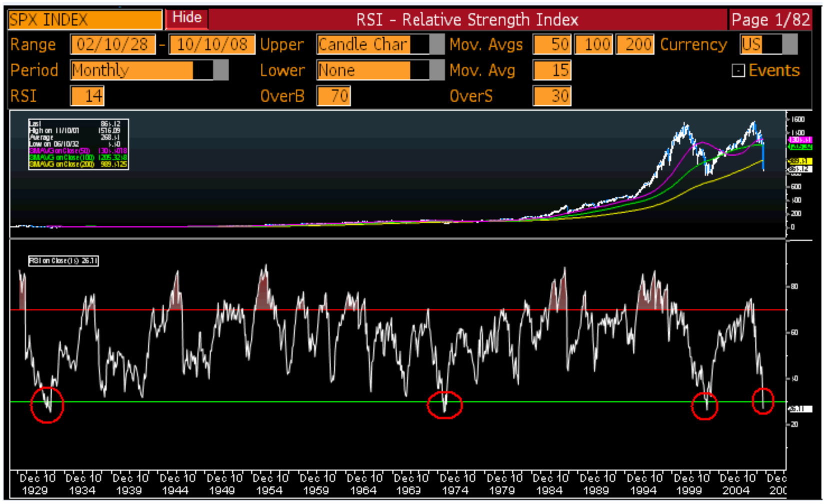
2) Today the major averages would have lost a lot more of yesterday’s gain had it not been for financial stocks. It was the only sector that was up significantly. Wall Street was relieved that we will not be seeing any major bank failures. Secretary Paulson is force feeding at least 7 of America’s largest banks $125 billion of new capital. They include Goldman Sachs, Morgan Stanley, J.P. Morgan, BankAmerica, Wells Fargo, Citigroup and State Street Bank. The U.S. government will own part of each of those banks and they will not be allowed to fail. We think the rally in those stocks will dissipate and they will pull back. If Wells Fargo falls below $30 again we intend to be buyers. There seems to be little doubt now that it is the best run major banking firm. Besides there are lots of backstops under it now, thanks to the PPT.

3) By the time 2009 arrives stocks could be rolling over again, but the path of least resistance for the next several weeks now seems to have changed—from DOWN to UP. The rally we are anticipating is partially seasonal, and partially bred out of the excesses to the downside that we have witnessed over the past couple of weeks. Every stream of bad news related to the markets tends to be interrupted by a little good news. If it happens, as we expect, we shall take it.

Here are a couple of examples that illustrate just how sold out this market is at current levels.

Since the S&P 500 was formed in 1928, its monthly relative-strength indicator has dropped below 30 on just four occasions: the 1929 lows, the 1973 lows, the 2002 lows and **last week**. I know that many of our readers don't even know what "relative strength" is, but imagine that we have seen these conditions only THREE other times in the history of the stock market. That alone tells you that we are stretched toward the downside.

As of last Friday ALL 30 Dow stocks were below their 200-day moving average -- a condition that has only occurred **ONCE BEFORE**. The last time was right after the 1987 crash.



There is a lengthy list of EXTREME CONDITIONS that have developed in these markets. The bottom line is that I have never seen markets so oversold in my entire career. That argues of at least a temporary bounce.

The two examples of that oversold condition that we point out here came from an article by Barry Ritholtz, written for RealMoney.com

If you would like to see the rest of Mr. Ritholtz list you can see it at http://www.thestreet.com/b/university/stockpicking/10442352.html

My simple point is that we have seen a sell-off of truly historic proportions and relief rallies usually follow.

Today the yields on 10 year and 30 year U.S. treasury bonds rose the most in two weeks and are now above 4% on both bonds.

We base a lot of our bond buying decisions off the movement of the 10 year Treasury yield. For the past year it has been trading in a range that spreads from 3.4% on the downside to approximately 4.25% on the upside. We have tried to be buyers each time the yield approaches the high end of the range.

We will be watching closely now to see if yields break above the 4.25% level. We would not necessarily consider that a positive sign for the economy as higher rates could be a drag. But we would interpret it as a sign that investors are simply demanding higher returns to suck up the HUGE amount of liquidity the Fed has been flooding the system with.

We are getting a lot of questions about whether or not we expect to put gold back into the models. The jury is completely out on that one. Gold triggered a few key technical buy signals in the last couple of weeks, but in the past few days those signals have disappeared as rapidly as they appeared. So unless we get some better confirmation of a rising trend the answer would be no.

That's it for today. Take care.

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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.

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.

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 polices 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.

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.

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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.

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Sincerely,

Paul Krsek
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