

BWMInvestment
Guidance**November 2008 Markets Review**
It's Darkest before the Dawn
*How Close Are We to Dawn?***Key Points**

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| <ul style="list-style-type: none"> • Year To Date 2008 Total Returns : S&P 500 (896) -38% ; US 10Yr Bond (2.93%) +13% ; NASDAQ (1535) -42% ; Foreign (EAFE) Stocks -47% • 2008 US GDP expected growth = -0.3% • 2008 earnings decline expected = -12.0% • Very negative 2008 portfolio returns |
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Executive Overview

Equity markets continued to crater until Nov. 20 (S&P 500 -50% year to date). The 11 week decline was unprecedented since the 1893 Panic! The Big 3 automakers made a pathetic plea for a \$25B bailout loan without an acceptable recovery plan on Nov. 19. An extreme flight to safety took the 10 yr and most other Treasury securities to 50 year low yields. Yet, lower quality debt instruments traded at extreme high yield risk premiums. In the Thanksgiving week the market seemed to have run out of near term sellers. The new enormous bailout of Citigroup may have ironically coincided with a near term bottom. Volatility will be discussed further; extreme fear and risk premiums remain. Mutual and hedge fund client redemptions continued. Deleveraging selling (debt value reduction) remains far greater than expected. The Federal Reserve Board (FRB), Treasury Dept., and FDIC provided numerous debt asset transfer facilities, TARP bank capital and derivative purchase plans, and guarantees in November.

The extraordinary increase in money supply will be problematic after the recession ends. Oil traded below \$50 per barrel or 67% below its' \$147 July peak before ending the month at \$54. Gold prices recovered about 2/3 of last month's decline to close at \$803 per ounce. The U.S. dollar (USD) exchange rate with the Euro and most major currencies was about unchanged during Nov. The revised 3rd Qtr. GDP estimate showed -0.5% contraction with elevated 4.1% inflation. The global financial bailouts will be discussed. Real consumption and profits continue to fall dramatically. Zacks calculates

S&P 500 firms' 3rd Qtr. 2008 total earnings fell 18%. Earnings disappointments persisted. Corporate guidance and analyst forecasts continue to fall fast. The new U.S. government administration's plan is coming into view. Market themes, the economy, and market sectors are discussed to suggest portfolio strategies to survive this bear market.

Themes

Current investment markets themes are: government financial rescues; unprecedented fear and risk premiums; President elect Obama's economic team and expectations; and economic conditions and outlook.

Government replaces Private Enterprise Leverage

A colossal tug of financial war is going on between private enterprise deleveraging (shedding depreciating derivative debt assets) and governments leveraging (buying or guaranteeing) the assets. The financial juice that supports economic transactions is starting to flow again after it froze up and intensified a developed world recession and emerging markets slow down. Government financial balance sheets are being degraded in order to rebuild the so called private sector balance sheets. The process cost is government direction (socializing) of the financial and possibly other economic sectors.

The FRB added more transfer facilities to exchange liquid U.S. Treasury securities for less liquid non-collateralized loans, asset backed securities, and foreign currencies during November. The balance sheet of the U.S. FRB continues to rapidly degrade. Great Britain, the European Union, China, and many other countries strikingly reduced interest rates in response to a global developed world recession and reduced inflation concerns. The change from emerging economy extreme demand and skyrocketing commodity prices in mid July to the lowest developed economies demand in 25 years by mid October has been breathtaking.

Where is the data?

The FRB, Treasury Dept., and global central banks have fought massive deleveraging without the necessary data and thus information to simply clean up the financial mess. The lack of transparency with the pseudo or parallel banking system products made up of structured investment vehicles, various debt assets based derivative securities, and credit default swaps and the rogue players including hedge funds,

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investment bankers, and private equity funds created the perfect storm. In these circumstances, the central banks have awkwardly tried and made errors with their inadequate tools. Since January, I have emphasized the need for a clearinghouse for the private opaque CDS market. Lack of knowledge about this market was a contributing factor in Secretary Paulson's decision to let the Lehman Bros. (LEH) purchase by a suitor fail and force the bankruptcy, which rocked the financial world. There would have been other problems in the dynamic world of deleveraged finance. Yet, many books will be written about the impact of the LEH failure.

What is the plan?

Secretary Paulson showed an awkward approach to using the \$700B bailout Troubled Asset Relief Program (TARP) funds, which were enacted by law on Oct. 3. The decision to focus first on recapitalizing the 9 largest financial institutions under the force, even though Wells Fargo apparently didn't like the deal with the strings attached, was efficient. Government purchases of toxic derivative assets at planned artificial long term values, instead of current depressed market values, will be fraught with future kickbacks and scandals. However, after Mr. Paulson stated that toxic derivative purchases would not be made, then he participated in another reversal. Mr. Paulson, FRB Chairman Bernanke and Vice Chairman Geithner, and FDIC Chairperson Ms. Bair constructed a second Citigroup bailout, which included purchase of \$300B of toxic assets, as well as guarantees, and new capital on Nov. 23. Yes, obviously the Big C is too big to fail. The Citigroup stock price rose about 100% from below 4 to over 8 in the next week. The U.S. and global governments are loading a lot of economic cost on their taxpayers, as the authorities socialize the burdens of financial deleveraging! Hopefully, the coming government regulations will focus on market transparency; not social engineering agendas.

Unprecedented Fear and Risk Premiums

There are a number of ways to measure fear and how much of a premium must be paid to take on risk. The simplest measure is the interest rate or yield that a buyer is willing to take for various types of debt, such as Treasury or junk rated securities. That is the world of loaning funds. Another way to measure fear is the world of stock or equity markets, where the buyer takes ownership shares in companies for a part of expected future profits. When the prospects of a

going concern company are very doubtful, such as Citigroup or General Motors on Nov. 19, the stocks effectively trade as call options hoping for some good luck, such as a government bailout to marvelously breathe new life into them.

The cost of debt matters

Government debt security interest rates have plummeted to levels not seen since Dwight Eisenhower was president. Those were the days of modest growth and low inflation. Recessions occurred periodically, but society had a stable USD to count on. Today's world is far different. A commodity boom built on cheap low risk premium money coincident with emerging developing country (China, India, Brazil, and Russia) expansion and high inflation. The condition was unsustainable. The U.S. subprime based housing price boom and emerging market financing could not continue long. After the Bear Stearns, Fannie Mae, and Freddie Mac bailouts were in place by the summer, the remaining global banking system with its opaque balance sheets was just waiting for the counter parties on the other side of transactions to say "**Show me the collateral!**" Effectively, poor collateral meant no deals and massive unwinding of financial leverage occurred in the past 12 weeks. Wall Street impacted Main Street. The cost of financing for the car dealer, credit card provider, butcher, baker, and candle stick maker went through the roof. Investors and bankers only wanted to hold the safest debt instruments. The risk and fear that they would not be paid back in an uncertain economy went sky high. On Nov. 20, US 3- month Treasury Bills yielded .01%. People bet there would be no near term inflation and just wanted to get their money back in 3 months. Treasury yields increased a bit since that time. And the 3 month T Bills to bank lending rates (TED) spread receded from an all time highest 4.64% rate on Oct. 10 to 2.18% on Nov 28. The spread between Treasury securities and the 5 grades of non investment (junk) bonds also hit record double digit levels of risk premium on Nov. 20. High fear in the debt market may be subsiding. Yet, the 10 year Treasury bond currently trades at 2.95%. (The related CDS is at an all time high 6.00% for the duration; implying the USD is not "AAA" rated.) The 30 year mortgage rate dropped more than ½% to about 5½% after the FRB announced a program on Nov. 24 to buy up \$600B of outstanding mortgages. This should lower refinanced mortgage payments and slow foreclosures.

Stock Volatility Up; Prices Plummeted

The VIX, Chicago Board Options Exchange Volatility Index, is based on S&P 500 Index options and a gauge of U.S. stock market fear. It is calculated from the past 30 day price swings. Since Sept. 15 the VIX closed over 30 for a record 50 days. On Oct. 24 it hit an intraday high of 89 and on Nov. 23 hit a closing day high of 80. Only the period after the dramatic Oct. 19, 1987 crash saw a longer period of fear than the ongoing streak. Volatility based on fear generally correlates with falling stock prices, because most long term investors are moving to the side lines while the speculators are whipping the markets with buy and sell surges. Prior to the availability of computers for nearly continuous calculations of any imaginable geek term in the 1970's, the VIX was not available. We can look at fear also by the number of weeks to push a market to an extremely (greater than 35%) sold off condition. The 11 week period from Sept. 5 through Nov. 20, 2008 saw a 41% drop in the S&P 500 Index. No other 11 week period saw a stock market index drop of greater than 40% in 11 weeks during the 20th century. Another intermediate term indication of fear is the 12 month decline of the S&P 500 in the modern era since 1926 and the DJI prior to that. During the 12 month period ending Nov. 20, the S&P 500 fell 50%. Detailed records were not available to search every 12 month period since 1900. However, for calendar 12 month periods, 1931 showed the record 47% S&P 500 decline. Based on a 19% S&P 500 rally over the past 5 market days, I don't expect calendar 2008 to end with an S&P 500 broad market 47% decline. The point is simply that fear has raged on all markets at unprecedented levels recently. There will likely be volatility in Dec., although the S&P 500 Nov. 20 low (April, 1997 level) may hold for the near term.

President-elect Obama's Economic Team

President-elect Obama won a clear victory to lead the U.S. executive branch of government from 2009 through 2012. The Democratic Party majorities in the House of Representative and Senate allow him a great deal of latitude to implement his agenda. At this time, it is not clear if he will have a filibuster proof Senate to close down legislative debate. Regardless of the politics, the US and developed global economies are in the midst of the most serious recession in at least the last 25 years. It is not clear yet if this recession will be similar to the 1973/74 or the double dip 1980/82 recession. In either case, 9%

potential unemployment is a sobering thought. Mr. Obama's economic team consists of Democrats with relevant government experience. Treasury Secretary designate Timothy Geithner was recently Vice Chairman of the Federal Reserve Bank and headed the important Federal Bank of New York. He has been closely involved in the negotiations of the Bear Stearns and AIG bailouts, the Lehman Bros bankruptcy, various bank bailouts, and numerous creative FRB asset transfer facilities. Mr. Geithner also was a member of the Clinton Treasury as under secretary to Robert Rubin and junior to Larry Summers. His mild manners and involvement in the current FB of NY probably resulted in his selection over the more combative and sometimes politically incorrect Larry Summers. The concern about Mr. Geithner is an inability to complete his assignment of implementing a CDS clearinghouse during the past 3 months. Economic Council Chairman designate Summers was an under secretary to Robert Rubin, as mentioned. His task will be to coordinate the executive branch department agendas. For example, the Health & Human Services proposals must be coordinated with other departments, so that they are not conflicting or completely overwhelming. Both of these men are intelligent and favor big government Keynesian demand stimuli to the current economic recession. If they are practical, they must speak out against \$1,000,000,000,000 deficits in 2009 and 2010. Otherwise, there is a strong chance that 2011 inflation will rise above 6% as in the 1972 to 1980 period and, from a political perspective, limit the Obama presidency to one term.

Expected Obama Policy Focus

President Obama will naturally govern from the left of the political spectrum. His challenge will be to negotiate legislation from the very liberal House and Senate in order to convince the American voters that he is in the middle of the political spectrum. His return favors to secular elites, environmental, union, and government/business coalition's supporters will make it hard to convince the independent voter of his honesty. Authorizing taxpayer money through executive order for embryonic stem cells research will gain President Obama favor with the secular elites, while forgoing some support from the moral religious groups. Support for cap and trade taxes on carbon emissions is likely in order to stay in the good graces of environmental special interest groups. Yet, sponsoring legislation to end

potential union formation secret ballots or to require time for liberal responses to conservative talk radio seems too divisive to propose directly. Raising income taxes on the top 5% of earners, who pay over 50% of taxes in the midst of a recession is dumb and probably will not be pushed. It will be easier to wait for the 2011 automatic termination of the 2003 Bush tax cuts. The greatest concern is the scope and shape of the promised economic stimulus package. One man's bridge to the future is another taxpayer's pork barrel project. Some level of corruption is expected from massive uncontrolled spending. Added societal controls and increased spending similar to the Carter administration are expected.

Economic Conditions are Horrible

The U.S. and other so called G7 European nations and Japan are in the midst of a serious recession. The 3rd Qtr. GDP declined in each region and the 4th Qtr. GDP is expected to decline in the serious 4% based on available economic data. People are responding rationally. The U.S. Oct. personal savings rate of 2.4% was much higher than anytime during this decade. Value consumption is the mantra. Discretionary spending for new cars or trips to the Bahamas is significantly limited. As unemployment rises from 6.5% currently to perhaps the 8.5% to 9.5% range in the 2nd half of 2009, value shopping will keep consumption demand down. CPI 12 month inflation, which is currently 4.1%, may drop to a stable 0%. But, with medical, education, other services, and food prices continuing to increase, the fear of a significant period of low demand-based deflation is needless. The FRB will likely cut the bank federal fund interest rate to 0.5% at its December FOMC meeting based on the futures market indicated rate with a 66% probability. That rate cut will not stimulate the economy, as much as the recently announced program to buy \$600B of mortgage backed securities. The housing sector remains in the midst of lower home prices and less new home construction. Housing prices are now at about their 2004 level and nearly at its long term income-to-mortgage payment level. The Treasury and FRB programs will likely result in more programs to adjust mortgage contracts and limit future foreclosures. The HOPE mortgage refinancing program has kept a significant number of owners in their homes, instead of foreclosure. The Obama mortgagee bailout program expansions will likely stabilize home prices by the 2nd half of 2009. Ironically, the lower price less than \$250,000 home market may

stabilize before the higher end of the market. As the U.S. net worth drops during this recession, the higher end household is losing proportionately more than others. Debt was financing the big homes and high life style.

The Big 3 Auto Makers will get their bailout

The 3 American automobile manufacturers and their union are expected to submit an acceptable restructuring proposal to congress in order to get the \$25B bailout loan that they are begging for. A controlled restructuring, especially of General Motors, is preferred to a straight loan so that meaningful strategic changes are made. General Motors CEO, Rick Wagoner, has done a poor job over the past 7 years. A restructuring overseen by Economic Council Chairman Summers has some merit. Aspects of the GM bailout loan should include: reduction of the 7 car brand division to 3 or 4, reduction of the number of dealerships by 50%, renegotiating union contracts to those of U.S. transplant manufacturing contracts, and replacing GM top management. North American GM operations should be downsized to compete in a smaller 2009 through 2011 U.S. car sales market. GM and Ford share prices rose over 100% in the past 5 trading sessions. The market is voting that the auto makers will get the taxpayer money.

The Economy and the Consumer

U.S. and developed country consumer confidence is at 25 year low levels. Monthly manufacturing and service industry measures dropped quickly to either 1982 or 1973/74 recession levels. The Dec. 5 employment report will show more lost job and higher than the current 6.5% unemployment rate. There are no current indications of a bottoming process. The 4th Qtr. GDP appears set to fall about 4%. Announced layoffs imply the 1st Qtr. 2009 GDP will also fall at least 2%. During the spring the unemployment rate will likely rise more than 1% above the current level. The deleveraging process, bank lending policies, and a bottom to low and mid level home prices will be the key to the second half 2009 end of a major recession.

Profits and Expectations continue to fall

Banks must still strengthen their capital structure through sales of deficient assets and new equity. Third Quarter profits are calculated to be below (-18%) 3rd Qtr. 2007 levels. Analysts still expect 4th Qtr. 2008 earnings to be positive, but top down economics implies no gain over the 4th Qtr. 2007. Consumer Staples, Healthcare, and

Utilities sectors show positive expected comparisons, while Materials and Technology sectors lead negative expected assessments. The Financial Sector with likely asset devaluations is difficult to judge. The 1st and 2nd Qtr. 2009 comparisons will likely also be negative.

Financial Analyst forecasts are more realistic.

The current analysts' forecast revision ratio is about 3:1 downgrades/upgrades in 2008 and about 7:1 in 2009. Analysts are gradually and methodically reducing forecasts. Market prices imply the current reduced 15% total operating earnings growth in 2009 remains optimistic. Zacks calculated that S&P 500 profits fell 13%, 16%, and 18% in the 1st Qtr. 2nd Qtr. and 3rd Qtr. 2008, respectively. At this time, the S&P 500 trades at 10.5 times 2008 earnings. If 2009 earnings equal 2008 earnings (instead of 15% growth), then the S&P 500 companies' index also trades at about 10.5 times 2009 earnings. Based on the no 2009 expected growth, there appears to be partial (optimistically 30%) 2009 S&P 500 peak recovery (1150) potential. Profit margins continue to be squeezed by finance expenses and weak consumer demand in various industries.

During past recessions earnings fell for an average of 3 consecutive quarters. They will fall for a longer period during this recession; i.e. 6 quarters likely. Consumer spending is the issue. The credit crisis (financial industry instability) may end in the spring. However, consumer balance sheets and spending will recover more slowly. The FRB policy decision to either promote growth or control late 2009 inflation will be the key to 2nd Half 2009 earnings.

Foreign Economies

Developed economies are set for little or no growth in 2008. Either very slight growth or slight decline is expected in the calendar year 2009. The British economy is expected to be weaker than the U.S. or any other developed nation economy. The emerging markets 2009 economic forecasts have been significantly reduced throughout the years. The U.S., China, Britain, the European Union and various other countries have announced Keynesian demand stimulus plans to push their economies out of recession. Key forecasts according to the *Economist* follow.

Table 1. Economic Forecasts

Economic Market	2008 GDP	2009 GDP	2008 CPI
United States	0.1	0.2	4.0
Japan	0.5	0.4	1.8
China	9.7	8.0	6.2
Great Britain	1.0	-0.1	3.7
Euro Common Mkt ECM	1.0	0.3	3.5
Russia	7.3	6.0	14.0
India	7.3	6.8	7.5
Brazil	4.5	2.7	5.7

All developed economies slipped into a 3rd Qtr. initial recession period. A global developed economies 1st Half 2009 recession is forecast.

In Table 2 the U.S. positively sloped yield curve continues to be the most stimulative monetary policy. However, all countries are dramatically cutting interest rates as economies slow and inflation fears subside.

Table 2. Current Global Yields

Economic Market	3 month	10 Year
United States	0.1	3.0
Japan	0.7	1.4
China	3.8	3.1
Great Britain	3.0	4.0
Euro Common Mkt ECM	3.5	3.5
Russia	12.0	9.0
India	7.0	8.2
Brazil	12.0	6.1

Economic Sectors and Investment Outlooks

A Technical Overview (BPNYSE, etc) indicates market demand and supply of U.S. stocks is uncertain, but about equal. The volatility fear factor fell during the quiet Thanksgiving week. December is historically volatile during Bear Markets, as tax loss harvesting is above normal. Hedge fund, mutual fund, and private fund redemption outflows continued in November. Total mutual fund assets (\$9.6T) are down 24% since Dec. 2007. That left investment cash on the sideline (5.0% estimated mutual fund cash held). Key developed country stock indices remain about 50% below the Oct. 2007 peaks. Money supply growth and bearish sentiment indicators are potential demand indicators. **Suggestion: Cautiously hold current positions.** Bear markets are currently in place. Yet, a relief rally is likely within the next 2 months as volatility declines and portfolios are rebalanced with increased equity weights. Sector price relative strength (RS) shows sector demand only in the

consistent earnings Consumer Staples. Stock demand favors the value style and larger capitalization stocks. Foreign equity securities denominated in the USD are weak due to the combination of their weak currencies and poor earnings outlooks.

Economic Sector Analysis and Outlook

The **Utility** Sector reported weak 3rd Qtr. and stable forecasted 2009 earnings. The RS is better than the general market and dividends are around 4% (over Treasury bond rates.) Normal portfolio asset allocation weights are suggested. Demand for dividend paying **Telecom** sector stocks is below normal in a recessionary economy. Hold current positions, but no new buys, is suggested. The **Consumer Staples** sector 3rd Qtr. earnings growth and 2009 earnings growth outlook remains stable with positive RS. Demand for this defensive sector remains solid and price increases continue as people keep on eating and buying cosmetics in a recession. A portfolio over weight position is suggested. **Healthcare** sector 3rd Qtr. 2008 earnings are in the single digit range, but biotech and medical products industry earnings are causing an overall positive RS. They are vulnerable to uncertainties concerning added regulations and have performed similar to the general market since the election. **Technology** Sector 3rd Qtr. reports were mixed. The highest P/E tech stocks were sold during the nervous markets; which implies little or no 2009 earnings growth. The **Energy** sector delivered good earnings growth with oil above \$140 per barrel, but RS has turned negative when oil fell to \$50 recently. Below market neutral portfolio allocation is suggested for this commodity sector, although Energy sector fundamentals at replacement estimates are attractive. The cyclical **Materials** sector is performing with negative RS, while earnings are a weak. A below normal portfolio weight is suggested. **Industrial** sector exports (and earnings) to developing countries are slowing. Below normal portfolio weights are suggested in this sector. The **Consumer Discretionary** sector remains a cyclical area. The RS is neutral but there is much dispersion between companies. Below normal portfolio weights are suggested. The Financial Services sector remains uncertain. Write downs of bank debt securities continue and caution is prudent. Low interest rates and numerous FRB bailout asset transfer facilities will increase profit margins for banks and other financial industries. However, dividend cuts remain a negative factor. **Financial Sector portfolio regional banks**

which avoided the toxic higher yield mortgage securities are **suggested**. Yet be prepared for continued volatility. **Economic sector earnings are weak in total and portfolio suggestions are cautious**. Conversely stocks are much less expensive than 3 months ago. There is liquidity to demand stock prices higher. **Summary**: hold current positions; if you were smart enough to be holding cash, buy in the suggested sectors with money not needed for consumption in the next 5 years. Be aware of and expect market volatility.

International Markets Are Very Vulnerable

Foreign stock markets fell 4% in October, while the USD (1.27 Euro) exchange rate remained unchanged. New developed economy stock buys are not suggested. As foreign banks continue to cut interest rates, the USD may recover more and act as a headwind for foreign stock returns. Emerging market stocks are very volatile. Normal weights may be considered only if you have the capacity to withstand a very large decline (more than 50% in 2008)

Fixed Income - Less Volatile

U.S. Treasury bond total 2008 returns (10%) benefited from an extreme November flight to quality and reduced inflation expectation. Investment grade corporate bonds (-9%) still suffer from uncertainty. Money is flooding out of stock funds to money market funds. A small portfolio weight in a TIPS fund is suggested, although the reduced inflation expectation also resulted in recent negative returns.

Alternative Investments – Diversification

The Real Estate Investment Trusts (REITs) index continued to hemorrhage 15% in November due to short term financing concerns and anticipated retail vacancies during the recession. Wait for more information prior to buying REITs. Gold funds are diversifiers. Normal alternative asset 5% gold fund weights appear reasonable. At the moment they are as volatile, as every other asset class.

Portfolio Management

Funds have some (5.0%) cash to boost stock or bond prices higher. The S&P 500 index is trading at about a 10.5 times trailing 2008 PE ratio. Normally, a reciprocal 9.5% earnings yield is favorable to the current 6.8% corporate “A” rated bond yield. Holding an 88% invested portfolio is suggested.

Current portfolio themes are:

Neutral – Underweight foreign developed stocks

- All U.S. stock caps funds normal weight
- Foreign EAFE funds below normal weights; Emerging stock funds below normal wts.
- Fixed income – TIPS preferred
- Hold stocks in suggested sectors

Disclosure: Personal holdings: 52% Domestic & International Large Cap stock funds, 39% Small/ Mid Cap funds, 9% cash (19% Total International funds)

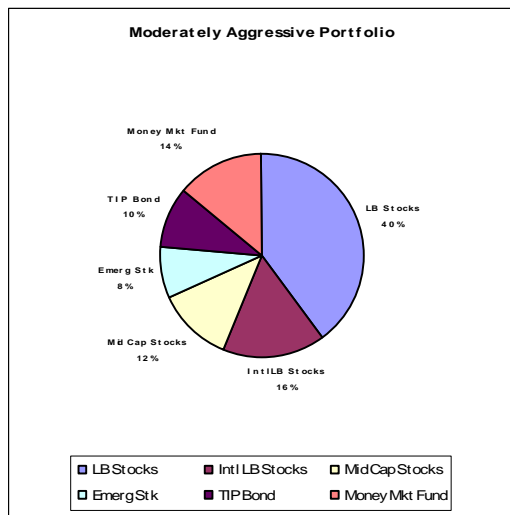
**Sample Portfolios are models
Not Client Recommendations**

Sample Portfolio A - **Moderately Aggressive**

Example 45 year old college educated parents with 1 high school child and 1 college child.

- 40% Large Blend Stock Index Funds
- 16% Large Blend International Fund
- 12% Mid or Small Cap Stock Fund
- 8% Emerging Market Stock Fund
- 10% TIP Bonds
- 14% Money market cash

Neutral Capital Allocation –

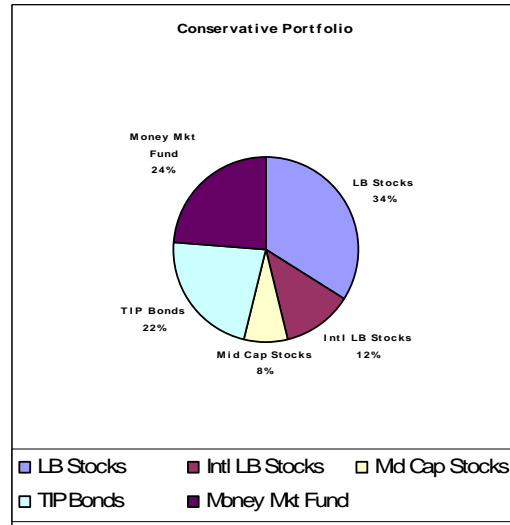


Sample Portfolio B - **Conservative**

Example 65 year old couple with Social Security Income (20% of spending needs) and Retirement 401K or Pension Plans converted to IRA's

- 34% Large Blend Stock Index Funds;
- 12% Large Blend International Fund;
- 8% Mid or Small Cap Stock Fund
- 22% TIPS Bonds
- 24% Money market cash

Capital Preservation –



Note client portfolios use available 401K plan funds and multiple funds in each category to reduce risk.

If I buy, hold, or sell securities discussed herein, then I will disclose my positions. Prices shown are approximate. Joseph Banach. www.BanachWealthManagement.com

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