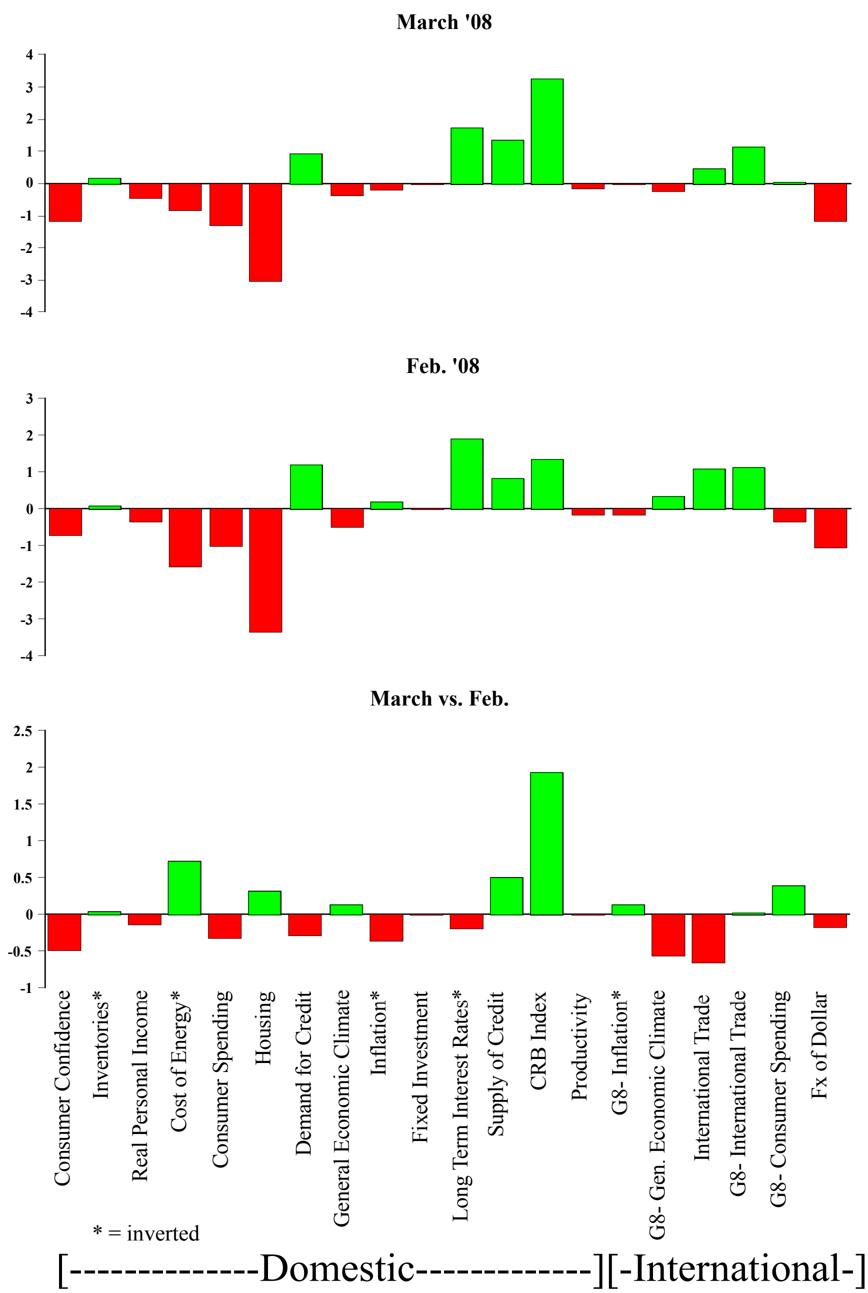
Analytic
Systems

Sector Analysis Research

Sector Weightings Changed - Commodities on Crash Alert   March 20, 2008

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



ASC Factor indicators of future activity suggest that the US economy remains weak. Following are significant changes in trends last month expressed in standard deviations around the average rate of change or "units." Initial Unemployment Claims rose by .47 units. Cost of energy fell by .74 units. Consumption fell by .3 units and is now solidly in the "recession zone." US Inflation rose by .34 units. Supply of Credit rose by .5 units. The CRB Index rose by 1.93 units. G8 General Economic Climate fell by .63 units. G8 Consumption rose by .39 units. While key factors such as consumption, real income and general economic climate are declining significantly, the overall score last month was 100.5 as compared to 99.3 in Feb. 08.

The CPI headline rate was unchanged in February '08 bringing the year over year rate to 4%, down from 4.3% last month. The core rate was also unchanged, down from .3% last month, leaving the year over year rate at 2.3%. The Cleveland Fed's .1% increase resulted in a 3% year over year rate. Inflation has finally begun to moderate and should continue as economic weakness persists. This should give the Fed more leeway to engineer a "soft" hard landing. The next area for improvement is likely to be a correction or something more pronounced in the commodities markets. With the US slowdown underway, the scale appears to be tipping away from reflation, except in China where inflation is still on the rise.

We have been debunking the decoupling theory for some time and arguing instead that the rest of the world would feel the slowdown in the US on an amplified basis. The US is headed for some sort of a recession depending on what happens to US housing prices. As the slowdown is felt abroad, we are likely to see a significant correction, if not a crash, in the commodity markets. After all they are commodities, not growth stocks.

The Federal Reserve is doing what it can to avoid a systemic financial collapse. If inflation continues to moderate, then it will make conditions a lot easier. In addition, the overshoot of the Euro is not likely to continue much longer. There is reason to be cautiously optimistic about the Fed's ability, along with the fiscal stimulus in the pipeline, to avoid a nasty downturn. The fact that the US is being proactive in dealing with an oncoming slowdown while the ECB is slow to recognize the problem looming ahead could actually lead to a firming of the US dollar with the eventual outlook for a recovery in the US as compared to the outlook for a slowdown in Europe.

The Chinese inflation threat appears to be accelerating with the latest year over year release at 8.7%. The increase in Feb '08 versus Jan '08 was 2.6% or around 36% on an annualized basis. For those saying it is mainly foodstuffs, the increase in non-food items was 1.6% or around 20.9% annualized. While many economists have been saying that these increases are a one month spike, they have been steadily increasing since last August when the year over year level was 6.5%. One should point out that according to government officials the monthly increase in the CPI, excluding the storms that stranded workers trying to go home for the New Year holiday, would have been approximately 1% or 12% annualized. The complicating factor is that with the Yuan pegged to the US dollar, as the US Federal Reserve reduces short rates, China is on the receiving end of the stimulative effect of lower US rates right when it is trying to rein in the economy. China's attempts to control inflation with price controls, rationing and restrictions on lending are likely to be more that offset by the US Fed's aggressive easing. With M2 growth in China running at 17.5% year over year (down from 18.9% last month) and negative real rates, inflationary pressures are likely to mount until China's economy slows significantly which is unlikely in the near term. Its efforts to control inflation may add to the uncertainty in commodities markets.

There are widespread views that the Fed has lost its ability to deal with the financial crises because of the weakening US dollar. Well, we have discussed the topic before, in fact, in September 1987 our report was entitled "The Fed is Caught Between the Dollar and the Economy" and advised that cash is king. No doubt with a weaker US dollar and continued inflationary pressures, it is more difficult for the Fed. However it appears that saying the Fed is unable to cope seems to be going too far. In 1987 the dollar was falling, inflation was rising and bond yields were rising. In 2007-08, at least so far, the dollar is falling, inflation remains problematic but bond yields are not rising. In addition, there are also early indications that inflation in the US is moderating. So, Fed critics appear to be overlooking a key aspect when they say, in effect, that the Fed has lost its effectiveness, the strong US bond market. Bonds are seen as a safe haven on panic days. Investors are not fleeing the most liquid of US markets but going into bonds as a safe haven. Speculation in currencies and commodities is just that, speculation by a large pool of hot money that is momentum driven. Central bankers around the world are still holders and buyers of US dollar bonds.

There are also those who think the US is about to lose it status as a reserve currency. As we have stated before, the outlook for the US dollar is hardly promising. However, the alternatives to displace the dollar, the Euro and the Yen, have their problems as well. Generally, new reserve currencies are established after the victor of a major war survives in much better economic condition than the previous reserve currency country. Such was the case with the dollar replacing the British pound after World War II. Britain was in hock to the US and in negotiations to make repayment of the debt more manageable; they had to give up their reserve currency status. Currently, the ECB is delaying cutting interest rates in Europe. Meanwhile the effects of the strong Euro are mounting. Europe is likely to begin slowing over the next 6-9 months which is likely to result in a weaker Euro. Japan is faced with an aging population, political stalemate and a slow growth economy. It is already complaining about the strong Yen. With the lagged effects of currencies, Europe and Japan are likely to begin slowing significantly later this year. It is not that the dollar is sound; it is that relatively speaking, it is not in bad shape.

Investment Strategy

Equities:

Health Care, Consumer Growth and Technology are well positioned based in the current uncertain economic environment. Over weights in S&P groups are advised in Health Care, Information Technology and Consumer Discretionary. Market weights are advised in Consumer Staples, Financials and Materials. Underweighted are Industrials, Utilities and Energy. Information Technology was upgraded this month; Energy and Utilities were downgraded.

Fixed Income:

Based on current macroeconomic trends, our view on long bonds is slightly less positive. Over the intermediate term, the yield on the long bond should start edging higher. Regarding the issue of duration, on a scale of 1 to 10, with 10 representing a maximum position in shorter term debt and

1 representing a maximum position in Long Treasuries, we would rate the current environment as a 6, the same as last month. With the whiff of a recovery in the air that the ASC model is providing an early warning on, the 10 year Treasury yield at 3.4 % is likely to start edging higher.

Hedge Funds:

We are long Health Care, Consumer Discretionary and Information Technology. The spreads of emerging market debt over Treasuries appear to be becoming more rational but are still too narrow. With greater economic uncertainty brought about by a slowing US economy, one should continue to reduce exposure to emerging market debt. Shorts should be ready to play a potential bust in commodities as well as subsequent weakness in commodity country currencies.

For information on ASC's methodology and examples of past reports please go to http://www.asc-sector.com.

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