



ELLUMINATION

The annual report and commentary to our clients which sheds light on the major trends in the markets that can make you money in 2008: PART 1

January 2, 2008

“Never make predictions, especially about the future.” -- Casey Stengel

Casey probably knew best, but it is an annual expectation of every money manager to inform their clients, and other interested parties, what to expect in the coming months. K&A is no stranger to this process. I have been making our fearless forecasts since we started K&A in 1998.

This year we are changing the format and process. This report, called PART 1 is the cliff notes version. It contains an outline of our main themes for 2008. There is little in the way of explanation offered here, simply our points of view. Starting next week I will be publishing a series of newsletters which will offer more detailed studies of the investment themes outlined here.

Those newsletters will focus on Commodities, Currencies, U.S. and Global stock markets, Interest Rates and Bond Markets, Real Estate, Macro Economic themes and possible surprises for 2008. By breaking up the forecast into a series of reports we hope to offer more comprehensive treatment of each asset class and yet keep the newsletters short and easy to read.

I can tell you one thing for certain right now. If you thought 2007 was a crazy year, you haven't seen anything yet. 2008 has the potential to be a more volatile and complex year than 2007. We are ready. So fasten your seat belts, return your trays to their upright position and get ready for what may be a wild ride through 2008!

Commodity & currency forecasts:

1) Gold will rise in price in 2008, continuing the multi-year trend that will ultimately culminate in gold prices rising to levels that we can't yet imagine. If you are a new reader of our newsletters don't jump to the conclusion we are "gold bugs". We aren't. We have simply been right about this trend for four years. We expect to be right again in 2008.

2) Oil prices will be equal to or higher at the end of 2008 than they are now. They are quite likely to pull back significantly in the first half of 2008 due to short term conditions that may be impacting the market at that time. It would not surprise us to see \$80-\$85 pricing. Don't be fooled by any pull back in oil prices that may happen in 2008. Any pull back will be quite temporary and relatively short lived. Over the next several years the price of oil is heading UPWARD, and like gold it will get to levels that are currently unimaginable. FYI, we have called this trend correctly for five years.

- 3) Natural gas prices have been volatile within a trading range throughout 2007. 2008 should be no different. Natural gas prices won't start to rise significantly until the world finally understands we are running out of oil.
- 4) The over all commodity bull market has at least another year to run (the truth is more than one, but this is the 2008 forecast)
- 5) The U.S. dollar will spend much of the year in a trading range. Much fuss will be made about the potential for a dollar rally. Don't be fooled by minor moves up in the dollar should they occur. The long term trend of the dollar is DOWN.
- 6) The Chinese Yuan will appreciate significantly vs. the U.S. dollar in 2008.
- 7) The currency surprise of the year may be that at least 5 or 6 Muslim nations will confirm their intent to join together in the use of a common currency. They will announce that they hope to do so by 2010, but we predict that it will take them to 2012 to really make it happen. It will be generically called the "dinar" and it may be backed by gold; or tied to a basket of currencies and commodities that includes gold. This new currency will contribute to the long term demise of the dollar's value against a growing field of competitors including the Yuan, Euro, Yen and Dinar.

Stock market forecasts:

- 1) Forecasting a trend in the U.S stock market for 2008 is probably a fool's errand. The market has weakening technical characteristics as we close 2007, even through the last trading day of the year.

Corporate earnings are in question for 2008 with estimates by equally competent, or incompetent, market mavens ranging all over the map; from down 12% for the year to up 15%.

What we do know is that buying stocks of great companies when they are widely out of favor has almost always turned out to be a good long term investment decision. Therefore one of K&A's focuses in 2008 is likely to be stocks that the market has given up on but that we expect to come back in late 2008 or into 2009.

It wouldn't surprise us to see "rolling capitulation" in various sectors of the market during different parts of 2008. By that we mean that various sectors of the market will put in bottoms as the year progresses. As that happens we plan to be ready at the time to capitalize on the situation.

- 2) Oil and gas stocks, natural resources stocks, technology stocks and precious metals (the metals, not the stocks) should do well in 2008, just as they did in 2007. Trends can be more than one year long you know. "Oil" doesn't realize that we are moving from 2007 to 2008. Neither does gold. How could they, having been around since the beginning of time?
- 3) 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.

4) Banks and financial stocks will continue to be a drag on U.S. and global stock markets for much of 2008. They will not appreciate significantly until 2009 or 2010, thus keeping a lid on U.S. stock markets. Since "financials" represent nearly 30% of the market it is hard for the market to gain significant momentum without their participation.

5) The U.S. stock market could be in for one more nasty surprise at the end of Q1 2008. All those banks and financial companies that said they had already written down all their bad loans are known to lie! There could be one more huge flushing sound and sell off before the sub prime debt crisis is over.

6) Frankly it is difficult to forecast what will be happening a year from now in the broad U.S. stock market given all the upheaval in domestic markets. We have already said that 2008 could be a wild ride. But it should also be a profitable one for clients of K&A. Whatever the stock market does, we will be working to beat its performance, just as we have done the past several years.

7) European economies and stock markets should slow significantly in 2008. We would expect the European markets to underperform the U.S., China, Brazil and Russia, for example.

8) Japan will spend another year struggling. Japan is not yet a "buy".

9) Australia and much of Asia will continue to grow faster than Europe and the U.S.

Interest rate and bond forecasts:

1) Short term U.S. interest rates will continue to decline. The Fed Funds rate may get as low as 3%. It will surely drop below 4%.

2) Long term U.S. rates will remain contained and not rise significantly. But the "yield curve" will steepen thanks to significantly lower short term rates.

3) Inflation, if measured the same way as prior to 1997, would be running at 7 to 9 percent per annum, despite the housing price collapse. But the annual rate of inflation will not get worse in 2008. Higher real inflation than we are experiencing now is not realistic in 2008. The Fed can relax.

4) As our friends at BCA say, "There is no value in any of the G-7 bond markets" and we have a tough time imagining that we will be buying bonds any time soon (except to keep the Hatteras model in balance).

Real Estate U.S. forecast:

1) Residential real estate prices will be lower across the U.S. at the end of 2008 than they are now. Few markets, if any will be immune. Pity the poor fool that thinks this crisis will be over by summer of 2008. Unfortunately, I have met a few.

2) Commercial real estate prices will soften across much of the country in 2008, but the magnitude of the decline will not be as much as in residential real estate prices.

3) The real estate downturn is very real and will last for several years. The U.S. housing stock is overbuilt and supply simply exceeds demand. It will take several years to be sold off. The truth is we have seen this before. Real estate developers just can't help themselves.

Possible surprises for 2008:

1) Oil prices might not fall at all, and/or they could rise more than we expect by the end of the year. You might remember that we are believers that "peak oil production" has either already happened or is about to. The most likely case is that "peak oil" is arriving in stages. For example, the major western oil companies reserves are either past peak or in some cases will peak between now and 2011. Before anyone feels argumentative about this, please tell me how much new oil has been discovered between 2000 and 2007. I happen to know. Do you?

Neither the public nor Wall Street is dealing with this fact. If 2008 turns out to be the year that "peak oil" becomes part of the daily lexicon—watch out. Oil prices rise; oil stocks rise and global stock markets tank. The exception would be in the "alternative energy" sector. Where is the Presidential candidate who has the vision to jump all over this issue? Sorry, doesn't exist.

2) If "peak oil" becomes conventional thinking, instead of 'fringe thinking' then alternative energy stocks will blow through the roof.

Things to understand about 2008:

1) Disinformation is rampant in the markets right now. We can't remember a time when so much contradictory economic and financial analysis is available to confuse decision makers. It is extremely important to use reliable and trustworthy research services at this point. Better to have already figured out who tells the truth and actually has an edge on the markets than to try to figure it out now. The good news for K&A is that we accomplished this years ago.

2) 2008 will be another year in which the gap between the life styles of the "haves" and "have nots" continues to get wider. If you are in the "investor class" and can afford to own stocks and liquid tradable investments then 2008 is likely to be a good year for you. If you are a "borrower" making less than \$100K per year, and who managed to "trick up" your credit score during the past few years to buy two to five houses that are now in foreclosure, you are in the deep doo. Your plans for prosperity are over.

3) By the time this current "sub prime" crisis is over the financial landscape of the U.S. will be permanently altered. Bear Stearns, Citigroup, J.P. Morgan, Merrill Lynch and others will have significant foreign ownership. It is quite possible one or more of them will not exist as independent companies.

4) By the time the 'sub prime crisis is over the likes of AMBAC, MBIA and other municipal bond insurers may be out of business or merged into other financial institutions.

5) 2008 is a Presidential election year. We expect this to be a relative positive for the markets. If the Democrats are smart they will return to an "it's the economy stupid" campaign theme. Republicans may or may not find themselves in a trap, depending on just how bad the economy gets in 2008, but all the major candidates will keep their distance from President Bush.

In the mean time President Bush will pull out all the stops to keep the economy afloat and to give his party an edge.

Investors should benefit from these political circumstances.

So there you have the "Cliff Notes" version of our forecast. But you might want to read the next section of this report, just to find out how good a money manager K&A really is.

I want to take the opportunity to brag a little!

We put together a little marketing presentation a couple of months ago to help us tell the K&A story to centers of influence who can refer clients to us. The truth is that we are not very good at telling our story. We are better at making the story. In the end we decided that there are lots of characteristics that we like about K&A. I guess you could expect that to be true, or we wouldn't be here. But K&A really comes down to two things. We are totally dedicated to our clients and we are totally dedicated to providing solid investment performance. We speak to both in our mission statement:

"K&A is known and highly regarded for its investment results and level of commitment to its clients. Our clients understand that we manage their money like it was our own and that we care for them like they were members of our family."

	K&A Model	31-Dec	That begs the question, "How has the family done lately?" Well let's just say it was another terrific year for the family. All of our models outperformed their benchmark indexes for the period January 1, 2007 through December 31, 2007. That seems to be becoming a habit at K&A. We will be releasing our full performance reports within a few days, after we have had a chance to audit all the model groups. Here is a snapshot of how the model trading accounts did for the year in percent returns.
Hatteras		10.44	
Mendocino		12.03	
Halifax		12.50	
Bonavista		7.28	
Fresnel		13.43	
New World		23.56	
	Index		
S&P 500		3.53	
Lehman U.S. Aggregate Bond Index		6.62	

There are lots of ways to put spin on numbers. We frankly don't think these numbers need any spin. They speak for themselves in that once again K&A clients have enjoyed

returns that are superior to the markets annual return. The returns we produced were achieved with much lower volatility than the over all market and with much less risk.

At no time during 2007 were the models ever fully invested in the market.

We like to think of it this way, as expressed by Harold Geneen, former CEO of Raytheon and ITT:

“In business, words are words; explanations are explanations, promises are promises, but only performance is reality.”



We look forward to providing you more in depth analysis of major trends in the markets that can make you money in 2008 during the coming weeks. We may also reveal some of the secrets to why K&A has become so consistent in providing “competitive total returns with below average portfolio volatility”. Lee O’Dwyer says it is in our “secret sauce” which is “best if used daily”.

All the best,

Paul Krsek
For K&A Asset Management, LLC

Note regarding performance calculations: The returns shown in this newsletter are simple annual returns for the 6 accounts used by the portfolio managers in their daily modeling and trading. All accounts within a model group are traded in blocks so as to keep

each account as perfectly aligned with the model account for their group as possible. However, it is not always possible to have all accounts within a model group perfectly replicate the model accounts. The biggest potential for disparity arises when account owners add cash or withdraw cash from their account. The returns shown in this newsletter are tracked daily by the portfolio managers, but they are not reconciled through the Centerpiece software system that generates our quarterly performance reports. Account holders should rely on their individual quarterly performance reports for an accurate representation of their Time Weighted Return. Returns shown in this newsletter and in individual quarterly performance reports are net of all management fees and trading costs.

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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>.

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 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.

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 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
Updated: August 13, 2007