



Kerns Capital Market Report

May 15, 2008

Dear Friends & Clients,

Since its bottom on March 10th, the stock market has bounced back about 11%. It has slowed somewhat during these first two weeks of May but the uptrend appears to be intact.

There are some inconsistencies in the market place we will attempt to explain, such as:

1. Is the US economy actually in a recession?
2. How can the stock market go up in the face of rising oil prices, declining housing prices and the onset of inflation?
3. Is this rally just a temporary rally in a Bear market about to continue?

There are several interrelating themes that give us clues as to the answers to these questions and we will explore them just enough for you to get the general idea of what to expect without burying you in details.

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There has been much speculation as to why gasoline prices and oil prices are so high compared to the past. The three reasons given are:

1. Since the value of the dollar is falling, it takes more dollars to buy imported oil.
2. Speculators are pushing up the price.
3. World demand is increasing.

It is our feeling that all these have contributed to the price increase. However, over the last few weeks, the dollar has (temporarily I think) stopped falling while oil prices have kept climbing, so the dollar is clearly not the sole reason for oil price escalation.

There seems to be speculation in the market but in our opinion, not as much as many think. When the price reached an all time high of \$127 per barrel last week, one would have expected that speculators would have been betting the price would fall and would have sold oil short (placed a bet that would make them money if the price declined). This did not happen. Short interest is minimal. That indicates oil users and investors are expecting oil to go higher.

So that leaves us with real world demand. Virtually all of the major developed and developing nations of the world are growing faster than the US. The key word here is GROWING. If we have shortages at the current level of world usage, supplies can only get tighter as demand GROWS. It makes no difference that the world's economies may be experiencing slower growth - because there is still GROWTH.

The following are excerpts from an article from in yesterday's Bloomberg News by *Mark Gilbert*.

"Slower global economic growth won't halt rising oil prices because supply is failing to keep up with demand, according to Jochen Hitzfeld, a Munich-based economist at UniCredit Spa."

"Since the fourth quarter of 2007, demand has been roughly 2 million barrels per day above supply, which is stagnating at close to 85 Million barrels per day." "The falloff in demand because of the global economic slowdown will trigger only a slight decline in this primary deficit. We anticipate a drastic inventory rundown." Hitzfeld wrote in a research report on the May 13th.

"Analysis of the 230 most important new [oil] production projects shows that even if all projects can be realized as planned, there will be a supply/demand gap of 12.5 mbpd, or close to 15% of current [world] demand, in coming years." "Without counter-measures, this will undoubtedly trigger a supply crunch and escalating oil prices."

I don't know whether his numbers are right but apparently the market thinks they are! That is why oil prices continue to climb.

All other hard commodities and metals are experiencing demand which is growing faster than new mines can be brought into production. There is a world scramble to lock up resources. I read last week that China has cut a deal to rebuild the infrastructure of the Congo in exchange for exclusive rights to their natural resources.

So, the big question is - how do we benefit from these trends rather than becoming their victims? Our answer is to invest heavily in those companies that will profit from the current and future oil and commodity shortages. Demand is the overriding reason for price escalation and if speculators are smart enough to benefit from it, it will just push prices up more.

Perhaps The Economy is Not In a Recession

The following are all quotes from yesterday's Wall Street.

"A funny thing happened to the economy on the way to the recession: It's taken a detour."

"... stock and credit markets have steadily improved since the Federal Reserve intervened to keep Bear Stearns Co. from bankruptcy in early March, while a series of economic reports have been stronger than expected."

"The numbers we've seen recently haven't been as bad as we were led to believe just a few months ago."

I won't dump all the statistics on you because all we need to know is that things are better than

expected and that is why the market only fell about 20%. Normally it would have been much worse.

Remember, I said in the last letter - "There is currently \$3.5 Trillion dollars in Money Market funds, Treasury bills and cash setting on the sidelines waiting to be invested! Much of this money has flowed out of the stock market over the last few months as market risk and volatility grew.

Since the stock markets are like everything else economic, they are governed by supply and demand. When fear of market losses rose over the last year, money flowed out of the stock market and the market fell!

Now the "Fear Level" is starting to fall, money is starting to flow back into stocks and the market has risen over the last month! As a matter of fact, April was its best month in years."

Brazil, Russia, India & China

I have been talking about the BRIC countries for the last couple of years so I will just quote some facts:

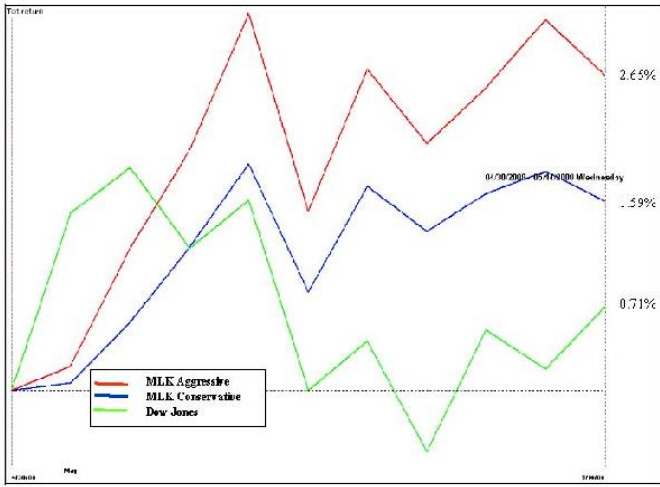
- China's capital spending for infrastructure building in their country is at the heart of the Chinese economy. It accounts for 40% of their GDP, compared to only 15% in the United States and just over 20% in Europe. No wonder the use of natural resources is growing.
- As China has transitioned from having their currency pegged to the dollar to a more of a floating currency exchange rate the value of their currency (compared to ours) has increased about 16% over the last two years and the real growth rate of their exports has slowed from about 20% per year to zero. Even with this slowdown, their economy will grow over 8% this year.
- Consumers of commodities have faced an 80% increase in the price to ship goods. Why? Because of the incredible growth in consumption worldwide. China's imports of iron ore are running at an annualized rate of 455 million tons compared to last year's 394 million tons. China is importing iron ore to make steel from all over the world. They are buying a large amount from Brazil, (the B in BRIC).
- Brazil's exports agricultural products all over the world.
- Russia is the main supplier of oil to Europe.
- India is not rich in natural resources like Brazil Russia and China but they are exporting labor. Many US companies have outsourced to India. Their economic growth is so hot that the government is trying to slow the economy to fight inflation.

Add up the facts and it seems obvious that countries with huge growth have companies with huge growth generating growing profits for their investors, increasing demand for commodities and inflation for the entire world. Commodities are the best way to grow and protect your wealth when inflation creeps in.

Current Investments and Performance

For the month of May and Year-to-Date our models are ahead of the broader US markets.

The chart at the left shows May performance for Our Aggressive and Conservative models compared to the Dow Jones Industrial Average. As you can see, the rally slowed slightly for the Dow (and the other US averages) during April, but our portfolios have progressed nicely due primarily to our overweighting in commodities and international holdings in BRIC (Brazil, Russia, India & China) countries.



As I said in the last letter, "Our portfolios are over weighted in commodities and we feel that even though they add volatility to the portfolios, the opportunity for long-term growth exceeds the jitters that come with short-term volatility. Remember why you are investing. We need long-term growth with manageable risk. We feel the volatility is manageable and acceptable over the next few months and perhaps 2-3 years."

We also hold High-yield bonds and an S&P 500 Index fund.

We're Going Green

Our semi-monthly newsletter distribution list has grown into the thousands. In the past we have sent the newsletter electronically and by hard copy, with many receiving it by both means. In an effort to do our part to protect the environment, we are going to **discontinue the mailing of hard copy letters except to those readers who notify us that they do not have email access or that they prefer hard copy.** If you'd like to continue receiving hard copy, please let us know by giving us a call or sending an email to KCM@KernsCapital.com with your preference.

As always, this letter will be published periodically with our views on the market, investing and things that seem important to us at the time. Remember, all of this is filtered through over 40 years of experience including a fair amount of both "Good Judgment" and "Bad Judgment". To quote William Hazlitt - "Prosperity is a great teacher; adversity a greater."

Please feel free to share this with anyone you think might be interested.

Lane Kerns
President & Chief Investment Officer

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