



DAVID R. KERN

ASSET MANAGEMENT
Dynamic Asset Allocation Strategies

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Historic changes are sweeping across the financial markets as the excessive debt encouraged by the Federal Reserve's low interest rate policies, and congress's efforts to promote homeownership over the years quickly unwinds. Bear markets have taken their toll on almost every asset class, and even money markets and bank CD deposits were a great cause of concern, as the wheels have come off the wagon of the economy and sent the global financial picture reeling toward a recession.

In the U.S. as of 10/10/08, the benchmark index S&P 500 was down 42.5% from its all-time high, making it the third worst bear market in the last 50 years. This race to the bottom has been led by the Emerging Markets around the world, and both China and Russia are each off over 60% so far in this never-to-be-forgotten market year. One of the big drivers of the sell-off in equities and bonds is the need for institutional investors to reduce debt. Many hedge funds and investment banks are heavily leveraged with borrowed money.

A quote from an article titled "Crony Capitalism Is Root Cause Of Fannie And Freddie Troubles", from the Investor's Business Daily, dated 9/23/08, says this. "It all started, innocently enough, in 1994 with President Clinton's re-write of the Carter-era Community Reinvention Act. Ostensibly intended to help deserving minority families afford homes, a noble idea, but it instead led to a reckless surge in mortgage lending that has pushed our financial system to the brink of chaos". Another paragraph headed "Subprime Mentor's" reads, "Fannie and Freddie, the main vehicle for Clinton's multicultural housing policy, drove the explosion of the subprime housing market by buying up literally hundreds of billions of dollars in sub-standard loans, funding loans that ordinarily wouldn't have been made based on such time-honored notions as putting money down, having sufficient income, and maintaining a payment record indicating creditworthiness. With all the old rules out the window, Fannie and Freddie gobbled up the market. Using extraordinary leverage,

they eventually controlled 90% of the secondary market mortgages. Their total portfolio of loans topped \$5.4 trillion, half of all U.S. mortgage lending. They borrowed \$1.5 trillion from U.S. capital markets with (wink, wink) an "implicit" government guarantee of the debts. This created the problem we are having today".

All was well as long as home prices continue to rise, but as the excessive debt began to pile up, home values peaked and began a rapid decent pulling all financial assets down with it. Wall Street packaged these mortgages in large bundles with a sprinkle of sub-prime to spread the risk, and allow for investment grade ratings. Many of these mortgages will be repaid, however accounting standards imposed by Congress as a result of the Enron collapse and other accounting problems, have forced companies to value their assets based on current market prices. There is currently an imbalance in supply versus demand for these packaged mortgages because of the unknown sub-prime liability. When adjusting to market value these assets quickly become worthless. The best intentions of Congress have unforeseen consequences. Our Federal Chairman Bernanke is a straight shooter, offering a long list of gloomy conditions. His predecessor, Alan Greenspan, talked in riddles so you weren't sure where the economy was going.

We are watching the seasonal forces for signs of a turnaround before the end of the year. With the election over in November, the strongest seasonal period of the year traditionally is the three months through January. The stock and bond markets look ahead, and move now on what it anticipates conditions will be six to nine months ahead. We are anticipating a recovery in the months ahead.

Please contact David R. Kern Asset Management if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.

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