

4th
Quarter
Investment
Strategy
Report

December 31

2008

*"Have more than thou showest,
Speak less than thou knowest."* William Shakespeare

A.L. WATERS CAPITAL LLC

Overview:

2008 has been a troubling year for many here in the U.S. as we have witnessed what many claim to be a once in a lifetime event. Easy lending, a collapse in housing prices, extreme leverage, and high consumer debt have only been some of the major problems this economy has faced. We have discussed the poor risk management and greed of major financial institutions like Lehman Brothers, Bear Sterns, Fannie Mae and Freddie Mac. However, no one could have predicted the outcome and spillover effects that a collapse in our financial institution has had on all other industries in the U.S. Perhaps the most prominent problem is that we are not alone in this predicament. The United Kingdom is suffering similar if not worse problems in their housing market, Japan has experienced significant negative effects to exports, and China is lowering their key interest rates to try and maintain the growth they have experienced over the past decade. This is surely a global recession and the worst since the Great Depression. Never in history has the world been so intertwined in all industries so that the term “global village” has a true meaning. While the U.S. economy has been at the center of the world, we are seeing an overall long-term shift as the European Union has been more successful than many have expected and emerging markets are catching-up to developed countries.

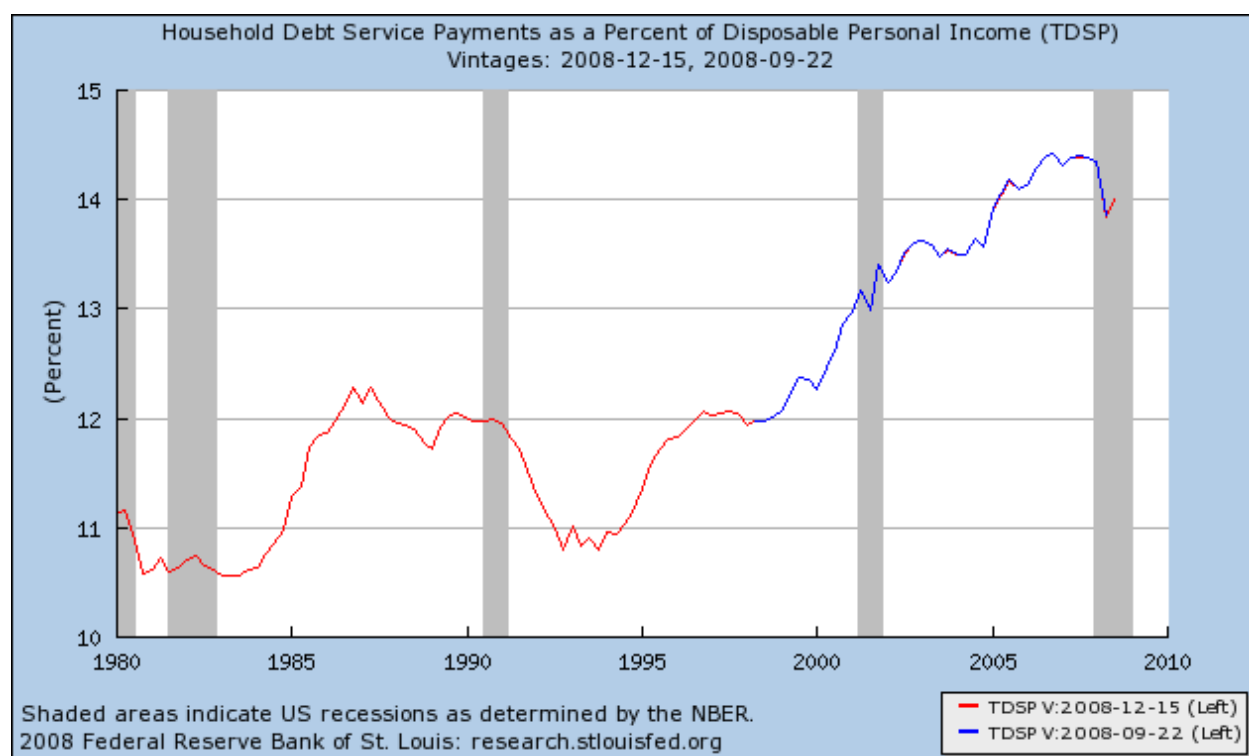
In the financial and investing world, 2008 has seemed like a lifetime in and of itself. Long-term trends have been broken across the board and the hedge fund industry, once secretive and under the radar, has come to the forefront of the investing world. Not even the hedge fund industry escaped the disaster this world has faced. According to Hedge Fund Research, Inc., their HFRX Global Hedge Fund Index is down about 23% YTD. This compares to a decline of 40.6% for the S&P 500. Although hedge funds have generally outpaced the broader market, a loss of this magnitude is unacceptable to most investors. This has separated the men from the boys, those who stayed with their strategy and correctly hedged versus those who became too leveraged and went after greedy hedge-less returns. While these funds have done well during the multi-year bull market prior to 2008, a correction of this size will flush out those who have not been disciplined.

We will analyze some of the long-term trends that have changed during this past year and attempt to give some insight into the future. The economy does not look like it will recover significantly over the course of 2009 as global economies move deeper and deeper into their own recessions. While the 4th quarter showed evidence that traders were betting the U.S. economy would outperform the world by the initial strengthening in the U.S. dollar, we have seen a significant retracement almost to the 200 day moving average showing some uncertainty to the U.S. outperformance. This has been coupled with two major bearish moves for the dollar, a larger amount of aid from our treasury versus those in other countries has increased our

government's debt and the Federal Open Market Committee's decision to lower their target federal funds rate to a range of 0-.25%.

Long-Term Trends

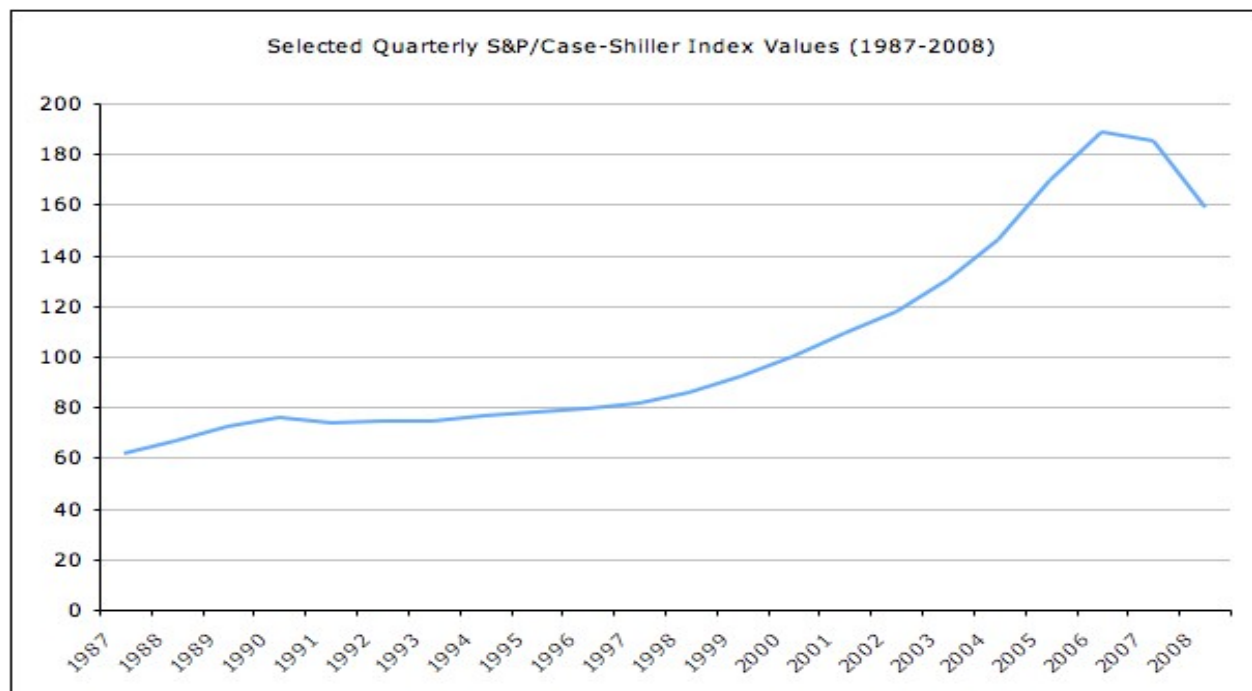
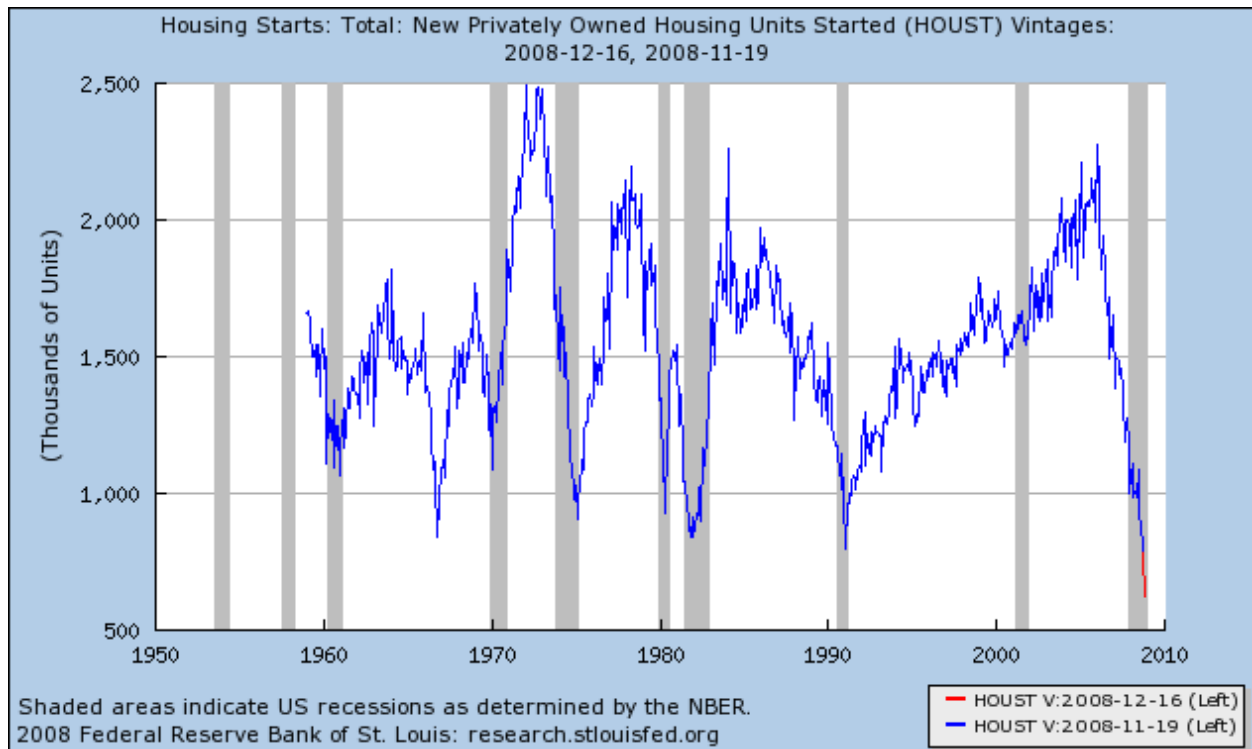
The housing market has experienced continued weakness during the 4th quarter. The loss in equity value for families in the U.S. has caused widespread concern about how consumers are going to emerge from this recession. This loss has a real effect on the wealth of these families and in turn affects the leverage and borrowing power. The loss in leverage results from less collateral, and could be a healthy reversion to the mean regarding consumer debt. The following chart shows household debt service payments as a percent of disposable personal income. A correction to the upward long-term trend may be imminent.



The second effect the loss in equity value from home price declines has been psychological for consumers. Emotions and psychological effects are deeply embedded in the way markets move. When consumers start to see declines in their wealth they tend to spend less. This can be seen in the decreases in consumer spending. Some have argued that the housing collapse spurred this recession, and it is going to be a housing recovery that will spur a turnaround. In our opinion, this was certainly one of the factors. It is difficult to pin a year in the

markets such as this one on a single factor. It is our belief that a recovery will be a result of a strengthening U.S. consumer. Until we see the psychological components of consumer confidence and sentiment rise, only coupled with the real reaction of increased consumer spending, will the economy begin to turn around. Increases in housing prices are definitely one factor, but it should also include an increase in real income and a strengthening dollar would help.

The following charts show the severity of this recession illustrated by the long-term trend in total housing starts and the S&P Case-Schiller Index through September, 2008. The Case-Schiller Index is an indexed measure of home prices.

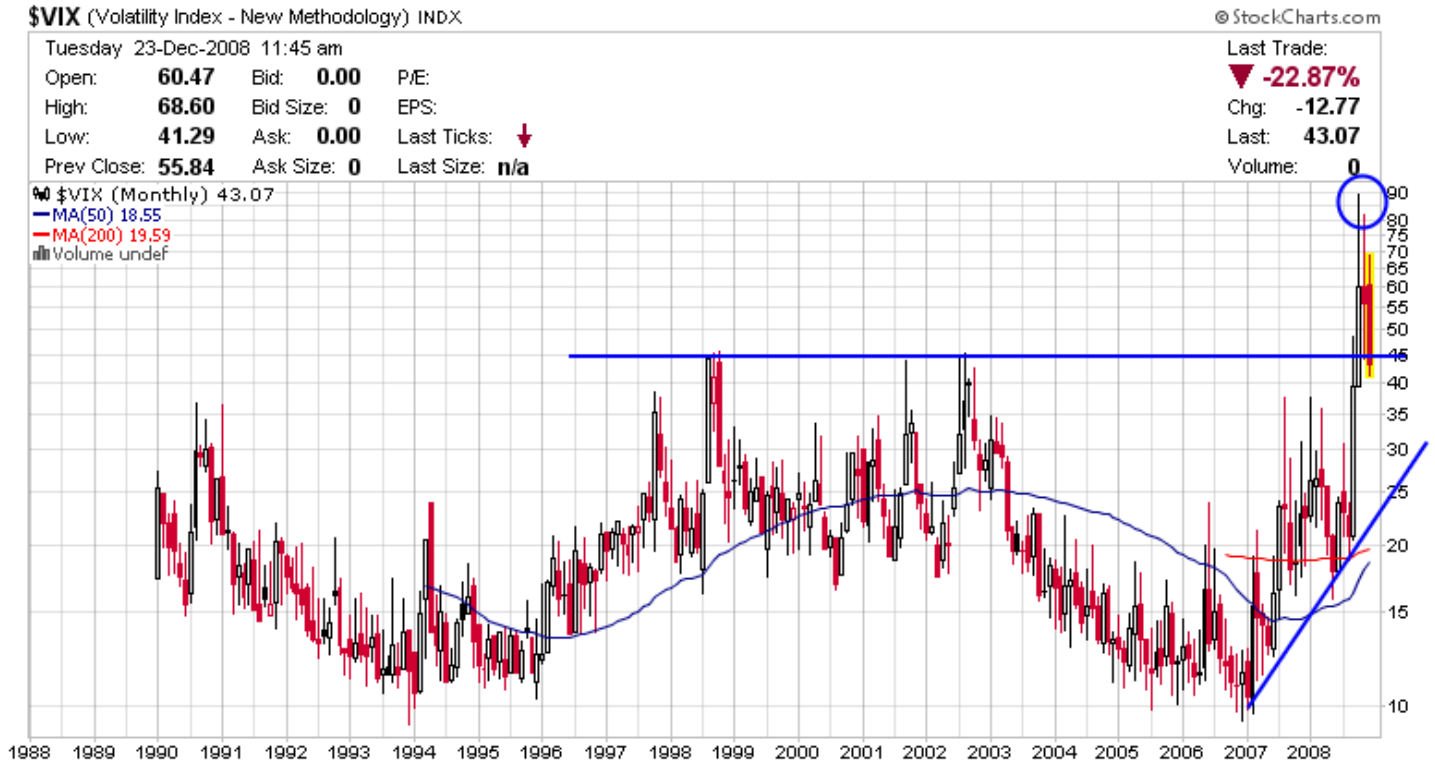


Typically through history, the U.S. economy has experienced roughly a single recession per decade. The first decade of the new millennium has thus been uncharacteristic. The question remains if this type of volatility in both the markets and the economy is going to be sustained as we move forward into the next decade. As you can see from the following chart, the S&P 500 has seen drastic moves relative to historical prices. The long-term bull market was first broken in the early 2000's, followed by a formation of another longer term bull market, and then again broken by the current recession. You can see the changes in the very long-term trend, as well as the changes in market trading over the past 10 years. In our opinion, this recession will be the longest and hardest since the Great Depression, and as a result, the subsequent bull market will be just as strong if not stronger than past bull markets. However, there are some important facts to keep in mind. The recession will remain for at least part of 2009, and the global economy will remain in a slump, but the equity markets tend to bottom before the end of the recession. This indicates it may be likely to witness a rally in early 2009, followed by another down leg. The importance of this down leg will be whether or not it breaks below the previous bottom. If not, the markets could trade sideways for some time forming a strong base and support. If it does break the bottom, they could trend downward followed by a sharp upward move when we are about 75% of the way through the recession. The most difficult question for today's economists is when exactly will the recession end. We believe the highest probability of reaching the 75% mark is at some point between the 2nd quarter of 2009 and the 1st quarter of 2010.

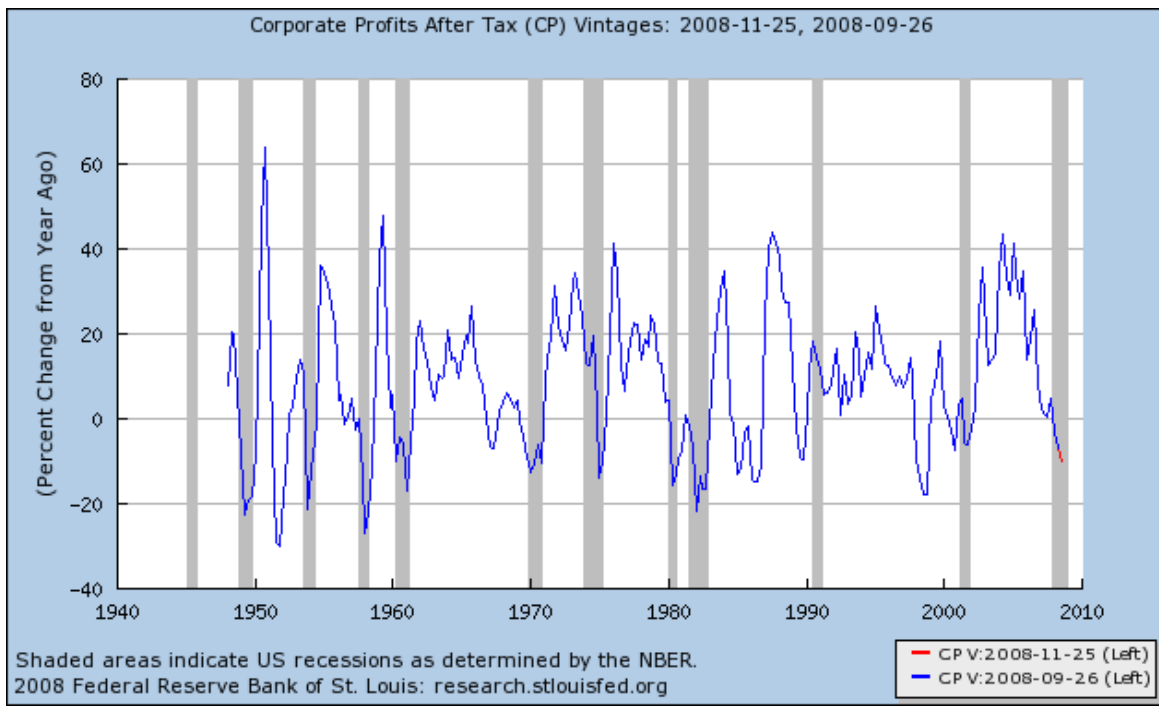


The long-term trend in the S&P 500 is sideways. If the bull market that follows this recession, possibly beginning in 2010, can break above 1,600, we should see a significant rise in the overall markets. Economically, this could coincide with even stronger emerging markets that catch-up to developed countries and a strengthening global market.

A simultaneous indicator of the change in market volatility over the past 10 years can be seen in the long-term trend breakout of the VIX Index. The question then becomes what will be the future normality for volatility. We may see the normal range change from around 20 to 30-40 on the index.



One of the significant factors that has been historically tested to be correlated with the overall direction of the markets is corporate earnings. We have seen major losses at financial institutions, as well as the spillover effects on other industry profits from a weakening consumer. The following chart shows that while corporate profits have fallen, there may be some more room for the economy to continue to slide. One of the key indicators to a recovery will be a simultaneous unexpected rise in corporate earnings to break the downward trend. Once profits begin to rise, equities become cheaper, wealth in the U.S. rises, and investment spending to increase future growth will increase. An increase in these profits combined with extremely low borrowing costs would be two very beneficial factors for the argument of a very strong bull market following this recession. The chart shows the percentage change year over year for after-tax corporate profits.



A major theme in 2008 has surrounded the commodities market. A year filled with large increases in commodity volume through increases in the number of commodity funds, attacks on commodity speculators blaming them for the “bubble”, and the subsequent crash in this market has proven to be one of the most followed asset classes by investors and traders. Because of the diversification benefit and negative correlation to equity markets, we can understand the increase in capital put into commodities. This was not only a trend in the first half of 2008, but has been going on for years now. The trend in commodities was strong versus the downtrend in the equity markets that began in 2007. This is perhaps why many traders and funds were caught when the commodity “bubble” burst. However, while they may have been overvalued over the short-term, the most significant factor in our opinion to the decline in commodities was an impending deeper global recession. They are being driven over the short-term by demand. We can see this in the oil, natural gas, copper, and platinum markets. These commodities have seen some of the most extreme losses, while gold has maintained its long-term trend.

The following are charts of some of the commodities we have followed. We are not ready to jump back onto the boat yet for most of these, but they are on our key watchlist going forward. Any more exhaustion selling with sharp oversold indicators may prove to be entry points. However, the broader global recession has a true impact on commodities. While we were wrong before on some of these plays, we do not want to jump back into a trade gone wrong until the indicators and economic signs are there for a recovery. It will be important to note that materials stocks tend to do well during the recovery and expansion phases of the economic cycle. With the S&P 500 down 40.6% YTD, the Materials sector has underperformed at a 48.9% loss, 2nd only to Financials at a 59.4% loss. Therefore these are two sectors that should outperform others over the long-term and during the subsequent bull market that may emerge during 2009-2010.

Platinum and copper has been directly driven by demand. Platinum has been negatively affected by the poor automotive market while copper has one of the most general uses in our

economy. The weak U.S. and global economies have caused these two commodities to be two of the weakest performers this year and during the 4th quarter. We are currently analyzing various trading opportunities but remain on the sidelines until the picture becomes clearer. The long-term up trends have been broken in these markets. However, sharp falls could signal sideways trading.

\$COPPER (Copper Futures - COMEX (EOD)) INDX

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Monday 22-Dec-2008 4:00 pm

Open: **165.65** Bid: **n/a** P/E:
 High: **167.50** Bid Size: **n/a** EPS:
 Low: **128.65** Ask: **n/a** Last Ticks:
 Prev Close: **164.95** Ask Size: **n/a** Last Size: **n/a**

Last Trade:
 ▼ **-18.43%**
 Chg: **-30.40**
 Last: **134.55**
 Volume: **0**

Ⓜ \$COPPER (Monthly) 134.55

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 — MA(200) undef
 ■ Volume undef



\$PLAT (Platinum Futures (EOD)) INDX

© StockCharts.com

Monday 22-Dec-2008 4:00 pm

Open: **881.90** Bid: **n/a** P/E:
 High: **891.30** Bid Size: **n/a** EPS:
 Low: **783.00** Ask: **n/a** Last Ticks:
 Prev Close: **882.30** Ask Size: **n/a** Last Size: **n/a**

Last Trade:
 ▼ **-2.39%**
 Chg: **-21.10**
 Last: **861.20**
 Volume: **0**

Ⓜ \$PLAT (Monthly) 861.20

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The crude oil and natural gas commodities have also seen similar declines to those of copper and platinum. Again, the main driver behind these moves is in demand. Global demand

has been weak for the 2nd half of 2008 and is expected to remain weak into 2009. Traders seem convinced of weaker demand as crude oil declined even with a 2 million+ production cut by OPEC in December. Oil continues to fall as we go deeper into a global recession. However, over the long-term, we are convinced that crude oil will rise once again. Over the short-term the demand may be elastic, but over the longer term, and without significant advancements in the alternative energy space due to lower crude, demand will be closer to inelastic. This means long-term supply is what will drive the prices of oil and natural gas. With supply constraints around the world, it is going to take more technology and capital to continue to produce the same amount of barrels per day. The move over \$140 per barrel should be evidence that more people are giving in to the idea of Peak Oil. Over the long-term, we expect demand to rise as developing countries continue to grow, and supply to slow if not decline, and oil will rise. We believe that oil between \$25-30 per barrel would be significantly undervalued.

\$WTIC (Oil - Light Crude - Continuous Contract (EOD)) INDXX

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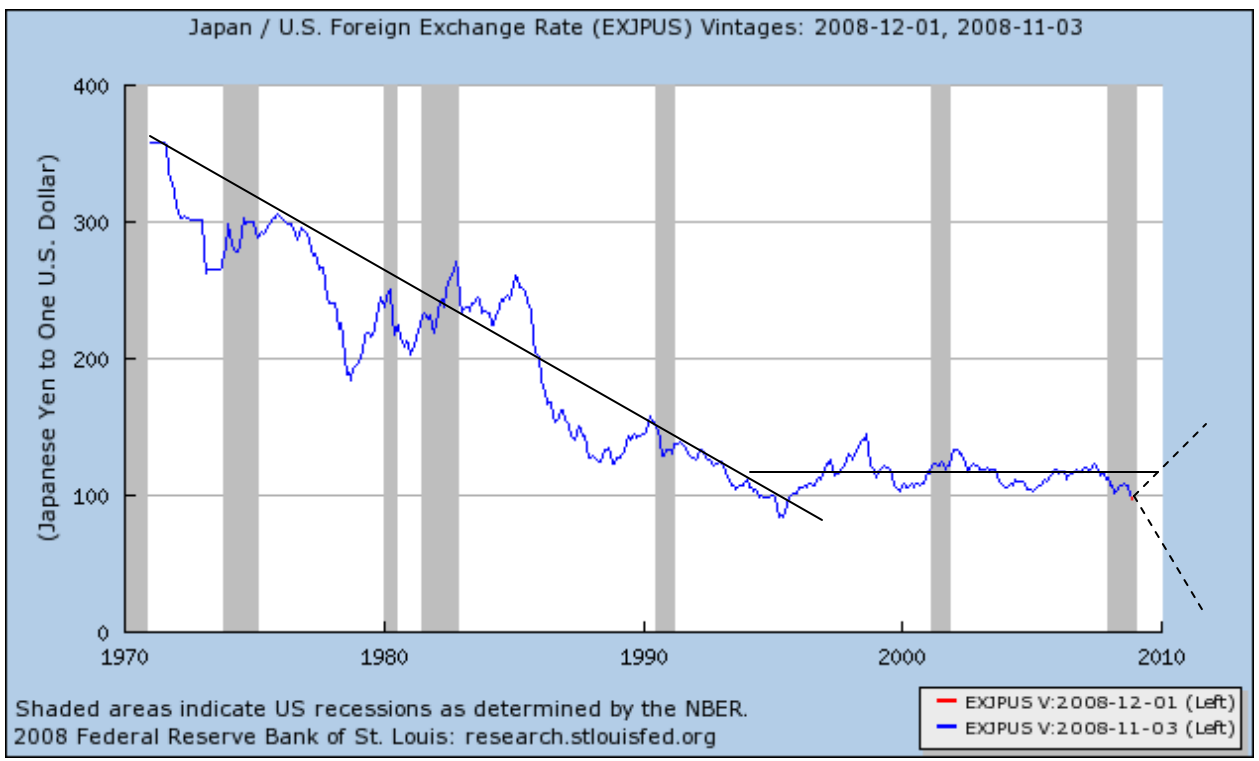
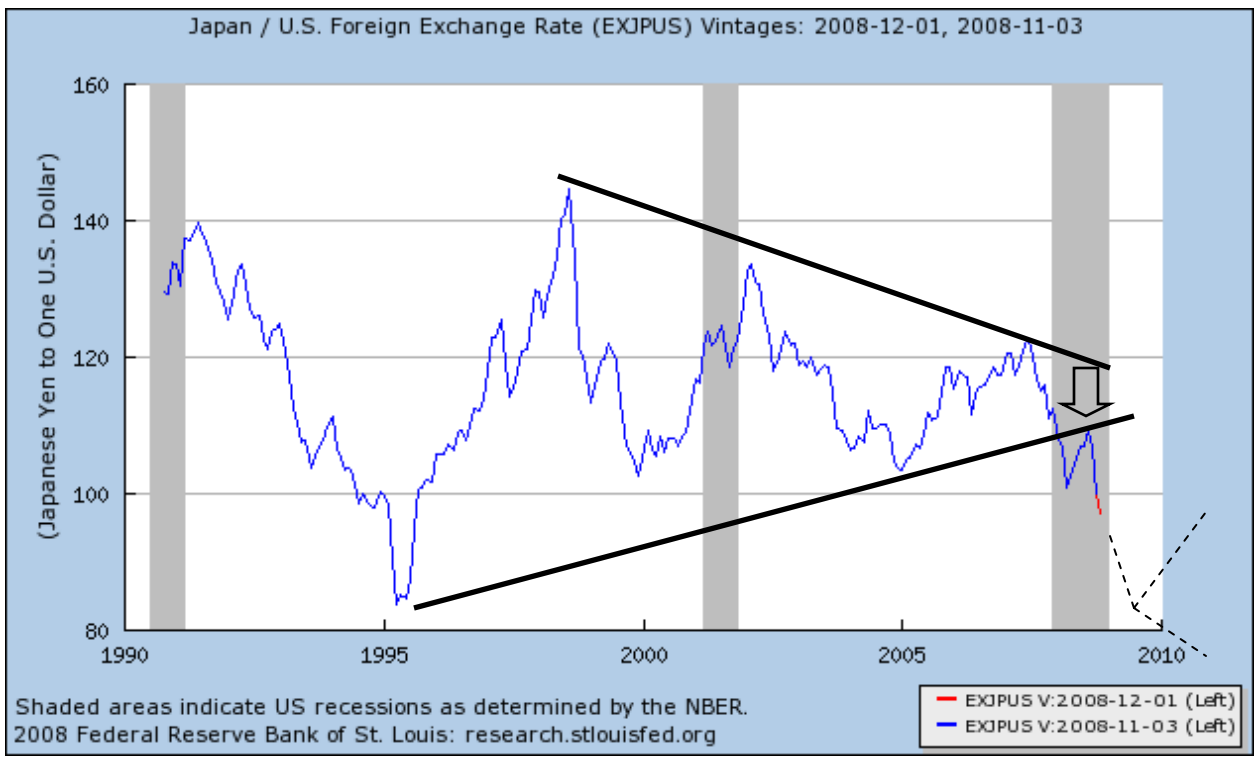
\$NATGAS (Natural Gas - Continuous Contract NYMEX (EOD)) INDXX

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The final long-term trend we would like to discuss is in the foreign exchange market. Since the beginning of 2002, the U.S. Dollar index maintained a down trend until we formed a base from March to July of this year. We then saw a break through the 200 day moving average with a strong strengthening of the dollar. However, December proved to be harsh as the dollar weakened once more on concerns of high government debt and a target federal funds rate close to 0%. Based on the chart, the long-term down trend of the dollar may have broken and we might see strengthening due to a flight to quality. The downsides, as mentioned before, pose a major threat to more strengthening as we will see if the dollar can hold its intermediate-term uptrend. Also, it is interesting to see the Yen's strengthening against the dollar and where it stands relative to its long-term chart. The long-term support for the FX rate for this pair of currencies lies in the low 80's yen per dollar.





Strategy

Trading strategies going into the 1st quarter of 2009 should focus on entering into positions that will benefit from the changes in the long-term trends we discussed previously. We are analyzing trading opportunities to take advantage of the sharp movements in the markets during 2008. The equity market, or S&P 500, has heavy support around \$750-800. We are looking for a break above \$900 and a further move to \$1,000, where resistance should kick in. The other possibility is a decline to the support levels, in which we will look for heavy buying volume. As of the end of the 4th quarter, the S&P 500 has traded in a range with light volume to finish the year off. No real trend has been established and thus we are not betting on any major positions.

We will continue to use a long/short strategy with Pairs Trading ideas. The economy continues to weaken and that has increased the market risk premiums. Pairs Trading can maintain a market-neutral portfolio to lessen your exposure to those premiums. Another trading strategy can be seen in the corporate bond markets. Many corporates, especially Financials, are offering extremely high yields. With deflation a new concern, this will make many of these corporate bonds even that much more attractive over equities. Also, the debt portion of the capital structure can give you some relief as to rising default/bankruptcy premiums. This causes equity risk premiums to rise substantially. Deflation will severely damage earnings for the U.S. economy, and thus increase the risk of bankruptcy. By holding senior debt, we can eliminate some of that risk in the hope of having claims to assets. Also, in the case of no default, the yields on the bonds are increased for the deflation premium. These arguments make a strong case going forward for buying into corporate bonds.

Based on the above information, one Pairs Trading opportunity would be to short U.S. Treasuries and buy similar maturity corporate bonds. The difference in yield is an added benefit, as well as the potential for the spread in bond prices to narrow. You can see gains on treasury prices as their yields are historically very low and their prices will fall when we leave this bear market. Corporate bond prices for those companies that can withstand this recession will rise as the current borrowing costs for these firms indicated by the yield-to-maturities on their current debt are too high for them to operate successfully long-term. This Pairs Trade thus provides you with three benefits: the yield of corporates over treasuries, the addition of a deflation premium, and the potential for gains on both sides from a narrowing in prices.

A second Pairs Trade we are analyzing is in the commodities market. We are looking into buying platinum and shorting gold. The difference in returns this year has been significantly disadvantaged for platinum. This may be rightfully so as platinum has the more practical applicability to the automotive market, while gold's primary use is in jewelry. The bet we are specifically making is that platinum will outperform gold over the next several years, especially when we emerge into the strong bull market. These metals can continue to decline, or both can rise, we would be indifferent. Platinum is more oversold, while gold has been trading in a neutral downward sloping channel. In our opinion, over the longer term it is more likely that platinum outperforms gold.