

MARKET HIGHLIGHTS

OUTLOOK 2008

- ❖ **Eclectic Stock Market** – A Year Including Rising Risks and More Selective Reward; Major Decline Underway.
 - *Bull, Bear, Hybrid still in Play.*
- ❖ **Editorial Commentary:** The New World, and Stock Market Order.
 - Confluence of Bear Declines at Hand.
- ❖ **Other Markets:** Gold, Oil, CRB (Agriculture), U.S. Dollar, Interest Rates.
- ❖ **Additional Points of Interest.**
- ❖ **Looking for Inflation in all the Wrong Places: Consumer Essentials, Deflation, Inflation.**

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OUTLOOK 2008

Eclectic Market – A Year Including Rising Risks and More Selective Reward. A New World Order Emerging.

REVIEW

We entered 2007 “with quite a positive technical top-down indicator profile,” but cautioned for a “Less Americentric” environment, as the world outperformed the U.S., noted in the global performance table herein last week.

- The major U.S. equity markets have completed the fifth consecutive up year (2003, 04, 05, 06 and 07),** historically an occurrence only during structural bull markets, and only three times in history (1921-29; 1949-56; 1990-98).
- These five advancing years keep our 2006 “Bull? Bear? Hybrid?” view of the market in play (see *Technical Perspectives* dated February 15, 2006): That there are stocks beginning, or still extending (from 2000), their respective structural “Bear” markets (see *Technical Perspectives* dated November 28, 2007); and also those in, and extending, new structural “Bull” markets (see *Technical Perspectives* dated December 5, 2007), as a benefit from a new (2002) structural “Global” bull market (resulting from a global build out, not unlike the U.S. domestic build out of 1942-66 and the accompanying U.S. structural bull market).
- The DJIA achieved our 13,000 target from late 2006; moving toward our next target of 16,000 may now be put on hold for a while. The 2003-07 advance has slipped into **seventh place** in the top 10 record advances before a 10% reversal (see Figure 1).

Figure 1.

Top 10 Advances in percentage without a 10% Reversal							
No.	Start Date	End Date	Start Level	End Level	Duration (Calendar days)	Points	Percent
1	10/11/1990	8/6/1997	2,365.10	8,259.31	2491	5,894.21	249.22%
2	7/24/1984	8/25/1987	1,086.57	2,722.42	1127	1,635.85	150.55%
3	3/31/1933	7/18/1933	55.40	108.67	109	53.27	96.16%
4	7/8/1932	9/7/1932	41.22	79.93	61	38.71	93.91%
5	9/14/1953	9/23/1955	255.49	487.45	739	231.96	90.79%
6	7/26/1934	4/6/1936	85.51	161.99	620	76.48	89.44%
7	3/11/2003	10/9/2007	7,524.06	14,164.53	1673	6,640.47	88.26%
8	5/20/1924	2/11/1926	88.33	162.31	632	73.98	83.75%
9	6/26/1962	5/14/1965	535.76	939.62	1053	403.86	75.38%
10	11/9/1903	12/5/1904	42.15	73.23	392	31.08	73.74%
AVERAGE:					889.7	1,507.99	109.12%

Source: LY Advisors

- The S&P small and mid cap indexes followed through on the late-2006 technical evidence of a developing underperformance trend versus larger caps (violating the six-year ratio uptrend, but *still maintaining their eight-year uptrends*). The S&P 400 then moved more in line with larger caps again.

** With the exception of minimal slippage only for the DJIA, due to General Motors (GM) 2005.

- Gold reignited the structural uptrend to challenge the all-time bull market high (following an extended corrective trend, as calculated to complete between June 2007 and January 2008).
- The U.S. dollar (DXY-76.11) continued the anticipated decline (from 2002) to break structural support at 80 in 2007.
- Energy also completed the first extended cyclical correction to renew the structural uptrend and achieve our targets at 80, 94 and 98.
- Utilities followed through on our offensive expectation as the basic materials for a high tech world (see *Technical Perspectives* dated June 7, 2006, "A New Definition for Utilities? -- The New Basic Material for the High-Tech World Economy?")
- Bonds remained in our now six-year *transitional trading range* between 3 ½ % and 5 ½ %, based on historical evidence that transitions from falling to rising rate cycles can take 2-14 years. (Observations of history suggest all these reversals encompass periods inclusive of deflationary pressures.)
- *Inflation* is now specifically becoming more publicly recognized in what we have identified over the decade as *Consumer Essentials: Food, Water and Energy* (see *Outlook 2007*, dated January 3, 2007).

In addition, in the course of 2007:

- In early 2007, we reiterated the relative strength deterioration in Financials, portending absolute price risk;
- We identified the 2007 relative strength deterioration in Consumer Discretionary groups and their corresponding price risk; and
- Warned against a secondary decline in Homebuilders.
- By summer 2007 (see *Technical Perspectives* dated July 18, 2007), we cited an emerging outperformance profile for the Technology sector, the only basing configurations in evidence, with the caveat of a *strict stock selectivity*, to find the "new" new tech and the survivors of the fittest with a durable niche.
- As 2007 evolved, the equity market technical indicators began their slow erosion and remain precarious.

PEERING INTO 2008: Eclectic Market – A Year Including Rising Risks and More Selective Reward; A New World Order Emerging.

Eclectic Stock Market – Major Decline Underway

We enter 2008 in protective mode, with much *weaker technical underpinnings*, inclusive of extending the evolving 2007 negative divergences, to suggest that at least a portion of 2008 may prove defensive (see *LY Alert*):



LY ALERT
Stock Market

January 7, 2008
Vol. IV, No. 1

MAJOR DECLINE UNDERWAY

- Eight-month listed support levels breaking sequentially across indexes (except Dow Utilities).
 - See Table (Figure 1) repeated from *Technical Perspectives* dated January 2, 2008 for listed support levels.
- Long-term monthly momentum *Sell* signals now in place for all indexes (again, except Dow Utilities).
 - Similar monthly *Sell* signals have not occurred since 1999-2000 for the major indexes.
 - Characteristically, the technical indicators have been warning of internal deterioration over the past 4 to 6 to 9 months (the usual time frame prior to a more serious market decline).
- --**A Bear Market may now be in progress !!!!** (Reference table for 20% Bear thresholds).
 - Use any interim rallies to continue to lighten deteriorating positions.

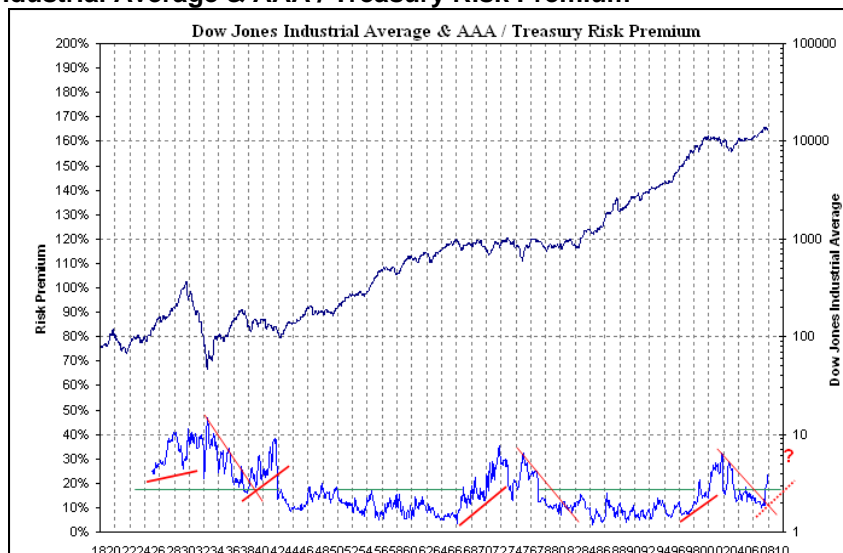
Figure 1.

Parameters for the Major Indices							
INDEX	Low since 2002	Recent High (Resistance)	Low to High %	Key Support	% Decline from Recent High to Support	10% off High	20% off High
DJ Industrial Average	7,286.27	14,164.53	94.40%	12,845.78; 12,743.44	-9.31%	12,748.08	11,331.62
DJ Transportation Average	1,942.19	5,446.49	180.43%	4,366.60	-14.21%	4,901.84	4,357.19
DJ Utility Average	167.57	535.72	219.70%	512.04; 474.32	-4.42%	482.15	428.58
NYSE Composite	4,452.49	10,311.61	131.59%	9,389.50; 9,087.10	-8.94%	9,280.45	8,249.29
NASDAQ Composite	1,114.11	2,859.12	156.63%	2,540.99; 2,451.07	-11.13%	2,573.21	2,287.30
S&P 500	776.76	1,565.15	101.50%	1,407.22 - 1,406.70	-10.09%	1,408.64	1,252.12
S&P 400	372.88	926.23	148.40%	821.32 - 819.97	-11.33%	833.61	740.98
S&P 600	170.73	445.19	160.76%	389.75 - 382.60	-12.45%	400.67	356.15
Russell 2000	327.04	855.77	161.67%	735.07	-12.18%	770.19	684.62

Data Source: Bloomberg

- Multi-month deterioration has continued for the Cumulative Advance-Decline line (more declining issues), the New Highs versus New Lows (fewer and fewer new highs) and less than abundant Volume to carry the market higher.
- The autumn price breakdown below the August 2007 lows for the Dow Transportation Average, the Russell 2000 and the S&P 600 set in motion a potential reversal of the five-year equity market advance; any further breaks below the multi-month support levels, as noted above, imply risk of further, more substantial, downside.
- The technical evidence remains in place that *underlying demand appears to be transitioning to a trend of supply for a growing number of stocks*, including our leaders (the best go last) notwithstanding kickback rallies (which can be used to sell weak stocks into strength). Thus, we anticipate a more eclectic market, inclusive of rising risk and selective, limited reward.
- Reviewing *the decennial pattern* study going back to 1890, for all years ending in “8” (in order to peer into the entire year statistical prospects) reveals an 83% chance of 2008 being an up year!! Hardly convincing at this point in time, but over 12 months a lot can happen, both down and up!!
- Regarding *the four-year cycle*, which anticipated a cycle low in 2006, or a right-aligned decline into 2007, one might judge that this *has been effected more selectively* by U.S. Domestically-Exposed, sequential sector declines (Homebuilding [identified herein December 2005, February 8, 2006], REITs [identified March 21, 2007], Financials [identified February 8, 2006], Consumer Discretionary [identified April 2007]) than by the market as a whole.
 - Whether today will prove a cycle similar to the 1994-95 four-year cycle, in which the major indexes held up without the 20% bear market decline, while 70% of stocks rotationally declined 20% or more, is yet to be determined.
 - Nevertheless, a major decline in 2008 would present a rare, very late (three years) four-year cycle decline and consequently, could prove more severe!
- The *AAA / Treasury Risk Premium* (see Figure 2) remains a market concern, having lifted in an uptrend fashion that historically has been accompanied by equity bear markets. The current ratio lift is a secondary event to the 2000 observation (that helped identify the developing bear); and not unlike the secondary lift in the 1930s, to suggest that the “repair phase” of the 2000 structural bear may still be in play (in our “Hybrid” market) for the structurally bearish stocks. *The risk parameters for this market environment remain high based on these observations.*

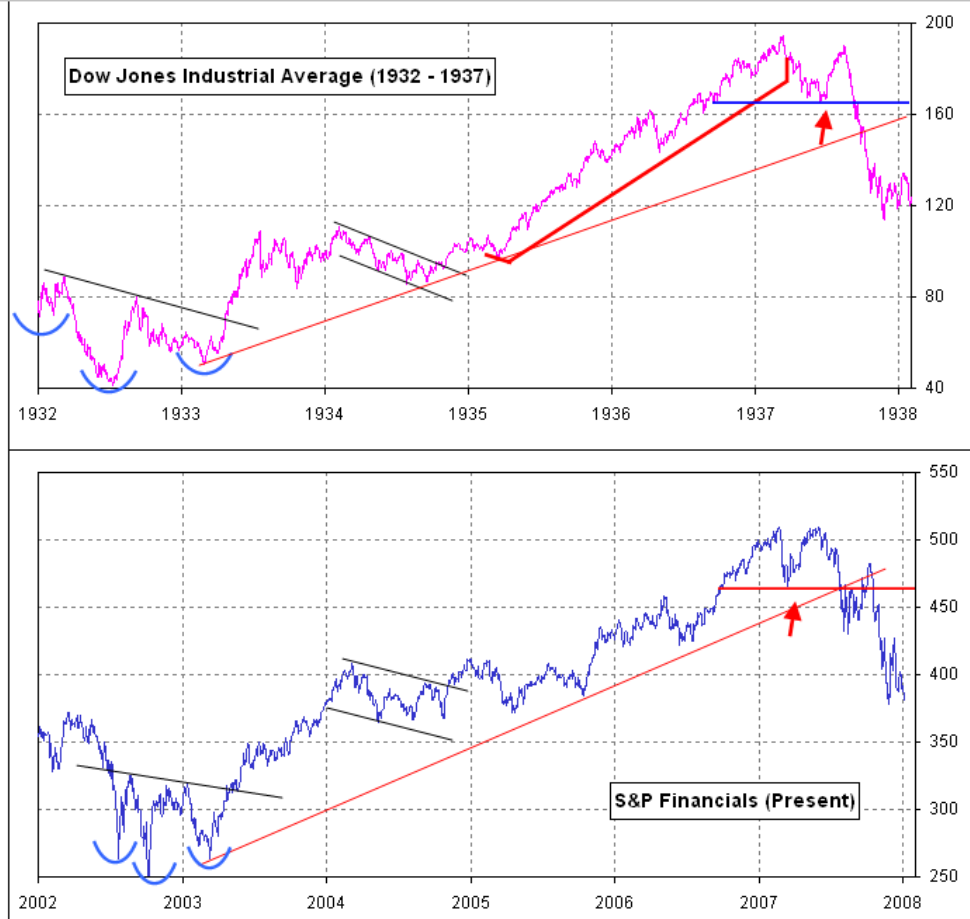
Figure 2. Dow Jones Industrial Average & AAA / Treasury Risk Premium



Source: Bloomberg and LY Advisors

- **Our “Alternate Hypothesis”** (Will 2002-07 repeat the alternate cycle of 1932-37?) is now at a critical point of comparison (facing the 1937 decline of 47%). Interestingly, the Financials have already completed our 1932-37 Alternate Hypothesis analogy, breaking support and, in some cases, already have declined an equivalent 47% and may have further to fall! (see Figure 3). The major indexes now may be poised to follow suit.

Figure 3. Dow Jones Industrial Average (1932-1937) S&P Financials (Present)



Source: Bloomberg and LY Advisors

- Is our Y2 Olympics effect in progress? (*Technical Perspectives “Outlook 2007”* dated January 3, 2007):

“.....it is possible that sometime during late 2007, the equity market may be discounting a certain amount of post-Olympic slow down, or hiatus to (*though far from halting*), *China’s pace of growth*. Such an occurrence might suggest a positive first portion of 2007, with a potential corrective trend later

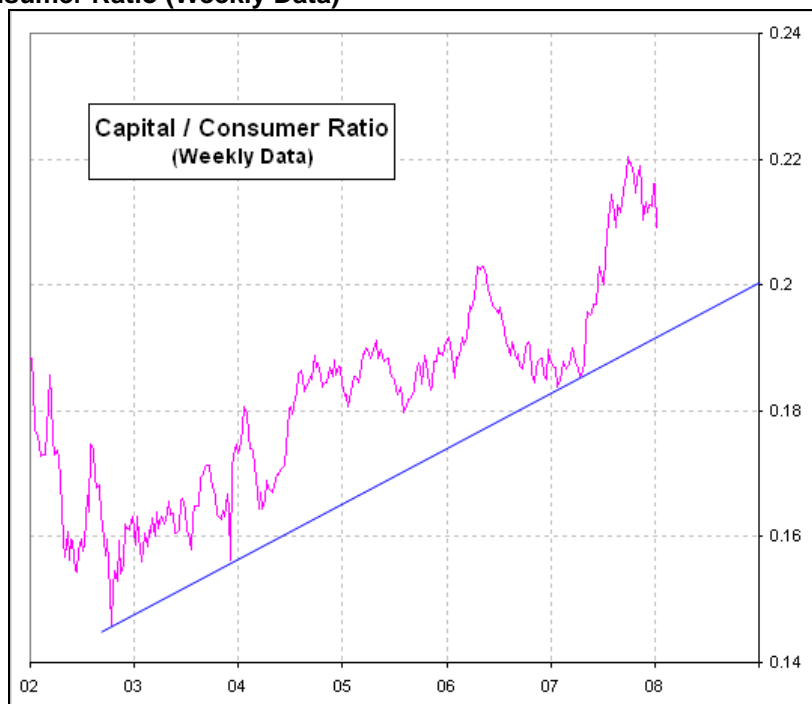
- **“Bull, Bear, Hybrid” still in play: Setting the stage for a New World Order?** (see Editorial below.) Select individual U.S. indexes have behaved differently from one another over the past five years, some moving sustainably above their 2000 peak (NYSE, S&P 400 and 600, Dow Industrials, Dow Transports, Dow Utilities and Russell 2000; others simply tickling their 2000 highs (S&P 500 and Russell 1000); and others *not even achieving* the 2000 levels (S&P 100, and NASDAQ), creating the profile of equities in our “Bull, Bear, Hybrid” observations (see *Technical Perspectives* dated February 15, 2006):

1) With the distinct U.S. Domestically- versus U.S. Globally- Exposed stock divide and our “Less Americentric” view; and that

2) The expected 2000-02 structural bear market repair phase (post the 2002 pivot low) may have been truncated (by the global build out), creating the “Hybrid” market behavior.

- As such, any 2008 decline should represent both: 1) The first cyclical bear market (or corrective trend) for the technically stronger global markets and stocks (representing “the Bull”), within the global bull progression, as well as for those U.S. Globally exposed stocks participating in same; and 2) A continuation of the 2000-02 structural bear decline and repair phase (representing “the Bear”) for other weak stocks (along with the newly emerged structural bear market declines, as in Financials and Consumer Discretionary).
- **Most important for preservation of capital** will be to focus on the structural price and sub-industry patterns (profiles), both up and down, and respect support breaks as stop-loss levels; to watch and participate in the sector and stock outperformance areas for leadership; and let the overall market take care of itself.
 - The declines for the Consumer Discretionary and Financial sectors appear more *structural*, longer term, in nature and are technically *unlikely* to return to a leadership role in 2008-09. These sectors (which carried a pre-decline aggregate S&P capitalization weight of over 31%) have **removed a significant support for the equity market**. Nevertheless, contratrend rallies (temporary rallies in the opposite direction to the major trend), born of bargain and value hunting (even though dividends ultimately may be cut), will occur (as was the case for Homebuilding) and can be used to lighten weaker positions.
 - Selling in large-weighted stocks such as the above, inevitably can result in **more money chasing fewer and even smaller names** as witnessed in December, with a rush into Agricultural, Material and other names (many representing smaller cap), rotationally creating parabolic advances (as mid caps develop into the new large cap and vice versa).
- **The Capital / Consumer ratio leadership profile**, thus far, remains in the outperformance uptrend from 2002, favoring Capital Goods, notwithstanding a contratrend (defensive) move underway toward select Consumer Staples (see Figure 4), as Capital Goods begin to correct.

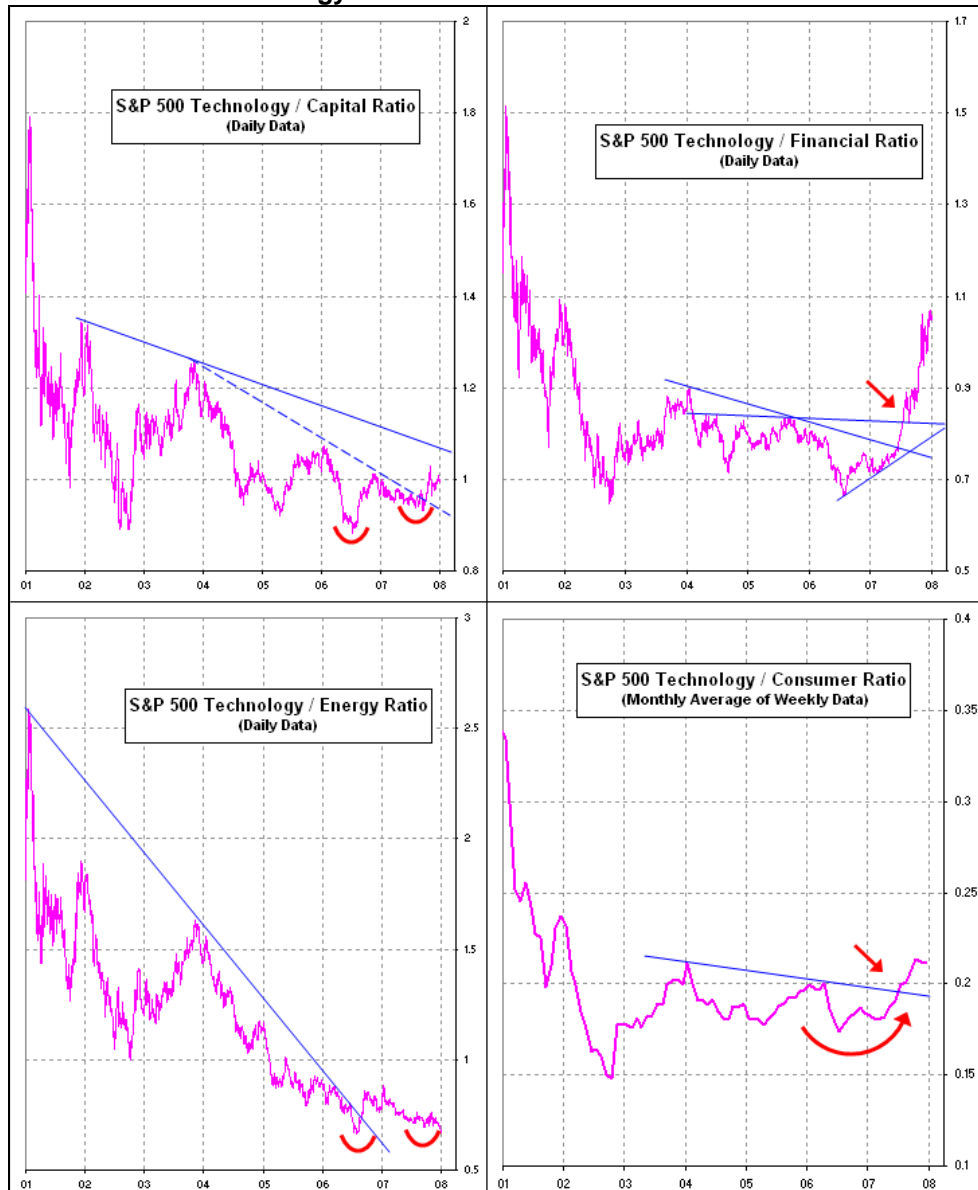
Figure 4. Capital / Consumer Ratio (Weekly Data)



Source: Bloomberg and LY Advisors

- New, as well as continuing, *leadership stocks* should be expected to pull back (albeit sharply and steeply in some cases) and still hold at higher lows (uptrends) into any equity (bear) market declines; and correspondingly *consolidate sideways in a range*, albeit possibly wide, and / or move to new highs on any market bounces.
 - Such pullbacks already appear selectively, within the *leadership market groups and stocks (survival of the fittest)*, including: *Energy, Industrials, Materials*, as well as for some specific *Consumer Staples, Health Care, Technology* and *Utilities* names.
 - The *Information Technology* sector, participating in the Capital Goods, technically profiled an outperformance cycle (see Figure 5) that began in mid 2007. But, *we have been disappointed*, to date, in their behavior, and reiterate that *stock selectivity is critical* and should remain focused on stocks holding their critical support levels (presumably indicative of those offering the “new” new tech, or a unique new technological advantage, along with those that have not yet been commoditized, yielding durable competitive advantages).

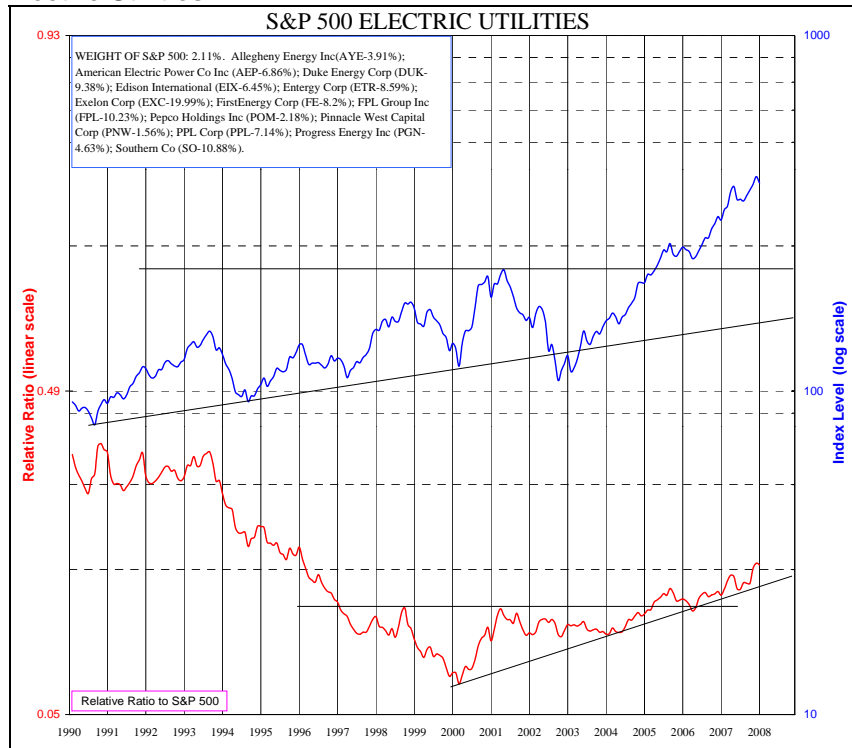
Figure 5. S&P Information Technology vs. Other Sectors



Source: Bloomberg and LY Advisors

- The **Utilities** sector continues to impress us both in relative strength and in absolute price, as well as within the multi-year historical trends (see Figure 6). We wonder whether, as a surprise of the century, these stocks will **continue their offensive leadership into a major capitalization weighted** group (now only 3.7% of the S&P 500) over the decades ahead (see *Technical Perspectives Utility Special Feature* dated June 7, 2006), fulfilling our 2000 observation that **Utilities may prove to be the basic materials for the new high tech environment** (as well as for the developing world).

Figure 6. S&P 500 Electric Utilities



Source: Bloomberg and LY Advisors

- The S&P capitalization allocations should continue their transitions, as Financials and Consumer Discretionary decline further and further in weight and those smaller weighted, New World Order leaders continue to appreciate in weight (see Figure 7).

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Figure 7. S&P Capitalizations.

S&P 500 Capitalization Weights		
Sectors	1/2/2008	3/1/2006
Consumer Discretionary	8.44%	10.33%
Consumer Staples	10.23%	9.39%
Energy	13.11%	9.55%
Financials	17.46%	21.16%
Health Care	12.03%	13.25%
Industrials	11.48%	11.26%
Information Technology	16.66%	15.47%
Materials	3.34%	2.98%
Telecommunication Services	3.63%	3.26%
Utilities	3.63%	3.37%

Data source: Bloomberg

EDITORIAL COMMENTARY: The New World Order (And the New World Stock Market Order).

The technical complexities of the last five years (set forth in our “Bull, Bear, Hybrid” observations) suggest that the stage is being set for a *New World Order* and a *New Stock Market Order*, as we move through the 21st Century.

THE “BEAR”

Many “old leaders” and “old industries” have not, and may not, rise to survive, as the 2000 bear market continuation patterns take their prices to new lows, or are threatening to do so (see *Technical Perspectives* dated November 28, 2007) in a process of moving from the *Disbelief phase* (disbelief that they didn’t rise) to the *Belief phase* (finally believing that they are not and may not rise), and will finally be let go, in a capitulation of selling, represented by the *Fear phase*.

Many old names and sectors may represent dying industries that will not survive in the New World Order (U.S. Automobiles?, when there are \$2,500 Indian cars?; Publishing?, when there is the Internet?, etc.). We may experience another generation of, and / or another leg down, for what we dubbed “Old Tech” a decade ago.***

THE “BULL”

New leaders in the New World Order also have moved from their own *Disbelief phase* (disbelief that they could be the new bull leaders from the 2002 lows), into their *Belief phase* (belief that they could continue to advance for five years), and even on to the *Greed phase* (the excess advances witnessed for many names in late 2007). Yet, the strongest of the newly emerged (globally-exposed) leaders *should grow* in Capitalization over time and participate / lead in the next Bull advance over the years ahead.

Confluence of Bears = Market Decline

The confluence of these two opposing events created our “Bull, Bear, Hybrid” market observation of several years ago. Now, the confluence of the extension of structural declines for former as well as current structural “Bear” stocks, simultaneously with the cyclical decline of the new “Bull” market stock participants, technically may have set the stage for a global equity market decline. The decline may represent the washout that establishes new leadership and really destroys non-competitive names in the global arena and through which the New World Order (and the New Stock Market Order) should emerge.

Long Wait For New Bull?

But the next leg in the global *Bull Market advance may be some time away, based on history*, and representative of both:

- 1) The multi-year portion of a *structural bear repair phase*, post the 2002 pivot low and similar to the 1937- 42 decline (within the 1929-42 structural bear market, see Figure 8, A); and / or
- 2) The first, also extended, *cyclical bear decline* within a new structural global bull market (2002-????) that we have postulated is developing from the *global* build out, and may prove similar to the first cyclical decline (1946-49) during the equivalent 1942-66 U.S. *domestic* post war build out and the corresponding structural bull market, see Figure 8, B).

Note, interestingly, that *both those declines represented multi-year periods* during which the market experienced frustrating failed rallies, and retreats in a neutral to down-trending range. We may face a similar period ahead and will explore these years in greater depth as 2008 unfolds.

*** Market Magic, John Wiley & Sons, 1998

Figure 8. Dow Jones Industrial Average (1929-1956)



Data Source: Bloomberg

A Few Additional Editorial Thoughts:

- The survivors of the fittest *countries* for the New World Order should provide leadership for the New Stock Market Order, which should include:
 - Our Consumer Essentials (Food, Water, Energy) leadership for a 6 billion, growing to 9 billion, world population); and
 - Infrastructure for a new emerging world, as well as for repairs in a crumbling developed world !!
- These leaders should expand into the *new* large capitalization stocks and sectors (in another *Disbelief* into *Belief* progression). After the dust of a decline settles, we would not be surprised to witness enormous capitalization growth and expansion on the part of now smaller-cap participating stocks and sectors such as:
 - Utilities – becoming even more offensive, rather than defensive, as the New Basic Materials of the high tech and growing world.
 - Agriculture, Water, Pollution and Climate Controls as demand grows.
 - Energy and Green – traditional as well as new technologies (including associated areas with chemical and tech advances), for health survival, scarcity, global warming, growing populations (beyond the Earth’s capacity to absorb the excesses).
 - Materials – traditional and new (carbon fiber, Nano etc, to lighten loads, fuel usage and other developing needs).
 - Medical / Biotech, filling emerging and advancing technological issues; addressing *new heretofore unknown pathogens* being brought to life, activated by temperatures and pollutant environments in which they can flourish; many known warm climate pathogen

carriers are also moving north to infest formerly colder climates; and addressing the growing resistant strains of heretofore controlled pathogens; as well as new environmental and health problems already emerging from Genetically Modified food (threatening extinction of critical species in the ecological chain); new allergies resulting from the above.

- Technology—the “New” new technologies of all descriptions as well as those that will help / develop efficiencies and cost cutting in all of the above areas.
- The extension and growth of small- and mid-cap stocks and their outperformance cycle (notwithstanding even a sharp contratrend correction) on the part of companies that are innovative, flexible, quick to adapt and recognize the New World Order and respond to the changing needs.
 - This, at the expense of those behemoths (many large cap) that may prove slow to adapt, or to innovate, with changing needs, and have therefore become equivalent of “old tech” in their respective industries.
- The developing global equity market decline *may represent a major global retrenchment* from: The excessive consumption and debt behavior on the part of individuals, the “old world order” Governments, Financial institutions; as well as changes in personal habits, necessitated by a world of growing scarcity in the Consumer Essentials.
- A new Financial system (perhaps a return to some form of Asset Based Currencies?) in which more productive and stable habits may become required to accommodate the needs of billions more people emerging into a middle class, in a world for which *our old, fully (and excessively) debt based, Financial system may no longer be sustainable.*
- A New World Order in which *Productive* Economic leadership (not unproductive consumption), the Reserve currency, and Political Power will transition from Old to New countries and governments over the course of the 21st Century.

We see our five-year “Hybrid” market and the current declining global equity market environment as setting the stage for the major transition in a New World Order from what we might describe as a *larger* “New World Order” *Disbelief phase*”, into the larger New World Order “*Belief phase*,” as this New World Order continues to emerge and define itself!!!!

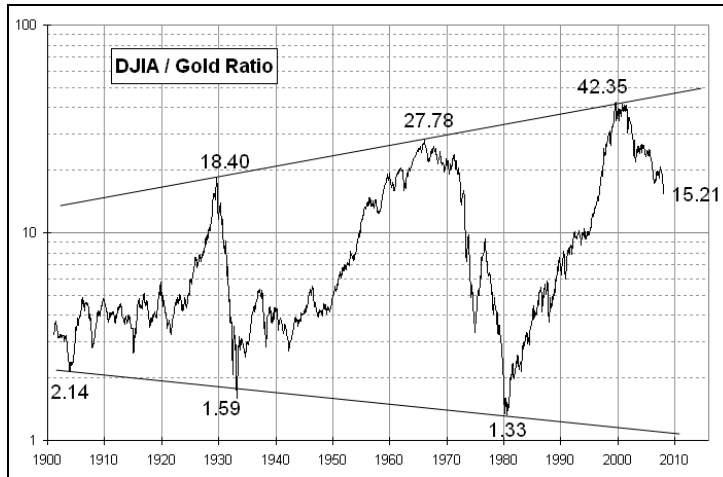
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OTHER MARKETS

GOLD

- *Gold* maintains the structural bull market initiated in 2002, recently lifting through the December symmetrical triangle to challenge, and now exceed, the 1980 all-time high at 850; a short-term technical target measures to 900 and longer-term targets remain in quadruple digits to 1000, and higher; major support 770 and 700.
 - Gold may not just provide an investment alternative to fiat currency, as in the 1970s, but also a hedge against the ability of central banks to overcome the current debt crisis and still preserve purchasing power.
 - With respect to outperformance, gold continues to outperform the U.S. major indexes from the 1999-2000 peak (see Figure 9), as well as other developed (Old World Order?) countries.

Figure 9. DJIA / Gold Ratio



Source: Bloomberg and LY Advisors

OIL

- *Oil* continues to march ahead in a structural bull market. We have outstanding targets at 115.00 and 124.00. Our purely statistical study (see *Technical Perspectives* dated October 31, 2007) calculates even further potential over the *decades* ahead toward 250 and 450 (another dollar effect?).

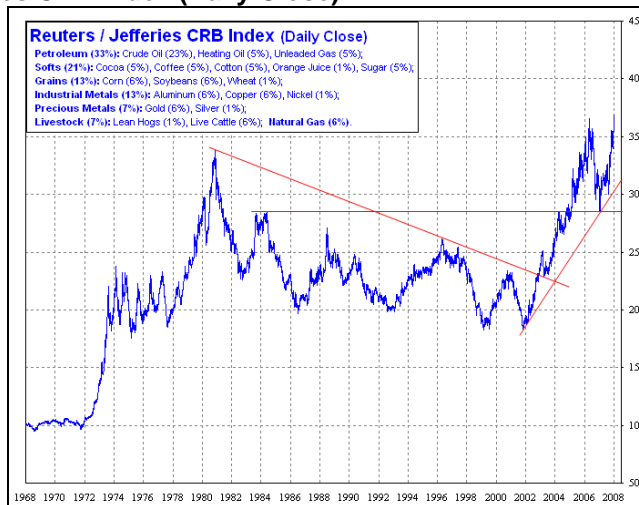
CRB INDEX

- The *CRB index* has just stretched to a new 27-year high in the structural bull market, identified in 2003 with the breakout through the 22-year downtrend (see Figure 10). Energy, of course, is a large component and has maintained a structural bull market since 2002, as has Gold.

But now *Agriculture* is coming to the fore with major breakouts from 34-year bases (see Figure 11). This Agriculture observation adds further credence to our Consumer Essential inflation into the 21st century (see “Looking for Inflation In all the Wrong Places,” ahead).

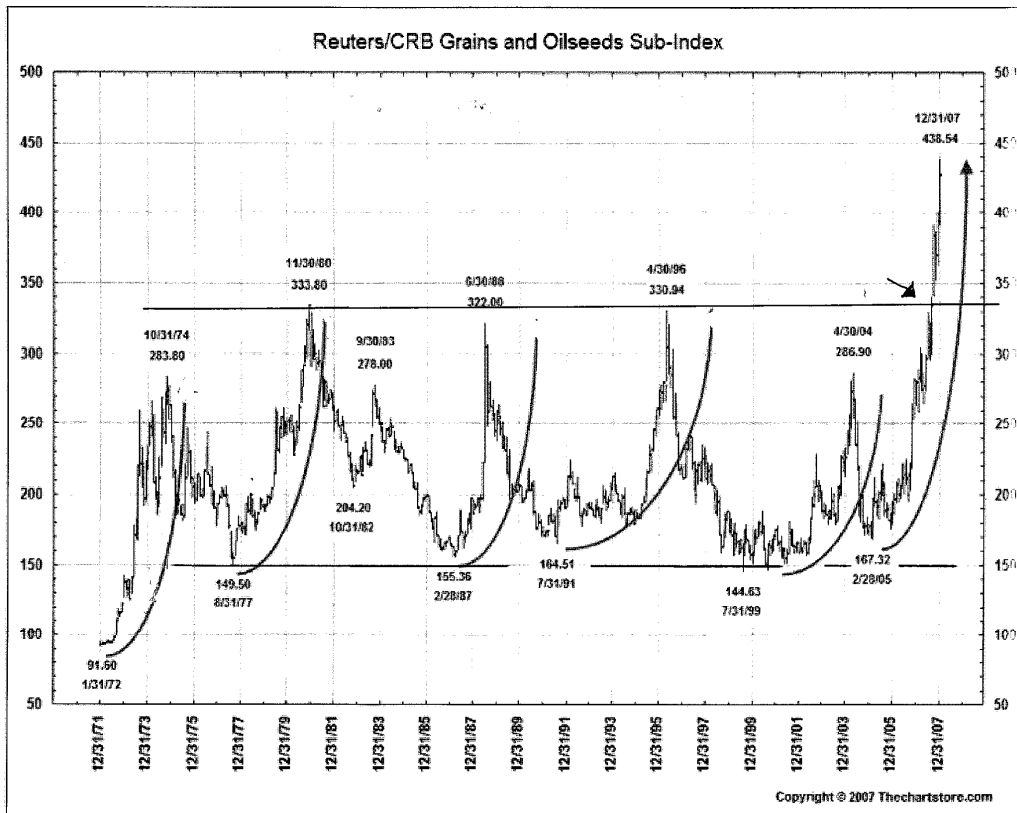
This breakout through a multi-decade consolidation suggests, technically, that a long-term structural bull market for grains has initiated, which ultimately will carry food prices significantly higher. One should, however, expect the usual commodity volatility along that bull market trend for corn, soy and wheat. For details on the individual grains, see our colleague, Jonathan Lin’s, Agriculture section herein.

Figure 10. Reuters / Jefferies CRB Index (Daily Close)



Data Source: Bloomberg

Figure 11. Reuters/CRB Grains and Oilseeds Sub-Index



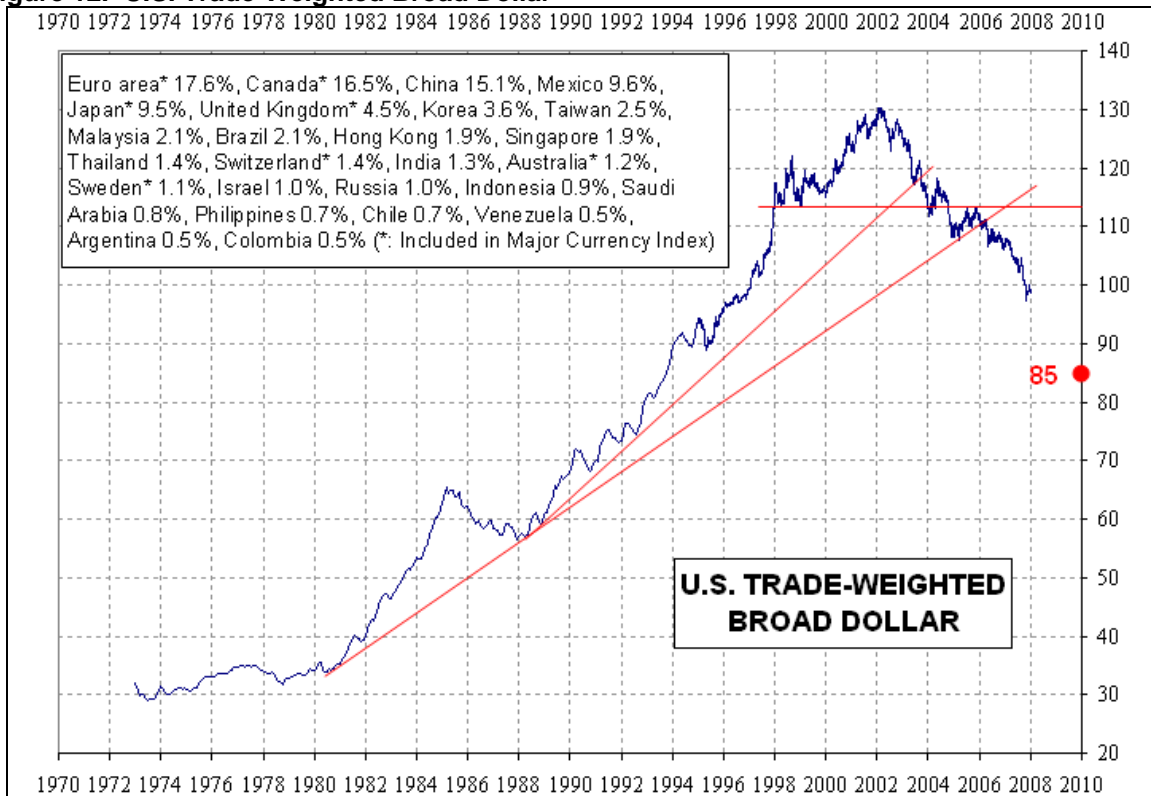
Source: Thechartstore.com

U.S. DOLLAR

- The *U.S. dollar's* structural decline over six years, for a 38% depreciation (on a closing basis), may now be due for a rest, *if* the dollar can hold above the recent low of 74.87. The contratrend rally underway as we entered 2008 has attempted to carry toward 80, the resistance level of the 20-plus year breakdown. A failure, however, and any breach of the recent low, would suggest the *renewal of the structural dollar decline*, as foreign diversification out of dollars gains momentum (and gold continues to rise).
- The *Broad Trade Weighted dollar* (see Figure 12) continues to be *our favored dollar depiction*, given the *inclusion* of those *productive* (New World Order??) economies with strong currencies, giving greater understanding to the effect of such productive growth on currency strength.

Growth driven by high levels of business investment leads to currency strength; but growth driven by strong consumption and government spending (read debt!!) leads to currency weakness. A PhD isn't needed to know which countries represent which!!! This dollar profile, showing a 25-year uptrend reversal and a 6-7 year top, is very telling technically, increasing our long-held concern that the dollar is losing status as the world reserve currency as we move into the 21st Century. The next target is noted at 85.

Figure 12. U.S. Trade-Weighted Broad Dollar



Source: Bloomberg and LY Advisors

INTEREST RATES

- *Interest rates* continue in our now six-year transitional trading range. The decline in rates fits the historical pattern of multi-year transitions from falling rate cycles to rising rate cycles, all periods carrying deflationary (debt?) pressures. We continue to have little control over U.S. long rates as the global holdings of our debt are so large. Given the current financial crisis, even a break of the summer 2003 lows would not come as a surprise, and an adjustment in the lower 3 ½% transitional trading band then would be required.

ADDITIONAL POINTS OF INTEREST – Including Editorial Comments.

- **Deflation versus Inflation: Still “Looking for Inflation in All the Wrong Places!!”**

“Looking For Inflation In All The Wrong Places”

*Technically, we have opined for a decade that inflation is in the process of “shifting seats” *** out of the Capital Goods arena where we had known it in the 20th Century, into what we call Consumer Essentials (Food, Water, Energy) for the 21st Century.*

This observation carries major implications for our future. Whereas inflationary pressures in Capital Goods cycles might have led to a diminishment of consumption of those finished goods (while excess inventories unwound), inflationary pressure in Consumer Essentials does not allow that option; there is nothing to unwind, just a trend of continued demand and resultant higher prices.

*** Market Magic, John Wiley & Sons, 1998

Therefore, as the scarcity, and simultaneously the cost, of these essentials continues to mount, (with 6 billion people growing to 9 billion, while land, water and oil, that must be shared, are finite, and depleting), the quality of life that we have come to know in this country, is what will diminish (there are no inventories to unwind in a trend of Consumer Essential inflation)!

Deflation

The current financial crisis is a recipe for deflation, in the huge contraction of liquidity as major banks take major write downs. Has anyone noticed the private deals to shore up finances, such as Merrill Lynch, selling its own stock (\$5 billion) *at a discount*, to Temasek, as well as (\$1.2 billion) *at a discount* to Davis Selected Advisers? Doesn't this suggest the market pricing is at falsely high levels?! Implications of Deflation?!!!

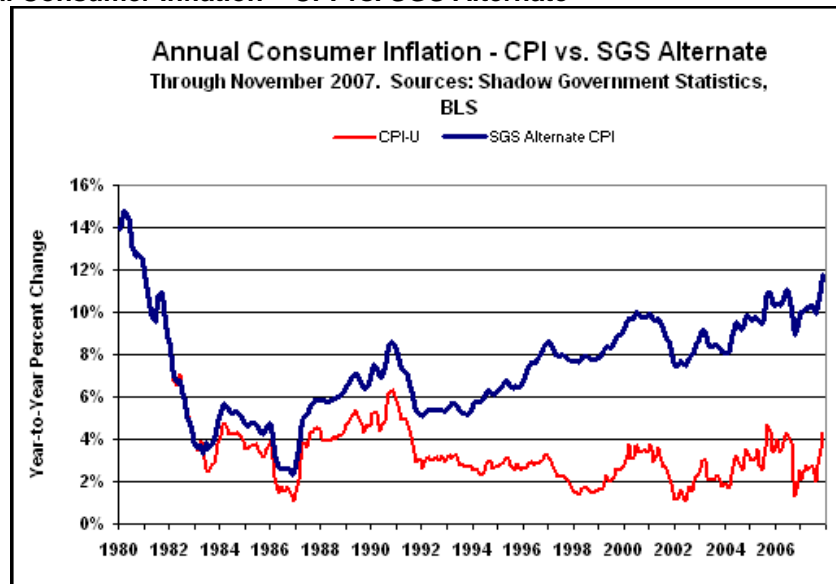
Isn't the theory that, within a debt currency system (which we have), a chain reaction of bankruptcies and write-offs within that debt currency system could cause the money supply of a debt currency (the dollar) to *deflate* very quickly to a small fraction of the pre-crisis size? Such an event would undoubtedly take all the other fiat currencies with it.

Understanding that hedge funds leverage from 10:1 to 20:1, there is a good deal of fluff in the equity markets globally. One can only hope that the good sense of a planned and *orderly* deleveraging process is underlying the technically deteriorating equity markets. Thus, a slow unwinding process may avert a more serious market event, eventually allowing the markets to advance again from a more reasoned foundation.

Inflation

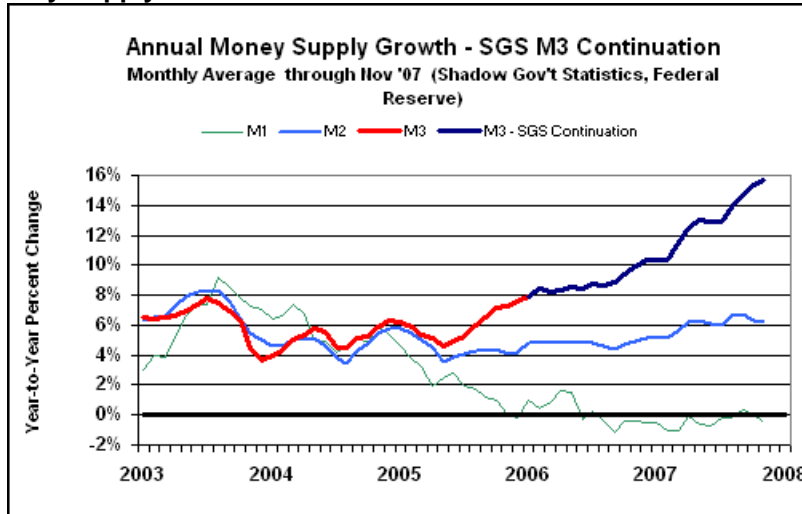
Yet, one need only look at the Shadow Government inflation statistics (see Figure 13) to see that the *real inflation number is considerably greater* than reported (which is what we all are experiencing !!). Keeping the CPI, the PCE or the revised CPI low, enables the government to report a greater GDP than actually exists, and to pay social security at half the actual inflationary rate.

Figure 13. Annual Consumer Inflation – CPI vs. SGS Alternate



Similarly, the Shadow Government data on M3, Annual Money Supply Growth (see Figure 14), which was withdrawn from public reporting might also be of interest: Clearly in an uptrend; no wonder this data was cloaked.

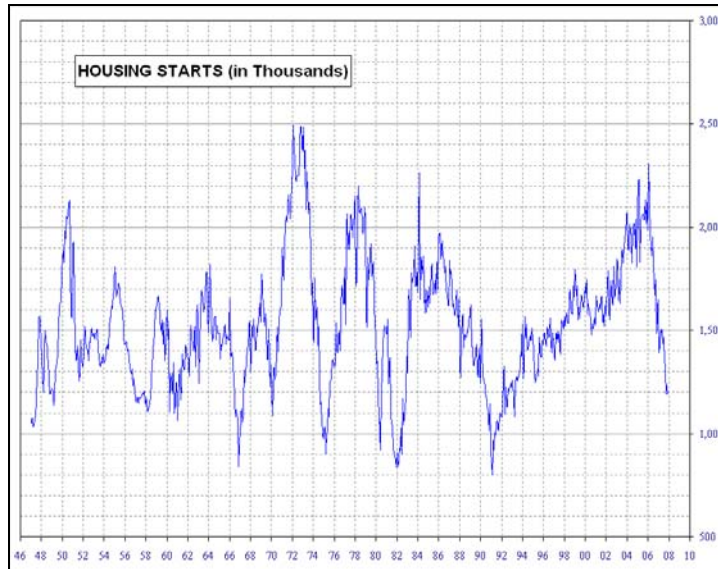
Figure 14. Annual Money Supply Growth – SGS M3 Continuation



Housing Starts

- There is another chart which struck us as essential to share: The Housing Starts data from the 1940s (see Figure 15). What is striking technically is that the housing expansion from 1991-2006 is unprecedented (15 years) in the available history!!!; even longer than the 1940s expansion into 1950, when our domestic post-war build out was in progress.

Figure 15. Housing Starts



Data Source: Bloomberg

- A noteworthy observation is that in spite of the bear market in housing to date, the data has declined *to nowhere near the level from which new cycles begin*. The chart suggests that at least another two years of unwinding may be needed before that depressed level is achieved, and should keep one on the sidelines.

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