

2008 will go down as a seminal year in world history. In the same way that the 1929 crash was the defining event for the decade that followed, the unprecedented events we have experienced in 2008 will be a focus point for many years to come. Whether financial markets and society swallow the bitter medicine of deflation as the antidote to years of wild credit growth, or whether inflation will correct the imbalances, is a question for 2009 and beyond.

And make no mistake, it is THE most crucial question as far as financial markets are concerned. In our top ten themes for 2008, published at the beginning of the year, we highlighted the battle between inflation and deflation as the major big picture event.

At the time we speculated that while deflationary forces would be powerful, inflation would eventually 'win' the battle given the desire of central bankers around the world to lower interest rates and create inflation.

This led us to believe that while the banking and finance sectors would struggle through their own deleveraging process, the resource sector would be relatively immune and benefit from the inflationary policies of central banks and governments around the world.

In the first half of the year, this view held up reasonably well as the resource sector outperformed all others. However, the sector was simply the strongest amongst a fragile lot. In early 2008, leveraged money was fleeing structured credit products and trying to keep the easy money dream alive by moving into commodities.

Then, by September, the game was over for everyone. The credit bubble that had been slowly deflating since mid 2007 finally burst. The last bastion of strength, the commodities complex, unravelled with frightening speed.

We were wrong on our call of inflation being the winner and we were wrong on our call of commodities being the safe haven. Well, wrong as far as 2008 is concerned, anyway. This is particularly frustrating for us because we understood that the deflating credit bubble had the capacity to cause much damage. Hence our recommendations to avoid those sectors which benefitted most from the good times; financials and consumer discretionary stocks.

On the commodity side, we failed to realise that the fundamental soundness of mining companies' assets was based on economic growth that was itself a product of the credit bubble. Cheap credit begat phoney economic growth, which begat phoney earnings right across the market, from financial engineers to basic industrials.

The rather obvious lesson learned is that equities of all stripes do not fare well in a global credit contraction. Unfortunately, it will be many years before we can employ these lessons learned. Such a vicious credit contraction is unlikely to be seen again in our lifetimes.

And given the boom was largely global, so has been the bust. The table below shows the year to date performances of some of the world's major stock market indexes, from the US through to the UK and Europe, and on to Australasia. The table is ugly. A huge amount of wealth has been destroyed all around the world this year.

Stock Index	YTD Performance
Dow Jones Industrials (US)	-36%
S&P500 (US)	-41%
NASDAQ (US)	-42%
FTSE100 (UK)	-34%
CAC 40 (France)	-44%
DAX (Germany)	-43%
Nikkei (Japan)	-43%
CSI 300 (China)	-64%
ASX200 (Aust)	-44%

The great majority of that wealth has evaporated since September. As shown in the ASX200 chart below, the market broadly trended lower for the first 8 months of the year, losing around 19% of its value. At the beginning of September, the index was trading around 5130. That's when the panic set in. Since then, the ASX200 has fallen another 30% in value. Putting these extraordinary falls into some sort of context, 2008 will go down as the worst in the Australian market's history



It is worth re-examining why the pace of declines picked up from September. Throughout the first 6-8 months of the year, it appeared the credit market issues would be largely confined to the banking system and other

credit related areas, such as property trusts and leveraged investment vehicles.

Then, when the northern hemisphere returned from their summer holidays, the collective wisdom of the market reassessed. The ominous realisation set in: without a healthy banking system, economic growth was not possible.

It violently dawned on equity markets that the US, UK and European banking systems were capitalised by overvalued property markets. These property markets had been in the process of deflating since 2006. But by the second half of 2008, the loss of value on these properties and the associated write-downs to bank capital began to raise questions over the solvency of the global banking system.

Suddenly, everyone looked around and realised the western banking system was heading for bankruptcy. There were no strong players to support the weak. The thin layers of capital that had been supporting wildly overvalued asset markets were being eroded quicker than new capital could be raised.

Banking is a confidence game and confidence and trust evaporated as soon as the players realised the game was over. The crisis in the banking system immediately spilled over into the real economy. Credit, the lifeblood of modern economies, was withdrawn and economic contraction set in.

That the economic deterioration was unbelievably rapid is now only clear in hindsight. The charts below highlight just how quickly economic growth around the world has collapsed. Firstly, we show the oil price. Oil peaked in July at US\$147 per barrel and recently touched a low of around US\$32, representing a near 80% price collapse in just a few months.



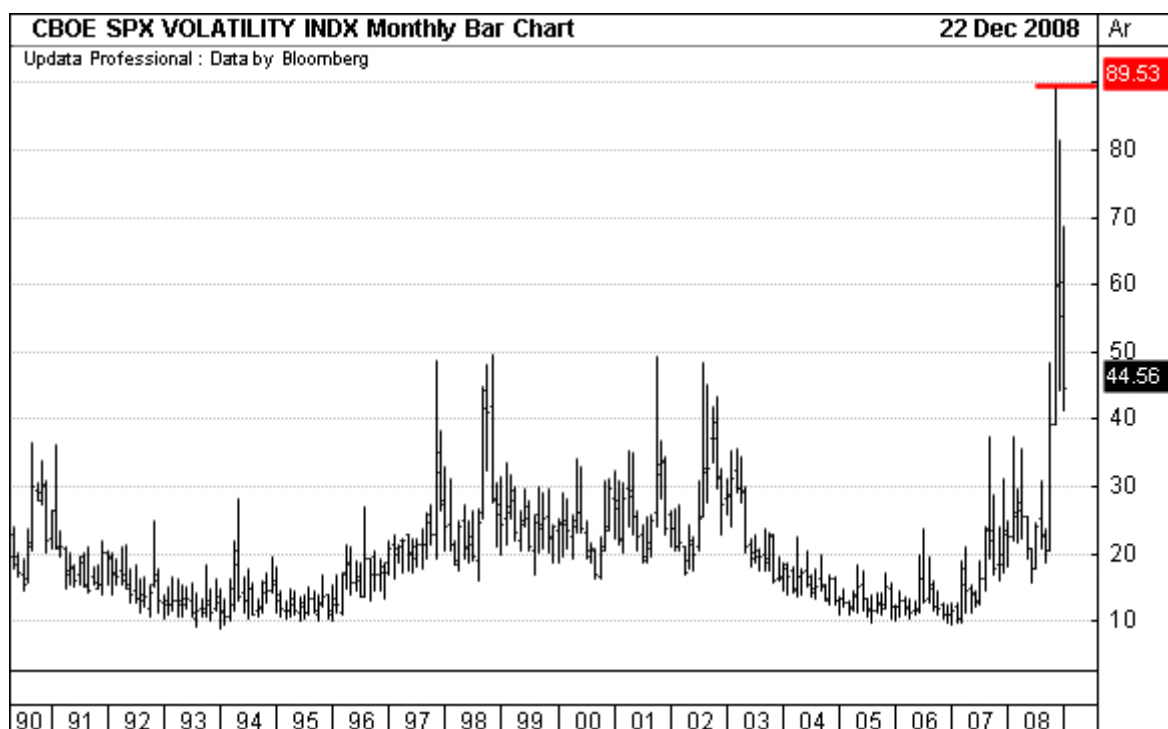
Copper prices have also collapsed. Copper is often referred to as Dr Copper, because it has a PhD in economics. Copper is used in just about every economically sensitive development. As the chart below shows, copper prices have mirrored that of oil, reflecting the fact that global economic growth has fallen off a cliff.



Exhibit C is the Baltic Dry Freight Index, which is a measure of shipping costs for bulk goods like iron ore, wheat etc. The chart below is a proxy for world trade and judging by the chart below, world trade is freezing up.



The realisation that a severely impaired global banking system was causing an unprecedented economic slowdown was the reason behind the panic and fear that we experienced during October and November. The volatility index, known as the VIX, clearly reflects this spike in investor fear. In fact, the fear gauge of the market in late 2008 was higher than at any other time in the index's history.



In what is perhaps an encouraging sign, the VIX is now subsiding and moving back down to more 'normal' levels.

All this activity had major effects in the foreign exchange markets. Perhaps the most surprising was the fact that the US dollar began to rally around the same time that other markets began declining. As we have stated on a few occasions, we believe this recent US dollar rally was simply a function of the credit contraction.

Owing to the US dollar being the world's reserve currency, the expansion of credit largely emanated from the US (and as we will see, Japan). Much of the world's debt is therefore US dollar denominated. In the boom years, those dollars were sold to finance investments all around the world, including commodities.

When credit markets started to tighten and investor attitude to risk changed, these trades were quickly reversed. The need to quickly repay that debt therefore saw a huge demand for US dollars worldwide.

A similar situation unfolded with the Japanese yen. Like the US, Japan has also been a source of much of the world's liquidity, especially since the Bank of Japan began a policy of 'quantitative easing (QE)' around 2001. QE refers to alternative monetary policy actions undertaken after official nominal rates hit 0%.

But instead of the newly created liquidity flowing into the moribund Japanese economy, the funds flowed around the globe. (Japanese investments in the high yielding Australian and NZ currencies were a favourite trade). Once the credit markets started to contract, these funds returned to the source, pushing the value of the yen much higher as leverage was unwound.

The Aussie dollar was a major casualty of this deleveraging. The charts below show that the Aussie was indeed an attractive destination for yen and US dollar based investors up until July. However, these trades were unwound rapidly as the crisis intensified. From the July peak to October, the Aussie had fallen by nearly 40% against the greenback and nearly 50% against the yen.



Mirroring the pace of the economic contraction, Wall Street was falling apart at a rapid clip. JP Morgan, with the help of the Federal Reserve, absorbed Bear Stearns back in March, but the real action occurred from September.

First, the mortgage giants Fannie Mae and Freddie Mac had to be rescued. Then, in mid-month, Lehman Brothers filed for bankruptcy and Bank of America purchased Merrill Lynch. A Federal Reserve bailout of the world's largest insurer, AIG, quickly followed and then the last remaining US investment banks, Goldman Sachs and Morgan Stanley, applied to become bank holding companies so they could borrow directly from the Federal Reserve.

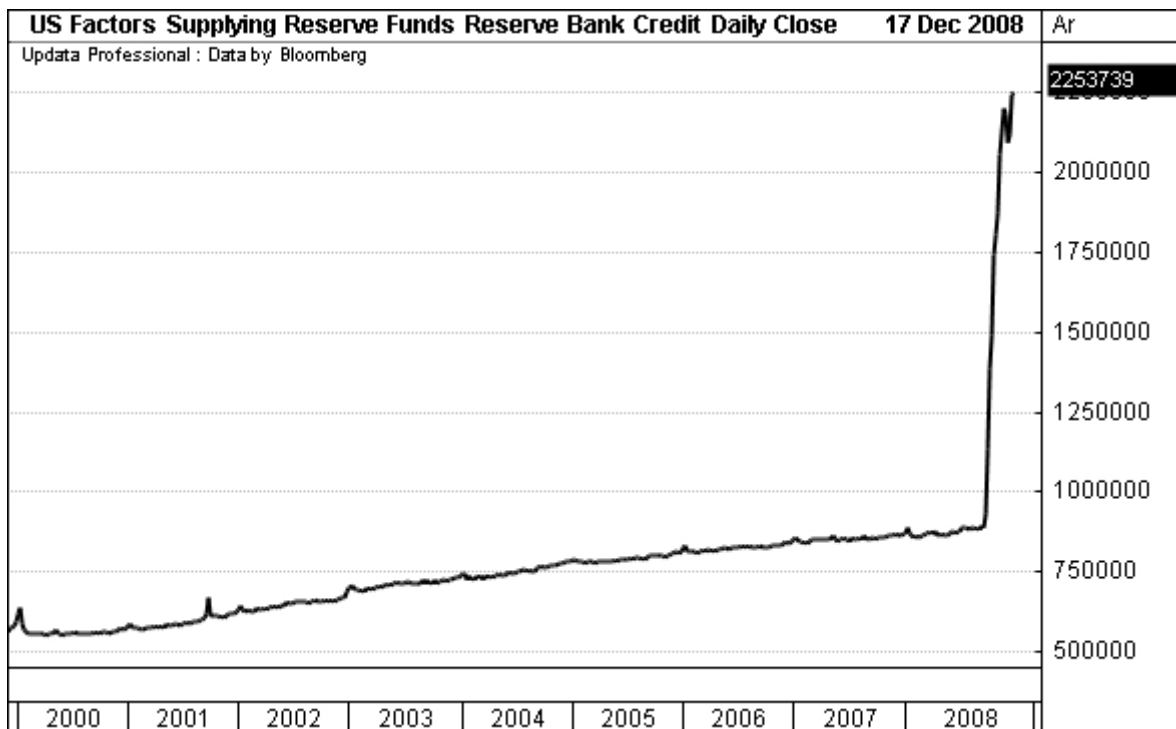
October brought other banking collapses and mergers and the passing of the Troubled Asset Relief Program, or TARP. This provided for US\$700 billion in government funds to prop up the beleaguered banking system.

Then, soon after receiving US\$20 billion in TARP funds, one of the largest banks of all, Citigroup, was the subject of a rescue in late November.

In just a few months the US banking and financial sector had changed irrevocably. Long a symbol of the US' financial and economic power, the decline of US financiers is an apt metaphor for the slow decline in US global power and influence.

Recognising that no banks or national banking systems were strong enough to step in and fill the void (one of the pitfalls of globalisation is that risk taking and stupidity are a global phenomenon) central banks and governments around the world are attempting to stem the bleeding.

The global banking system is severely impaired. Central banks are now in the process of shifting the bad debts of the private sector onto their balance sheets. Below we show a chart of the Federal Reserve's credit growth, which has exploded since September.



The problem though is that the Fed's injections of cash into the system are not being extended to the private sector. Banks are hoarding cash and the traditional method of credit creation (which occurs through the banking system) looks to be broken, for now at least.

The next step for the Fed is to begin buying assets directly. They have recently stated that they intend to buy massive amounts of mortgage backed securities (issued by the likes of Freddie and Fannie) and even Treasuries. This is the last resort of central bank overseeing a broken credit system and will eventually prove inflationary.

The fact that the Fed is now discussing printing money to buy assets in the open market, and the fact that interest rates around the world are heading towards zero, is one reason why gold has performed strongly relative to the market in 2008.

In both US and Aussie dollars, gold has still managed to rise in value this year, although owing to Aussie dollar weakness against the greenback, gold priced in AUD has been a standout performer, as shown in the chart below.



As we mentioned earlier, our big picture call on inflation has been wrong in 2008. In fact, every asset except for government bonds has been subject to violent deflationary forces this year. This has led to an exceptionally poor performance from the stocks in the Fat Prophets Portfolio.

We took the view at the start of the year that conditions would be tough, but by avoiding the sectors most at risk from the credit contraction, we would do relatively well. We failed to realise that all sectors were at risk and instead of taking a defensive stance and reducing our market exposure (especially at the smaller end) early in the year, we have experienced significant losses.

The fact that the market has also fallen significantly does not absolve us from our responsibility and our desire to make the right decisions. And clearly the decision to hold stocks throughout this downturn has been

the incorrect one.

We took the view that valuations had become attractive enough to justify holding. But the ferocity of the market contraction throughout October and November certainly made that view seem stupid. Hindsight will often do that to you.

We did however take some profits and losses throughout the year, as briefly shown in the table below. We provide more detail on these completed recommendations in this week's report.

Stock	Purchase Price	Issue Date	Sale Price	Issue Date	Return	Annualised
AVJ	\$ 1.31	339 Aug-07	\$ 0.94	359 Jan-08	-27%	
BCM	\$ 3.96	297 Sep-06	\$ 3.69	359 Jan-08	-7%	-5%
BTA	\$ 1.36	332 Jun-07	\$ 1.05	359 Jan-08	-31%	
EBI	\$ 3.21	288 Jul-06	\$ 2.88	359 Jan-08	3%	2%
MLE	\$ 0.68	82 May-02	\$ 3.16	359 Jan-08	464%	82%
RJT	\$ 1.02	299 Oct-06	\$ 0.62	359 Jan-08	-33%	-27%
FGL	\$ 4.51	150 Sep-03	\$ 5.76	364 Feb-08	49%	12%
HHL	\$ 1.39	21 Mar-01	\$ 13.67	365 Feb-08	945%	135%
MCC	\$ 1.25	98 Sep-02	\$ 11.90	366 Mar-08	926%	169%
TLSCA	\$ 2.00	298 Oct-06	\$ 3.06	366 Mar-08	74%	53%
AEZ	\$ 1.29	319 Mar-07	\$ 0.26	MWA Jun-08	-76%	-59%
IRN	\$ 0.20	80 May-02	\$ 1.33	387 Aug-08	553%	85%
API	\$ 2.39	328 May-07	\$ 0.70	392 Sep-08	-70%	-53%
NUF	\$ 3.62	102 Oct-02	\$ 15.25	392 Sep-08	364%	62%
TAP	\$ 2.72	258 Dec-05	\$ 0.90	392 Sep-08	-60%	-22%
WOTCA	\$ 0.60	219 Mar-05	\$ 0.39	392 Sep-08	-11%	-3%
OGC	\$ 5.00	169 Feb-04	\$ 0.40	395 Sep-08	-92%	-42%
PJF	\$ 2.08	230 May-05	\$ 2.16	404 Dec-08	4%	1%
TLS	\$ 4.57	216 Feb-05	\$ 4.95	405 Dec-08	8%	2%

It's times like these we need to remind ourselves that investing is a long term game. We are investing in businesses, not share prices. While we would have been better off selling some businesses earlier in the year, many companies are worth holding on to as they will emerge from the downturn in good shape. Certainly, the value that the market is now attributing to many businesses is a fraction of their worth.

That is what happens when recessions hit. Recessionary profits become priced in and investors don't expect the environment to improve. The bottom line is that the economy always improves after a downturn. The question is how long will the improvement take.

As investors, it is also worth reflecting on the emotional side of the equation. When times are good, the primary consideration is what to buy. When times are bad, as now, many investors don't want to buy and are instead focussed on selling. The good news is that it is this general attitude that creates bear market bottoms and sets the stage for the next advance.

While the future is inherently uncertain, we will be intently looking for signs of the next advance. We will discuss our outlook for 2009 in our next report, which will be published in early January.

Continuing an ongoing tradition at Fat Prophets, we have once again invited Members to award us a grade between A and D. An A being excellent and D representing a very poor effort.

Given the state of the market this year and our own disappointing performance, we were expecting more brickbats than bouquets this year. As evidenced by the 2008 Report Card, this has been the case and we have earned an average 'C' grade.

In an extremely difficult year for all involved, we sincerely extend our thanks to all those who voted and provided feedback; the good, bad, and the ugly! While we can't respond to all the comments, we do take note of your comments and we will be looking to make a number of improvements to the report next year.

If we haven't lived up to your expectations so far, we hope that our hard work will provide better rewards in 2009.

We wish all Members a happy and safe Christmas, and a very prosperous New Year.

Signing off for 2008, we take this opportunity to thank you for your continued support.

Best wishes,

Fat Prophets

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