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## Newsletter Beginning Q4 2008, October 1, 2008

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

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#### **Introduction:**

Welcome back to the Alphareturns Newsletter to open the 4th quarter of 2008 and close out a very volatile and challenging 3rd quarter. We want to preface this newsletter by saying that we love America and hope that our comments are not viewed as being un-patriotic. The analogy we like to use is one of a family where an alcoholic father gets drunk, wrecks the family car, and gets thrown in jail. The family still loves the father but hates his addiction to alcohol. With regard to our home country, we still love America but hate its addiction to debt. An old saying goes: “*liquor and leverage have caused half the world’s problems*”! While we do not believe there is anything fundamentally wrong with liquor or leverage (borrowing money), we do believe that both must be consumed with caution and moderation. So we hope our clients will read our commentary in the spirit of this analogy.

As in the 1st and 2<sup>nd</sup> quarters, global equity and credit markets experienced incredible volatility. We are now seeing a deep recession scenario unfolding before our eyes in a way that has not happened since the Great Depression. For the past year or more we have relentlessly forecast recession and a worsening of the credit crisis:

- *April 2007 Alphareturns newsletter excerpt: “One argument being floated on Wall Street is that risk can be hedged away with the use of complex investment instruments like derivatives and credit default swaps. We strongly disagree with this assumption and believe that credit spreads will widen back to historical norms as much of the debt that is being issued goes into default.”*
- *January 2008 Alphareturns newsletter warned that “Credit crisis will get worse in 2008”.*

Unfortunately for our economy, our predictions are coming true in a more pronounced way than even we imagined. Perhaps our biggest failure was allowing ourselves to be influenced by the steady stream of blind optimism coming from Washington and Wall Street instead of following our own forecast more closely. In our previous newsletter we warned of stagflation. While we are still concerned about inflation happening along with this global slowdown, we are beginning to re-

evaluate whether or not this inflation will be consumer price driven or merely currency devaluation induced. Why is this crisis shaping up to be worse than expected? The answer lies in the degree of fraud and mis-information fed to us by Wall Street Institutions and our U.S. Federal Government over the past year. Never before in my career have I seen large Wall Street Institutions and the Federal Government feed the American people such mis-information about the health of our economy and financial system. Even as recent as one month ago, we were hearing from our government officials and leaders on Wall Street that our economy had turned the corner and the worst of the housing downturn led credit crisis was behind us. Then suddenly 10 days ago we were informed that this was not true. Instead we are now told that if the government does not spend \$700 billion to buy up bad assets from the banking system we will experience another Great Depression! In our previous newsletter we operated on the data we had at the time. Our forecast was based on a U.S. economy that was turning the corner and emerging markets that were poised to benefit from re-energized exports to the U.S. Now we find that the data we were being fed by our government economic bureaus was in fact false. Housing sales and pricing data from the Office of Federal Housing Oversight were grossly optimistic, Fed data about non-performing assets on bank balance sheets was wildly optimistic, and the Fed's ability to inject liquidity into the financial system was overestimated by a wide margin. 10 days ago the mirage created by our Federal government and Wall Street evaporated. In just a couple of weeks we have seen the failure of Lehman Brothers Bank, AIG insurance (world's largest insurance company), Washington Mutual (largest U.S. bank failure so far), Wachovia Bank, and Fortis Bank in Europe. We have witnessed our Congress and Senate fight over the details of a \$700 billion bailout. Since July, an unprecedented bear market situation has deepened worldwide where global stock markets sold off another 17%, U.S. markets lost another 8%, commodities sold off 40%, and bonds lost 3%. The only asset classes holding steady this past quarter were gold and short-term treasuries. In past bear markets, there were more asset classes producing positive returns in the face of the broad market downturn. This time around, there is no place to hide except for gold and short-term treasuries because the banking crisis has impaired the bond market's ability to function properly. Normally, bonds and most commodities hold up well in a bear market for stocks. However, in a bear market caused by the bursting of a major credit bubble all asset classes sell off as institutional investors and highly leveraged banks and hedge funds sell everything to de-leverage. Investors flee to short-term treasuries and gold as the ultimate safe havens in crisis. Having said that, our portfolios have healthy exposure to gold and short-term treasuries and therefore are performing quite well relative to the broad markets. Going forward we will begin to average into certain areas of the global stock market that we feel are becoming attractive.

### **Executive Summary:**

- Year to date our Conservative, Moderate, and Aggressive Model Portfolios returned -6.03%, -11.61%, and -17.08% respectively compared to the S&P500's return of -20.67%, the Dow Industrials at -18.20%, and the MSCI-EAFE at -28.28%. Since inception January 1, 2007, our portfolios have also performed well relative to their respective benchmarks. The Conservative Model Portfolio returned 1.25% since inception vs. its benchmark of 2.53%, the Moderate Model Portfolio returned -4.81% vs. its benchmark of -6.88%, and the Aggressive Model Portfolio returned -10.79% vs. its benchmark of -15.16%. Diversification in all of our portfolios created superior performance with considerably less risk and volatility than the broad markets. Even though we are beating the broad markets by a wide margin, our portfolios are all experiencing negative total returns for the year.

Although we hope to avoid short run losses, we understand that successful investing requires a disciplined approach over the long run. We hope our clients will recognize this and judge our performance over a minimum timeframe of 3 or more years.

- Our economic forecast for 2008 and into 2009 now calls for a deeper slowdown in the US economy with GDP (gross domestic product) growth falling to 1.5% this year and 1.2% in 2009. U.S. Residential and commercial real estate markets continue to decline, as lending rates remain high. Job losses are escalating and petrol prices remain high by historical standards. Our research shows that whenever GDP growth falls below 2% for any meaningful period of time, corporate profit margins tend to be negative. In fact we are already seeing negative corporate profitability in most sectors of the U.S. economy. Only 2 sectors are expected to post positive profitability this year: basic materials and energy. With commodity prices falling recently, the energy and materials sectors may see profits evaporate as well before the year ends. Euro-zone GDP growth is also forecast to fall to 1.5% this year and 1% in 2009. Asian economies are expected to slow from 4.8% to 3.9% this year. Even though Asian growth will be relatively strong, we believe parts of Asia (ie. Japan) are currently overvalued. When Japan is excluded from the Asian GDP forecast, Asian growth ex-Japan is expected to be a point higher at 5% through 2009. Therefore, we predict a tremendous decrease in corporate profitability during 2008 and into 2009. This may drive stock markets down further as analysts are forced to cut their earnings forecasts. The renewed fear in the market recently is due to worries over the global slowdown being deeper and longer because of the crisis in credit lending. The imminent U.S. election has injected political posturing and chaos into the legislative process for passing a banking bailout plan. Forecasts of the biggest financial meltdown since the Great Depression by President Bush, Treasury Secretary Paulson, and Fed Chairman Bernanke have also rattled investors from Main Street to Wall Street. At this point we are reiterating our forecast for a U.S. recession during the second half of this year and into 2009. We also believe Europe will experience recession as well. It is too soon to tell how deep or long these recessions will last because that will be determined by government and central bank policy actions. Judging from the political turmoil surrounding the U.S. bailout plan, we believe the landscape is very unpredictable going forward.
- Perhaps the biggest change in our forecast is in the area of consumer price inflation. With the global slowdown and credit crisis deepening, we are now calling for consumer price inflation to moderate and drop over the next year. We have already seen commodity prices for metals, energy, and food drop significantly. Our prediction that emerging market demand would offset demand weakness in the U.S. and Europe was based upon our belief that U.S. and European Central Banks would be able to contain the credit crisis. Now that Congress has failed to pass the bailout plan and the crisis is spreading rapidly to Europe, we are forced to reduce our inflation forecast. This crisis is now leading to a deflationary scenario as banks, businesses, and consumers are forced to de-leverage their balance sheets.
- Again in the 3rd quarter, we witnessed further write-downs 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

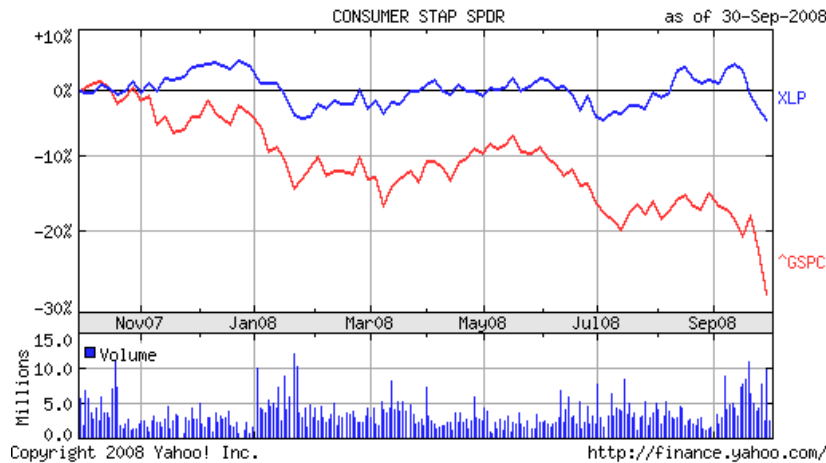
billion in mortgage related securities, \$240 billion in commercial real estate lending, \$120 billion in corporate lending, and finally \$20 billion in consumer credit. So far in this crisis, banks have written off over \$650 billion. Since our last newsletter, we have seen the failures of Fannie Mae, Freddie Mac, Indymac Bankcorp, Lehman Brothers, AIG, Washington Mutual, Wachovia, Merrill Lynch, and Fortis. Fannie, Freddie, and AIG were directly taken over by the government. Washington Mutual, Indymac, and Wachovia were shutdown by the FDIC and taken over by other banks. Merrill Lynch sold itself to Bank of America to avoid bankruptcy and Fortis was bailed out by the European Union. We believe many more banks and insurance companies will fail unless the government or the private sector intervene to clean up non-performing assets in the global financial system.

- Even with the recent sell-off in stocks, we still believe that U.S. and European broad markets will remain under pressure and may fall further as uncertainty persists. We take this position based upon the deteriorating corporate profit situation and the fact that credit market turmoil is in uncharted territory. When GDP growth slows below 2%, corporations have a very difficult time making a profit. It gets even more difficult when credit is not available on reasonable terms. Money market, commercial paper, municipal bond, corporate bond, and mortgage rate spreads above treasuries are at unprecedented levels as financial institutions refuse to lend and major bond trading firms like Lehman go bankrupt. Entire segments of the credit market are freezing up and becoming dysfunctional in this crisis. This credit contraction is producing such an abnormal situation that it is becoming extremely difficult for economists to evaluate business and economic fundamentals. It is safe to say that this is not your garden-variety bear market. Having said that, these acute market dislocations can yield significant buying opportunities for investors with medium to long-term time horizons. For instance, we believe that the municipal bond market is now in its most undervalued state ever with yields 100 basis points above comparable taxable bonds. We also believe that the Chinese and Latin American stock markets have sold off to the point that valuations are beginning to look very attractive again. Within the U.S. market we like the consumer staples sector since it has historically been recession proof. These are a few examples that we will explore further in our detailed portfolio discussion later.

#### **The Alphareturns Model Portfolios for Q4 2008:**

Because of the imminent recession and weak corporate earnings in the U.S. economy, we will make adjustments in our model portfolios to take an even more defensive posture going into Q4 2008. The table below details the model portfolio allocations we are recommending for the 4th 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 much less than the broad market (see chart below comparing the XLP to the S&P 500).



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**Consumer Staples ETF (XLP) outperforms the S&P500 (GSPC) during 2008.**

Source: Yahoo Finance

**Developed International Stocks:** We remain cautious regarding developed international stock markets due to the global recession scenario. While valuations in Europe are getting very attractive, we believe valuations may get even better as GDP growth remains in recession territory through early 2009. Q2 2008 GDP contracted by  $-0.2\%$  in the Euro-zone as consumer spending and exports fell. We expect this weakness to parallel U.S. weakness into 2009.

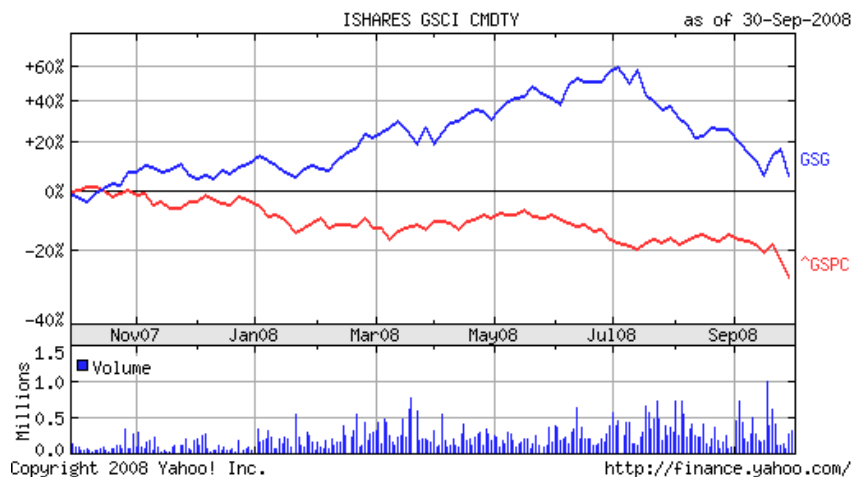
**Emerging Market Stocks:** Chinese and Latin American markets have fallen much further than U.S. and European stocks this year. These markets are now at valuation levels we believe are attractive. Latin America is currently selling at a trailing P/E ratio of 11 compared to the S&P500 at 13 even though Latin American GDP is still on pace to grow 5% this year and next. After falling close to 50% this year, China's market is selling at a P/E ratio of 13 even as its GDP is growing at 9%. Inflation is also moderating in China and Latin America such that central banks are able to keep rates unchanged. Latin American countries are better capitalized than they have ever been and China is flush with capital as well. China is actually in a position to stimulate their economy with their massive current account surplus and sovereign wealth fund. Last but not least, Chinese and Latin American banks are minimally exposed to the credit crisis currently infecting U.S. and European banks. Our portfolios are currently participating in the Latin American market with the Ishares S&P 40 Latin American Index exchange traded fund symbol ILF. To simplify the portfolio and because ILF already has a substantial exposure to Brazil, we are exiting our position in the Ishares Brazil fund symbol EWZ. For the Chinese market, we will participate through the Ishares FTSE/China 25 Index Fund symbol FXI. This fund tracks the 25 largest Chinese stocks via the FTSE China 25 Index. The FXI fund's largest holdings are in Telecommunications, Financial Services, and Energy with companies like China Mobile, Bank of China, and China Petroleum and Chemical.

**Fixed Income:** As forecast in our previous newsletters, the credit crunch and re-pricing of risk have caused a steeper yield curve. We now believe the U.S. Federal Reserve will lower rates again to fight the weakness in the economy. Therefore we are still recommending the Ishares short-term 1 to 3 year duration U.S. Treasuries symbol SHY exchange-traded fund as a safe haven. In addition to the SHY short-term treasury allocation, we are changing our bond allocation by adding the

Ishares National Municipal Bond fund symbol MUB, 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.

**Metals and Mining Stocks:** The US dollar index as reported in the Wall Street Journal has reversed its decline, erased its losses, and actually gained 0.3% year to date. How can this happen in the face of mounting deficits, slowing U.S. growth, and government bailouts? Flight to quality has caused international investors to flock to short-term U.S. treasuries and gold during the gut wrenching turmoil of the last few months. This increased demand for short-term treasuries has boosted the dollar temporarily in a much bigger way than we expected. We also see increased interest in gold as a reserve asset for central banks in the Middle East, Asia, and Russia. In this bear market crisis, short-term treasuries and gold have been the best hedges against inflation and stock market turmoil. So what about other precious metals and industrial metals? Other metals have performed very poorly as the reality of a deep global downturn and the flight to dollar denominated treasuries materialized. Over the past quarter, the strong dollar and the fear of demand destruction due to global weakness have forced dramatic declines in almost all commodities except for gold. Given the new outlook for a deeper global downturn, we will exit our metals and mining position and retain a position in gold until the U.S. and European economies get past this downturn.

**Natural Resources:** Because of the same issues mentioned above with regard to recent dollar strength and global commodity demand weakness, we will reduce our exposure to energy and natural resource commodities. Even though we forecast OPEC to adjust production in an attempt to keep crude oil above \$100 per barrel, we still have concerns about deteriorating global demand as conditions in the U.S. and Europe become worse than previously forecast. We now believe that the decrease in demand for oil and natural gas due to a more severe global slowdown will offset OPEC's influence and the effect of a weak dollar. Oil's upward momentum has changed and will probably not resume until global growth picks up again. Because of this change in forecast, we will exit our position in the Ishares Natural Resources fund symbol IGE. The IGE fund is heavily exposed to oil. To achieve a broad diversification in this sector we will continue with a small allocation to the Ishares GSCI Commodity index fund (symbol GSG). The GSCI index currently tracks 24 different commodities. The index is production weighted to reflect the relative significance of those commodities to the world economy.



**GSCI Commodity index fund (GSG) outperforms the S&P500 (GSPC) during the past year.**

Source: Yahoo Finance

**Alphareturns Model Portfolio Allocations For Q4 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%	18%	28%
ILF	Latin America S&P 40 ETF	2%	5%	8%
FXI	China FTSE 25 Index ETF	3%	6%	9%
SHY	1 to 3 year US Treasury ETF	50%	40%	30%
GSG	GSSI Commodity Index ETF	2%	4%	6%
BWX	Int'l Treasury Bond ETF	8%	6%	4%
GLD	Gold Bullion ETF	5%	4%	3%
MUB	National Municipal Bond Index ETF	22%	17%	12%

**Q3 2008 Performance Discussion:**

During Q3 2008 our model portfolios outperformed their respective benchmarks and the broad markets. Year to date our Conservative, Moderate, and Aggressive Model Portfolios returned -6.03%, -11.61%, and -17.08% respectively compared to the S&P500's return of -20.67%, the Dow Industrials at -18.20%, and the MSCI-EAFE at -28.28%. Since inception January 1, 2007, our portfolios have performed well relative to their respective benchmarks. The Conservative Model Portfolio returned 1.25% since inception vs. its benchmark of 2.53%, the Moderate Model Portfolio returned -4.81% vs. its benchmark of -6.88%, and the Aggressive Model Portfolio returned -10.79% vs. its benchmark of -15.16%. Our portfolios would have performed much better if we had been less exposed to commodities. When sentiment changed regarding the depth and severity of the credit crisis and its implications for a deeper global slowdown, commodity prices reversed course and fell by over 40% in just 2 months. Commodities are historically very volatile due to thin trading volumes and speculative volatility from the commodity futures market. We knew this going in to our positions last quarter, but in hindsight we should have kept our commodity exposure lower. Commodities are an important hedge against inflation and an essential portfolio diversifier. However, they are best used in small doses. Going forward we will try to have our portfolios less exposed to the volatility of commodities.

Alphareturns Model Portfolios →	Conservative Risk 1 to 3 year horizon	Moderate Risk 4 to 7 year horizon	Aggressive Risk 7 + year horizon
YTD 2008	-6.03%	-11.61%	-17.08%
Since inception 01/01/07	1.25%	-4.81%	-10.79%
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	-3.71%	-13.79%	-21.91%
Since inception 01/01/07	2.53%	-6.88%	-15.16%

*\*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*

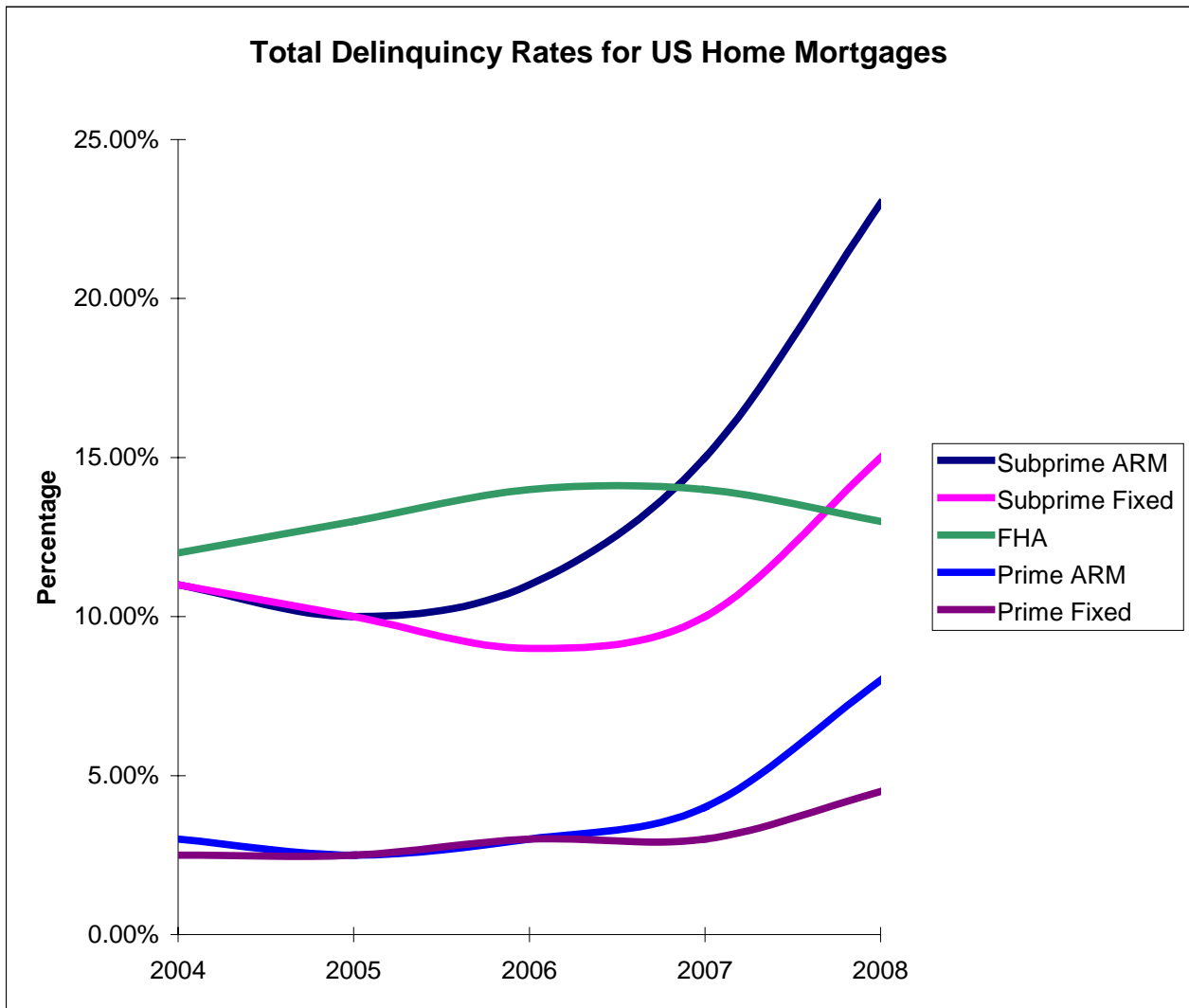
*a global all-stock index. Investors can identify an appropriate benchmark as the index that has the most similar historic risk characteristics. Stock exposure will typically range from 20% in the conservative portfolio up to 100% in the aggressive portfolio. See [www.djindexes.com/mdsidx/portfolio/index.cfm?event=showPortfolioGlobalRelativeRisk](http://www.djindexes.com/mdsidx/portfolio/index.cfm?event=showPortfolioGlobalRelativeRisk) for more information.* Copyright © 2008 Dow Jones & Company. All Rights Reserved

### **Detailed Global Economic Analysis and Outlook:**

During Q3 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. After Lehman and AIG failed, Treasury Secretary Paulson and Fed Chairman Bernanke announced a \$700 billion plan to buy troubled assets from banks and resell these assets over a long period of time much as the Resolution Trust Corporation did during the Savings and Loan Crisis of 1989. Paulson and Bernanke testified before Congress that this plan was necessary to avert a Great Depression style financial system meltdown. After deliberating on the plan for 10 days, Congress put a modified plan to vote on Monday September 29<sup>th</sup>. The plan was voted down by a narrow margin as partisan divisions over the amount of money involved and the lack of taxpayer protection surfaced. House Republicans and a number of House Democrats believed the plan as presented did not give taxpayers the ability to recoup the cost and make a profit in the future as banks emerged from the crisis. They wanted banks to give up more stock warrants and limit executive compensation in return for the bailout. Another feature they wanted was a comprehensive FDIC-like insurance program to insure taxpayers against future bailouts. The plan is up for re-negotiation and a re-vote later. After the plan failed, the Dow lost 777 points, its largest one-day loss since the 1987 crash.

### **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 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. In August existing home sales fell another 2.2% and new home sales fell 11.5%. The decline in new home sales was the largest one-month decline on record and is the slowest pace of new construction in 17 years. The median national home price declined a record 9.5% to \$203,100. The average price of a new home declined 11.6% in August to \$263,900 as builders slashed prices to attract buyers. As sales continue to decline, inventories remain high across the nation and especially in overbuilt states such as California, Nevada, Arizona, and Florida. Large declines in the value of residential housing are causing a surge in foreclosures for all types of mortgages. In many cases, even homeowners who are not in the sub-prime category owe more on their mortgage than their home is worth and are walking away and leaving their home in the hands of the lender. Even though this hurts their credit, these prime borrowers are not willing to keep paying an overvalued mortgage on an overvalued home. With regard to commercial real estate, we are seeing a severe contraction there as well due to very tight lending conditions. With job losses mounting in the global economy we are cautious with regard to commercial vacancy rates. Even though yields on REITs (Real Estate Investment Trusts) look attractive at the moment, commercial real estate is likely to remain under pressure through 2009 and those dividends may be reduced if the economic downturn gets deeper.

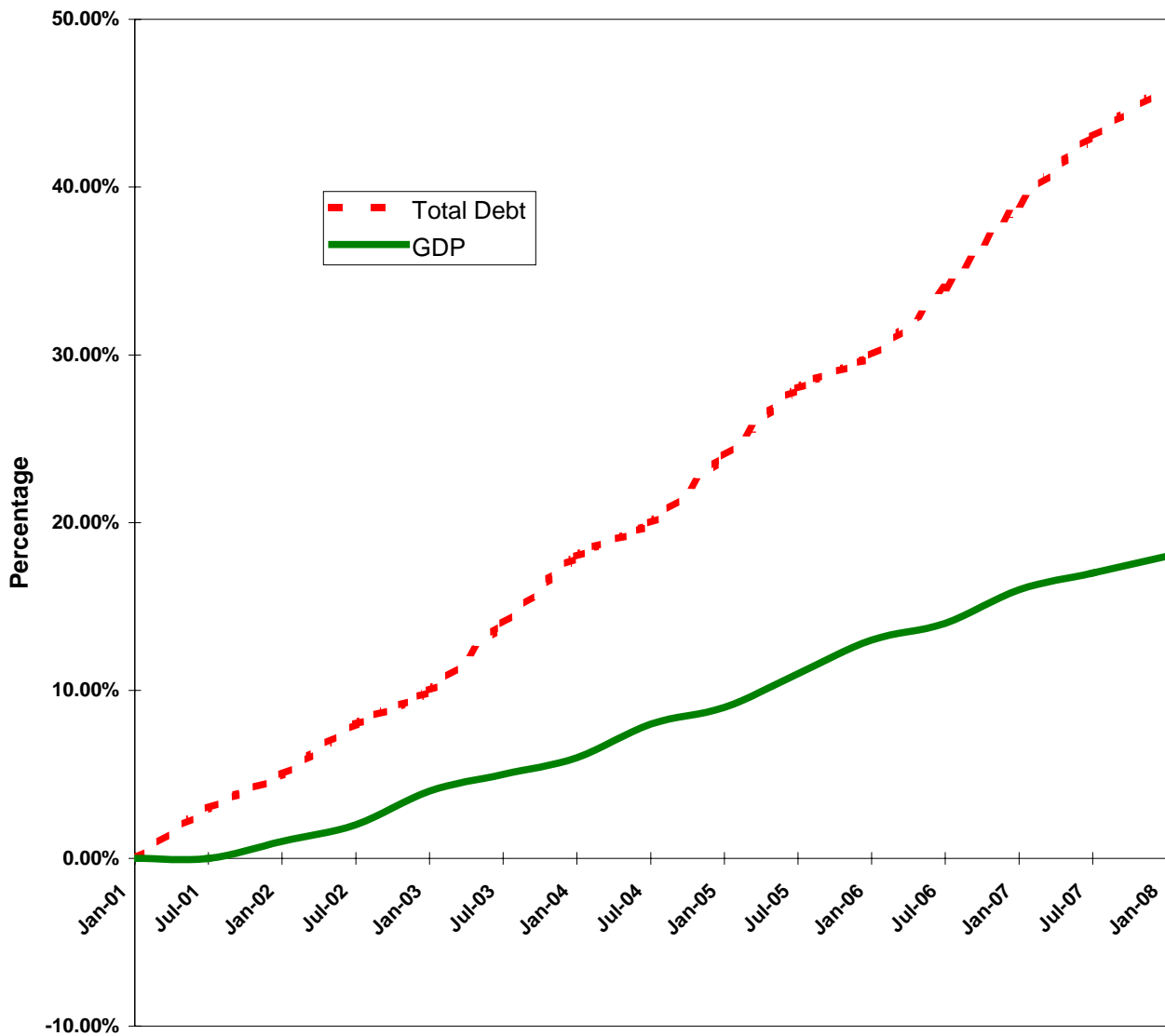


Source: Mortgage Bankers Association and Wall Street Journal

**Global Credit Crisis Continues to Get Worse:**

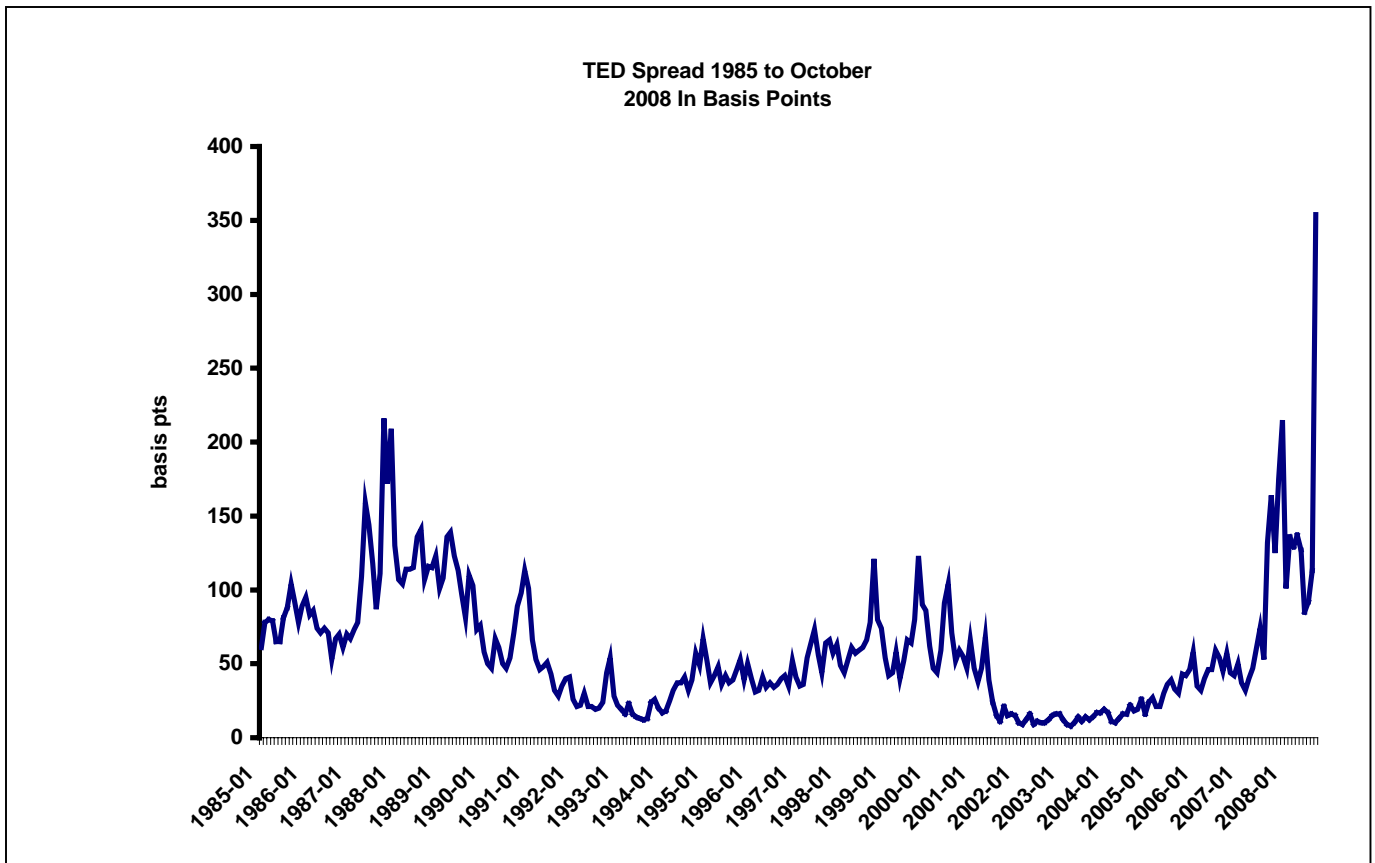
As we have predicted for the past 2 years, the global credit bubble has now run its course and is unwinding in a very painful way. Since the Federal Reserve reduced rates to 1% after the 9/11 attack and the tech bubble, this credit bubble has been the main driver of economic growth. The Federal Reserve has released recent data that suggest aggressive debt expansion may be responsible for a majority of our economic growth since 2001 (see chart below). Since 2001, the U.S. economy has needed approximately \$3 of debt to create \$1 of GDP growth. 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 deflating rapidly as debt markets re-price risk and the financial sector deals with defaults and foreclosures.

## Inflation Adjusted U.S. Debt Growth Versus Economic Growth



Source: Federal Reserve

As discussed in previous newsletters, one of the best indicators of stress in the world's financial system is the TED spread. The TED spread measures the spread in basis points between short-term Treasury yield and the short-term Eurodollar LIBOR yield. In the past few weeks as Lehman and AIG failed and the U.S. bailout plan was proposed, the TED spread increased to the highest levels on record. The TED spread is still elevated to levels exceeding spreads experienced during the 9/11 attack, the 1987 market crash, the Iraq wars, and the Asian currency crisis of 1998 (see TED spread chart).



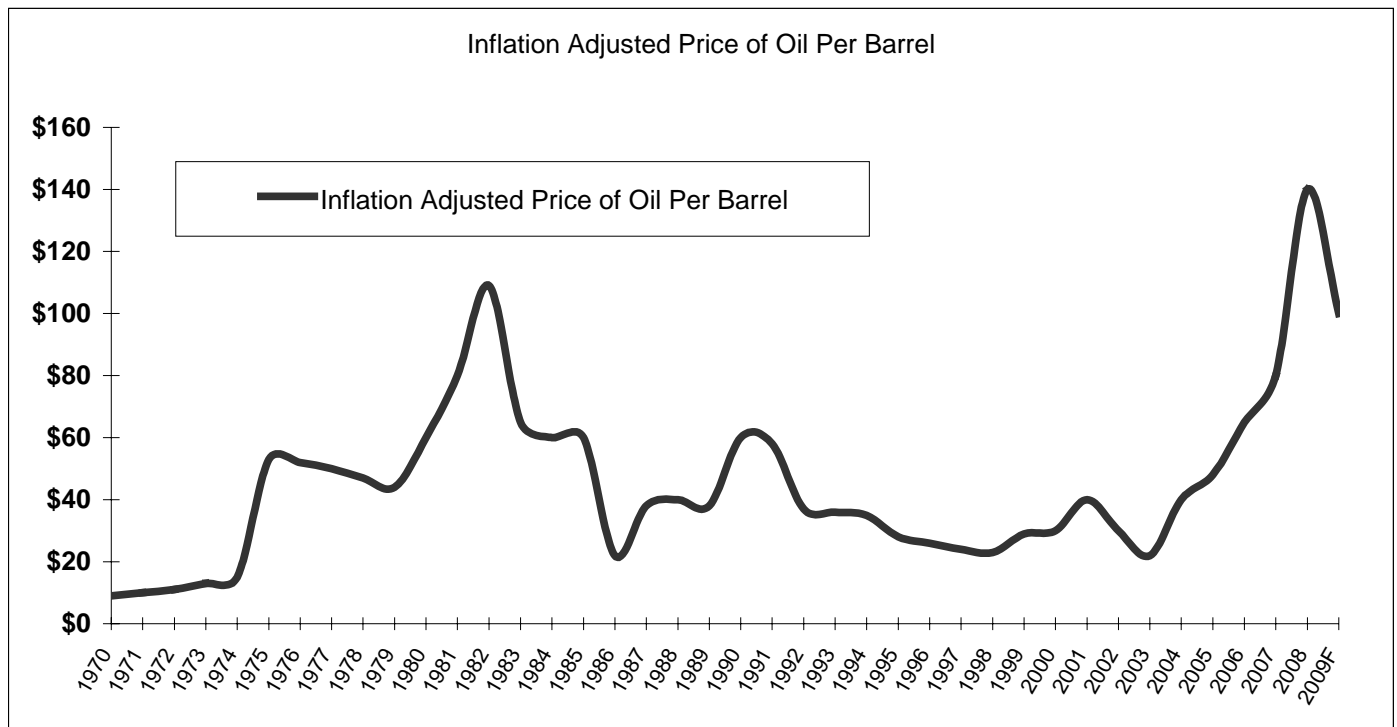
Source: Bloomberg

**What are relative global market valuations at this time?**

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 earlier, we continue to be bearish on the broad markets and only bullish on the U.S. consumer staples sector and emerging markets like Latin America and China. The reason for our bearish posture is our forecast for corporate profit deterioration in the U.S. and Euro-zone during 2009. Even though the S&P500 trades at around 13 times forward 12 month earnings and this sounds like a reasonable valuation, we have to understand that this is based on a forecast of 26% positive earnings growth in 2009 as reported by Thomson Reuters. 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 U.S. economic conditions deteriorating rapidly, 2009 S&P500 earnings growth of +26% looks highly unlikely. As mentioned in previous newsletters, we believe Wall Street analysts are usually too optimistic with regard to earnings forecasts. As far as the rest of the world goes, we see 2009 forward P/E ratios of 9 for Europe, and 10 for Emerging Markets at current price levels. Even though European valuations look attractive, we are concerned about weak GDP growth there through 2009. We forecast the Emerging Market economies of China and Latin America to have GDP growth of 9% and 5% respectively during 2009 therefore supporting profitability in those regions. The move to invest a small portion into China and Latin America is based on our forecast for relatively strong GDP growth in 2009 and attractive valuations.

## **Oil and Energy:**

Since our last newsletter, oil has fallen dramatically from a high of \$147 per barrel to just under \$100. The growing likelihood of a deeper, longer global recession centered in the U.S. and Europe has focused attention on the prospect of a significant decline in demand going forward. So far emerging markets are picking up some of the slack, but the consensus forecast is for significantly weaker global demand in 2009. OPEC cut production in early September and announced that it will try to cut production further if necessary to keep the price at or near \$100 per barrel. At this point we expect oil to trade between \$80 and \$105 per barrel during 2009. If recession spreads to Emerging Market economies and proves to be deeper in the U.S. and Europe than we are forecasting, perhaps oil could fall back into the \$50 to \$80 range. 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.

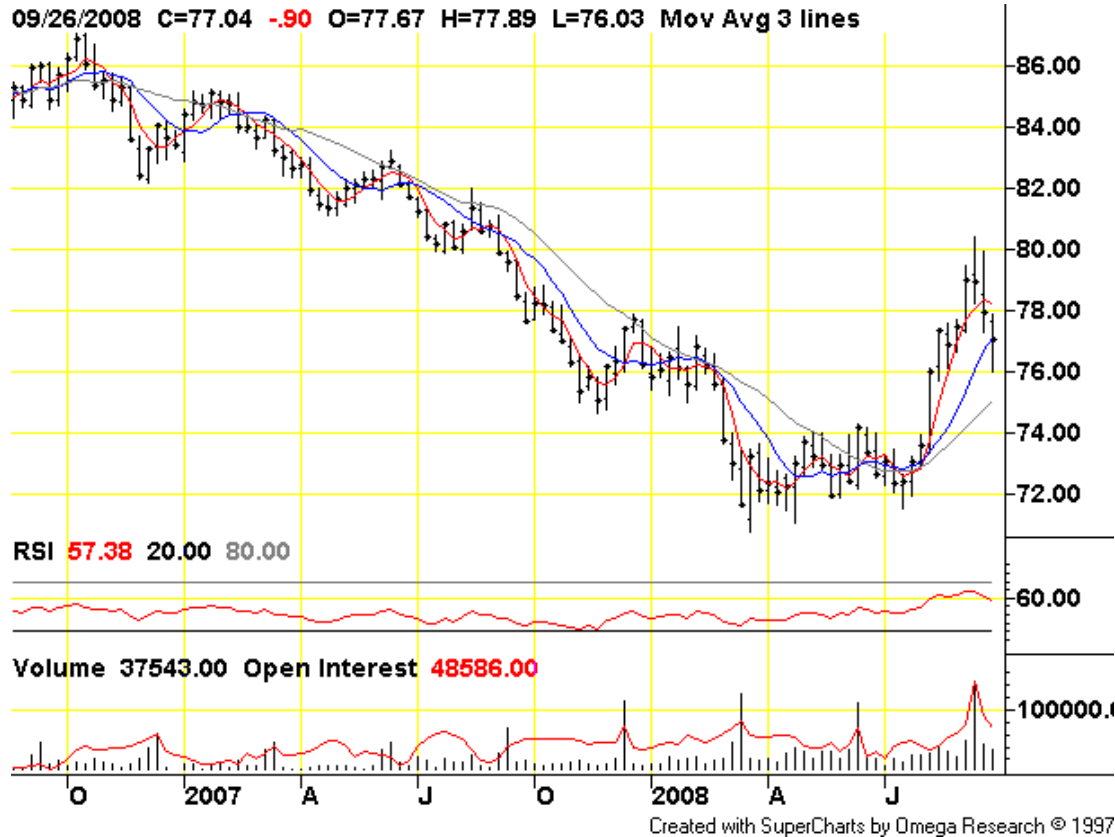


Source: Financial Times, IMF

## **US Dollar:**

The U.S. Dollar has made a surprising recovery over the past 2 months, with the U.S. Dollar Index (as reported in the Wall Street Journal) gaining just over 0.3% during so far this year. Most of this recent strength is due to a flight to quality as foreign investors flock to U.S. treasuries to escape global stock market turmoil. We expect that an imminent U.S. rate cut, unprecedented deficit spending to bailout banks, and a deep recession will cause the dollar to resume its downward

trajectory sometime in mid-2009. However, for the next few months we would not be surprised to see the dollar stay strong as this flight to quality continues.



US Dollar Index Values from 2007 to Present

Source: TradingCharts.com

### **Inflation Outlook:**

We now believe that the slowdown in developed economies will sufficiently moderate consumer price inflation for the rest of 2008 and most of 2009. This is a bit different from our previous inflation forecast. While we still believe that U.S. government data is understating inflation, it may be a moot point now as the U.S. and Europe slow to a crawl and slide into recession. We are reducing the inflation protection components (*gold and commodities*) in our portfolios due to our current belief that this credit crisis will cause a deeper recession in developed economies than we previously thought. These strong recessionary forces should moderate and reduce consumer price inflation as economic activity slows severely in the world's largest economies. We will keep a close eye on inflation, but for now our concerns have eased regarding the threat of consumer price inflation. Having said that, we still believe that when this credit crisis induced economic slowdown passes; the global economy may experience a sharp uptick in inflation. The huge increase in money supply and liquidity that is being thrown at this situation will most likely cause inflation and currency devaluation down the road.

**Conclusion:**

As previously discussed, 2008 is a year for caution and defensive investing. Going forward we are reducing exposure to commodities because we believe inflation is moderating and the near term concern is a deeper, deflationary, recession in the U.S. and Europe. We are also taking the opportunity to invest a small percentage in China and Latin America as those economies appear to be stronger than most, attractively valued, and less exposed to the global credit crisis. 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.

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