

Quarterly  
Investment  
Strategy  
Report

2<sup>nd</sup> Quarter

2008

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“Investors have very  
short memories.”  
-Roman Abramovich

Quarterly Investment Strategy Report  
7/1/2008 – Q2  
A.L. Waters Capital, LLC

*Just When You Thought It Was Over...*

From roughly March 15<sup>th</sup> to May 19<sup>th</sup>, the S&P 500 rose from 1,275 to 1,430 (a run of just over 12%), the U.S. Dollar Index rose from 71.50 to 73.00, the CPI for March and April remained in-line and below expectations, Industrial Production had not faltered to levels indicative of recession, and GDP estimates remained positive. So all is well, right? It seemed as though we were witnessing a healthy market recovery and were never in a recession. That's right; many investors at this point were certain that we never entered a recession and were merely in a minor slowdown. We strongly believe that doubters will exist through the entirety of **this recession** only to claim 'see, I told you!' when we finally emerge to a healthy economy once again.

So what was the problem during April, May, and June? At first glance, everything was looking all right. However, for anyone who consistently follows the markets and headlines from Bloomberg, Yahoo Finance, or any other financial information services should remember that as the S&P 500 continued to rise, many companies were laying people off. Along with many earnings announcements came a simple statement from management: 'We will be cutting XX,000 jobs.' Jobless claims and unemployment was becoming an increasing concern. The Unemployment Rate for May rose .5% to 5.5% and, still, the news pundits said this was "in-line with expectations". As consumer spending accounts for 2/3 of our GDP, these job losses will surely have a major impact going forward. The argument arose that the increase of .5% in unemployment was driven by teenagers. Well, if we think this through, most places that hire teenagers are places where consumers spend money (i.e. restaurants, landscaping). Therefore, they are not hiring because business is slow, and business is slow because of huge layoffs in corporate America. Surely, the effects of middle America's tightening budget will trickle down throughout our economy.

We cannot forget the other primary reason for a slowdown in consumer spending: rising food and energy costs. This may in fact be the cause for some of the job losses at corporations as they try to reduce labor expenses while their energy expenses continue to rise. Four day work weeks and work-from-home schedules are becoming more common as companies struggle to compensate for rising costs. Again, we do not have to show you the raw numbers of how much food costs have gone up. A strong, and maybe extreme, example of this is the issue with rice. While prices were hitting record highs globally, headlines surfaced about riots in Asian countries, along with consumers buying as many bags as they could, which eventually caused the government to step in and set a limit to the number of bags you could buy. Wall Street may not be feeling the full brunt of rising food costs because they tend to be upper-middle class. However, if you ask the average consumer about paying \$2 more for a carton of eggs, surely they will complain. Let's not forget the effect that fuel costs are having on consumers as well. Part psychological, part economical, rising fuel costs are and will continue to hurt our economy. With estimates ranging from \$150 a barrel from T. Boone Pickens and banks like Goldman, to \$250 a barrel from OAO Gazprom's CEO (although most investors believe this is absolutely absurd), we don't see the problem at the pump going away any time soon. This 'Oil Crisis' in America is also having major effects on corporations. While some companies like McDonald's are doing well, we are seeing many companies, where energy costs make up the majority of expenses, issue weaker guidance, such as FedEx. We need to remember that while we've seen crude rise, so has natural gas, heating oil, and diesel. Natural gas and diesel costs are going to be

detrimental to companies going forward. This has allowed the coal industry to be one of the top performers as a means for an alternative.

Lastly, the S&P 500 has since retraced from its short-term high of 1,430 back to the mid-to-low 1,300's; the CPI is hitting the highs from November, 2007 and inflation is bubbling; the U.S. Dollar Index has fallen slightly below 73.00; Industrial Production continues to fall and the Capacity Utilization Rate remains below 80; and GDP growth is dismal. Although our prior estimate of an S&P 500 target of \$1,200 during the 3<sup>rd</sup> Quarter is still in place, our prior opinion that the markets will recover during the 4<sup>th</sup> Quarter of 2008 appears dim. A rally is highly possible, but the current conditions in both the U.S. and its spillover effects into the global economy are indicating further weakness into 2009. It is important to note that the markets do not bottom at the **end** of a recession, but rather at some point within. Therefore, we will re-evaluate our estimates at the end of Q3, or once our current target is reached.

***Patience is the most important virtue for investors...***

It now should be obvious that we believe the U.S. economy is in a recessionary period and there is more room for the markets to falter. Global Insight highlights that the housing weakness has not yet bottomed and "remains the biggest drag on growth." They give much credit to the fiscal-stimulus package issued by President Bush for causing GDP growth for the 2<sup>nd</sup> Quarter to be above original expectations. They also believe that the stimulus will further aid growth in the 3<sup>rd</sup> Quarter and now estimate Q3 GDP to rise 2.3% annualized and 1.2% for the full year 2008. A certain quote from the same outlook sparked our interest, "But the impetus then fades and the next two quarters are perilously close to zero growth again." Global Insight believes the 4<sup>th</sup> Quarter of 2008 and 1<sup>st</sup> Quarter of 2009 may pose 0% growth for GDP. While we believe the markets will retain either a downtrend or trading range through this period of time, with a possible rally midway, we sense that GDP growth may be weaker than Global Insight's forecast. This inference results from a particular estimate they have made about the Fed Funds Rate: it will either remain at 2.0% or lower through mid-2009 when they will begin a new tightening policy. With inflation results for May outpacing economists' expectations, for both consumers and businesses, and the FOMC bringing their concern for inflation into the picture, we suspect that the fed funds rate futures may be correct in saying the Fed will raise rates sooner than expected, possibly within 2 meetings. It is not that we think a raise in the key interest rate is necessary, but rather what we think has the highest probability. The Fed is still vague and defined in their public statements; however, the comment regarding the appearance of a retreated recession coupled with the worries about inflation force us to believe the Fed may take this drastic and most likely detrimental action. Not only will the temporary and deceitful (to the GDP numbers) stimulus package dissipate, but a raise in the fed funds rate will further dampen our economy's ability to grow. It is difficult and uncertain for the FOMC to know exactly what to do at this point, and this is why we don't see our economy recovering by 2009. Patience is, therefore, the most important virtue investors can grasp in doubtful periods such as these.

Patience is also going to be key when evaluating the next few earnings seasons. We believe companies will continue to release weaker guidance for the remainder of this year and into the next. Earnings did not come in as dreadful as we had thought for the 1<sup>st</sup> Quarter as we may have forgotten to have patience. It is going to take time for the consumers to feel the full effects of this downturn, which will then take time to filter through to the Business-to-Business arena. The government's stimulus package is expected to only positively affect earnings for the 2<sup>nd</sup> and 3<sup>rd</sup> quarters. Therefore, the continuing sluggish effect going forward for consumers will find its way through the entire economy and earnings will persist to decline. With an S&P 500 PEG ratio of 1.8, we do not see significant value as of yet. Finally, the S&P is

finishing the 2<sup>nd</sup> Quarter falling through various technical support levels. The prior bottom of 1,270-1,280 will serve as heavy support. While we may see a rally at that point to the mid-to-low 1,300's, resistance should take charge and the index should continue to downtrend to our target price.

***Oil dries, the wind still blows and the sun still shines...***

What is to be said of the current commodity boom? Crude Oil is rising to all time highs and should continue, while natural gas and diesel are following suit. The Energy Information Institute projects a 57% increase in world energy demand between 2004 and 2030, much of it from emerging markets. We do believe the current supply and demand environment surrounding oil, along with the technical uptrend, promotes \$150+ crude. Weiss Research highlighted several of these supply and demand issues, a few of which were: Saudi Arabia and OPEC do not plan to raise production enough to have a major impact on lowering crude prices; while demand may slow in the U.S., emerging markets **need** oil, China is building supply in anticipation of the Olympics and India's car market is poised to take off; Mexico and Venezuela are having major supply issues (not to forget Russia as well); an above-average hurricane season is expected (watch out Gulf of Mexico); and it is going to take more money and technology to drill for the latter half of our world's oil. They didn't mention the strikes in Nigeria or the possibility of a war in Iran, both of which contribute to rising oil. The only major stimulus to benefit lowering oil and gas is the potential of Brazil becoming a leading export country. However, it is going to take time for them to begin to drill and retrieve, as the conditions off their coast include a layer of salt they must go through.

So if oil and gas are heading higher, what does this mean for investments? Well, the obvious play is in Oil & Gas industries. While refiners are getting squeezed on their margins from higher prices, it is the major drillers and services companies that we believe will benefit the most. The solution is to drill for the world's remaining oil, which will require deepwater drilling and advanced technology, of which oil services companies provide. We are also looking into companies that supply the parts for rigs as they are at the very beginning of the supply chain and should benefit from increasing demand. The not so obvious play is in **Alternative Energy**. Yes, oil is going higher and oil companies will benefit, but the most favorable risk reward scenario that we see in the markets lies in alternatives such as wind and solar. By now, wind power and solar power are no longer the niche markets they once were as investors across the globe are aware of their potential. However, due to the possibility of high growth in these industries, they often trade at extremely high multiples and carry a significant amount of volatility, or risk. In today's markets, higher oil and gas prices favor the risk reward presented by wind and solar companies as their products become more competitive with our traditional sources of energy. First Solar (FSLR) claims that they will compete with retail electricity rates by 2010. Well, as higher oil and gas costs sift through our economy, it may be that solar can compete even earlier. Wind power is also becoming a legitimate market for energy as some predict it may account for about 30% of U.S. energy in the next 20 or so years. These are going to be historic changes to the global economy's infrastructure that will take much time and money. However, where many believe alternative energy is still an infant and it will take years before anything economical takes place, these years become less and less as oil and gas continue to rise. It makes sense for companies worldwide to spend more money on capital expenditures and research and development to develop alternative processes to take effect more quickly, especially with crude approaching \$150 and natural gas approaching \$15.

While we do favor Alternative Energy as the hottest sector to be in over the next few years, we need to keep in mind that it is important to find the winners. As the infant industries prosper, 'survival-of-the-fittest' will take place and consolidation will surround the industry. Many companies will be

terminated, but the winners will earn some funds the 'big bucks'. This is not to say that we do not like the growth of oil and gas. We have stated reasons why we believe in higher energy prices, and we certainly like the oil and gas industries, but we favor the risk reward presented by alternatives. Wind and solar power are also not the only alternative energy forms out there, although they are the most developed. Alternatives will consume the global economy and investment exposure to these markets will come in many forms, ranging from alternative fuel hybrid engines to silicon manufacturers to companies that create the wind tower blades. You will be able to connect several sectors around the globe and their relation to some sort of alternative energy form as it begins to put a dent in our gigantic oil and gas infrastructure.

Finally, the last reason why we believe alternative energy will outperform going forward is that unlike traditional oil and gas, many of the alternative energy companies are rightfully classified under the Technology sector. As we move through this recession, we know that historically Technology companies tend to be the first to emerge higher. Therefore, the goal is to find the best alternative companies and get in at great prices. Because of the volatility, it becomes all the more important to have great entry and exit prices to limit that downside risk.

### ***What's popping and what's dropping...***

To conclude this report we wanted to give a brief review of the industries we didn't touch on as much. First, to coincide with higher oil and gas, we have seen the coal industry really outperform all others in the energy sector. The demand for coal continues to rise as it is being used by some as an alternative source. Peabody Energy (BTU) is one of the world's leading producers of coal and is located right here in the U.S. There are abundant sources of coal in the Appalachian region so it provides a reasonable source of energy for our country. It is difficult to buy coal companies at these levels, but the trend remains upward and exposure wouldn't hurt. Second, we wanted to highlight predictions from our 1<sup>st</sup> Quarter Investment Strategy Report about the prices of the metals. We saw a pullback and consolidation likely for gold, silver, platinum, and copper, which is exactly what we have seen during the 2<sup>nd</sup> Quarter. We believe the technicals look strong for these metals now. We would be bullish if copper breaks out to 52 week highs. Gold is our favorite chart as healthy consolidation took place and we are witnessing higher lows. We are bullish as long as support holds the 200 day moving average and we see a subsequent break through the \$920-940 resistance level. Last, the industry that continues to look weak going forward is Oil and Gas Refining. The downtrends remain in place and it is not so certain that they will benefit from higher prices. We hold our underweight recommendation on this industry as best potential exists elsewhere.

*Disclosure: Various third party and primary sources were used in the creation of this quarterly report. For simplistic purposes, we are not claiming any of this research to be our own but rather a multitude of third party information and data that we agree with and see necessary to include in a quarterly report. The purpose of the report is purely informational and is not meant to be the end all be all for an investment strategy. It is required that you do your own due diligence before investing. Anything stated in this report is opinion and is not guaranteed to be the case in the future. Also, we may or may not be employing any of the strategies discussed in this report, and we may or may not hold any of the securities discussed in this report at any given time.*

S&P 500 – 2 Year/Daily

\$SPX (S&P 500 Large Cap Index) INDX

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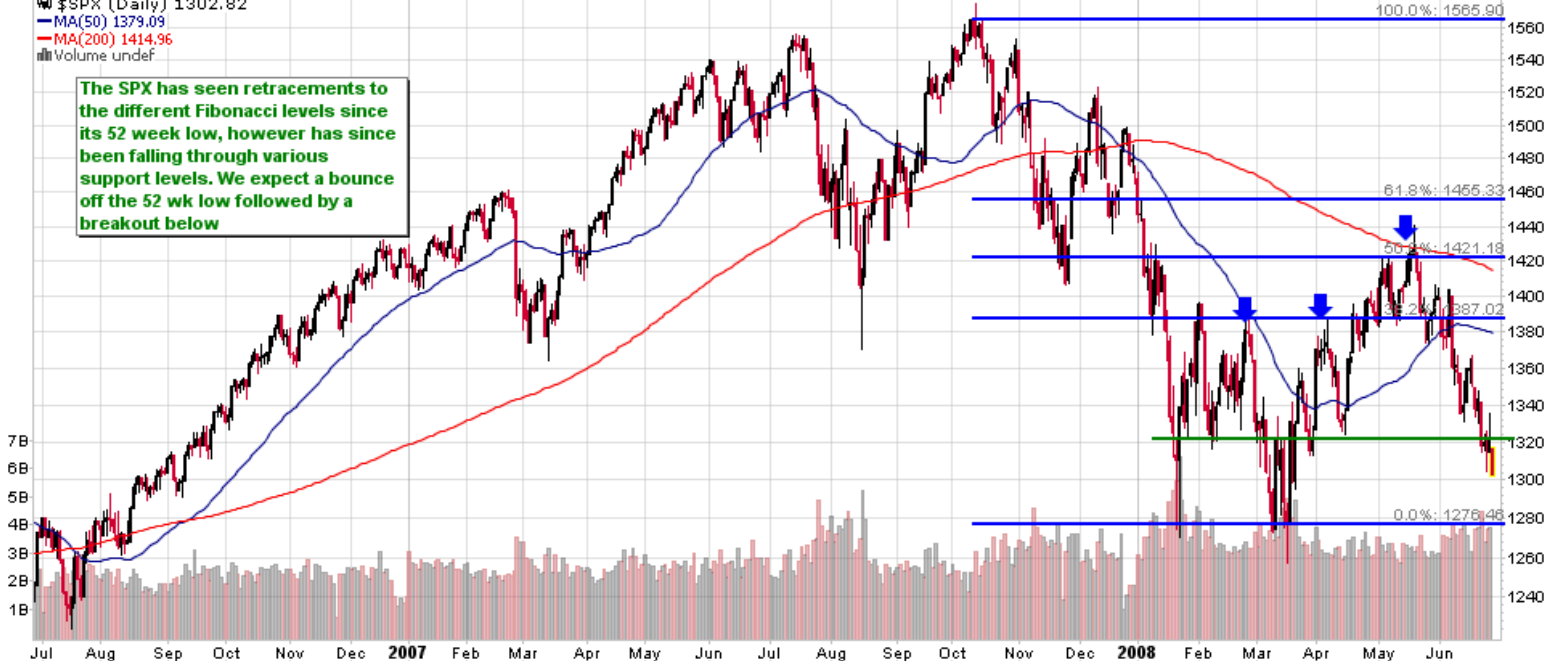
Thursday 26-Jun-2008 10:18 am

Open: **1316.29** Bid: **n/a** P/E:  
 High: **1316.29** Bid Size: **n/a** EPS:  
 Low: **1302.82** Ask: **n/a** Last Ticks: **↓**  
 Prev Close: **1321.97** Ask Size: **n/a** Last Size: **n/a**

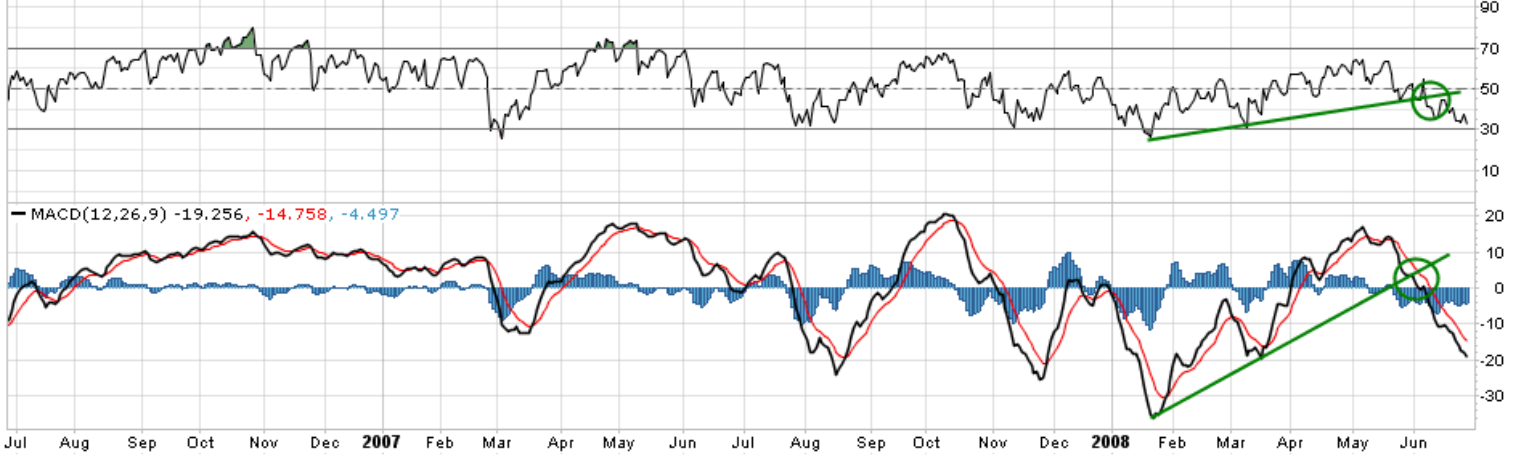
Last Trade:  
**▼ -1.45%**  
 Chg: **-19.15**  
 Last: **1302.82**  
 Volume: **0**

\$SPX (Daily) 1302.82  
 MA(50) 1379.09  
 MA(200) 1414.96  
 Volume undef

The SPX has seen retracements to the different Fibonacci levels since its 52 week low, however has since been falling through various support levels. We expect a bounce off the 52 wk low followed by a breakout below



▲ RSI(14) 32.39



Gold – 2 Year/Daily

\$GOLD (Gold - Continuous Contract (EOD)) INDX

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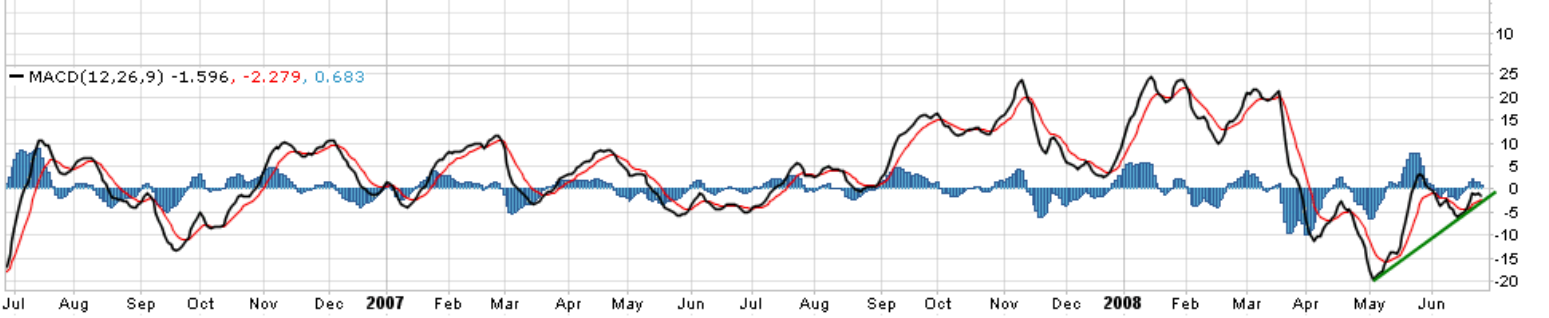
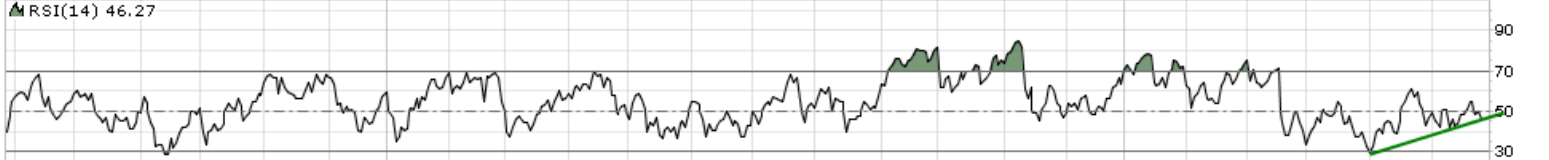
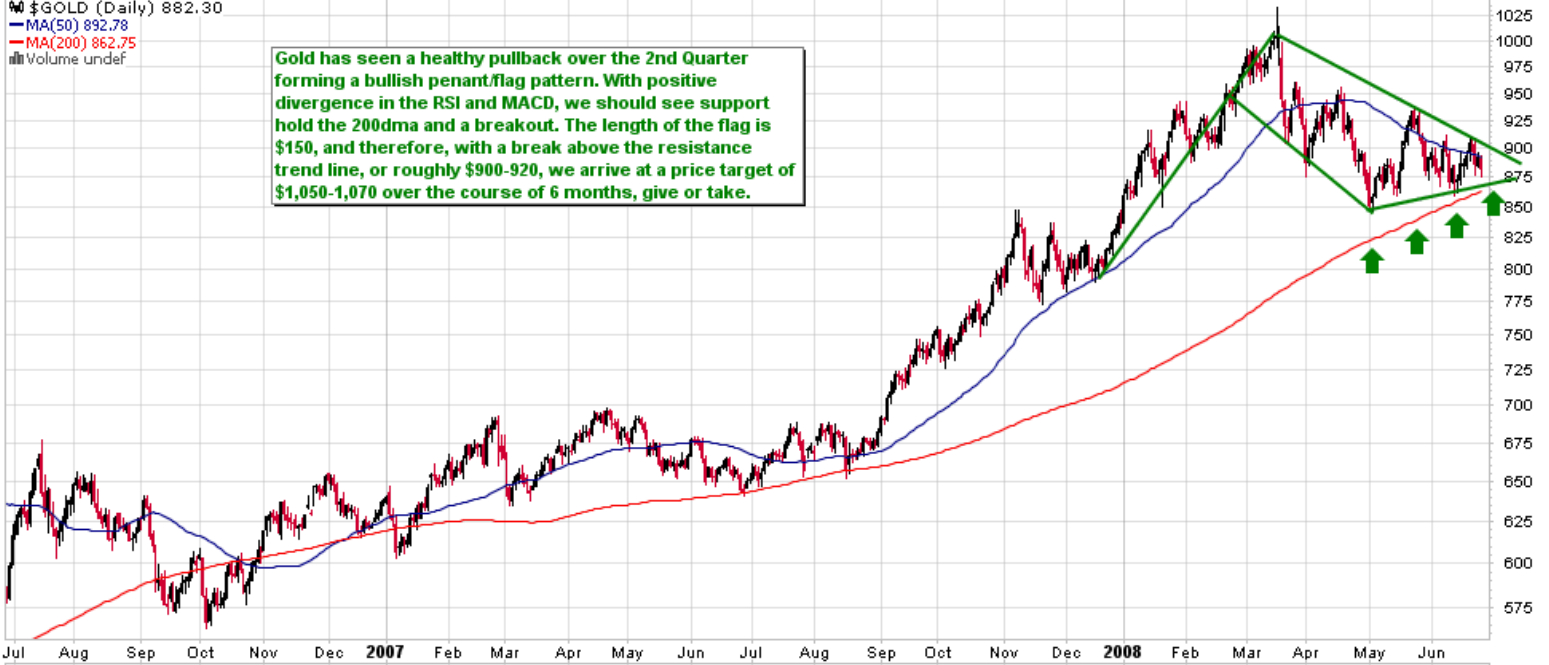
Wednesday 25-Jun-2008 2:30 pm

Open: **891.70** Bid: **n/a** P/E:  
 High: **892.90** Bid Size: **n/a** EPS:  
 Low: **875.20** Ask: **n/a** Last Ticks:  
 Prev Close: **891.60** Ask Size: **n/a** Last Size: **n/a**

Last Trade:  
 ▼ **-1.04%**  
 Chg: **-9.30**  
 Last: **882.30**  
 Volume: **0**

\$GOLD (Daily) 882.30  
 MA(50) 892.78  
 MA(200) 862.75  
 Volume undef

Gold has seen a healthy pullback over the 2nd Quarter forming a bullish penant/flag pattern. With positive divergence in the RSI and MACD, we should see support hold the 200dma and a breakout. The length of the flag is \$150, and therefore, with a break above the resistance trend line, or roughly \$900-920, we arrive at a price target of \$1,050-1,070 over the course of 6 months, give or take.



WTI Crude – 2 Year/Daily

\$WTIC (Oil - Light Crude - Continuous Contract (EOD)) IND.X

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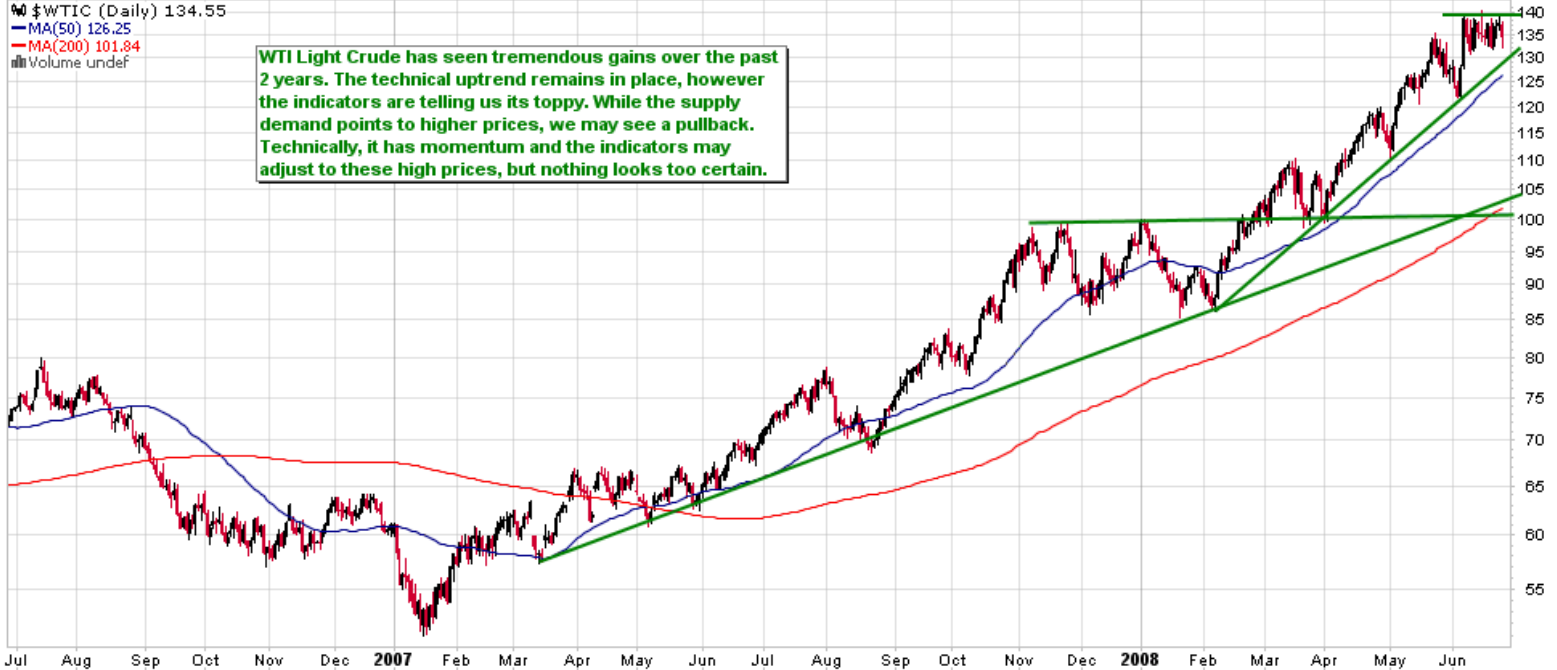
Wednesday 25-Jun-2008 4:00 pm

Open: **137.07** Bid: **n/a** P/E:  
 High: **137.58** Bid Size: **n/a** EPS:  
 Low: **131.95** Ask: **n/a** Last Ticks:  
 Prev Close: **137.00** Ask Size: **n/a** Last Size: **n/a**

Last Trade:  
 ▼ **-1.79%**  
 Chg: **-2.45**  
 Last: **134.55**  
 Volume: **0**

\$WTIC (Daily) 134.55  
 MA(50) 126.25  
 MA(200) 101.84  
 Volume undef

WTI Light Crude has seen tremendous gains over the past 2 years. The technical uptrend remains in place, however the indicators are telling us its toppy. While the supply demand points to higher prices, we may see a pullback. Technically, it has momentum and the indicators may adjust to these high prices, but nothing looks too certain.



▲ RSI(14) 54.79



— MACD(12,26,9) 2.926, 3.253, -0.327

