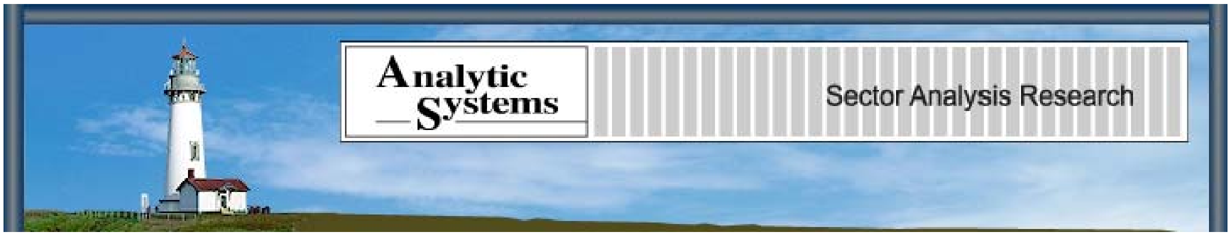

Bold Fed Move – Inflation Inflection Point Is Key *Dec. 19, 2008*

Investment Strategy

Analytic **S**ystems **C**orporation refined a model based on computer studies of the historical behavior of thousands of stocks and hundreds of economic time series to identify which variables and factors have the greatest impact on stock returns. The model developed in 1982 holds that past economic relationships have application to the future trends. This month's Sector Analysis Research has identified the specific industry group which appears to be in a favorable position based on the current economic climate.

Equities:

Consumer Discretionary and Information Technology are well positioned based on the current economic environment. An overweight among S&P groups is advised in Consumer Discretionary and Information Technology. Market weights are advised in Energy, Health Care, Financials and Materials. Underweighted are Utilities and Consumer Staples. This month Information Technology was upgraded; Health Care was downgraded.

Fixed Income:

Our view on long Treasury bonds based on current macroeconomic trends is becoming more negative. Over the intermediate term, the yield on the long bond should start edging higher. We would rate the current duration environment as a 9, up from 8 last month. Our duration is scaled from 1 to 10, with 1 representing a maximum position in Long Treasuries and 10 representing a maximum position in short term debt.

Hedge Funds:

We are long Consumer Discretionary and Information Technology. On bonds we are short the 10 year Treasury and long mortgage backed bonds and 10 year Inflation Protected Treasuries.

Looking into the Crystal Ball

Analytic Systems' approach to forecasting is fact-based, rooted in recent economic history and mathematically driven incorporating new realities.

Analytic Systems' Factor indicators of future activity suggest that the US economy is trying to arrest its rapid descent in December 2008. The overall latest score was 80.0 as compared to a restated 79.83 in October '08. The large decline in the November 2008 report was overstated because of a significant change in the monetary base which is explained on page 3.

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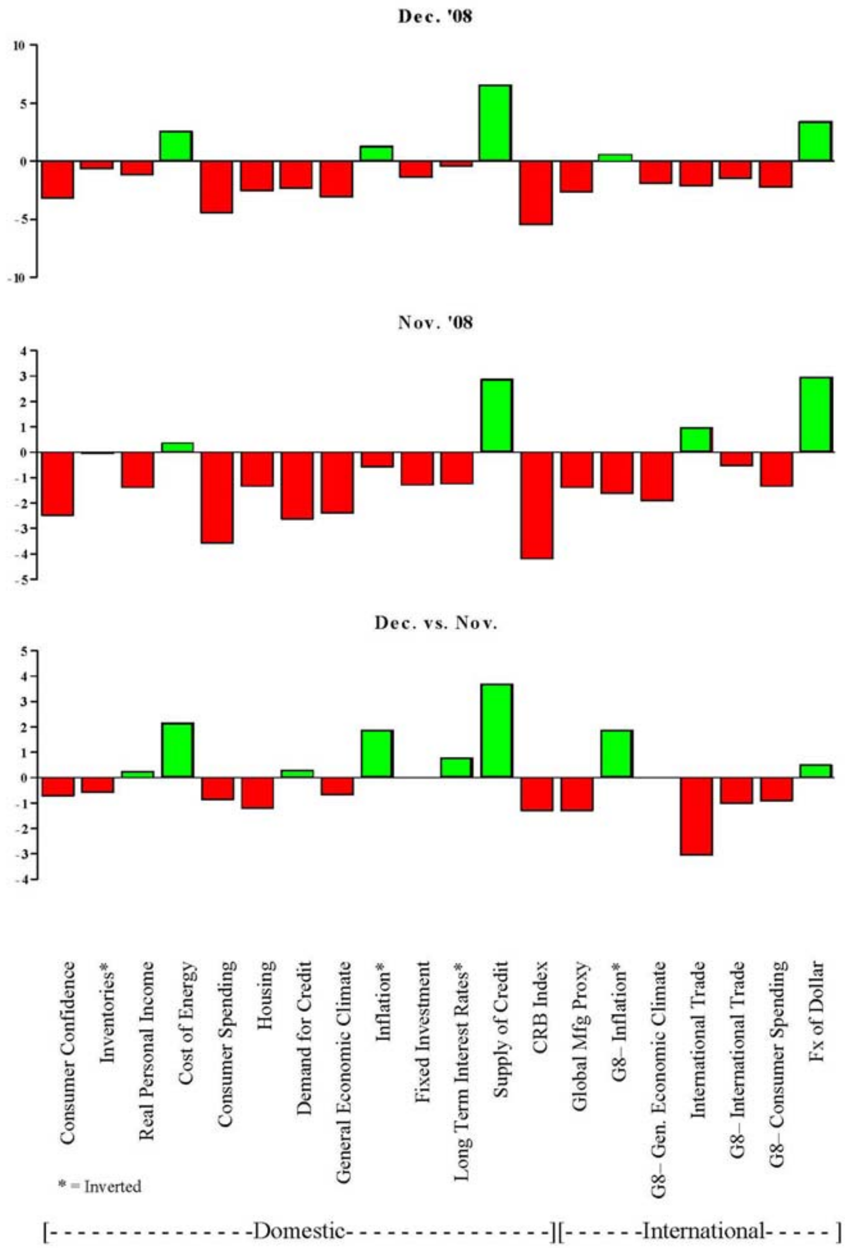
The following charts show fact based trends in ASC Economic factors as of December 2008 as compared to November 2008 and changes expressed in standard deviations around the norm, hereinafter referred to as “units.”



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The US along with other major industrialized economies did not lose any altitude last month. There were several significant positives.

The Economic Factors indicators that changed in the comparing December 2008 to November 2008 are shown in the following table:

The model highlights the units that rose in November	
Supply of Credit	3.69
Cost of Energy	2.17
US Inflation	1.87
G8-Inflation	1.86
Long Term Rates	.78
Fx US Dollar	.49
Demand for Credit	.33
The model highlights the units that fell in November	
US Exports	(3.02)
Supply of Credit	(2.36)
CRB Index	(1.25)
Global Mfg Proxy	(1.25)
Housing	(1.19)
G8 Exports	(0.98)
G8 Consumption	(0.87)
Init. Unemploy. Claims	(0.68)
US Gen. Eco. Climate	(0.63)
US Exports	(1.73)
Demand for Credit	(1.85)
US Consumption	(0.85)
Inventories	(0.53)

Instead of falling to 73.1, the overall sum fell to 79.8 in the November 2008 report which is within the historical range between 80 and 120. The factor weightings on the series that make up the Supply of Credit Factor had to be updated because the relationship between the two underlying series has changed substantially over the past year. Supply of Credit is soaring, lead by a dramatic increase in the monetary base of 70% over the past three months while M2 growth has been more modest, increasing at an annualized rate of around 6%. The increase in the monetary base reflects the Federal Reserve's increased role in providing support to financial institutions, buying commercial paper, bonds and

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mortgages securities. It is almost as if the US had an unannounced, two for one split in its currency and the post split price is trading at a higher price that before the split. Many holders of US dollars have not yet figured out that there are now almost twice as many dollars outstanding.

Quantitative Easing

When the Federal Reserve announced that it would start buying long Treasuries or adopt "quantitative easing," which the Japanese Fed resorted to in the early 1990's, instead of Treasuries selling off, they rallied. The 10 year yield is down to 2.1%. There is currently a deflationary mind set in place that has led investors to ignore the inflationary implications of such a strategy and to seek to get ahead of the Federal Reserve in buying Treasuries. In the short term we are having our cake and eating it too. In the long run the Fed is running the risk of creating another bubble in long Treasury bonds. To test the appropriateness of an approach sometimes it is helpful to see what would happen if one went to extremes. In this case, the Federal Reserve could raise its monetary base to around $60 trillion and buy Treasuries. Presto, all of the US's debt and unfunded obligations would be met. However, history has shown repeatedly that a country cannot create wealth by printing more money. The trick for the Fed is to be able to withdraw the stimulus in an orderly manner and bring about a smooth transition from deflation to some inflation without either getting out of control.

The September increase in consumer installment credit of $6.7 billion was reversed in October with a decrease of $3.5 billion. Decreases in consumer installment credit are very rare events and only occur when consumers are under extreme stress, such as we have seen over the past few months. The last three month's decreases of 1.3 %, 2.9 % and 1.8% in retail sales also show the extreme stress of the consumer. With an unfreezing of the credit markets and the latest effort by the Treasury to encourage lending to consumers, consumption is unlikely to continue in its free fall beyond a quarter or two.

Industry Group Changes

The December 2008 Economic Factor Model is giving a clear signal favoring industry groups that would benefit from a recovery with the rise in rank of Technology (PC related), Electronics (semiconductor related), Retail Growth and Computer Services. Falling in rank were Foods, Utilities and Coal. Energy moved up in rank from 36^{th} to 23^{rd}. The overweight of Consumer Discretionary is an early cycle beneficiary that has already discounted a significant recession. Information Technology generally does well when the US dollar is weakening, capital expenditures are growing, economic growth is expanding and interest rates are rising. While most of those factors are extreme in the opposite

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direction currently, the ASC factor model is suggesting that these deviations are temporary. The mean reversion nature of the ASC Factor model works best when extremes exist, such as is the case today.

The US dollar is likely to weaken after the current flight to safety runs its course, not only because of the dramatic increase in the monetary base, but also because interest rate differentials are working against the greenback. As the dollar weakens, bond yields in the US will eventually rise. Those panicked investors that sought safety in Treasuries at any price will find themselves in low yielding instruments that are highly exposed to risk of capital losses because of rising yields. As deflation bottoms in Q1'09 or Q2'09 and inflation begins to ratchet upward, equities and high yielding debt securities should be the primary beneficiaries. Equities and other at risk investments should get a substantial boost as the implosion of the Treasury bond bubble yields a flood of money looking for a hedge against inflation. The next bubbles are likely to be a repeat of 2000 and 2006, equities and real estate.

V Shaped Recovery

A "V" shaped recovery could begin by late spring '09 in response to the monetary and fiscal stimulus already in place. When the Obama administration takes over, there is very likely to be a $ 700 billion dollar stimulus package to aid consumers, state and local governments and to upgrade the nation's infrastructure. The basis for a reflationary "V shaped" recovery lies with a mean reversion type response to the downward vortex the US is now experiencing. In addition, significant drops in Cost of Energy, mortgage rates and long term Treasuries should allow the US economy to gain some traction. Economic activity should accelerate when we reach the inflection point on inflation and deflation, at the point that deflation rolls over and inflation starts heading higher. When there is no longer a risk of deflation growth should accelerate. In addition lower energy prices will lower the drag on growth from imports net of exports.

Our long term subscribers understand that the high ranking of recovery type groups such as Technology, Electronics and Retail Growth is not based on a forecast of a "V Shaped" recovery. Such industry groups are based upon current fact based economic conditions and how these industry groups have performed in the past in response to such trends. Even though the US economy is in somewhat of a unique position the ASC Factor Model does not need to have experienced a similar situation in the recent past, but to have individual responses to past economic conditions that hold true. In other words, if in the past extremes in Supply of Credit have helped technology, then an abnormal positive deviation in Supply of Credit such as is currently the case should be a positive for Technology. The fact that other extremes are also positive for Technology is an additional plus. Industry group ranking are based on facts on an objective basis, then comes the subjective part of

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trying to come up with an economic scenario that is consistent with those industry group rankings.

The CPI headline rate was down 1.7 % in November 2008 bringing the year over year rate to 1.1 %. The core rate was up unchanged leaving the year over year core rate at 2 %. The Cleveland Fed's .2 % increase resulted in a 3.1% year over year rate. Fears of deflation are being fed with published results. Deflation is likely to continue as the economy drops sharply in the fourth quarter of 2008 and then start leveling out in the second quarter of 2009.

Americans Are Spenders

For those who are worried that the US is likely to suffer a similar fate in 2009 that Japan experienced in the 1990's, there are some significant differences. Japanese are by their nature savers. Along with other Asians, they save over 20% of their income. Americans are spenders. The highest the savings rate got to was around 8% in 1975, a period of extreme uncertainty. In the past two cycles savings rates were negative a significant part of the time. If helicopters dropped money out of the sky, Japanese would wait until they collected enough to feel comfortable before deciding to make a new purchase. Americans hearing that helicopters are going to drop money from the sky, would get a loan to finance buying to be repaid with the dropped cash. Another example, Japanese are very patient. With prices falling they are in no hurry to buy. Americans have actually stampeded stores such as the recent case when a Wal-Mart employee was killed when customers rushed in to take advantage of lower prices.

For information on **A**nalytic **S**ystems **C**orporation's methodology and samples of past reports please visit our web site http://www.asc-sector.com.

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