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Serving Your Personal Investment Needs Since 2003

July 6, 2008

HIGH DESERT ADVISOR - FINANCIAL MODEL ADVISORY

Please forgive the length of this advisory. You understand the reason for its length after you have read it.

Once again, we are retesting the lows from last February and March. Such a retest calls into question the state of the U.S. economy and the global economy. It also causes a great deal of concern about the general state of the investment and financial markets. Are we headed to another year 2000-2002 meltdown? Will there be another recession similar to what we experienced 7 years ago?

On May 8, 2008, I wrote:
"It seems pretty clear that the stock market has found a bottom in the 1250 price area of the S&P 500 Index....... it appears that there is a new trading range area established between about 1425 and 1300."

What if this market bottom isn't really the bottom after all?

Suffice it to say, I don't believe that is the case. **Presuming that the equities market is a function of the business and the domestic U.S. economy, there appears to be no reason to believe that the economy will go into a recession.** Overall, the growth characteristics of the U.S. economy are a function of the Fed's ability to grow money supply. Our Financial Model is designed to capture economic growth based upon pretty basic monetary aggregate data. Its predictive success - forward, concurrent, and historical - has been pretty well documented.

However, it is clear that the last 12 months of market price action has been inconsistent with the Model. It is also just as clear that the "off balance sheet" transactions including Leveraged Debt (LDO) and Collateralized Debt (CDO) - and whatever other creative debt name applies - has skewed the Federal Reserve monetary data such that the market outperformed during 2007 and underperformed in 2008. **Thus, the data used in the Financial Model does not accurately reflect actual monetary aggregates during the period from 2005 thru 2008.** I now have sufficient data, I believe to interpolate the results with enough accuracy in order to, rather closely, determine the actual difference between the Federal Reserve data during this period and the "off-balance sheet" monetary aggregate variations.
These "off-balance sheet" transactions appear to have added about 7% growth to the monetary aggregates in year 2006, mostly during the period from May thru December. Then, throughout 2007, the closing down of these "off-balance sheet" transactions caused an unrecorded contraction of the monetary aggregates by an annualized rate of almost 12%. This contraction would have taken place after June 2007. Because of the concentration of the time period of the market collapse, during the period from July thru December 2007, this period actually resembles the six month period shortly after the start of year 2000 when the Federal Reserve under Alan Greenspan withdrew so much money form the monetary system.

What we have seen in the price action of the stock market since December 2007, reflects this contraction in the monetary aggregates beginning in July 2007, and continues to this day. It appears that the U.S. market is pretty much done with the process of bringing these transactions back on the books and collapsing the leverage created by them.

In summary, within a rather short time, it is likely that the stock markets will stabilize. In addition, assuming that the Federal Reserve continues to add money to the system at the current rate, it is probable that there will be a 3%-4% increase in the stock market value by the end of 2008, from where it is priced today.

The domestic U.S. market is ahead of the rest of the world in adjusting for the distortion in the monetary aggregates as described above. What this means is that we will be recommending lower levels of international category equities, while recommending increases to investments in small and mid-cap growth and value equities and in large cap growth equities here in the U.S.

These changes will be made over time, as each portfolio is reviewed for performance, and specific recommendations are made as appropriate to each individual portfolio. There is no immediate need to rush to make these changes because this forecasted market rotation should take place over a longer term - perhaps the next 6-12 months.

Most of our portfolios already contain sufficient fixed income included in the mix of investments, thereby providing a significant amount of stability to each.

I have not commented on the impact of rising energy prices and the inflation that this portends. For now, it is not clear how our economy will react to such rapidly rising energy costs. My sense is to rely on the American economic system to rapidly adjust to these higher prices and to find a way to grow in spite of the energy upset.

The caveat to all of this rhetoric is the financial system and the Fed's ability to grow the money supply. We certainly have the right leaders at the Fed and at Treasury. Creative response to each liquidity issue is required in order to keep the financial system strong and actively providing that liquidity.

Today, the Model recommends that investors be fully invested - in accordance with individually designed investment asset allocations.

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