



ELLUMINATION

JULY 15, 2008

MIDYEAR REPORT

It is a big bear!

The first draft of this newsletter was written ten days ago, and I have been editing it ever since. It has been most difficult to write because it may be the most important one I have ever written.

The central theme of this letter is that during the past few months we have probably witnessed the biggest change in U.S. stock markets that has taken place in my entire career.

As recently as April of 2008 it looked as if the markets were making a bold attempt at breaking out of their trading range to the upside. We showed you the chart to the right in our April 24th newsletter called **Trading With Conviction**. Several major U.S. stock averages were looking like they were breaking out of their recent trading range and attempting to move to new highs. All of them failed in that attempt.

We now know that stocks have been in a new “cyclical” bear market for about nine to ten months now. We also know that the “cyclical” bull market of 2003 to the fall of 2007 is clearly over.



But a much more important breakdown in the markets has been developing over the past few months and frankly it sends a shudder up my spine as I think about it. The chart to the left shows the weekly closing prices of the S&P 500 (SPX) going all the way back to the start of the long term ‘secular’ bull market that began in August of 1982. You can see on the chart that the long term rising trend was broken in 2002. After falling to its lows in early 2003 the market (represented here by the SPX) rose again until last fall. Now, once more the long term trend is being challenged and in a much more serious way in my opinion.

The current long term trend line connects the “low point” of the market back in 1982 to the low in 2003

and now that line has been broken. This does not bode well for the future of the markets.

But before we get ahead of the story let's examine some history and define some terms.

The entire financial services industry uses the year 2000 to mark the end of the "secular bull market" that started in 1982. That date is irrelevant as far as I am concerned.

Bull markets end when the rising support line of the long term upward trend is violated, not at tops. Identifying "tops" as the end of bull market trends just doesn't count. The long term trend has to change. "Change" is identified by the market finally breaking below the bottom support line of the long term trend. Therefore if the bull market ended any time before now, it might have been in 2002. That is identified by the point where first blue line on the left is intersected by the falling market (See Chart directly above at the bottom of page 1). That was certainly a legitimate breakdown below the long term trend line. The market kept falling into the spring of 2003 before it turned around and started back up again, through last fall.

Now look at the part of the same chart that is in the blue circle and you can see that the weekly trend line of the SPX has now fallen below the trend line that connects the 1982 low to the 2003 low. By our way of reckoning the 'secular bull market' actually lasted from August of 1982 to July 7, 2008 (the date that trend line was broken). Now that the trend line is broken we have no way of knowing how low the market will go before it stops falling.

Our take on current market trends is that the current cyclical bear market in stocks, which began approximately 9-10 months ago, is finally putting an end to the secular bull market in stocks that began in 1982. That's right; the 26 year bull market is ending right before our very eyes. This is history being made. It is a tide turning. It is a sea change.



I will also be explaining later in this letter that the 'secular' bull market should have ended in 2002.

That is what was happening at the time. But fate and terrorism intervened. When 9-11 occurred the Greenspan Fed, the Treasury Department, the President, the Congress, and other members of the "Plunge Protection Team" put together the biggest fiscal and monetary stimulus package this country had ever seen and revived the economy and the markets. The 'secular bull market' got shock treatment just as it was dying and it worked! The market lived.

Now, let's make sure you and I have the same understanding of the terms I am using like "secular" and "cyclical" markets.

The media throws around a lot of terminology and they offer few that are accurate relative to what really defines a "bull" or "bear" market. They certainly never

differentiate between "secular" markets and "cyclical" markets, and the two are very different cycles.

The idea that we are in a "bear market" when stocks drop 20% from their highs is meaningless when trying to understand "bulls" and "bears" and what to do during each phase of the market. If you wait for a

20% drop in stock prices you are going to experience huge damage to your portfolio. We rely on chart patterns to tell us whether we are in bull or bear markets.

So what is a “secular” bull market?

“Secular trends typically last 5-20 years and they consist of one or more primary trends in sequence. As long as each successive bull market high and each bear market low (expressed in constant dollars) is higher than the previous one, we are in a secular bull market.”

Mike Alexander, author of Stock Cycles

In other words, “secular bull market” refers to the **primary trend** of the market which has been upward since 1982, despite the fact that it can “cyclically” go down from time to time, within the context of the primary upward trend.

Check out the chart of the DJIA on page 2. Again, there is no break of trend in 2000, so I still have no idea why everyone picks that date as the end of the “secular bull market”. The trend was broken in 2002, just as on the SPX and most other major averages. But the DJIA actually went onto new highs in 2007, as did many other U.S. stock averages. But now the long term support line connecting the bottom of the market in 1982 to the bottom of the market in 2003 has clearly been broken. **I reiterate; that is not good!**

Now let’s get back to defining some terms. What are “cyclical bull markets”; and “cyclical bear markets”?

K&A has always defined “cyclical” market trends as short term trends, lasting a few months to a few years, that are taking place within a longer term overriding trend (secular market). For example, if you check back on our previous newsletters you will see that we always referred to the 2003-2007 bull market as “cyclical” because it was the secondary trend taking place within the context of the primary “secular trend”.

Similarly we have been referring to the period from October 2007 to the present as a “cyclical bear market” because it has been taking place within the overall context of the major secular bull market since 1982.

But that is all now changing, and very quickly. I reiterate that K&A believes that despite all the ups and downs of the market the “secular” upward trend which began in 1982 never ended until now. The DJIA finally violated that trend earlier this year and the SPX seems to have finally capitulated on **July 7, 2008**. That may turn out to be an historic date.

In the interest of accuracy and fairness we remind you that conventional opinion differs from ours. Most institutions use 2000 to mark the end of the secular bull market. Those that do say we have been in a secular bear market ever since. **The only problem with their thinking is that if you chart the market, as we are doing for you here, the long term lower trend line WAS NOT BROKEN in 2000. All that happened back then is that the S&P 500 and the NASDAQ Composite stopped rising.**

In addition to the DJIA many other U.S. stock market indexes went on to make new highs after the year 2000. The DJIA, The Wilshire 5000, the S&P 400 Mid Cap, and the Russell 2000 all peaked in 2007. The Dow Jones Transportation Index peaked in 2008.

Being purely objective, there is risk to our suggestion that the “secular bull market” is ending right now in that not all averages have yet confirmed that event. But the current charts of the SPX and the DJIA clearly show a breakdown of the long term trend, and they are the scariest charts of those two averages that I have seen in 26 years.



Here is a chart of the weekly closes of the NASDAQ Composite Index (COMPQ). It has a very different look from the SPX and the DJIA. It clearly peaked in 2000 and bottomed in 2003. It has not yet come close to a new high. But what I find more intriguing is that for this average to “confirm” a complete breakdown of its longer term trend it needs to recede to about 1600. That could be ugly. The Dow Jones Transportation Index, among others, has not yet confirmed the breakdown we are seeing in the SPX and the DJIA.

Our primary worry is that the DJIA and the SPX are acting as the leaders of the market and that it is only a matter of time before other averages join them in the collapse of the 26 year long “secular bull market”.

You might be asking yourself a simple question at this point. Paul, if the great bull market of the last 26 years is ending, then why didn't you stay in CASH last November! The answer to that is very simple. **A trend doesn't end until it ends.** As long as the trend is in place it dictates behavior. In this case it dictated that the odds were that stocks will rise, not fall.

But now two of the most widely quoted and “benchmarked” indexes representing U.S. stock markets have capitulated and have clearly broken their upward momentum. If the secular bull market is really ending this time; and it looks that way to us, then that changes everything. Our entire perspective on the market has to shift. Why? **Guess what follows secular bull markets? SECULAR BEAR MARKETS—AND**

THEY OFTEN LAST A LONG TIME.

Bear Markets	Number of Years	DJIA Annual Return
1906-1921	16	1.58%
1929-1949	21	1.69%
1966-1982	17	1.59%

This table describes the “secular bear markets” of the 20th century. There were three. As you can see, they lasted 16, 21, and 17 years respectively. The common characteristic is that the average annual return on investment, in the Dow Jones Industrial Average was

just over 1.50% per year. That is a terrible rate of return over nearly two decades.

We have felt for some time that the market was living on borrowed time, but we could never confirm that until now. We have always suspected that the “secular” trend should have ended during the bear market of 2000-2002. K&A has always believed that sell off never reached its intended climax. It never sold off enough to flush all the excesses out of the market back then. It certainly didn't break the upward trend, as the charts we have presented clearly demonstrate.

That bear market got interrupted by an event that we now know as 9-11. The Greenspan Fed, President Bush and the Plunge Protection Team went into overdrive to heat up an exhausted economy following 9-11 and the next thing we knew the markets were revived and the “bull market” of 2003-2007 followed. Only now are we seeing the unwinding of the extraordinary excesses that accumulated in our economy during that time, piled onto the excesses and imbalances that already existed at the end of the 2000-2002 “cyclical bear market”.

Let me share with you an excerpt from our annual forecast written in December 2001, for the year 2002. It should help you build perspective and context with which to follow along with the rest of our thoughts in this newsletter:

“In our opinion the U.S markets are significantly overvalued. Valuation standards have changed dramatically in the past 10 years. What seemed expensive to most people back in 1990-91, now seems quite normal. We frankly haven’t made the adjustment. We tried and we didn’t like it. Nothing good came out of trying to ignore meaningful rules of valuation.

We remain old-fashioned enough to believe that there should be an acceptable correlation between Price to Earnings (P/E) ratios on stocks we wish to buy and the Earnings Growth Rate (EGR) of the company represented by that stock. The most comfortable, and formerly normal, correlation is 1:1.

In other words, if a stock is selling for a P/E ratio of 15, the EGR of the company should be 15. That is what we mean by one to one. The P/E equals the EGR. 15=15.

As of December 24, 2001 the average “forward” P/E on the 30 stocks represented in the Dow Jones Industrial Average was just over 20. That means that the average stock was selling for 20 times earnings forecasted for 2002. The average EGR for the 30 Dow stocks was 9.2. That is a ratio of over 2:1 (20:9.2). That is twice what it should be for this point in the cycle.

The economy is supposed to be at a trough. Therefore stock valuations should be there too—or somewhere near the trough. If they are, this “trough” is the shallowest one we have experienced during a recession. While we weren’t around for “the big one” in the 1930’s, some of us were around for 1973-74, 1981-82, and 1990-91. We have written extensively in the past that we would like to have seen stocks get cheaper at some point along the way. They didn’t. Therefore our expectations for the coming year are muted.

“Average” valuations for the stocks listed on the S&P 500 are even higher. The NASDAQ remains ridiculously expensive. That is why we mentioned previously that we hope the NASDAQ finishes 2002 at EOY 2001 levels. We’d like to see the NASDAQ grow into its high PE’s by simply marking time as earnings recover.

We have stated in previous reports that bear markets usually end with stock valuations at approximately one-half current levels. We keep looking over our shoulder for the events that would drive valuations downward, in a final capitulation spiral, and therefore toward a more “typical” bottom to a bear market cycle.”

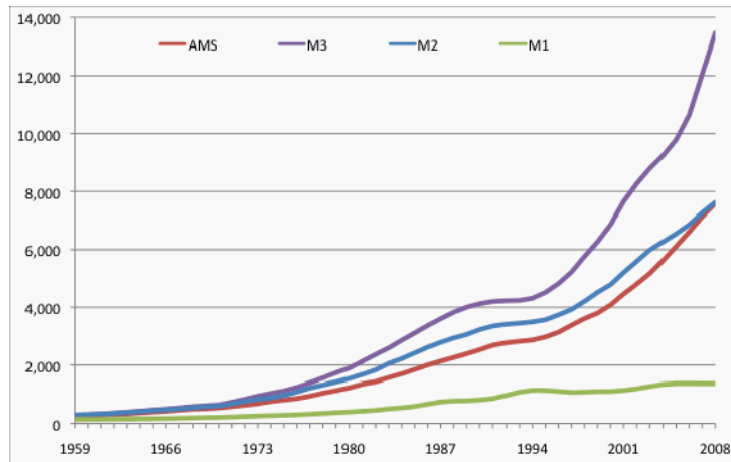
So there you have it folks; unedited from late 2001. The markets NEVER sold off enough back then to achieve a classic washout or a meaningful bottom. Osama Bin Laden seemed intent on inflicting real and symbolic damage on the American psyche and economy on 9-11. Little did he realize that he was providing the spark for one of the biggest monetary and fiscal stimulus packages of all time; and therefore sparking the “cyclical bull market” that ran from 2003 through the first nine months of 2007. That stimulus package bought us 5 more years, but it has probably also sealed our fate as we now face down a bear market that is likely to get worse before it gets better.

What do I mean by “one of the biggest monetary and fiscal stimulus packages of all time?”

- 1) Money supply exploded upward, after already growing aggressively since Greenspan took over the Fed in 1987. Money supply growth accelerated in the mid-1990’s and then really kicked into high gear after 2001.

K&A has always understood that explosive money supply growth leads to inflation. It is as simple as that.

“It is of paramount importance to realize that inflation is an increase in the money supply that will cause prices to rise. Inflation is not an increase in prices itself. Prices can rise due to changes in demand or disruptions in supply and can decrease as a result of technological advancements that lead to increased productivity. But regardless of what else may influence prices, prices will always rise in excess of where they would otherwise have been as a result of inflation -- which is an increase in the money supply. Paul vanEeden (chart also by Paul vanEeden)



- 2) The Greenspan Fed responded to the recession of 2000-2001 and the 9-11 attacks, in a series of steps, by lowering the key federal funds rate to a 40-year low 1.75 percent during the 2001 calendar year. The Fed continued to cut rates, reaching 1.25 percent in November 2002 and 1 percent in June 2003. Think about the extreme conditions we are talking about in this paragraph. **Interest rates in this country hit multi-generational lows at that time.**
- 3) Explosive money supply and incredibly low interest rates were fuel for the explosive growth in the housing market from 2002-2007.
- 4) But the Fed had a very willing ally. It was the President of the United States who led the charge for the “Ownership Society”. The following information is from the White House website. **(if you have been wondering where the sub-prime debacle got its start then look no further):**
 - The President believes that homeownership is the cornerstone of America's vibrant communities and benefits individual families by building stability and long-term financial security. **In June 2002, President Bush issued *America's Homeownership Challenge* to the real estate and mortgage finance industries to encourage them to join the effort to close the gap that exists between the homeownership rates of minorities and non-minorities. The President also announced the goal of increasing the number of minority homeowners by at least 5.5 million families before the end of the decade.** (emphasis added by K&A)
 - Under his leadership, the overall **U.S. homeownership rate** in the second quarter of 2004 was at an all time high of 69.2 percent. **Minority homeownership** set a new record of 51 percent in the second quarter, up 0.2 percentage points from the first quarter and up 2.1 percentage points from a year ago.
 - President Bush's initiative to dismantle the barriers to homeownership includes:
 - ***American Dream Down payment Initiative***, which provides down payment assistance to approximately 40,000 low-income families;

- **Affordable Housing.** The President has proposed the Single-Family Affordable Housing Tax Credit, which would increase the supply of affordable homes;
- **Helping Families Help Themselves.** The President has proposed increasing support for the Self-Help Homeownership Opportunities Program; and
- **Simplifying Home buying and Increasing Education.** The President and HUD want to empower homebuyers by simplifying the home buying process so consumers can better understand and benefit from cost savings. The President also wants to expand financial education efforts so that families can understand what they need to do to become homeowners.

5) President Bush's tax relief packages of 2001 and 2003 provided tax breaks to 111 million U.S. taxpayers and 25 million U.S. businesses (numbers from the White House website)

For the record, K&A was for the tax cuts at the time they were introduced and we are still in favor of a new President maintaining them.

Also, for the record, when President Bush announced his plan for expanded home ownership K&A also favored the idea. But I don't think anyone understood at the time that that his concept would lead to opening the floodgates to a deluge of "free money" in the form of subprime loans to millions of families who otherwise could not have afforded their home.

Now, let's all get on the same page again. What I have described in the 5 points above is the biggest fiscal and monetary stimulus package since the Great Depression. It worked sufficiently well to buy our economy and financial markets roughly 5 years of outperformance we wouldn't have had without it. It effectively ended the 2000-2002 bear market. Until now, that is. The simple truth is that the piper must now be paid.

So here we are in 2008 and the markets have rolled over again, and EVERYONE is debating how low we will go and when it will all end. We can't tell you that we know the specific answers to those questions. **We believe that we are entering the most dangerous times for U.S. equity markets in my entire career.**

This time is different

I use those words very deliberately because there is a tradition among professional managers that you NEVER say "this time is different". The idea is that no one is so smart that they can truly identify when conditions are changing. I guess that belief in "reversion to the mean" and that "you can't time the markets" or that "you can't beat the markets" dissuade people from trying to identify true trend changes. Maybe it is just that no one wants to go out on a limb and state flatly that "this time is different, and the trend is changing." But every 16 or 17 or 21 or 26 years things get very different for a while. A "sea change" does take place. At first you don't feel it; just as you don't feel the very beginnings of the tide changing. Tides change slowly at first. All that happens is that the next wave comes up a little lower on shore. The next one is a little lower still. But if you are walking on the beach there comes a moment when you notice that the waves no longer lap over your feet. You haven't left the water. The water has left you. **We think July 7, 2008 was most likely the day that the water no longer splashed over our feet.**

Inevitably the process of the tide changing accelerates. In some places it gets violent, with cross currents galore. But in the end the tide goes out and if you are still standing on that beach you are high and dry.

And there the analogy ends, because the changes of tides are COMPLETELY PREDICTABLE. The change of a secular bull market to a secular bear market is COMPLETELY UNPREDICATABLE. If the change from secular bull market to secular bear market was predictable WHY DID EVERYONE LOSE EVERYTHING THEY HAD IN THE MARKET CRASH OF 1929-1932? Why did it take THREE YEARS? Why did people keep hoping that it would turn around in the face of that level of capital destruction?

If you have read Ellumination for any length of time you know that I have always considered timely recognition of the next Great Depression to be my greatest personal and professional challenge. I have always wondered if I will be aware enough, smart enough, technical enough, or savvy enough to recognize it as it is starting.

I offer up that thought in the context that only a handful of investors got it right the last time. Almost EVERYONE got wiped out.

I now realize that I have always been looking for the wrong thing. It isn't the next Great Depression that I should have been looking for. It is the next "GREAT SECULAR BEAR MARKET".

If you accept our definitions, our charts and the reasoning we are using to identify the trend change, then the good news for you (if you are a client of K&A) is that we have identified it within weeks (measured by the DJIA) and/or days (measured by the S&P).

Even if we turn out to be wrong, we are now very aware for the potential of a trend change and will be behaving accordingly. That is going to help prevent losses that we suspect could wipe out others who are not keenly alert to present conditions in the markets.

Each of the last three major bear markets was very different. The one in 1929-1945 saw the markets lose over 80 percent of their value before the New Deal and WW2 intervened to help them recover. The one from 1966-1982 saw the market meander in what seemed like an endless set of waves, up and down, between lows that tended to be in the 700's on the DJIA and highs that were near 1000. That bear market started in the spring of 1966 with the DJIA at 744 and ended 16 years later with the DJIA at 776. It was a long journey to nowhere.

Those that contend that this bear market started in 2000 have at least one set of data on their side. In the summer of 2000 the DJIA temporarily peaked at 11215. It is at 11055 as I write this paragraph 8 years later. No matter how you define the end of the 'secular bull' it has been a tough decade for many large cap stocks and indexes.

I must admit that while we were uneasy with the markets during the fall of 2007, the theory I am espousing here was not fully developed. The markets simply had not revealed themselves at that time to be breaking 26 year trends.

Lots of people make lots of assumptions that often prove to be wrong about markets. Despite all attempts to forecast the future, no one can do it accurately. It is only after you have accumulated hard evidence, through the process of the markets revealing themselves, that you can be totally confident that you are right—or that you have been shown to be wrong.

It is only after gaining an understanding of the magnitude of the current credit crisis and understanding the reasons for the crisis that we can offer this view of the markets. **The charts that show the actual breakdown of the markets also help!** (A picture is worth a thousand words—so long as you understand the picture. Therefore in this case you are getting the pictures and the words to explain them).

What comes next?

Let's get down to dealing with the "brass tacks". What do we do now and why?

The credit crisis is clearly larger, more pervasive, and more global than anyone was aware of one year ago or six months ago for that matter.

It is also important to understand that the current credit crisis is simply the culmination of a process that started back in the days of the Vietnam War. The "empire" of the United States has been sustained for more than 40 years by the expansion of credit that now has gone beyond reason and beyond anything that anyone could possibly have imagined.

Somehow it became the norm that all Presidents since Lyndon Johnson have been "guns and butter" Presidents and Congress, in its ultimate impotence, has followed right along. But we can't just blame the politicians. **The U.S. economy, private and public, has been built on decades of spending beyond our means.** It is estimated that our collective debt, public and private, now exceeds \$50 Trillion. That figure does not take into account that every state in the Union is broke and in debt up to their eyeballs. Practically every city and county is operating on financial life support. And, the indebtedness of cities, counties and states is growing faster than you can imagine.

States are trying to survive by taking more money from cities and counties that have no money. What kind of insane "revenue sharing" is that? It's not. It is more like robbing Peter to pay Paul (except that in this case Peter had no money in the first place!)

We are also suddenly facing oil prices that are up 50% year-to-date, and roughly 9 times since 1999 when crude was selling for \$16 per barrel. **K&A is one of the very few sources that have continuously warned about the potential for reaching high prices because we are reaching PEAK OIL PRODUCTION.** The problem is really very simple. There is **LIMITED SUPPLY** of light sweet crude on the planet, and very strong demand. The current "blame game" regarding who is responsible for these high prices is ridiculous. EVERYONE is to blame. Practically NO ONE has been willing to face up to the reality of the oil markets—until now.

We never knew at what price there would be demand destruction and panic, but we seem to be getting there. The combination of the global credit crisis, staggering indebtedness in the U.S., and \$145 barrel oil are clearly too much for the markets to bear. No pun intended.

What was likely to go up for the past 26 years, is now more likely to go down for an indeterminate period of time. It may take years to approach a bottom. If there was ever any doubt as to whether this is a real bear market, that doubt should be gone from everyone's thinking.

Big tactical shift required at this time

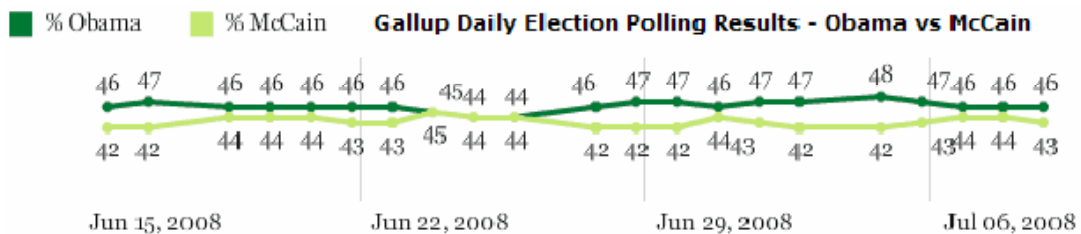
The good news is that K&A has managed to bring solid competitive rates of return to our clients despite the poor relative performance of the equity markets over the past 10 years. We have done that by always trading with a tactical bias to the "long side" knowing that the major trend was UP. The major trend is now DOWN, and as we have said, it could be down for years to come.

Therefore, what follows is a description of tactics we will be using and the signals that will be guiding us:

- 1) We will be looking for the other major averages to confirm the “secular bear market” that the DJIA and the S&P 500 are now forecasting.
- 2) We believe all other major averages are likely to break their long term trend lines and therefore are solid candidates to “short” over time.
- 3) We believe that rallies in the S&P 500 and the DJIA are likely to be contained by the broken long term trend line and will therefore fail as they approach the trend line.
- 4) We believe that all future rallies must be interpreted as not only “bear market rallies” within the context of the current 9 month bear market, but also within the context of the ‘secular bear market’ that is in place. The PRIMARY trend is now DOWN. That is likely to put much more drag on the market for a longer period of time.
- 5) Our current short term and intermediate term targets for the major indexes are as follows:

Index	Current Price	Short term Target	% Decline	Intermediate Target	% Decline
S&P 500	1226	1174	6.97%	1080	14.42%
DJIA	11055	10700	5.21%	9900	12.30%

- 6) We believe the short term targets could easily be reached by the end of August or September. We also believe that if oil and gas prices level off that it is possible that the domestic equity markets might not retreat much below these levels for now, and that the potential would exist for significant rallies before further erosion takes place. **Rallies are to be shorted as they roll over.**
- 7) This is a Presidential election year and normally the months from now through the date of the election should be very good for the market. **This time may be different. The markets do not like the prospect of Obama tax hikes. If it becomes clearer that Obama will win that will also act as a drag on the market.** (This is not a statement of preference one way or another; simply a report on the characteristics of the market.)



“But an Obama victory is not yet a foregone conclusion. According to the daily Gallup daily election polling result, Barack Obama has been ahead of John McCain by no more than six percentage points since June 15th, and fits best into Gallup’s “competitive” category. Gallup pointed out that the leader in the July polls, in a competitive race, lost in 6 of last 9 elections. In 1976, Jimmy Carter, was ahead by 33-points in mid-July, won by only two-points. In July 1988, Democrat Michael Dukakis led by 17-points, and lost the election by 8-points.”

Global Money Trends, July 11, 2008.



clearly violated its six months trading range, let alone its 26 year trend.

We would expect any rally attempt to be confined by the resistance zone we have drawn on the chart. In other words, a rally should fail after a run up to the 11750 area on the DJIA.



we expect that it is just a matter of time before it “confirms” the DJIA bearish break of the January and March lows and the 26 year secular trend breakdown.

8) To be clear, the markets are already at a point at which they could rally before heading down even to our short term targets. Here is a one-year chart of the DJIA. You can see the precipitous decline through the month of June (and into July). We know that it was the worst “June” for stocks since 1930. Yea, that can give you some shivers. In the end the DJIA broke below its low closes from January and March of 2008.

That is another confirming signal for the current bear market trend and not a good sign for the overall markets. **The DJIA has been the stalwart of the markets since 1999. It broke down less during the 2000-2002 bear market than did the other averages. It has been the reliable work horse while other averages have underperformed it, or exhibit more volatility. We don't like the fact that it has**

9) For the record, a “Bull” or a “Dow Theorist” could make the case that we are wrong in our assumptions. They would be relying on the fact that the Dow Jones Transportation Average (DJTA) is still holding above its January lows. “Dow Theory” calls for a confirmation of trends by both the DJIA and DJTA. Since the DJTA has not yet broken below its recent lows, nor is there any violation of its “secular” trend, therefore a “Dow Theorist” would contend that there is no confirmation that the markets are headed lower. With respect to our favorite Dow Theorist (Richard Russell), we think the point is being missed. To the left is a six year view of the DJTA. It is clear that the longer term rising trend, dating back to 2003 is broken. It is clear that the DJTA has experienced a “double top”; often a sign of significant resistance. And, it is clear that the DJTA recently broken below its 50-

10) The charts below are side-by-side one year weekly charts for the S&P 500 (SPX) and the Wilshire 5000. If you want to get a clearer picture of major trends, use weekly charts instead of daily charts. These averages represent two of the broadest measures of the U.S. stock market. On July 3rd both of them broke below the January and March lows on a closing basis. The trading range that has held these markets hostage for six months has clearly been penetrated to the downside. **That is a very bearish signal which indicates the potential for more downside.** Rallies on the two indexes could easily be confined to the resistance zone represented by the two blue lines on each chart.



11) If oil prices continue to rise we would raise the odds that our so called “intermediate targets” should come into play. They are 1080 for the SPX and 9900 for the DJIA. Oil at \$175 per barrel, for example, represents a significant economic and psychological drag. It is very reasonable to expect the equity markets to react drastically to such an event given the pressure the markets are feeling at \$145.

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. Until that happens we are unlikely to be able to turn these markets upward. What are the odds of that happening? K&A believes they are slim, but a “friend” of K&A believes there is some significant hope that prices could drop dramatically in 2009 and 2010. Where would that relief come from? It would be from huge new refining capacity in this country and in India.

The public keeps being told that “there have been no new refineries built in this country in 30 years”, and that is true. But there are very large scale additions to existing refineries that are being built as I write. And, much of this new capacity is able to handle the refining of “heavy crude”.

The so called “light sweet crude” that we all hear about everyday is in very short supply. That is one of the reasons that oil prices are so high. “Heavy crude”, which is harder to refine and more expensive to refine, is more plentiful. In fact the Iranians have excess supply that they are currently not able to sell because of the lack of global refining capacity.

It is our understanding that most, if not all of the new refining capacity is aimed at handling heavier grades of crude. All of the new refining capacity being built in India will be aimed at the export market. Only time will tell if any of those refined petroleum products will make their way to the United States.

Our “friend” who is in the oil services industry and working with major U.S. refineries tells us that he is hearing directly from executives at U.S. refining companies that they expect prices to come down dramatically once all the new capacity is on line and operational. At a recent conference refining industry executives and engineers numbers like \$70-\$90 per barrel were being discussed.



K&A has been telling you for years now that the path for oil prices is upward. But just as “trees do not grow to the sky”, prices are not likely to move straight up forever. They will likely continue to zigzag their way higher and a nice “zag” down below \$100 would be great for the markets. Unfortunately we don’t think we are there yet. Remember that we told you that a trend is a trend until it is broken and right now the trend in oil prices is clearly up.

But oil is now dramatically “overbought”. (See the RSI section at the top of this chart. The area in the top blue circle points to the dramatically “overbought” condition).

Is it just a coincidence that approximately \$75 marks the bottom of the current long term trend line? That is

certainly within the range that the refining “execs” were talking about at their recent conference.

There has been much consternation and “gnashing of teeth” lately about why oil has become so expensive. K&A is on record stating that “speculation” is not the cause. K&A has explained as clearly as we can why oil prices have gone through the roof. For those of you that missed it, here is a history (and economics) lesson from **Ellumination, on April 3, 2004:**

“So why is oil so expensive now?”

Do the OPEC nations hate us and simply want to make us pay higher prices for oil? Is the latest production cut among OPEC nations part of a conspiracy to unseat George W. in the upcoming election? I’ve heard both theories lately.

But the answer probably lays elsewhere-- in the tumble of the value of the U.S. dollar. The dollar has lost of third of its purchasing power over the past three years against the euro. The dollar has also collapsed vs. the Japanese yen.

OPEC takes payment for its oil in dollars. So as the dollar’s relative value has fallen, OPEC is getting paid in a currency that has less and less purchasing power elsewhere in the world.

It wasn’t long ago that OPEC seemed satisfied to keep oil prices hovering at about \$25.00 per barrel. Last year OPEC used a top target of \$28. Granted, prices might float higher or lower, but that was the “peg”

and OPEC seemed fairly content to maintain that pricing level. Americans, could therefore build and purchase the biggest truck and SUV fleet in the world, and count on cheap gas to keep the fleet running.

But prices have now crept up to the \$35 to \$38 range and may be headed higher. What gives?

Actually the math is pretty simple. Assume you have been trading one barrel of oil for something called \$28.00. You then take your \$28.00 into the market place to buy food, clothing, cars, houses, etc.—and you are able to buy what you need.



Now suppose that the purchasing power of your \$28.00 drops by 33 percent. You still have \$28.00 in your hand, but the merchants selling the food, clothing, cars, houses, etc. will only give you \$18.75 worth of goods and services in exchange for it. That is effectively what has happened to the “purchasing power” of the dollar outside the United States. The upshot is that you took your \$28.00 “bucks” into the market place and came up short of food, clothes, and other necessities of life.

If that happened to you, what would you do the next time someone tried to give you \$28.00 for a barrel of your oil? You might just try to raise the price! That is exactly what OPEC is doing.”

Since I wrote that in 2004 the U.S. dollar has collapsed against all major competing currencies. Is it any wonder that the price of oil keeps getting repriced upward? Want to know the best thing that could happen to oil prices? Stop pricing in dollars!

OK, I know that the astute mathematicians are saying to themselves that the dollar hasn't dropped enough to account for all of the increase in oil prices. So the difference has to be attributable to SPECULATION!

Wrong my friends!

Have you forgotten all the warnings we have given you about the simple laws of supply and demand as they relate to oil. Prices are also rising because of limited supply! That is the rest of the equation and represents one principal of capitalism that is as old as the hills. If I own something that is scarce, hard to replace, expensive for me to come by, and you want to buy it from me—guess what I am going to do—particularly if I know you can't do without it? CHARGE YOU A LOT!

K&A is now in the camp that prices could and back off a bit and we have been looking for a correction since late May. It is very hard to say when we will reach the top, but we think we are a lot closer. We simply don't know where the top is. The bad news is that it seems like it is likely to be higher than current levels—maybe \$160. We do know that prices over \$140 are creating real demand destruction and financial damage in the U.S.

At some point this market will simply get too over extended and “zag” back down. As we get clearer signals that the trend is flattening, or reversing we will be adding UltraShort Oil and Gas Proshares

(trading symbol: DUG) to the models. Close observers of the models may recognize that we have already traded the “DUG” a couple of times. But at this point we will be waiting for the markets to give us a clearer indication that the trend is at least “cyclically reversing”. What would a clear signal look like? Check out the chart to the right. The first breakdown would be oil below \$137.50, which might take us to \$132.33, the 50 day moving average, and the bottom trend line connecting the low of February to the low in April. That is the point at which it would make sense to add the DUG in size. A break of \$132.33 could easily signal a breakdown all the way back to \$105.



We think that a traditional technical regression back to the \$70-\$90 range is **EXTREMELY** unlikely for the foreseeable future (WITH DUE RESPECT TO OUR FRIEND). We also firmly believe that the longer term path for oil prices is upward, not downward. Therefore even if there is a temporary reprieve and prices do fall substantially, a longer term downward trend is unlikely given all currently known conditions.

In the absence of a sharp drop in oil prices we do not see other catalysts to move equity prices significantly higher in the near term—bear market rallies aside.

Finishing the 2000-2002 Bear Market Now

Our contention that the bear market of 2000-2002 was interrupted by the huge stimulus package after 9-11 may ring true with you, or it may not. I am guessing that not a lot of people have ever really considered that as a possibility. The irony is that we are now in another period of unprecedented stimulation by the Fed. The Bernanke Fed has been just as “stimulating”, if not more so than the Greenspan Fed was.

K&A has clearly stated that we support the Fed’s current actions. We have also made it clear that they have had no choice in their direction.

“All this begs the question of why has the U.S. government chosen the path of inflating money supply while deflating the value of the dollar. K&A has contended for a very long time that they had no choice. It was this path or depression. Without the expansion of money supply and the devaluation of the dollar the USA would have rolled over into recession years ago.”

Ellumination, May 28, 2008

The fact that the markets are rolling over in the face of historically unprecedented stimulation can’t be good. It indicates that the Fed is pushing on the proverbial string. (Oops, there goes another shudder up the spine.)

It also indicates that the markets believe that this cumulative “credit and oil crisis” is going to take more time to clear than anyone previously knew.

It indicates that the markets are tending toward the notion that the “credit and oil crisis” is spilling over into the broader economy. That is of particular interest, especially in light of the fact that much of corporate America (outside the financials), and corporations around the world are still reporting strong earnings

growth and offering constructive guidance. This is still a “contra indicator” to a deep bear market. But earnings season is just getting going and by the time it is done there may be no “contra indicator”. Earnings just might get weaker.

It indicates that the markets are starting to price in the reality that it “really is different for the consumer this time” and that the U.S. consumer is finally out of “financial fuel”—as well as gasoline!

These are the trends and factors that we will be monitoring.

What will these things mean to our actions and how would we summarize various components of the markets right now?

- Big down days in the markets might provide some buying opportunities in order to create opportunities to sell or sell short all subsequent rallies. ALL stocks are RENTALS until further notice.

Rallies will fail.

- While the “global growth story” is still intact, it is looking strained. Great Britain is clearly rolling over. Germany is on the brink of recession. Japan is crawling along the bottom. Along with the U.S., that puts four of the world’s largest economies into trouble.
- Everyone has always believed that China will do well at least up until the Olympics. Well the Olympics are almost here, and so we shall see what happens beyond that event. K&A has continuously been in the camp that the Chinese economy will continue to do well. The Olympics are symbolic and have little to do with the long term growth of the Chinese economy. The bottom line is that it is an economy built on exports first and domestic consumption second. If all the foreign customers are broke can China continue to do as well as in the recent past? Their stock market would indicate that the answer is no. It has fallen almost 50% this year.

But sometime soon Chinese stocks are going to be a SCREAMING BUY again. Think of the economic potential of the U.S. in 1920. That is China today.

Yet, 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.

- In one of our recent newsletters we made the comment that “The global economic growth story is still intact, despite what is going on in the U.S and the deflation we are exporting to the world. DEFLATION is the key word in that statement. **Another core worry at K&A now is that we are actually headed into deflationary times.**

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 do not believe that bank stocks have hit the bottom yet. In fact, if there is one thing in this whole report that we can be absolutely sure of, this is the one.**

Several will go to zero. This country is grossly “over-banked” considering the much lower demand for banking and mortgage services that the U.S. will experience going forward. We have no idea

how many banks will go out of business but it will certainly be more than IndyMac. There are 90 currently on the FDIC's list of very troubled banks and an FDIC spokesman said today (July 14) that number will surely grow.

One of our research services sent us an interesting data brief and set of charts over the weekend. It portrayed the stock market action after several big bank failures in the past and showed that in every case the "big bank" failure marked a stock market bottom. Those failures were Franklin National in 1974; Penn Square in 1982; Continental Illinois in 1984; First Republic in 1988; and Bank of New England in 1991. The only problem with the comparison is that we believe "this time is different". We won't be having one bank failure. (IndyMac) We will be having many.

- 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.
- We are still bearish on the dollar for the long haul. That translates to—we are more bullish on other currencies. The Renminbi is one (China). We have never owned it but we are looking to. The Swiss Franc is another. We own it in two models and will probably be adding it to others.
- We keep saying that the "spread" between the "haves and have nots" will continue to widen. That situation is now exacerbated by the new tighter lending rules and regs from the Fed today (which merely confirm policies that banks have already defaulted to). Credit standards have tightened across the board. **SEVERAL MILLION FAMILIES WILL LOSE THEIR HOMES IN THIS CRISIS AND NEVER RETURN TO THE "OWNERSHIP SOCIETY"**. They are now locked out of home ownership forever. We have said this before.

"Did I tell you that these are the toughest markets I can ever remember? Yes, I am sure that I did. In fact I have told you several times. Did I also mention that these are the most extraordinarily and sometimes surprising markets I can ever remember? If I didn't, I am telling you now. I am sure I have told you that the current credit crisis is of sufficient magnitude that if left to take its own course could cause another Great Depression. That is no exaggeration."

Ellumination, April 24, 2008

The markets have done nothing but deteriorate since that time. The Fed is still working overtime as is the whole Plunge Protection team. They will valiantly defend the stock market in the range of 10,800 to 11,000 on the DJIA—and unfortunately they are likely to lose. The fact is that we have never been so bearish on stocks. Why? The markets are clearly telling us that the Plunge Protection Team is losing the battle. 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. The PPT, as we call them is only prolonging the agony at this point. The longer they fight this fierce battle to bolster the markets, at taxpayer expense, the longer it will take us to eventually clear out the excesses of these markets.

Lee and I were discussing this very condition today. 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.

Even if the PPT were to stand back from the markets and let “market forces work” there is no reason for a “Great Depression” this time. Millions of families are out of the housing market forever, as we have already pointed out. That won’t change. What will change is that imaginary money that does not exist, until the moment it is created by the Fed, will stop being created. Where do you think all this bailout money is coming from? It doesn’t really exist. You know that, right? The imaginary money is all being created in the form of new federal DEBT that someone will eventually have to repay. Who do you think that someone is? You aren’t looking at me, are you? I am looking at you!

Who do you think is buying up all that debt? Bill Gates? Bill Gross? Warren Buffet? GE? Microsoft? Apple? Google? GM? (just kidding)

Think again. Our debt, our bonds, our markets are being bought by the people who have REAL MONEY. There are those of us who may be worth millions and the likes of Bill Gates may be worth billions. Do you think either has REAL MONEY compared to Saudi Arabia, Qatar, Dubai, China, and every other country that has a SOVEREIGN FUND. There will be trillions accumulating in those funds collectively at the prices we are paying for oil and finished goods, in the case of China.

Our spending habits and our oil consumption habits, as a nation, are going to break us unless we get them under control. Throw in the fact that we just created the largest financial debacle since the Great Depression and you have a pretty ugly picture.

It is not time to be in denial about that. It is time to fiercely protect capital and invest to make money while everyone else is losing it.

Paul Krsek

For K&A Asset Management, LLC

July 14, 2008

Disclosure and Disclaimer:

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 Andrae 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