

January 7, 2009



Clients,

This letter is to provide interpretation to your specific and my overall performance reports that are enclosed. How do I make sense out of what has happened in our economy and the markets, and what will happen? I will start with some big picture thinking, since price changes have been far beyond the scope of what fundamental, technical or statistical analysis of specific positions and histories would have anticipated. Therefore my focus has turned much more to trying to understand macro-economic and larger market dynamics.

The Big Picture

Government activity in economic affairs occurs primarily at the three levels of monetary, fiscal and regulatory interventions. My understanding is that the current economic collapse occurred primarily because of lax regulation of derivatives such as Credit Default Swaps (CDS).

The restoration and efficient functioning of the world economy will require a new world-wide level of regulating the world's interconnected economic institutions. The United States taxpayers bailed out A.I.G., the huge insurance conglomerate, to the tune of \$150 billion dollars or some humongous figure. Insurance is regulated by all 50 states. Where was the problem? The problem was in the Credit Default Swaps that operated out of London – London because of the lax regulatory environment. Who or what will oversee global economics and business organizations?

The New Deal brought a national governmental intervention to a scene where fragmented state actions were ineffective against the failures of business and economic organizations integrated at a national level. Today, business and economies are global, but we are without a comparable global political structure to introduce the safeguards necessary to get the orders flowing again and the economic game of musical chairs to proceed.

At the monetary level, I understand that the world's central bankers form a pretty tight and cohesive group. Money supply is coming out of the woodwork. Except for Germany and Japan, most countries are responding with fiscal stimulus as well. The greatest challenge is to create a global regulatory environment that provides transparency and security in contracts, and to deal with global issues such as climate. There is no going back to a protectionist national economy. For a few colonies to form a United States, or for some European countries to create a common market and common currency, represents only the beginnings of an arduous process needed for global economic collaboration. (For more on this, read this month's *The American Prospect* at www.prospect.org.)

Optimists and Pessimists

I continue to be amazed at how some economists and press find all kinds of data to support a very pessimistic view, and others find all kinds of charts to support an optimistic view. For balance, I try to find the best of both sides, although I must confess that I can't read housing guru Gary Schiller's *Insight* in one sitting. I think if he didn't have such a perverse pride in being so negative, he would be at risk of suicide halfway through writing his newsletter. The TARP legislative process probably did more harm to sentiment than the money will do constructively. The Star Tribune had a recent article about investors "fleeing" the market. How many left? Three percent.

On every significant question, I find respected experts on both sides of the answer. I'm not sure if they develop products to support their perspectives, or the products were developed in response to their take on the world. Even James Paulsen of WellsCap Management, whose newsletter I regard highly, is there to promote people placing and keeping money with the Wells Fargo organization.

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The Relevant Questions

So what are the significant questions and what answers are most dependable ?

Do we have a bubble in Treasuries? If so, when will it burst? Yields have come down and bond prices have gone up dramatically. Yields can only come down so far, and the chances of them staying down are remote. When should we go back to TBT, the ProShares UltraShort of the 20+ year US Treasury?

Will the lead come from commodities and emerging markets or from domestic equities and banks?

What will happen to the dollar?

Are we looking at a market moving up, down or sideways?

Replies

Fortunately, it is not my responsibility to solve the world's problems. All I have to do is make the lines on our charts go back up. If I can have a sense of how things evolve, I can adapt and capitalize on what takes place.

One factor arguing for a faster rebound than is typical of downturns is the integration of supply management. Suppliers today have online access to the detailed needs of their customers, and have responsibility to supply Just In Time. The result is more responsive production volumes and variation, along with shorter cycles since there is less inventory accumulation. The commodity purchasing was shutoff very quickly, and may just as quickly be back in demand. The resurgence of commodity demand may be especially true because of governments doing stimulus spending rather than relying upon consumer demand.

We are probably facing a lateral market with considerable volatility within a range-bound market. How does one capitalize on a market that bounces around but goes nowhere? One option is buy high and sell low within the daily and weekly market gyrations. While not necessarily easy or reliable, this can be done using technical analysis, sentiment newsletters (Sentimentrader.com), and neural nets. Trading is probably best done with ultra or leveraged ETFs to extend the volatility and gain/loss potential. It means having fewer positions and going in and out more frequently, while maintaining long-term positions relegated to riding out the storm.

A second option in a range-bound market is to try to find positions that do not correlate with the market and escape the range-bound parameters. While 2008 was the year of systemic risk with almost everything correlated in going down, 2009 will more likely be the year of specific risk. We will see more bankruptcies as business problems catch up with some firms. On the other hand, many of the strong will thrive. While the markets as a whole may move laterally with some volatility on the way, specific stocks will likely soar. It is not a time for buy and hold.

The third option is to sell calls above the range and puts below the range (an options collar). I have hired a money manger (not necessarily a bad idea) to do this for me with commodities futures. He did very well at first, then things went down abruptly. I have left him to dig himself out of the hole, and over the last six months or so he is up about 50%. Your money manager also has to dig himself out of a hole, which I'm confident will happen, but I don't see it happening with options and collars.

My main lesson of the last six months is to trust the data and the trends more than the theories and perspectives. While I will seek out illuminating perspectives, it is one step at a time and work not to be seduced by beguiling views as to what will or should happen. As your portfolios attest, I still believe the greatest potential is with energy, basic materials and commodity related companies. But when the trend goes against us, I will be quicker to sell and look to come back another day.

Thanks.

Lee