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The extreme volatility of markets around the world has continued. Virtually all asset classes from stocks and bonds to commodities and real estate have sustained major losses. As the world de-leverages, investors are selling even high quality assets to raise cash. The latest is that hedge funds reportedly are indiscriminately selling in anticipation of investors bailing out of their funds. Despite all our problems, the US is considered to be the strongest country in the world so the US dollar has rallied, while the Euro and many other currencies have dropped. Close to home, you can see the wild volatility by the rise and fall of gas prices at the pump. It is a crazy world.

It looks like October 2008 may go down as one of the worst months ever for the financial markets. Our client's portfolios had held up relatively well until this fall as diversification helped against market declines. Unfortunately, with indiscriminate selling in the last couple of weeks, virtually all asset classes went down and our clients' portfolio losses for the year have roughly doubled since September. The US market as measured by the Dow Jones Industrial Average and S&P 500 Index is down between 35 and 40 percent for the year, clearly a bad bear market. October brokerage statements are going to look terrible unless there is a huge rally in the next couple of days.

Experts who analyze the emotions of investors argue that they see extreme pessimism. From a contrarian standpoint, this is actually an optimistic sign. Many also comment that the selling panic we have been witnessing for the last two weeks through last Friday is typical of forming a market bottom. It would be wonderful to get at least a relief rally of more than one day. As an example of how wild things are, tax exempt bonds last week rallied roughly 4 percent, about what we expect them to return in a whole year, as they recovered roughly half of their recent losses.

We caution clients not to make wholesale changes in portfolios during periods of extreme volatility. It is very easy to get whipsawed. While stock markets were booming (yes, this did happen not too long ago) we suggested taking profits when positions got too large. Recently we have been working with clients to remove or reduce specific investments from portfolios that we thought do not make sense for the future. We believe long term investment decisions should not be based on one month's markets' performance during what could be the worst in recent history.

We believe we are in a recession and the media will be reporting very bad economic news for at least the next six months. The recession could be the worst we have seen for some time, even better for headlines. Economic downturns, although painful, are normal and do serve a purpose of purging excesses and preparing for the next period of economic strength. Investors need to keep in mind that, while past performance is not guaranteed, historically financial markets can do well during recessions as the markets are predicting better times ahead. It will be challenging for investors not to let the headlines influence their investment strategies.

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On top of the market and economic challenges, Washington has multiple issues before it. A non-comprehensive list might include whether and how to provide help to home owners and how to stabilize home prices; how to tighten the regulation of credit and derivative markets; and what level of international cooperation is appropriate for the future smooth functioning of capital markets. On the housing issue, the drop in values back to levels of three to five years ago is real and somebody is going to have to pick up the losses. The arguments over whether that will be the homeowners, the mortgage owners, or the taxpayer will be highly public, emotional, and bitter.

We think the world is changing and our views on how to structure portfolios to benefit from this will continue to evolve. We continue to seek out the opinions of various experts as we do this. At a symposium last week sponsored by the Bank Credit Analyst (BCA), Niall Ferguson made upbeat observations on the US. These are summarized in the attachment (provided by permission of BCA).

One possible strategy we are considering is to increase the proportion of bonds in portfolios. In a period of recession and deflation we think the merits of owning bonds increase. Bonds typically do well in bad times. Additionally, they have been sold heavily along with everything else so we think they are relatively cheap. For investors concerned about reducing risk in their portfolios, bonds may have a unique opportunity for providing better than average risk adjusted returns over the next 6 to 18 months.

Regarding stocks, last week we had the opportunity to talk with Professor Roger Ibbotson from the Yale School of Management. He argues the equity-risk premium for stocks has improved for the long term. In layman's terms, eventually he expects stocks to provide higher than historical returns but with greater risk and volatility. Thus, investors with a tolerance for greater portfolio volatility should still own stocks to maximize potential long term returns.

The economic changes we have been seeing are huge and will affect most people's lives for years to come. We recognize the impact may be largest on individuals close to or already in retirement, and we are paying particular attention to the needs of clients who are in this situation.

Please give us a call or schedule a meeting to come in to discuss any of the above. We know these are difficult times.

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