4TH QUARTER 2008 COMMENTARY
Prepared January 3, 2009

Bear Market Scorecard. The bear market that began in October 2007 accelerated in intensity during the 3rd and 4th quarters of 2008, with most major stock market averages showing declines of approximately 50% off the prior bull market highs reached in October 2007. The late December rally mitigated the decline in the major market averages with the year's decline in the Dow Jones Industrial Average being 34% and the S&P 500 falling 38%. This bear's declines now match or exceed those declines reached in the 1973-1974 and 2000-2003 bear markets and officially places this bear market as the second-most severe in history, only trailing the 1929-1932 debacle. The declines of October and early November 2008 indicate the degree of downside intensity typically found during the mature stages of bear markets. Below is a snapshot of key technical and fundamental market cycle indicators. My own personal opinion is that the bear cycle is in the process of reaching its full maturity. Any market declines in the next few months could be used to build positions in the most oversold sectors including energy, technology, small cap stocks, and emerging markets. An additional theme for 2009 is that I would sell short long-dated treasury bonds in anticipation of a bursting of the current bubble in treasury securities (see commentary below).

TECHNICAL, SENTIMENT, FUNDAMENTAL INDICATORS

Investor Sentiment (AAII Intelligence, Investors Intelligence Poll data): Extreme bearish readings for months. **Conclusion - bullish**.

McClellan Summation Index: October's extreme reading reached at -4000 is seldom reached. It could take several months of stock market rally to work off this extreme oversold reading. **Conclusion – bullish**.

Lowry's Sentiment: super-oversold readings reached in: spread between buying power/ selling power indices, average stock power rating, moving average of short-term index, number of stocks over 10-day moving average. **Conclusion – bullish**.

Rydex Sentiment (bearish to bullish positions): reached super oversold reading of 1.5. **Conclusion – bullish**.

Arms Index (Measure of Selling Intensity): Reached rare extreme oversold levels comparable to lows reached during 1987 crash and 1997 bottom is indicative of exhaustion of selling pressure. **Conclusion – bullish**.

Initial Public Offerings: Initial public offerings have completely vanished, similar to the disappearance of IPOs at the end of the 1973-1974 bear market. **Conclusion – bullish**.

Monetary and Fiscal Policy: On an unprecedented scale, the government is throwing everything but the kitchen sink at the country's economic problems. Aggressive monetary and fiscal policy is a positive for the market. **Conclusion – bullish**..

Fundamental Backdrop: To have a sustainable market bottom, it is required that the economy bottom out either concurrent with the market or within a number of months following a market bottom. Economic conditions are declining quite rapidly as of the date of this writing. It is this uncertainty and inability to judge the whereabouts of the bottom of the recession that argues against an aggressive "all-in" approach to the market at this time. **Conclusion – inconclusive/bearish**.

Valuations: I would note that stocks had not gone to the level of extreme over-valuation at last October's top that had occurred at the bull market top in early 2000. So the current bear decline began from point of only modest over-valuation, certainly not a valuation bubble as was the case at the year-2000 bull market top. Therefore, with the market's top-tic to bottom-tic 50% decline, valuations have arguably overshot to the downside**. Conclusion – bullish**.

Duration and Extent of Bear Market Damage: Fifteen bear markets since the 1920s have averaged 17 months in duration. The current bear cycle which began in October 2007 is 15 months old. The average bear market decline for the 15 bear cycles was 32.9%. From top price in October 2007 to bottom price in November 2008, the S&P 500 dropped 52%. **Conclusion – turning bullish.**

Capitulation: In my 2nd Quarter 2008 Commentary I noted that the final stage of investor "give-up and capitulation" had not yet occurred. This critical pre-requisite of a stock market bottom has now occurred in spades with the retail investor having thrown in the towel, and as evidenced by heavy mutual and hedge fund redemptions. **Conclusion – bullish**.

Prominence of Bearish Sentiment: Bob Pisani (CNBC commentator) on Nov. 10th - "there's still no compelling reason to own stocks long-term"……Michael Moore on Nov. 20th – "this is the end of capitalism as we know it. And good riddance"……Various commentators (late Sept.) – "It is the end of the world as we know it"; "it's just bad news, bad news"; "high odds of imminent depression"……Page one of The Wall Street Journal on Dec. 29th – article about Russian economist, Igor Panarin, that predicts end of the United States by 2010 and civil war/ split-up of the US into 6 provinces……the New York Times best seller list includes the following: "The Return of Depression Economics and the Crisis of 2008 (Krugman)", crisis oriented book "The Ascent of Money: A Financial History of the World (Ferguson), "The Story of Modern Financial Insanity (Lewis)". You could always find bearish sentiment; after all I'm sure the Russian economist has *always* believed in the downfall of the US. So that's not new news. The significance of this super-bearish sentiment is that it is finding its way to prominent places in American culture, phenomena typically found at major stock market bottoms. **Conclusion: bullish**.

Preponderance of Sharp Rallies: The "spiky" looking 300+ point one-day rallies that have been occurring with great frequency in the past couple of months are symptomatic of bear market rallies and not bull market behavior. It is interesting to note that the current bear trend has seen more than 15 one-day rallies of more than 300 points. I note that the bull trend of 2003-2007 did not include one rally of more than 300 points. Bull markets climb in a more steady, relentless way and tend not to include sharp price spikes. This makes sense because bull markets eat up more than twice the amount of time than bear trends, so the angle of ascent in market averages tend to be less dramatic but covers a more extended period of time. The continued appearance of 300+ point one-day rallies is a bearish phenomenon. I would prefer to see the market calm down and base for a number of months before the next up-leg begins. I note that prior to the 2003 upleg that began in March 2003, the market bottomed a full five months prior, in October 2002. **Conclusion – bearish**.

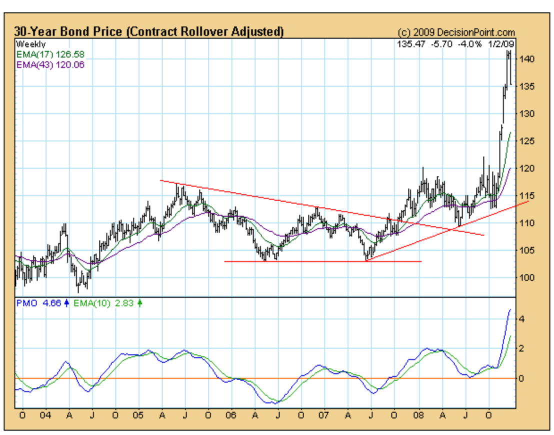
News Containment: While the fundamental news has been bad and getting worse on a near daily basis, recent market declines have neither carried very far, nor carried the averages to new lows, indicating that the market is beginning to contain bad news. **Conclusion – bullish**.

Market Internals: The advance-decline line has turned up modestly since early November and the number of stocks making new 52-week lows have been shrinking even on down days. Evidence of new bull market would include an "explosion" in the advance-decline line, which has not yet occurred. **Conclusion – conditions improving, but not overwhelmingly bullish.**

The Case for Higher Oil Prices. In my mid-year commentary I made the case for sharply lower oil prices in recognition of a parabolic move in price that topped out late in the second quarter 2008 at $147 per barrel. The price decline has come and gone and brought prices down far in excess of my expectations to a current price of about $40 per barrel. In the words of the great sportscaster Mel Allen – "Holy Cow!" The focus on circumstances that led to the decline – falling economic activity and demand destruction, have now shifted to factors affecting withdrawal of supply from the marketplace. With the price of oil having dropped to levels not seen for 4 years, supply sources across the globe are rapidly disappearing as OPEC cuts output, the world's largest oil fields experience natural production declines, new production projects are being delayed due to negative economics or lack of financing, and existing production projects are being curtailed as the cost of producing the hard-to-get-to oil now exceeds its market price. Just as this summer's price spike to $147 per barrel was an overshoot to the upside, the subsequent decline to below $40 per barrel is likewise an overshoot to the downside. A revival of economic activity combined with supply withdrawal could result in price spikes at some point in 2009. This would ultimately be super-bullish for energy companies whose profitability heavily depends on the price of oil, such as the Canadian Energy Trusts.

Speaking of energy, my wife Barb, yours truly and brother-in-law, Dave visited the world's largest wind farm facilities in Sweetwater, Texas this fall. To the right we are pictured along with contingents from the highly competent staffs of Luminant (Texas power generation utility) and E.ON Corporation (wind farm management company). We spent a full day with these experts who educated us on the wind power industry. Currently, electricity generated from wind power comprises about 2% of US electricity generation with future capability maxing out at 12-15%. The movement to wind power is currently slowing down due to financing constraints for the turbines that cost in excess of $1.5 million each, and the recent decline in energy prices that temporarily make electricity generated from wind power less economical. My takeaway from the experience is that wind is one component of the eventual movement toward complete energy independence, but there is no one overwhelming answer to the energy problem.

US Treasury Bond Bubble in Process.



The chart on the left represents a parabolic (defined as an uninterrupted and accelerated price movement) price blowoff in the US Treasury's 30-year bond. Parabolics, rare price patterns, usually end the same way – it's just a matter of time when the parabolic move becomes exhausted and collapses under its own weight. Other recent collapses in parabolic moves include the sharp reversals in the Chinese and emerging markets in early 2008 and the price of oil in Q3 2008. I note that the 20 point move in the "Long Bond" since Mid-November has been nearly straight-up with up "gap" openings on 4 specific days.

The chart to the right represents the yield of the US Treasury 30-yr. Long bond since 1948. The years 1960 to 1966 saw the yield "base" in the neighborhood of 4% which preceded a bond market bear cycle of nearly 20 years that culminated with a topping out in the rate at 14% in 1981. Since 1981, the bond market has been in an uninterrupted bull. The recent price spike has drive the yield down to 2.7% as of yearend, a level last seen when Elvis Presley recorded his first song. Fundamentally, in recognition of multiple trillions of dollars of monetary and fiscal stimulation being injected into the system, it is difficult to envision a continued bullish outcome for long-dated US Treasury securities.

Late Notes: The last trading day of 2008 and the first trading day of 2009 saw the price of the US Treasury 30 yr. bond trade "limit down" (3 full points) on each day. This is a rare event and the severity of the price break signals the beginning of the bursting of the bubble in US long-dated treasury bonds, in my opinion……the stock market rallied strongly in the last few trading sessions of 2008 and the first day of 2009 into an extreme overbought condition, arguing for a pullback in the near-term. A pullback or sideways move as the market's overbought technical condition is worked off would be a bullish event for the market in the months ahead; on the other hand, a sharp break in prices would indicate the maturing bear cycle is still in force. I think we're at an especially important juncture.

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HAPPY HOLIDAYS!!

JOHN HEGLER
21ST CENTURY EQUITY ADVISORS CORPORATION

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