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A Review of Recent VKRA Commentary

We make a regular practice of reviewing other analysts' records in order to assess their past accuracy. This series of our complete online comments since March 1st enables the reader to subject our own recent forecasts to the same discipline.

The following chart is of the S&P500, along with indications of the timing of the notes below.



A: Nearing a bottom?

Monday, March 10th, 2008 at 7:28 PM

Today's decline showed preliminary signs of potentially nearing a turnaround point. One indication was that energy shares declined sharply, even though crude oil prices simultaneously rose over \$2 to a new record high at nearly \$108 per barrel. Under such circumstances, weakness in energy shares may have resulted from forced liquidation. That is, some investors may have had to unload their more liquid positions (e.g., energy shares) in order to repay margin debt or to reduce equity exposure due to excessive losses.

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B: An elusive bottom

Wednesday, March 19th, 2008 at 7:19 PM

After stocks rallied sharply yesterday, thanks to better than expected results from Lehman Brothers and Goldman Sachs -- and a large interest rate reduction from the Fed -- equity markets appeared ready to begin a sizable intermediate term advance. Instead, shares sold off sharply today. Many of our favored sectors -- energy, natural resources and emerging markets -- were especially hard hit.

Could the U.S. mortgage and banking crisis slow world growth sufficiently to impede the heretofore unstoppable advances of China, India, Brazil and other emerging economies? Until recently, we had not thought such an outcome likely. Now we are not so sure.

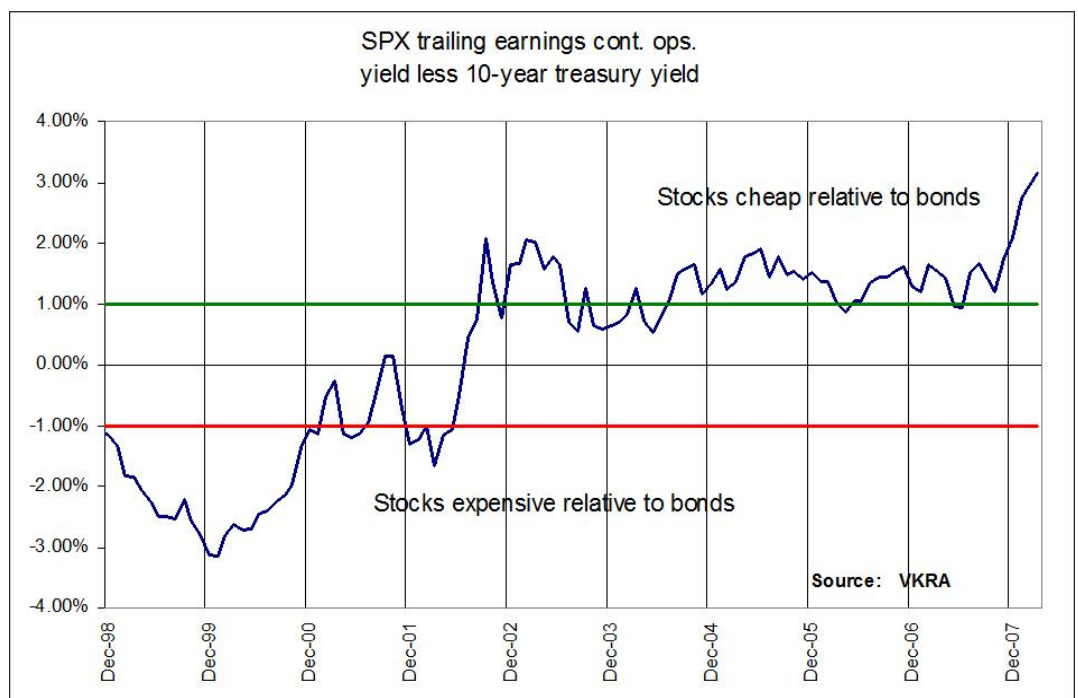
Lurking in the background are our concerns about domestic political trends, which could lead to substantial tax increases (particularly on capital gains and dividends) and to less than full-throated support for free trade.

Over the next few days we will conduct another in a series of reviews of the longer term investment outlook. Once we have finished the latest review process, we will post a summary of our conclusions.

C: Stocks represent excellent value at current levels

Thursday, March 20th, 2008 at 2:40 PM

Good value does not always lead to a market bottom, but it is certainly one of the components that we consider when deciding what our equity exposure should be. We will have more to say over the weekend, but the chart below suggests that, should the Fed successfully contain the U.S. financial crisis, stocks are considerably less expensive compared with bonds than they have been during the past decade. The chart below shows the difference over time between the yield on 10-year treasuries and the earnings yield (which we define as the fully diluted trailing earnings from operations divided by price) of the Standard & Poor 500 stock index.



D: Energy and natural resources continue to look attractive

Friday, March 21st, 2008 at 9:31 AM

Over the past several days, we have been sifting through data, looking for signs of a stock market bottom. In many ways, Tuesday appeared to have marked that bottom. Sentiment had become broadly bearish, which often accompanies low points in the stock market; equity averages had challenged the prior intraday lows of January 22nd without descending to new lows; and the Bear Stearns debacle was reminiscent of other financial crises that have marked good buying junctures. Significantly, stocks rallied very strongly into the Tuesday close. Everything seemed to have come together to mark an important bottom.

The next day, however, oil and gold prices plummeted, as did prices of a large number of other commodities. Energy shares and other commodity-oriented equities were sold aggressively, and the rest of the stock market soon followed suit. By the end of the day, stock averages had given up three-quarters of Tuesday's gains, and energy, resource and emerging markets shares had dropped especially sharply.

We concluded that the commodity selloff was likely a part of the overall bottoming process. Until this week, the commodity and resource sectors had been relatively unscathed by the pervasive selling; on Wednesday they came into their share of liquidation, if only because they were "the last man standing."

Stocks opened lower Thursday morning but as Thursday progressed, most shares gradually recovered, and the overall market regained most of the prior day's selling.

Looking ahead, we continue to believe that stocks have been engaging in a bottoming process. We see no substantive reasons to alter our opinion that energy and other natural resources will continue to experience strong demand as worldwide economic growth continues -- and supplies continue to be constrained for a variety of reasons.

The financial crisis will no doubt cause volatility to continue. However, we believe that the Fed has shown that it intends to do whatever is necessary to maintain the functionality of the markets. That being the case, we think it prudent not to "fight the Fed," but instead to focus on the extraordinary values that have been created (see below).

E: Wall St. Journal: "Lost Decade"

Wednesday, March 26th, 2008 at 11:50 AM

Today's Wall Street Journal highlights the flat performance of stocks over the past nine years ("Stocks Tarnished by 'Lost Decade'", *Wall Street Journal*, March 26, 2008). As the article points out, the Standard & Poor 500 index has

The following chart is of the XLE (An ETF, the Energy Select Sector SPDR), with a marker indicating of the timing of this energy-related note.



made no headway at all since April, 1999. We note that the above analysis ignores dividends which, when included, increase the total return to + 1.9% per year compounded annually. Better, but still anemic.

The article goes on to quote two equity bears, Robert Shiller and Jeremy Grantham, both of whom continue to expect little from stocks over the next several years.

Our view, as you might surmise, is different. We are not bearish going forward. Since April 1999, with the S&P index flat, the fully diluted trailing earnings from continuing operations of the S&P 500 companies have risen from \$43.68 per share to \$85.29 currently -- a gain of 95%. Furthermore, during that period, the 10-year government bond yield has declined from 5.2% to 3.5%. Accordingly, the yield spread we graph here from time to time has improved from - 1.85% (i.e., bonds yielding more than stocks) in April 1999, to + 2.88% currently (stocks yielding more than bonds). Compared with the key alternative investment of bonds, equities represent very attractive value at current levels. Furthermore, we expect profit margins for non-financial companies to remain high because of the growth prospects for overseas emerging markets.

F: A more balanced equity view

Monday, May 5th, 2008 at 11:49 PM

Equities have rallied strongly off of their March lows, and they now appear to have arrived at a juncture where the risk-return tradeoff has become somewhat more balanced than it had been several weeks ago.

In late March, the yield spread we pay attention to had risen to 3% (stocks had become much cheaper than bonds); now the spread has declined to 2% (still attractive for equities, but far less so than near the March lows).

Meanwhile, sentiment is less pessimistic than in late March (stocks tend to do especially well when pessimism is at very high levels).

From a corporate profits perspective, the U.S. economy will continue to benefit from export markets, especially the fast-growing emerging markets of Asia and Latin America. Furthermore, worldwide infrastructure spending will increase steadily over the next several years. However, the U.S. economy also appears likely to be constrained by reduced lending and the deterioration of U.S. consumers' net worth resulting from home price erosion.

In sum, equity investors are getting paid less to assume the risks of owning stocks than in late March. Therefore, although we remain bullish on equities, we are not quite so bullish as we had been several weeks ago.

A near term strategy is to retain core holdings of natural resources (particularly energy), emerging markets and infrastructure firms -- especially those with a global reach -- with short positions in domestic small caps and financial shares.