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Newsletter Beginning Q3 2008, July 1, 2008

Prepared by Daniel R. Shore, Chief Research Analyst, Publisher, and CEO

Introduction:

Welcome back to the Alphareturns Newsletter to open the third quarter of 2008 and close out a very volatile and challenging second quarter. As in the first quarter, global equity and credit markets experienced incredible volatility. We are now seeing a stagflation scenario unfolding before our eyes in a way that is eerily similar to the stagflation of the 1970's. This is a very difficult investment environment due to the fact that stagflation not only hurts stock markets but can also cause bond markets to lose value as investors demand higher interest rates on fixed income securities. Real assets like commodities tend to do well during times of stagflation. So far during 2008, the commodity sector (energy, metals, agriculture) is one of the few asset classes that is performing well. Once again, as in the 1970's, we see an external price shock causing inflation at the same time our economy is slowing. This time around the external price shock is a shock in energy, food, and metal prices driven by demand in the emerging markets of India, China, Russia, and Latin America. While it is true that these emerging market economies depend upon the U.S. consumer to some extent, this dependence is much less than it used to be due to the emergence of middle class consumerism in these developing economies. Unfortunately for the U.S. and Europe, textbook economic monetary policy (lowering interest rates to stimulate the economy) may not work in a stagflation environment because the lower rates just fan the flames of inflation.

Executive Summary:

- Q2 2008 ended with the market exhibiting nervous volatility due to continued stress in the financial, consumer, and real estate sectors. Even with this turmoil, the Alphareturns model portfolios beat the S&P500 by more than 8 percentage points on average so far this year. Year to date our Conservative, Moderate, and Aggressive Model Portfolios returned 1.43%, -1.52%, and -4.53% respectively compared to the S&P500's return of -12.83%, the Dow Industrials at -14.44%, and the MSCI-EAFE at –12.5%. Wise diversification in all of our portfolios created superior performance with considerably less risk and volatility than the broad market (see Q2 2008 performance discussion below).

- Our economic forecast for 2008 still calls for a significant slowdown in the US economy with GDP (gross domestic product) growth falling from 2.2% in 2007 to 1.5% in 2008. Historical data show that whenever GDP growth falls below 2% for any meaningful period of time, corporate margins tend to be negative. Euro-zone GDP growth is also forecast to fall from 2.9% to 1.5% in 2008 while Asian economies are expected to slow from 4.8% to 3.9%. Even though Asian growth will be relatively strong, we believe Asian stock markets are currently overvalued. When Japan is excluded from the Asian GDP forecast, Asian growth ex-Japan is expected to be a point higher at 4.9%. Therefore, we predict a tremendous decrease in corporate profitability during 2008. This will drive stock markets down as analysts are forced to cut their earnings forecasts. The renewed fear in the market recently is primarily due to analysts slashing their forecasts for 2008 earnings. Analysts are now saying that S&P500 earnings for the second quarter will ***decline*** 9%. In January they were predicting an S&P500 earnings ***gain*** of 4.7% for Q2 2008. ***How quickly these wizards of Wall Street can change their tune!*** Lower earnings and rising inflation have caused institutional investors to reduce exposure to stocks in favor of bonds and commodities.

- In spite of the slowdown in global GDP, we still expect global consumer price inflation to be in the 7% range during 2008 as consumption weakness in the US and Europe is offset by Asian demand and rising food and energy prices worldwide. We expect the dollar to continue its decline against other major currencies as the U.S. Federal Reserve is forced to keep rates low to stimulate growth. During 2007 the dollar index as reported by the Wall Street Journal declined in excess of 7%. During the first half of 2008, we have already experienced a 5.5% drop in the dollar index. This continued dollar weakness is being driven by the excessive liquidity being pumped into the financial system by central banks as financial sector losses and credit crisis fears grow. ***The Federal Reserve's decision in June to leave the Fed Funds rate at 2% virtually insures another round of commodity inflation and dollar weakness.***

- Again in the second quarter, we witnessed further write-downs and losses by global banks even after these banks repeatedly said that they had already written off all their possible losses. The International Monetary Fund released a study in April forecasting global banking system losses in excess of $900 billion before this crisis is over. The IMF forecasts losses of $565 billion in mortgage related securities, $240 billion in commercial real estate lending, $120 billion in corporate lending, and finally $20 billion in consumer credit. In mid-June, ratings agencies downgraded the major bond insurance companies removing their AAA ratings. This caused another round of panic in the municipal bond and asset-backed securities markets.

- Also during the first half of 2008 we watched a number of economic indicators deteriorate rapidly to levels that we have not seen since past recessions:
    - US consumer confidence is at a 28 year low.
    - The US economy lost 49,000 jobs in May and 324,000 year to date so far in 2008. Unemployment rose to 5.5% in May as more family members re-entered the workforce to find jobs to supplement family incomes.

- US median home prices have fallen close to 15% this year and over 20% from the 2006 peak. The only other time that home prices declined this significantly was during the Great Depression of the 1930's.
- US and developed global stock markets are down 13% year to date.

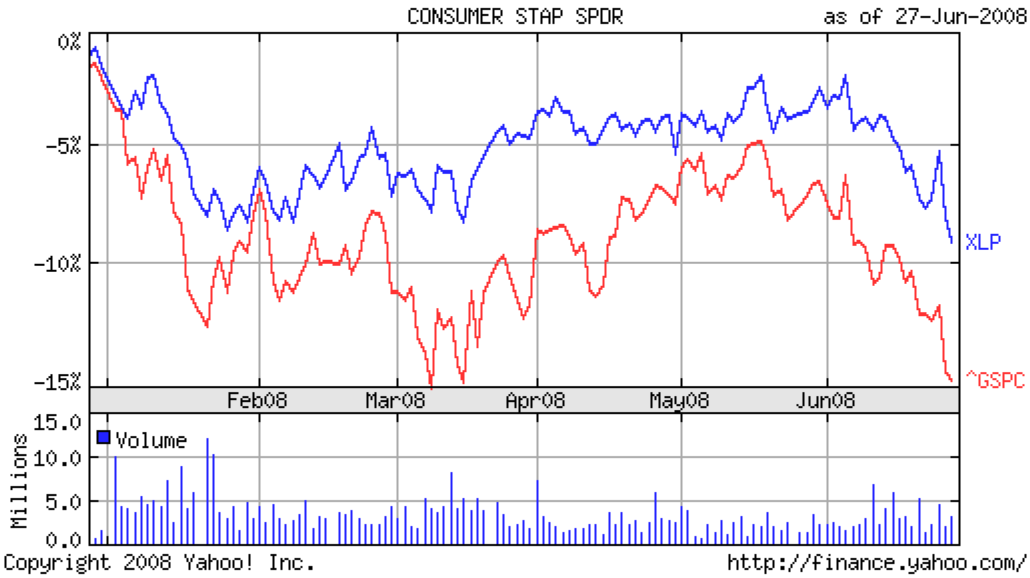
- Even with the recent sell-off in stocks, we still believe that major developed stock market valuations are overvalued when compared with historical data. We take this position based upon the deteriorating corporate profit situation. When GDP growth slows below 2%, corporations have a very difficult time making a profit. It gets even more difficult when you have commodity inflation making a company's inputs more expensive and a credit crisis making credit more expensive. We calculate that US stock markets are valued at around 20 to 22 times 2008 earnings. This is well above the historical average of 15. European markets are in the range of 15 to 18 times expected 2008 earnings, and Asia (ex-Japan) is at 18 to 20 times earnings. Even though these ranges are not as outrageously high as they were before the last recession/bear market of 2001/2002, we are still very cautious regarding stocks in 2008. We still believe that the global financial credit crisis and GDP slowdown will hurt corporate earnings more than analysts expect in 2008. Wall Street analysts are chronically too optimistic with regard to corporate earnings growth for 2008 and are just now starting to reduce earnings forecasts for the remainder of the year. Although we expect this slowdown and recession to be short and shallow, it is not likely that the economy will bounce back as quickly as these optimistic analysts think. During the second quarter, virtually every stock analyst and research group began aggressively cutting earnings estimates for 2008 as slowing global growth and increasing commodity prices weighed on corporate earnings.

- Our Alphareturns Model Portfolios will continue to be defensive with even less exposure to stocks and more exposure to global treasury bonds and commodities. This limited stock exposure will be concentrated in the large cap multi-national consumer staples sector and in Latin American markets. We had expected Asia (ex-Japan) to weather the coming economic storm better than the US, Europe, and Emerging Markets. While economic growth in the Asian region (ex-Japan) has been strong and less affected by the US slowdown, Asian stock markets have been overvalued. Asian (ex-Japan) markets are down 13% year to date and Chinese markets are down a whopping 48% so far this year. Our analysis shows that these Asian markets have further to fall before valuations become attractive again. The only stock markets doing well this year are in Latin America and Canada. The commodity and natural resource centric MSCI Brazilian and Canadian stock market indices are up 9.8% and 3.8% respectively year to date. We do not have a way to specifically invest in the Canadian market, but will make an allocation to the Latin American market going forward.

<u>The Alphareturns Model Portfolios for Q3 2008:</u>

Because of the likelihood of recession and lower corporate earnings in the US economy, we will make adjustments in our model portfolios to take an even more defensive posture going into Q3 2008. The table below details the model portfolio allocations we are recommending for the third quarter of 2008. We will briefly touch on the rationale behind the various asset allocation choices:

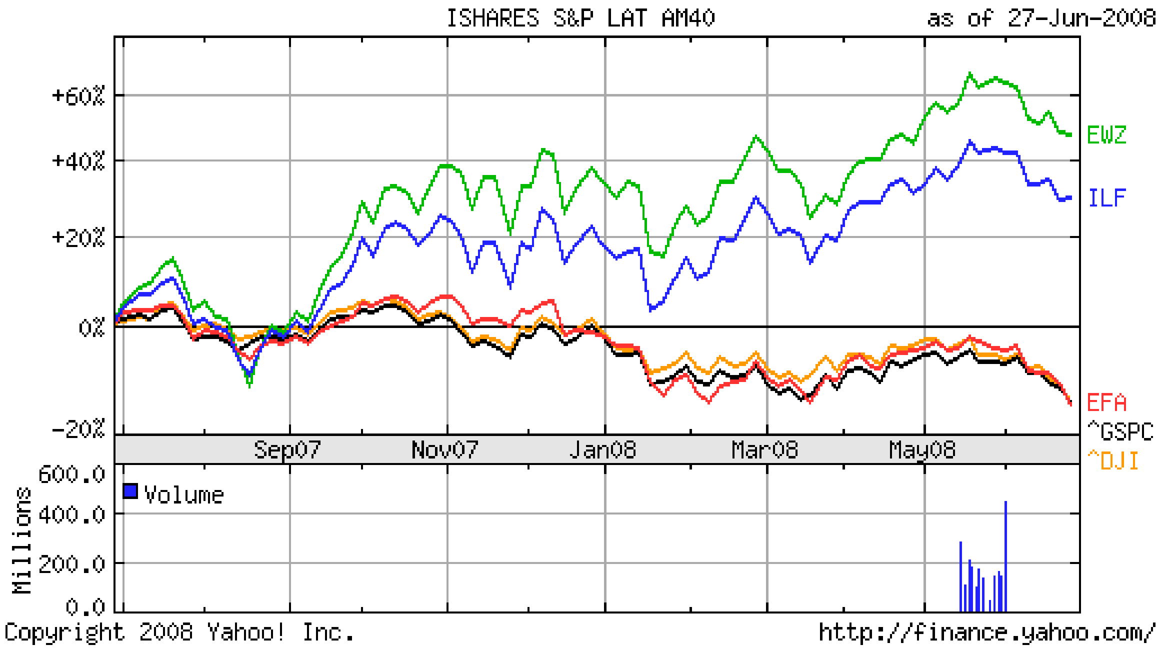
US Stocks: With our cautious posture regarding the threat of recession in the US, we will continue with the US Consumer Staples ETF fund symbol XLP. Our theory is that consumers will still buy the staples they need (food, medicine, hygiene products) even as the economy slows down. Historically during past recessions, the consumer staple sector has held up well. So far this year the consumer staples sector has lost about half as much as the broad market (see chart below comparing the XLP to the S&P 500).



Consumer Staples ETF (XLP) outperforms the S&P500 (GSPC) during 2008.
Source: Yahoo Finance

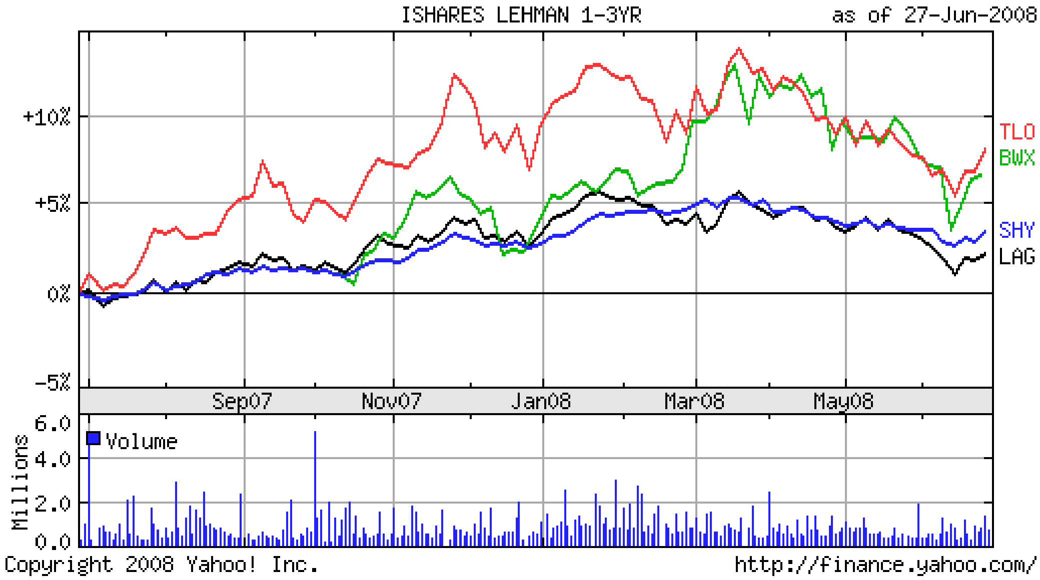
International Stocks: We remain cautious regarding developed international stock markets due to the global stagflation scenario. Therefore we will exit our allocation to the international consumer staples exchange traded fund symbol KXI and replace it with Latin American exposure. Latin American emerging markets should perform well in a stagflation scenario and are also more attractive from a valuation standpoint.

Emerging Markets: With the overheated stock market situation in many of the emerging markets, we are maintaining our overvalued call on emerging market stocks with the exception of Latin America.   Chinese and Indian stocks performed well during the full year 2007, but traded down substantially since October of last year. As we have been predicting for over a year now, the Chinese stock market bubble has officially burst. The Chinese CSI 300 stock index has declined by 48% during 2008 and is 52% off the October 2007 high. India's stock market is also down substantially in 2008 with a 32% loss year to date. However, when we look at GDP growth and market valuation fundamentals for Latin America, we see an opportunity that is unique. Latin American countries are forecast to maintain robust, above trend growth due to their commodity driven economies. We will participate in the Latin American market with the Ishares S&P 40 Latin American Index exchange traded fund symbol ILF and also with the Ishares Brazilian exchange traded fund symbol EWZ. The chart below shows how the Latin American ILF and Brazilian EWZ funds have gained during this stagflation crisis while the S&P500 (GSPC), DOW (DJI), and MSCI-EAFE international stock index (EFA) have declined. With price earnings (P/E) ratios around 15 on a trailing 12-month basis and GDP growth in the 5 to 6% range, we believe Latin American markets are attractive at these levels.



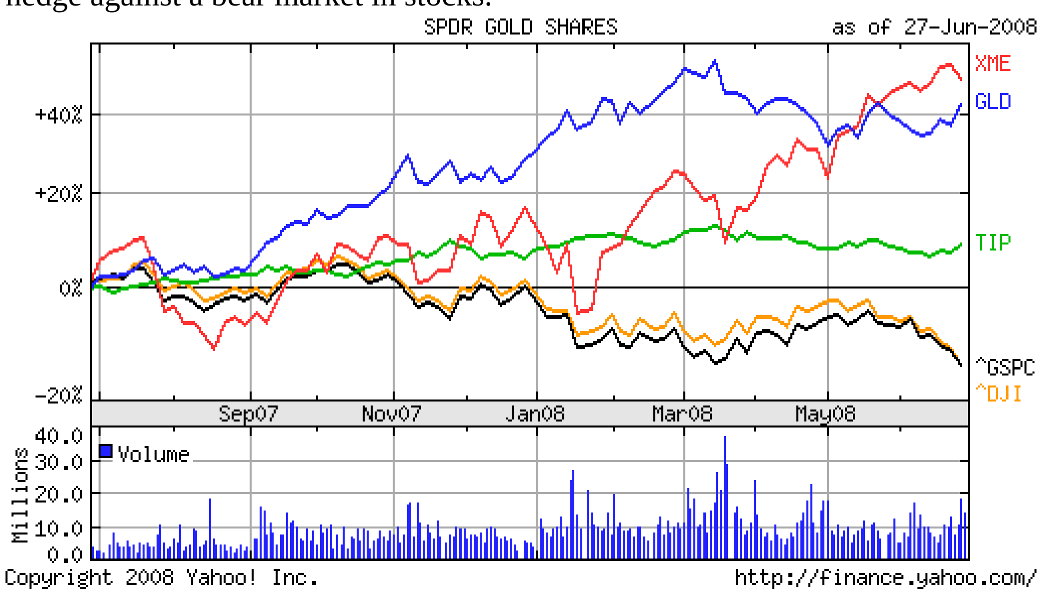
Latin American S&P40 fund (ILF) and Brazilian fund (EWZ) 1 year performance relative to the MSCI-EAFE (EFA), S&P500 (GSPC), and Dow Industrials (DJI)
Source Yahoo Finance

Fixed Income: As forecast in our previous newsletters, the credit crunch and re-pricing of risk have caused a steeper yield curve. This steepness has been primarily caused by a reduction in short-term rates. While we do think the Fed has finished reducing rates and is now likely to tighten slightly over the next 12 months, we still believe the Federal Reserve will be forced to keep short-term rates under 3% to fight the weakness in the economy. Therefore we are still recommending short-term 1 to 3 year duration U.S. Treasuries with the SHY exchange traded fund as a safe haven. In addition to the SHY short-term treasury allocation, we are changing our bond allocation by exiting the long-term U.S. Treasury fund symbol TLO, and staying with the International Bond fund symbol BWX. We predict that foreign central banks will not lower rates as much as the U.S. Fed. Therefore, this differential of higher yields in foreign bonds along with a weak dollar will continue to lure investors to foreign bonds. We are exiting long-term U.S. Treasuries because they have already benefited fully from Fed tightening and are likely to be hurt much more by inflation and future rate increases than short-term Treasuries. Historically, long-term Treasuries have lost more value during times of high inflation because inflation erodes the value of long-term bonds before the yield can be reset. In summary we will stay with the SHY short-term U.S. Treasury fund and the BWX intermediate-term foreign bond fund as our fixed income investment vehicles.



Int'l Bonds (BWX), Long Term Treasuries (TLO), and Short Term Treasuries (SHY) outperform the Lehman Aggregate Bond (LAG) bond market index during the past year.
Source: Yahoo Finance

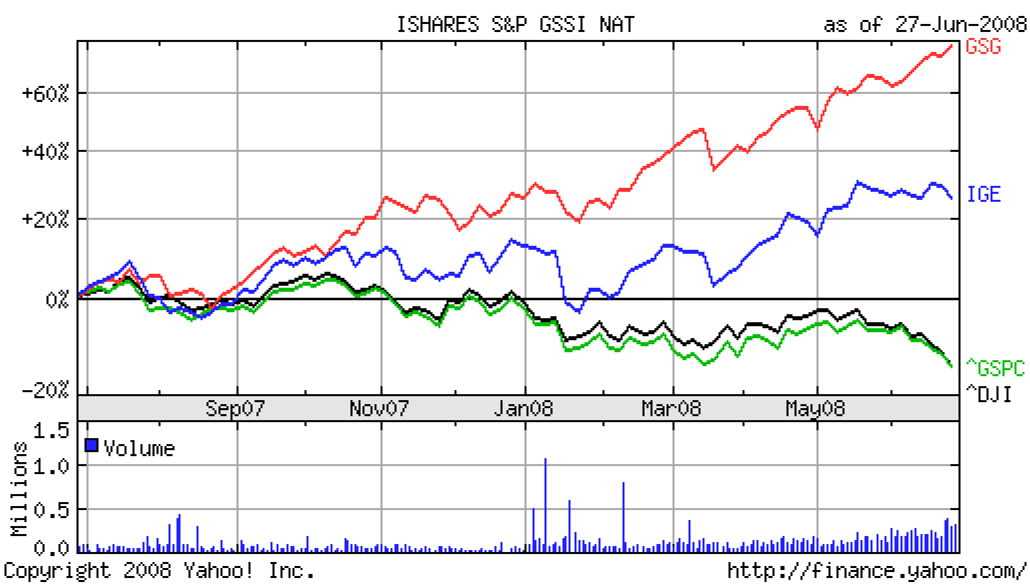
Metals and Mining Stocks: The US dollar index as reported in the Wall Street Journal has declined an astounding 5.5% already in 2008 after posting a decline of 7.2% in 2007. This dollar devaluation causes metals commodities to increase in value since they are denominated in US dollars. We also see increased interest in gold as a reserve asset for central banks in the Middle East, Asia, and Russia. Gold has now proven to be a better hedge against inflation than Treasury Inflation Protected Treasury Bonds (TIPS). Over the last few years as energy, food, and commodity inflation have increased; we have witnessed gold vastly outperforming TIPS. We also like gold as a hedge against a bear market in stocks.



Metals and mining fund (XME) and Gold bullion fund (GLD) outperform Treasury Inflation Protected Securities (TIP), S&P500 (GSPC), and Dow (DJI) for the past year.
Source: Yahoo Finance

Historically, gold has been negatively correlated with stocks. So far, our predictions have been correct, in that gold and commodities have outperformed during this time of economic and market stress. Our gold exposure is achieved via the Gold Trust Bullion ETF symbol (GLD). The GLD fund has performed very well this year with a gain of over 10%. In addition to gold, we want to maintain our exposure to metals commodities including steel, aluminum, enriched uranium, copper, titanium, and other metals. We believe the declining US dollar and demand from emerging markets will continue to favor companies involved in mining precious and industrial metals. We still see demand strength from Asian, Middle-Eastern, and Russian infrastructure growth. To participate in this sector we are staying with the SPDR S&P Metals and Mining Index exchange traded fund (symbol XME). The XME fund has also performed very well this year with a gain of 35%.

Natural Resources: We are also standing firm on our allocation to the natural resources sector because we believe the falling US dollar and energy supply issues will continue to favor companies involved in the natural resource sector. Energy companies involved in oil, refining, and natural gas are especially attractive. To achieve a broad diversification in this sector we will continue with an allocation to the Ishares S&P GSSI Natural Resources Index exchange traded fund (symbol IGE). Year to date our allocation to the IGE fund has served us well as it has gained over 12%. Furthermore, to gain a broad exposure to more commodity sectors such as agriculture we will add an additional fund: the Ishares GSCI Commodity index fund (symbol GSG). The GSCI index currently tracks 24 different commodities. It is weighted with approximately 67% invested in energy, 16% in agriculture, 7% in industrial metals, 7% in livestock and 3% in precious metals. The index is production weighted to reflect the relative significance of those commodities to the world economy.



GSCI Commodity index fund (GSG) and Energy Resources fund (IGE) outperform the S&P500 (GSPC) and Dow Jones Industrial Average (DJI) during the past year.
Source: Yahoo Finance

Alphareturns Model Portfolio Allocations For Q3 Calendar 2008:

Symbol	Asset Class	Conservative Risk 1-3 year horizon	Moderate Risk 4-7 year horizon	Aggressive Risk 7+ year horizon
XLP	**US Consumer Staples Stocks ETF**	8%	17%	26%
ILF	**Latin America S&P 40 ETF**	6%	8%	10
EWZ	**Brazilian Market ETF**	0	5%	10
SHY	**1 to 3 year US Treasury ETF**	34%	27%	20%
GSG	**GSSI Commodity Index ETF**	6%	8%	10%
BWX	**Int'l Treasury Bond ETF**	30%	20%	10%
GLD	**Gold Bullion ETF**	10%	7%	4%
IGE	**GCSI Natural Resources ETF**	3%	4%	5%
XME	**Metals and Mining Stocks ETF**	3%	4%	5%

Q2 2008 Performance Discussion:

During Q2/2008 our model portfolios outperformed their respective benchmarks and the broad markets during the quarter as well as since inception on January 1, 2007. During Q2/2008, our Conservative Portfolio returned –0.88%, our Moderate Portfolio returned –1.10%, and the Aggressive Portfolio returned –1.24%. However, as indicated by the data below, our portfolios lost less than their respective benchmarks and also lost less than the S&P500 index (-3.23%) and MSCI EAFE (-4.34%). Since inception January 1, 2007, our portfolios have outperformed their respective benchmarks by a wide margin. The Conservative Model Portfolio returned 9.28% since inception vs. its benchmark of 6.11%, the Moderate Model Portfolio returned 6.06% vs. its benchmark of 2.22%, and the Aggressive Model Portfolio returned 2.70% vs. its benchmark of –2.22% (see performance table below for details).

Alphareturns Model Portfolios →	Conservative Risk 1 to 3 year horizon	Moderate Risk 4 to 7 year horizon	Aggressive Risk 7 + year horizon
Q1 2007	2.47%	2.80%	3.07%
Q2 2007	3.49%	4.57%	5.60%
Q3 2007	1.50%	1.42%	1.28%
Q4 2007	0.10%	-1.23%	-2.41%
Q1 2008	2.33	-0.42	-3.33
Q2 2008	-0.88%	-1.10%	-1.24%
YTD 2008	1.43%	-1.52%	-4.53%
Since inception 01/01/07	9.28%	6.06%	2.70%

Dow Jones Benchmarks∗ →	Dow Jones Relative Risk Conservative Global Portfolio	Dow Jones Relative Risk Moderate Global Portfolio	Dow Jones Relative Risk Aggressive Global Portfolio
YTD 2008	-0.35%	-5.37%	-10.10%
Since inception 01/01/07	6.11%	2.22%	-2.22%

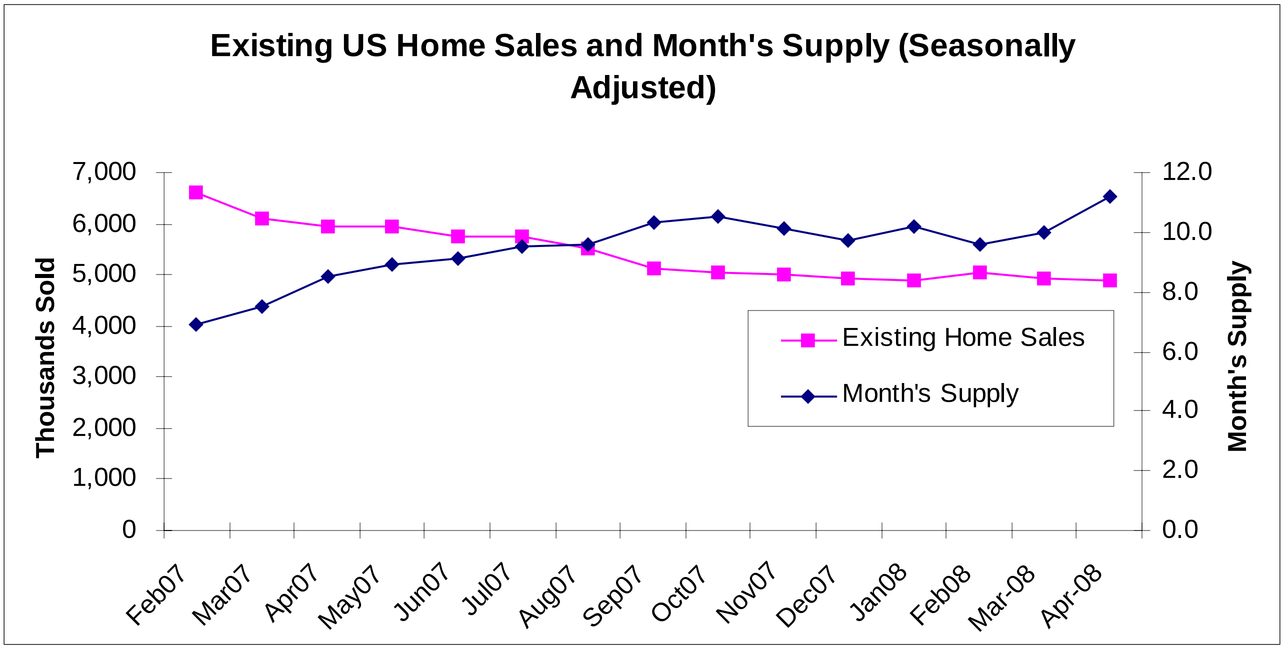
∗**Note:** *The Dow Jones Relative Risk Indexes measure the performance of conservative, moderate and aggressive portfolios based on incremental levels of potential risk. The indexes are designed to systematically measure various levels of risk relative to the risk of a global all-stock index. Investors can identify an appropriate benchmark as the index that has the most similar historic risk characteristics. Stock exposure will typically range from 20% in the conservative portfolio up to 100% in the aggressive portfolio. See www.djindexes.com/mdsidx/portfolio/index.cfm?event=showPortfolioGlobalRelativeRisk for more information.*

Detailed Global Economic Technical Analysis and Outlook:

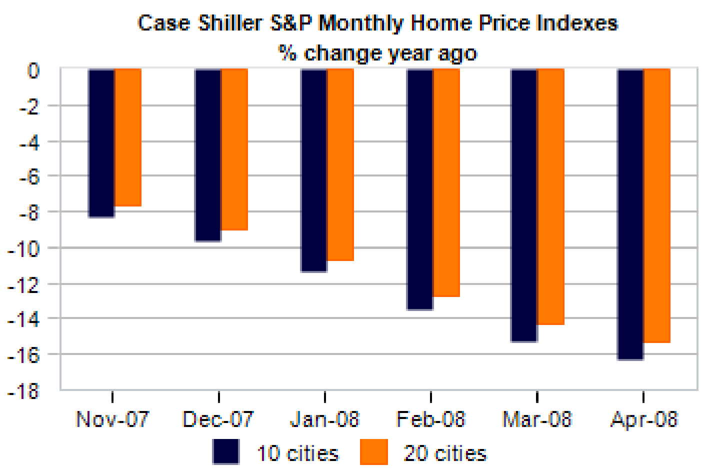
During Q2 2008, the world's financial markets continued their volatile gyrations. Problems continued to grow in the battered real estate and financial sectors of the US market and spread to consumer markets. As in the 1st quarter, credit problems in the US financial sector spilled over to markets in Europe and Asia. The U.S. Federal Reserve has been letting financial institutions have access to federal funds in a way that we have not seen since the 1930's. The question remains however as to how much taxpayer money will eventually be needed to cover losses that the Federal Reserve will incur on these loans. It is looking more and more like the collateral that the Fed is taking in could become worthless. Even with the temporary optimism of this government action, the markets remained nervous and skeptical as the quarter ended. Even as the majority of economists increased their forecasts for a US recession in 2008, the government's reading on first quarter GDP came in at a slightly positive 0.6% growth. Goldman Sachs, Morgan Stanley, Merrill Lynch, Moody's, the Swiss Bank of International Settlements, Warren Buffet, and many others are predicting recession this year in the US. At Alphareturns, we still believe a mild US recession will occur this year even though government GDP data is yet to show a quarter of negative growth***… yet***. Judging by past experience we know that government GDP data is usually revised downward months after it is released.

US Real Estate Sector Continues To Weaken:

The re-pricing of risk in the financial sector and weakness in the real estate sector continue to get worse in 2008. In previous newsletters we explored the weakness in the U.S. residential housing market at length, so we will not go into the same level of detail as before. We will take a look at recent home sales, price, and inventory data to show that the real estate market is still deteriorating. See the charts below regarding existing home sales and inventories.

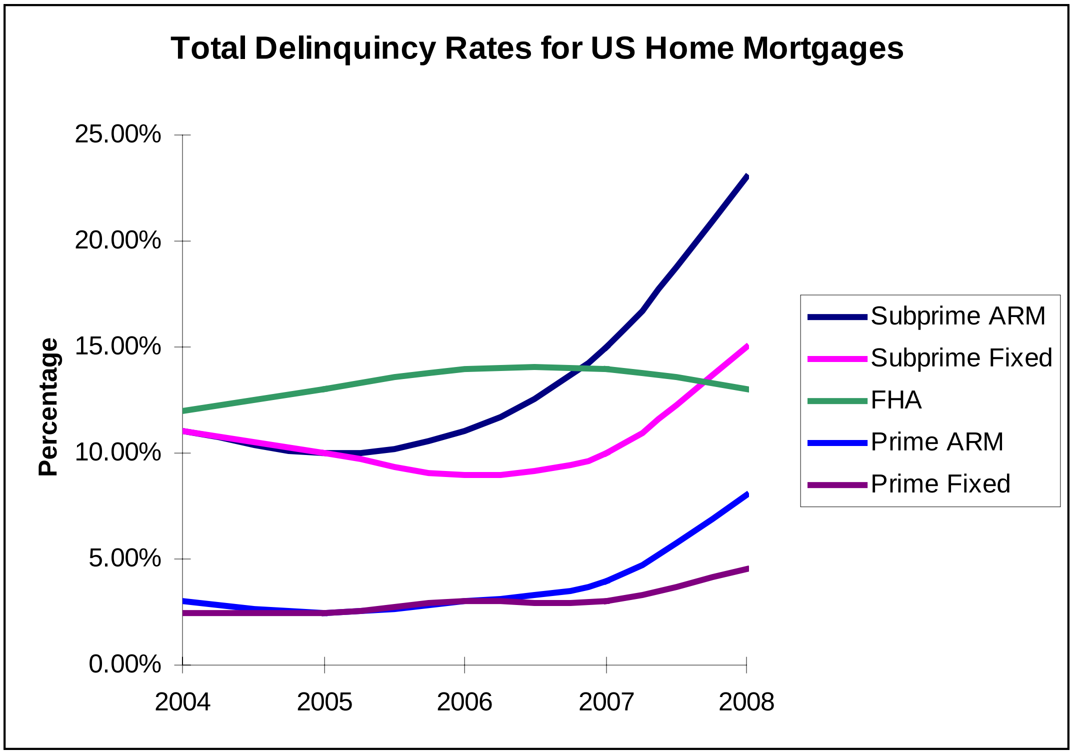


Source: National Association of Realtors



Source: Moody's

As we can see from the charts above, high inventory supply and weak demand are causing median home prices to fall significantly year over year. This has not happened since the Great Depression. Because of these large declines in the value of residential housing, we are seeing a surge in mortgage foreclosures. In many cases, even homeowners who are not in the sub-prime category owe more on their mortgage than their home is worth. This is causing foreclosures outside of the sub-prime area to escalate as homeowners who have to sell due to job loss, divorce, or other circumstance find themselves upside down on their mortgage (see chart below).

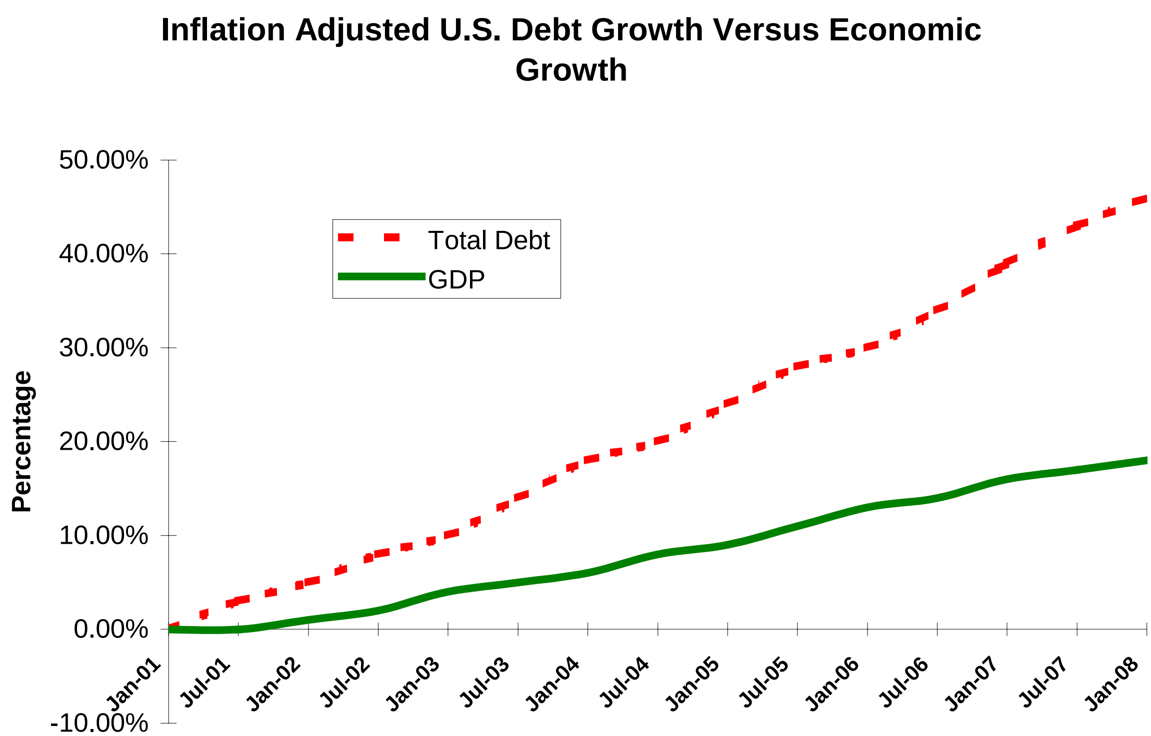


Source: Mortgage Bankers Association and Wall Street Journal

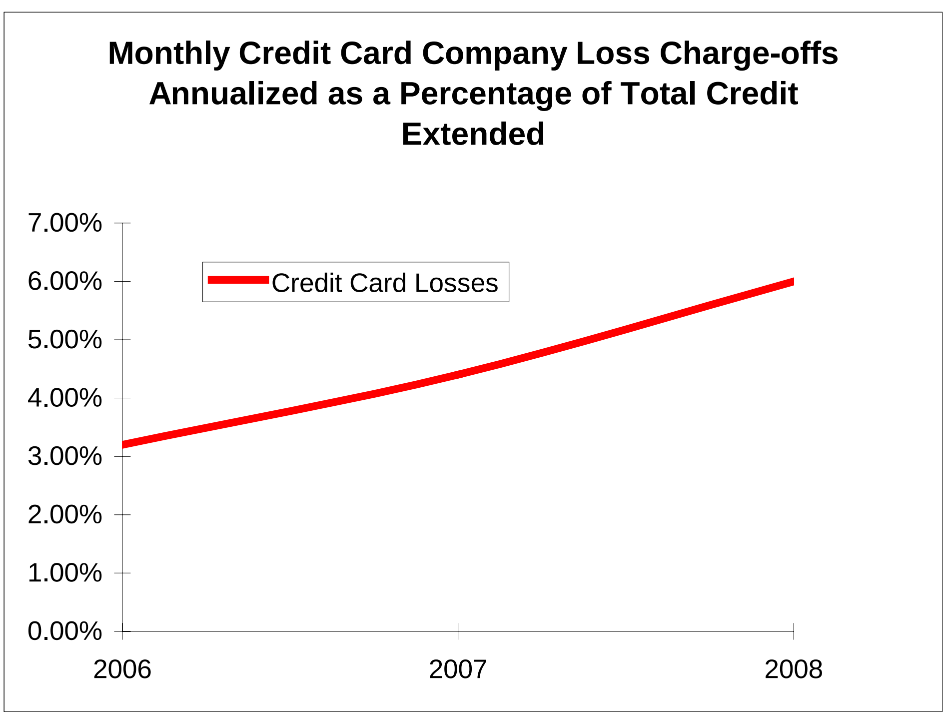
Banks and mortgage firms had hoped that home prices would stabilize and keep the problems contained within the sub-prime loan sector. Unprecedented declines in home prices are now causing loan problems to spread to prime mortgages. This will cause more write-offs as loan portfolios outside of sub-prime experience default and loss.

Global Credit Crisis Continues to Get Worse in 2008:

As we have predicted for the past 2 years, the global credit bubble has now run its course and is unwinding in a painful way. Since the Federal Reserve reduced rates to 1% after the 9/11 attack and the tech bubble, this credit bubble has been the main driver of economic growth. The Federal Reserve has released recent data that suggest aggressive debt expansion may be responsible for a majority of our economic growth since 2001 (see chart below). US household debt per dollar of disposable income increased from $0.92 in 2000 to $1.34 at the end of 2007. As we discussed in previous newsletters, the lowest interest rates in a generation, liquidity created by derivatives, deficit spending worldwide, poor mortgage and corporate lending standards, and a global housing boom created excessive credit and debt issuance. This bubble is now officially deflating as debt markets re-price risk and the financial sector starts dealing with defaults and foreclosures.



Source: Federal Reserve



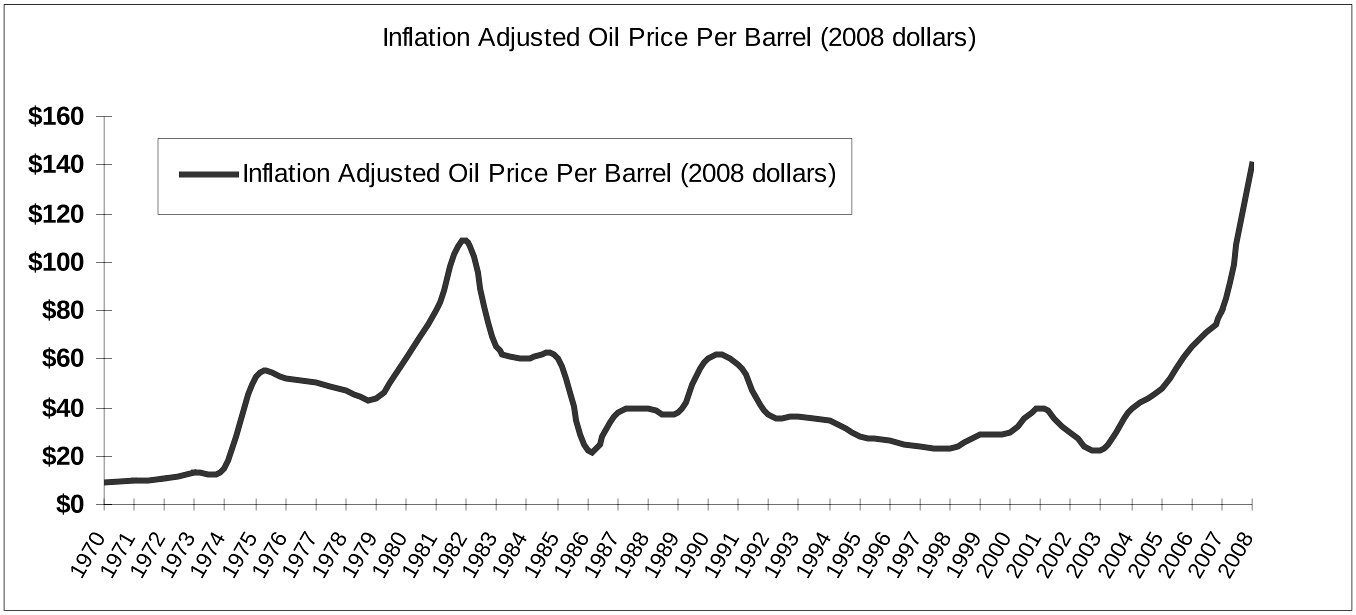
Source: Moody's

<u>But Isn't All This Bad Economic News Already Factored Into Stock Market Valuations and Aren't Valuations Reasonable?</u>

So by now, our readers are probably asking the question: "But Isn't All This Bad Economic News Already Factored Into Stock Market Valuations and Aren't Valuations Reasonable?" As we discussed in last quarter's newsletter, we continue to be bearish on the broad markets and only bullish on the consumer staples sector and commodity driven markets like Latin America. The reason for our bearish posture is our forecast for corporate profit deterioration in the U.S., Euro-zone, and Asia during the remainder of this year. Even though the S&P500 trades at around 16 times forward 12 month earnings and this sounds like a reasonable valuation, we have to understand that this is based on a forecast of 16% positive earnings growth in 2008! Historical earnings performance during recessions suggests that corporate profit growth drops to –5% when GDP growth is around 1 to 2%, and profit growth drops to –10% on average when GDP growth slows to zero. With total US GDP growth in 2008 forecasted to be in the 1.5% range, we expect corporate profit growth to be in the –5% range. This is a far cry from the 2008 S&P500 earnings forecast of +16% reported by Reuters. If we apply our –5% forecast to the actual 2007 S&P500 earnings of $71.56 per share, we still have the S&P500 trading at around 20 times forward earnings instead of 16. Currently the S&P500 trades at around 21 times trailing 12 months earnings compared with a long term average of around 15. As mentioned earlier in our executive summary, Wall Street analysts have been busy recently cutting their forecasts for global corporate earnings. For example, at the beginning of this year their consensus forecast for S&P500 Q2 earnings growth was 4.7% and now they have slashed their Q2 forecast to a loss of 9%! ***That is a downward revision of 13.7% in just the last 3 weeks. It is no coincidence that the S&P500 is down 13% year to date. Corporate earnings have been and still are the primary driver of stock market performance.***

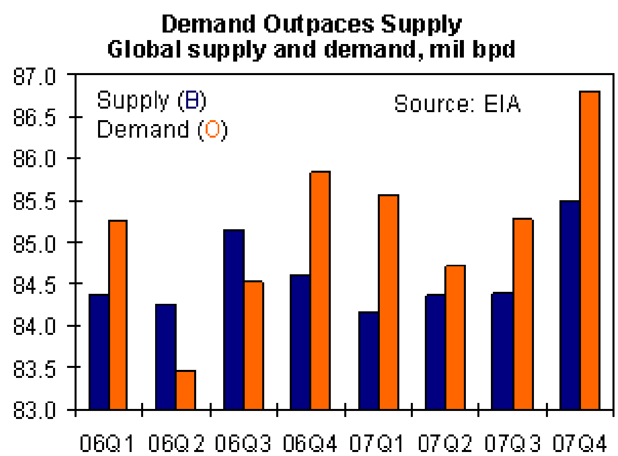
<u>Oil and Energy:</u>

As we have predicted for two years now, crude oil continues to rise in price as a result of the falling dollar, increasing global demand, OPEC supply constraints, and investor speculation in the future's market. At this point we believe the new floor for crude is around $100 per barrel and expect oil to trade between $100 and $150 per barrel during 2008. If recession in the US spreads globally and proves to be deeper than we are forecasting, perhaps oil could fall back into the $70 to $100 range. However, at this time we do not see the global slowdown being deep enough or long enough to force oil lower for very long. We expect emerging market demand combined with further Fed induced dollar devaluation to provide upward pressure on oil prices for some time to come. As we can see from the inflation-adjusted price of oil chart below, inflation-adjusted prices are just now reaching late 1970's/early 1980's levels. OPEC nations and other foreign oil producing countries finally woke up to the fact that the U.S. has been printing dollars for the past 30 years at an alarming pace and therefore paying less for a barrel of oil than we should have been on an inflation adjusted basis.



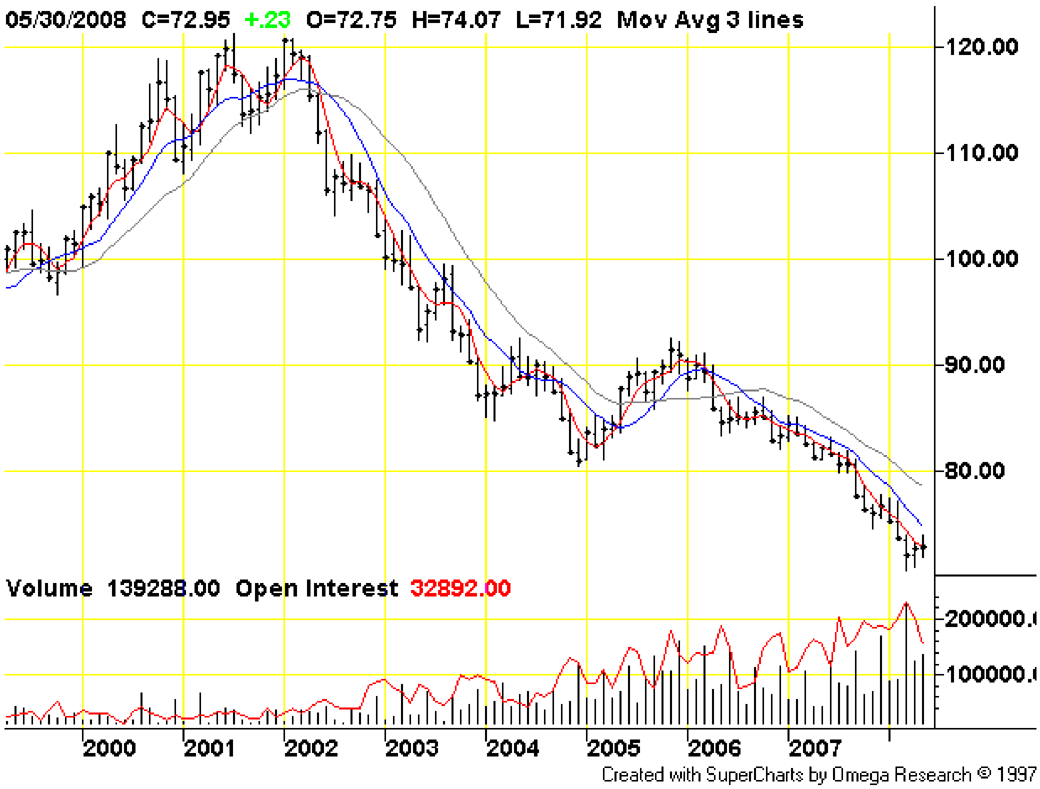
Source: Financial Times, IMF

As the supply and demand chart below shows, global barrel per day demand has been outstripping supply since the end of 2006. This imbalance of supply and demand is primarily driven by emerging markets. In April of 2008, emerging market demand exceeded U.S. demand for the first time ever. Many have argued that most of the price increase in oil is due to speculation, but in our analysis we find very little of the price increase is due to speculation. While it is true that there has been a significant increase in NYMEX crude oil futures contract activity in the past few years, most of this activity is due to commercial hedging within the chemical, transportation, and airline industries. If there was excessive long speculation in the futures market, there would have to be an offsetting build up of supply from short interest. However, we do not see this build up of supply for delivery to the excessive number of long speculators who are supposedly out there. We believe that the markets are efficient and therefore very little of the recent price increase is due to non-commercial long futures speculation.



US Dollar in Decline:

The U.S. Dollar continues to lose its value relative to other currencies, with the U.S. Dollar Index (as reported in the Wall Street Journal) losing just over 7% during 2007 and 5.5% so far this year. Dollar weakness and global demand for commodities are causing price increases in most commodity sectors. Gold gained 31% during 2007 and has already gained another 11.3% during the first half of 2008. As the U.S. economy stalls in 2008, lower rates in the U.S. relative to foreign yields should cause the dollar to weaken further.



US Dollar Index Values from 1999 to Present
Source: TradingCharts.com

Inflation Outlook:

As we research the current macroeconomic environment our view of inflation is changing. We now believe that the slowdown in developed economies may not decrease inflationary pressures as much as previously thought. More and more prominent economists and institutional investors are calling U.S. government inflation data into question. Government reports continue to paint a rosy picture of inflation, but a closer look at the details raises troubling questions. Our analysis shows that even though the government wants to strip out food and energy for their core inflation measurement, the fact remains that the average American consumer spends 18% of their income on food and energy. When the rising cost of healthcare is added into the equation, we find that the average American consumer is experiencing more inflation and loss of purchasing power than the government's core inflation data would suggest. A recent study by the PIMCO (Pacific Investment Management Company) suggests that global inflation is actually running at around 7% this year and that the U.S.

headline inflation of 4% is understated. PIMCO's Bill Gross suggests that the U.S. inflation rate is much closer to 7% than our government would like us to believe. The reason for this is that the U.S. government calculates inflation differently from the rest of the world in 3 important ways: 1) hedonic quality adjustments to factor in quality and performance improvements in products, 2) use of owner's equivalent rent instead of housing prices, 3) geometric weighting/product substitution. Hedonic quality and performance adjustments attempt to make an apples to apples comparison between products of the past and present. For instance, a $1,000 computer in the year 2000 may have been ½ as powerful as a $1,000 computer today. So the government reduces the cost of today's $1,000 computer to $500 with their hedonic adjustment. They also compute housing costs by computing what an owner's equivalent rent would be for a comparable sized house as opposed to what that house actually costs. Therefore in times of house price appreciation, if rental rates do not increase at the same pace as house prices, then inflation is understated. Finally, geometric weighting and product substitution says that if a product goes up in price a consumer will simply buy a substitute that is less expensive. If gas prices go up, people will ride their bike or walk more often. A number of prominent economists believe that these adjustments may be understating U.S. inflation by as much as 4 percentage points. Why would our government want to understate inflation? Government inflation data are used to set Social Security cost of living increases, wage bargaining agreements, Treasury bond yields, commercial real estate cap rates, and healthcare coverage rates. Therefore if inflation data were to be higher, our government's debt payments, Social Security, and Medical care program costs would increase dramatically. When we analyze money supply growth (which is currently in the 6% to 7% range for M2) it suggests that the PIMCO study is correct and our government is understating inflation by approximately 3 to 4%.

Conclusion:

As previously discussed, 2008 is a year for caution and defensive investing. At Institutional Investment Research, we see many of the world's best institutional investment professionals making defensive moves to protect their clients' portfolios. Through the Alphareturns model portfolios, we hope to provide timely research to help the individual investor make wise institutional level portfolio decisions. Our performance (since inception and so far this year) is proving the merit of our investment philosophy. We hope our research will give you peace of mind in this otherwise turbulent and challenging investment environment.

Disclaimers and Disclosures:

 This report was prepared with information from the following sources: Moody's Economy.com, Reuters, Standard & Poor's, The Financial Times, The Wall Street Journal, and the OECD.