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WHAT'S NEXT?

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As the real estate bubble bursts and the sub-prime loans collapse, we see all sorts of repercussions.

1. Foreclosures are up, prices are down, and banks are forced to use their capital to cover the huge losses on these loans.
2. Mortgage rates are rising.
3. The repackaged loans bought by hedge funds and financial firms are priced as if worthless. No one knows what is in the loan portfolios and therefore can't value them.
4. We see the bankruptcy or near bankruptcy of major hedge funds, bank and brokerage firms.
5. Corporations are reporting sharply lower profits.
6. Inflation is here. Gold, oil, and other commodity prices are soaring. World-wide prices in wheat, corn, soybeans, and rice are sharply higher and rising. Supplies are limited. Shortages threaten.
7. There is a marked loss of trust and confidence in our financial institutions and regulators.
8. Deep declines in the dollar continue.

The list goes on. Speculative excesses are always painful when they end. Even those who never participated in the speculations are hurt. For example, your property values most likely went up with the bubble and are probably down now even if no one in your neighborhood had a sub-prime loan.

The sub-prime mess is not over. The bottom has not been seen in real estate. Balance sheets have not been cleaned up. It will take years, not months, before we return to a healthy state. But it is out in the open and it is being addressed. For that reason, we need not worry about these issues any longer. Don't take that to mean that this isn't a serious crisis. It is a huge crisis. But it's known. It has everyone's attention. Everyone takes it seriously and is working on solutions. As frightening as all of this might sound, it's what most people *don't* know yet that tends to hurt you, rather than what most already know. It's fairly obvious to most people right now which areas of the market to avoid.

My job as your manager includes doing my best to anticipate what is going on that might affect your investments. We want to have exposure to the things that will help you and avoid the things that will hurt. That's why you have seen so little damage in your portfolios from this mess. We had very little exposure to these areas. Now that this is front page news, my job is to try to anticipate and avoid the next crisis. The market *always* looks ahead. Investors who want good results do the same.

What we need to think about is what is coming next. What might it be? Little signs are everywhere. The state and local governments depend on real estate and sales taxes for their revenues. Those revenues are down sharply and will remain at reduced levels for a while. That means that cities and states will have to live on their savings (chuckle), raise taxes, reduce services, borrow money, default on existing obligations, or some combination of these. Which one of those options sounds appealing? The food shortages are beginning to look like famine warnings for someone. The fresh water shortages are also looking like something to watch. Old, decaying infrastructure, healthcare, tax hikes and a new President are all possible causes for concern. And there's that old standby, ever-escalating entitlement programs.

For the moment, I have decided to focus on food and the falling dollar. Let's talk about food first. Stratfor, whose research I subscribe to and highly recommend to you, is watching the situation closely. Let me pass along some of what they discuss. Wheat, corn, rice and soybeans form the basis of the food supply for both livestock and humans around the world. As developing countries emerge from poverty, meat tends to be added to the diets of the population. This is significant because it takes about 10 times the grain to produce one calorie from meat than it does to produce one calorie from grain itself. This gives us the combination of a rising population and a population that needs more grain per person for their diet.

Even as demand for grains is increasing, production is declining. Some of the corn grown is now diverted to bio-fuels rather than food. The International Grains Council estimates that it might be about 6.5% of the total amount grown. Whoever was eating that other corn is now going hungry. Drought and disease are also taking their toll. The current shortages are critical in some areas of the world. We are seeing food riots in Haiti, nation after nation shifting from net exporters to net importers, and rationing in entire countries. Reserves are currently being drained rather than replenished, meaning that most of what is being produced is now being consumed.

As countries announce that they no longer have excess supply to sell to their neighbors, some find that the next closest available supply is 100,000 miles away. The cost of transport makes the resulting price too high to pay. The obvious concern is that some areas will be facing famine.

Solutions for the problem will be found, but it will take time. Until then, fertilizer, farm equipment, fuel, alternative protein sources, dry shipping, and processing are likely to see increased demand. The price of these grains will almost certainly increase quite a bit.

The falling dollar is another concern. Faith and trust is the ONLY backing to the dollar. When the dollar declines, it means that other nations have reduced confidence in our willingness or ability to pay our obligations. Unless these countries see a very big change in our attitudes about debt, the obligation to repay debts, savings rates, and concepts of risk management, we could face a dollar crisis. A strong dollar is absolutely essential to our well-being. I'll spend more time talking about this in another letter if we don't see some rather immediate change. Meanwhile, look for some changes in the future role of the FED, especially with regard to their role in ensuring a strong currency. It's now almost inevitable.

For now, you will continue to see some changes in your portfolios reflecting these concerns about food and the dollar. We still have a large participation in the commodity areas, and in basic materials. There is almost no exposure to the financial sector, other than in plain vanilla bonds and CD's. As conditions continue to shift, we will continue to rotate into the more favorable areas. I still expect 2008 to be a good year for us, but it will continue to be a bumpy ride.

Cindi Showalter