



ELUMINATION

MARCH 3, 2008

WHO NEEDS LEAP YEAR?

Twenty-nine days was one too many for February. The last day was a disaster for the stock market as many U.S. and global equity indexes capped off four months of steady declines with a solid thud. All major U.S. indexes are down year to date and so are most foreign indexes. Brazil is the only major market that is up in 2008. The S&P 500, with which we compare our model returns, finished February down -9.33%. Bonds didn't exactly shine in February either as there are major problems in certain sectors of the bond market. The Lehman Aggregate U.S. Bond Index, with which we also make comparisons, is now up 1.82% through February.

K&A models continue to be positioned defensively. Hatteras, Mendocino, Halifax and Fresnel are up and Bonavista and The New World are down at the end of February. We will not report performance officially until the end of March. The returns range from .42% to 3.14% for the models that are up. The two that are down are at -.46% and -1.71%.



GOLD & SILVER

Gold remains a solid leader in 2008. We have drawn a chart for you that tracks gold's entire move up since 2001. 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 the 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.

We don't show you a chart of silver, but it too has been moving up quickly. Silver, which is owned by the Hatteras, Mendocino and Fresnel models, has actually been moving up faster than gold in recent weeks it, but we expect the same consolidation to start soon.

OIL & NATURAL GAS

In our last newsletter we told you that we had initiated a short position in oil, which is a bet that its price would decline. That trade lasted all of two days and we sold it out at a small loss. Seasonality factors should have come into play by now, taking the pressure off oil prices. You'll see from the chart on the following page that oil is also overbought, although not as extended as gold.



happen in markets don't always happen.

Natural gas is shown in the chart below Natural gas prices have not risen as much as oil prices. In fact they have been locked in more of a trading range in recent years. It was only a couple of months ago that prices fell below \$6 and one might have expected the range to be broken on the downside. Now there are signs that the range might be broken to the upside and therefore moving up to the \$11 area.



Seasonal characteristics might still come into play, but it became real clear, real fast, that it wasn't going to be right now. It would not surprise us to see oil move up over \$105 in the very short run, before we do meet a short term ceiling in prices.

We still believe that seasonal supply and demand characteristics favor a drop in oil prices back to the \$85-\$93 range. But guess what? It simply might not happen. We are still operating with full conviction that oil prices will top \$120-\$125 at some point in the next 12 to 24 months.

Everyone knows we are long term bulls on oil prices. There is just a lot of data indicating that the almost relentless push upward needs a period of consolidation or correction. All we can say is that things that should

We are very bullish on natural gas for the long haul too. Although, there does seem to be the potential for more domestic supply of natural gas than anticipated until recently. EOG Resources, XTO Energy, Chesapeake and others have made recent announcements related to the potential for significant reserve increases. So prices may not rise quickly.

WHY THE EMPHASIS ON GOLD, SILVER, OIL AND NATURAL GAS?

Collectively they make up allocations that approximate 20% to 35% of the assets held in each of five models. Specific allocations vary model to model: Hatteras, Mendocino, Halifax, Bonavista and Fresnel.

WHAT ELSE ARE WE DOING?

We explained in the last newsletter that we are picking individual stocks for all the models and are long several stocks in each model. We also said that we were short major indexes in all the models too.

Here is an excerpt from that letter, dated February 22, 2008, "As of tonight all the models are partially allocated to ownership of individual stocks. Those stocks vary model to model but we have been building back positions since January 8th. As of tonight all of the models are short three stock indexes.

Let me interpret that for you. We have been buying individual stocks as prices drop to levels that we think makes them good buys. The overwhelming majority of those purchases are profitable as I am writing this letter despite the fact that the overall market keeps dropping.

On the other hand, we have very little faith in the overall markets so we are also shorting the DJIA, the S&P 500 and the Russell 2000 indexes. That means the models profit as these indexes fall. The funny thing is that as I write this, most of those trades are profitable too.

The strategy here is simple. We believe that we are pretty good stock pickers and that even within this bear market we can find individual stocks that will be winners. That has turned out to be the case so far. On the other hand, we know of no reason why we shouldn't try to profit from the markets going down too—thus the shorts on the major indexes.”

It is only one week later and several of the individual stock picks are not as profitable. The short trades on the indexes are more profitable. Does that indicate a trend, or could we be in danger of misinterpreting the markets because we are simply looking at too short a time period. Remember that it was only one week ago that we felt compelled to write and comment on the raging rally that took place on February 22nd. We told you then that, “The market reacted to news, or rumor, this afternoon that one of the biggest muni-bond insurers might find a way to improve its capital base, keep its AAA credit rating and avoid a complete meltdown. Let's hope there is some fact behind this story, because if there isn't the markets will immediately be in trouble again next week.”

Guess what, by Friday, February 29th the rumors were that the AMBAC bail-out had been delayed and might be in trouble. Guess what, on Friday, February 29th the market moved back down dramatically. The markets were in trouble again, and for reasons that were more complex and more broadly based than reaction to the AMBAC bail-out. All of the news last week indicated that the U.S. economy is slowing dramatically, and at a faster pace than many expected.

So where does that leave us? Here is a chart that we don't show you often. It is the monthly closing chart of the Dow Jones Composite Index, which is comprised of all of the stocks that make up the Dow Jones Industrial Average, the Dow Jones Transportation Average and the Dow Jones Utility Average. You can clearly see that the long term bull market that started in 2003 ended in November of 2008. You can also see that since then we have had four monthly moves down. They are the four red bars at the upper right side of the chart. You can also see that the RSI (relative strength indicator) turned down at the same time. An MACD crossover happened simultaneously and the monthly histograms fell below zero like clockwork. All four indicators have continued downward since the break in November. We take it for granted that many of our readers don't know the definitions of these indicators. But we also take it for granted that your instincts are the same as ours. All those downward trend lines mean only one thing—the U.S. stock market has serious problems.





Want a little confirmation? Here is the monthly chart of the S&P 500. All the same conditions apply. The Dow Jones Composite Index and the S&P 500 provide a pretty broad based sample of the American stock market. These charts do one thing for us. They confirm we are truly in a cyclical bear market.

You might ask why we are showing you monthly charts instead of weekly or daily. Monthly charts take out all the “noise” and distractions that are characteristic of the shorter term charts. They show the longer term trend much more clearly. These charts remove any doubt about the bull market-bear market debate.

It might be easy to assume that since we have already had four months of downward movement that maybe we could expect some relief in March. That is a nice

thought, but possibly only wishful thinking. Look at the left side of the chart, down toward the area where it says 2003. Look at the price action that preceded 2003. We had six months in a row during which stock market prices were collapsing. The biggest move down took place in the sixth month. That was followed by two months up, then three more down. That was the “bottom” of the 2000-2002 cyclical bear market that actually ended in the spring of 2003.

Another month or two of downward pressure might be what it takes to get us to an area where the major averages could find significant support. That would be the 50 month average in each case. For the Dow Jones Composite Average that is at 3728 which is 9.7% lower than Friday’s close.

For the S&P 500 it is 1287 or only another 3.3% down from Friday’s close. We have shown you charts like the one to the right before. It shows the “Fibonacci” retracement levels. The first major one is at approximately 1276, which is devilishly close to 1287. The bottom line is that it is highly likely that the U.S. stock market works its way lower in March, and that bulls and bears really duke it out at levels around 1276-1287 to see if that level can hold.



Therefore starting immediately we will be minding our stop losses closely on any long positions we have already established. We will be adding to the shorts of the averages.

WHAT ABOUT INTERNATIONAL DIVERSIFICATION?

If you are talking stocks there isn’t much comfort to be found off shore these days. While some foreign markets have definitely done better than the U.S., others haven’t. The trend is down around the world, at least for now. The only place that hasn’t seen at least initial signs of a stock market downturn is Brazil.

On the other hand international diversification doesn't have to come through stocks or bonds anymore. There are plenty of currencies to invest in, or at least trade. We told you last time that we had established a short trade in the Euro for Hatteras and Fresnel. As of today that trade is not profitable, but it is not anywhere near our 9% stop-loss limits either. We continue to feel that the Euro is at a point that it is topping out against the dollar. It is clear that the "rubber band" is getting stretched a little tighter in that the Euro has now exceeded 150. It may move up to 153-155.

We remain convinced that the European Central Bank will find itself confronted with economic contraction soon and that they will be forced to move from tightening interest rates, to going neutral, to cutting. We also believe this will turn the Euro downward.

We expect that the longer term trend for the Japanese Yen and the Chinese Yuan are upward. We also believe that the Swiss Franc offers a safe haven in the global market storm. We have initiated a position in The New World model owning Swiss Francs.

We have also purchased Swiss Francs for our newest model, PT. REYES.

K&A ANNOUNCES NEW "PT. REYES" INVESTMENT MODEL

We are adding to our "lighthouse" series as we name our 7th investment model that is available to the public. Pt. Reyes is our first model devoted to producing monthly income. Its secondary goal is capital preservation and its third goal is growth of principal. Like its predecessors, Pt. Reyes has been developed to meet demand from our existing client base. We had a client who wanted to earn competitive income, while taking very low risk with principal value. Yet the client was also seeking appreciation, if it could be achieved with very low risk, in order to compensate for future inflationary pressures.

Like Fresnel and The New World, we had intended to operate only one account as the incubator for the first 12 months of operation, and then role this model out to the public. But we have had an increasing number of requests for a model like this, so we are doing an early roll out.

This style of investing is quite familiar to us going back to the early 1990's. In fact much of Paul Krsek's early practice at Edward Jones was done in this style. Conditions today are remarkably similar to back then, so it is no surprise that we are seeing clients and new prospects asking for this model structure.

Pt. Reyes will have the option to invest in common stocks, preferred stocks, and closed end funds that pay above average dividend yields. It will also have the option to invest in taxable bonds including U.S. Treasuries, foreign government bonds, and corporate bonds. It may buy FDIC insured certificates of deposit. It may also buy foreign exchange, like the Swiss Franc.

The current income goal may vary from period to period as K&A will be targeting a current yield that is competitive with current interest rate environment, while at the same time attempting to achieve some modest appreciation. The current yield goal for 2008 is 5%.

The model portfolio already owns several preferred stocks purchased at significant discounts to par value; a couple of common stocks paying high yields and the Swiss Franc.

Minimum initial account size is \$500,000. The annual management fee is a flat 1%. For more information about this model please contact either Lee O'Dwyer (603-2673) or Paul Krsek (603-2672).

FINAL THOUGHTS

K&A's models have performed exceptionally well so far in 2008, particularly given current market conditions. We can't tell you if there is more downside in global stock markets, but we think that the path of least resistance remains downward, at least for a little while longer.

Therefore we remain very cautious regarding equities. We think that there will be better opportunities to buy bonds later this year. The municipal bond market is struggling to put in a bottom that we think is near. We have been consistent in our views regarding bonds. We do own some Treasury Inflation Protected (TIP) bonds in our new Pt. Reyes model.

We have made our positions on gold, silver, oil and gas quite clear.

All the best,

Paul Krsek & Lee O'Dwyer

Portfolio Managers for K&A Asset Management, LLC