

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 7, 2008

This is the ELF Capital Management, LLC Market Comment for the month ended August 2008. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular basis by entering their email address on our list-server via this [link](#). Feel free to forward this to any of your friends! Thanks for your interest and we hope you enjoy the letter.

Is a Strengthening US Dollar Good or Bad?

August served up a very choppy stock market. And, it now looks hopeful that we are building a bottom in the US equity markets. Yet, trading volume was quite low during the last month of summer vacation season. Less noticed, however, was that the US Dollar was significantly strengthening against major foreign currencies. Why should this matter?

Well, the US is not only the largest promoter of international trade; it is also the globe's largest consumer. Large currency changes impact investors and more broadly impacts consumers. Haven't we seen oil make a significant retreat from July's highs? Will it go lower? Or, will it go higher? So far, into September, we are seeing it go lower.

This letter will take a look at the rapid strengthening of the US Dollar, discuss the impacts and take a look at how we might assess the benefits. It takes immensely large money flows to impact foreign currency exchange rates and where money flows, demand grows! It sure looks to me that money is flowing into the US Dollar.

If you remember, my last month's letter spoke about whether a strengthening dollar was a headwind or a tailwind for the US economy. Now, we'll take a closer look.

Rapid Strengthening of the US Dollar (USD)

During August, the USD appreciated most against the Australian Dollar (10.5%), the British Pound (8.8%), the Euro (6.2%) and the Canadian Dollar (4.0%). These are pretty big moves for one month's action. Also, the USD appreciated 0.7% against the Japanese Yen. On the other hand, the USD weakened against the Mexican Peso (2.2%) and the Chinese Yuan (0.1%).

It is also noteworthy that the price of WTI Crude Oil declined roughly 6.9% over the same period. WTI Crude (West Texas Intermediate) is considered the major price benchmark of crude oil in the Americas. So, when we're looking at spot oil prices on TV, this is the number that we are seeing. However, as we import most of our oil, the Imported Refiner Acquisition Cost (IRAC) numbers have more to do with what we pay. According to the US Energy Information Administration, IRAC is the volume-weighted average price of all crude oils imported into the United States and is calculated weekly.

In August, IRAC prices fell by 7.4%. Due to its believed correlation with foreign exchange rates, I've included oil in this discussion on currency. And, as a former currency peg, gold dropped 9.3% for the month as well.

Prices look to be coming down and, at first blush, this all sounds good – doesn't it?

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 7, 2008

Strengthening Dollar Impacts

When the USD strengthens against another currency, it means that \$1 buys more of that currency. And, it stands to reason that \$1 should buy more goods and services from that country. If all remains constant, we should be able to obtain more goods and services for each USD spent; or, be able to spend less for the same amount of imported goods or services we are accustomed to purchasing. If you're considering travel from the US to Europe, right now, things just got a little less expensive.

This is not much different, in concept, as when oil comes down in price. When oil prices come down, we expect to see prices at the "pump" come down also. When prices at the pump come down, we are able to save some money or choose to use more of it.

However, consumers don't always receive an immediate benefit. Sometimes foreign producers will keep a little of the savings and increase profits until competitive forces prompt more attractive pricing through the supply chain. The more parties in the supply chain, the slower it takes for the consumer to see any benefit.

Since the US is the world's largest importer of foreign goods and services, a stronger USD should help ease inflationary pressures. And, given the oil shock we've experienced this year, we could certainly use some relief, no matter how modest or gradual it may come.

In similar fashion, a strengthening USD disadvantages US exports of goods and services. It makes it harder for US companies to compete in the global marketplace. It also makes it less affordable for foreign tourists who are considering travel to the US. This spells potentially bad news for our struggling economy. If, as a result, US companies have to absorb price cuts or begin to slash production, this will lower profits and, in turn, increase job losses.

As a point for consideration, it is widely thought that there is an inverse relationship between a strengthening USD and prosperity in the US manufacturing sector. A stronger Dollar not only negatively impacts exports but it makes US manufactured goods less competitive at home as well.

When we think of the impacts of a strengthening USD, we should also consider the potential causes. This came to mind when I read a passage in a May 2003 Economic Policy Institute paper written by Robert Blecker, Blecker is a professor of economics at American University in Washington, DC. In the paper, he writes:

"One reason the dollar has stayed so high relative to these other currencies is that many of their governments either peg their exchange rates (fix them relative to the dollar or other major currencies) at artificially low values, or intervene heavily to keep their currencies undervalued relative to the U.S. dollar (the latter policy is also followed by Japan, which issues a "major" currency). Such manipulative exchange rate policies are usually pursued as part of an export-led growth strategy that fosters chronic trade surpluses with the United States and therefore effectively exports unemployment to this country's traded goods sectors (mostly manufacturing). The most egregious offenders in this regard are a number of prominent East Asian countries, especially Japan, China, and Taiwan, which (not coincidentally) account for disproportionately large shares of the U.S. trade deficit."

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 7, 2008

While much of this sounds both good and bad, it helps to consider both sides of the equation. Over the near term, if a strengthening USD helps tame consumer inflation pressures, it could also serve to ease our credit crisis as well. This can be very, very positive. It certainly could help provide upward stimulus to our economy if it improves consumer sentiment and spending at home. However, in the grand scheme of things, it is only helpful as a “band-aid” or a pain reliever while the US works on developing much more of its energy resources and works through its credit issues.

Over the short term, a rising USD can be good.

Assessing the Benefit

Foreign exchange is an extremely complex topic involving an overwhelming number of variables, relationships and factors. At the same time, I by no means profess having great expertise in this area. However, one can begin to develop a basic understanding and arrive at some reasonable expectations through doing a little detective work and applying some basic logic and math skills.

For starters, it is simple to realize that the price of any asset will rise when demand exceeds supply. In the case of the US currency, more buyers desire to own dollars than there are sellers wishing to part with it. For now, let's not focus on the why. Instead, let's just accept that excess demand has driven the USD higher against some other currencies.

Next, let's put ourselves in the shoes of the buyers. Now that we own them, we can use our Dollars to purchase US goods and services, invest them in the US, or put them in a vault. If I had to speculate, I'd venture a guess that most will be held for investment, some represent purchases of US goods and services, and a smaller amount may be kept in a jar. Remember, these are large amounts we are talking about and few people are content with keeping large sums not invested. Now, let's upgrade this story and apply it to the US economy.

Whether spent or invested, both of these scenarios offer possibilities for stimulating the US economy. Certainly, USD demand resulting from increased US export activity (spending) is good for business profits and employment. Whereas, the impact of Dollars purchased for investment purposes comes with a little less certainty. Once you consider that the USD in circulation is a relatively finite amount controlled by the US Treasury, in essence, the Dollars purchased are merely changing hands. The degree to which the US economy benefits, or not, then becomes dependent upon how these USD are invested. Think of money invested in furthering US commerce as good; and think of money invested in US government debt to be not as good. As this strengthening unfolds over time, the markets will tell us where this money is going. Yet, my hunch is that foreigners are expecting greater prosperity in the US than they are from those countries whose currencies are falling against the US Dollar. Otherwise, why own them?

Now let's shift to discussing how a strengthening USD impacts inflation. Adding to the above discussion, it becomes more informative when we assess the strengthening USD versus how much business we actually do in each of these currencies. Looking over data from the US Department of Commerce for the first half of 2008, this is what I found:

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 7, 2008

Australia: The Aussie Dollar fell 10.5% against the USD; they represent 1.2% of US exports and 0.4% of US imports; for every \$1.00 we spend in Australia, they spend \$2.23 with us. This is a nominal plus for lowering inflation in the US.

Canada: The Looney fell against the USD by 4.0%; they represent 14.6% of US exports and 13.6% of US imports; for every \$1.00 we spend in Canada, they spend \$0.78 with us. This is a plus for lowering inflation in the US.

China: The Yuan appreciated against the USD by 0.1%; they represent 3.9% of US exports and 12.0% of US imports; for every \$1.00 we spend in China, they spend \$0.23 with us. This is slightly negative for lowering inflation in the US.

Euro-zone (ex-Great Britain): The Euro fell 6.2% against the USD; they represent 11.8% of US exports and 11.4% of US imports; for every \$1.00 we spend there, they spend \$0.75 with us. This is a big plus for lowering inflation in the US.

Great Britain: The Pound fell 8.8% against the USD; they represent 3.1% of US exports and 2.3% of US imports; for every \$1.00 we spend in the UK, they spend \$1.00 with us. This is a big plus for lowering inflation in the US.

Japan: The Yen fell 0.7% against the USD; they represent 4.1% of US exports and 5.7% of US imports; for every \$1.00 we spend there, they spend \$0.46 with us. This is a slight plus for lowering inflation in the US.

Mexico: The Peso appreciated 2.2% against the USD; they represent 7.9% of US exports and 8.5% of US imports; for every \$1.00 we spend in Mexico, they spend \$0.68 with us. This is negative for lowering inflation in the US.

Oil: I want to reiterate that the IRAC prices decreased roughly 7.4% last month. While oil prices have proven to be much more volatile than currency prices, this is a major plus for lowering inflation in the US.

By applying a little math to the above, we can see that we import roughly 54% of goods and services from these countries, and export roughly 46.5% to them. When we apply a weighted average change in currency rates, our import costs from them is now 2.5% cheaper and our exports to them are now 2.9% more expensive. If we cross multiply these figures, we find that these numbers serve to reduce total import costs and increase total export costs by approximately 1.35%. Considering that these are one month's numbers, they represent a very large savings. This is a very good sign for US consumers. And, these numbers only partially contribute to our expected savings from lower oil prices.

All in all, the strengthening US Dollar will help to curtail inflation in the US. While an export-led recovery might have been the better path to prosperity, it has always been the US consumer and small business that has led us out of our recessionary cycles. One might term this the more conservative approach to prosperity and a strengthening US Dollar certainly supports it. In that regard, a stronger USD is a good thing.

Our Investment Strategy and Other Observations from August

ELF CAPITAL MANAGEMENT, LLC
(ENDOWMENT LIKE FUND MANAGEMENT)

September 7, 2008

During August, we saw signs that prompted us to begin reinvesting cash in our client portfolios. We have reduced our average cash levels from roughly 80% to 15%. As stated last month, we were taking our cues from lowering oil prices and began transitioning back into the market each time we saw a major sell off in equity prices – we were buying on dips. We have reduced our international positions to roughly 10% and believe that the US economy will be the first to emerge from what has become a global slowdown. However, we could still be several quarters from any sustainable recovery. Trading activity through the month of August leads us to believe that the US stock markets are consolidating and forming stronger downside base support levels – hence, creating a bottom in the market. Our weightings favor mid and small cap companies over large caps to take advantage of an expected US consumer led recovery. To support this belief, we are seeing modest improvement in consumer confidence and the recent strengthening of the USD should help that. We are also hearing of modest improvement, in a few parts of the country, in the housing sector. Yet the most lagging numbers, like unemployment, have continued to deteriorate. We will continue taking our cues from oil prices and international economic data. Also, we continue to think that the US stock market will remain in a volatile sideways trading range until we begin to see more positives emerge.

Our performance for August was down 0.86%.

For disclosure purposes, past performance is not necessarily indicative of future results and ELF Capital Management LLC (ELF), formerly Hoffman White & Kaelber Financial Services LLC, cannot guarantee the success of its services. There is a chance that investments managed by ELF may lose a substantial amount of their initial value.

ELF is an independent discretionary investment management firm established in February 2003. ELF manages a strategic allocation of primarily exchange-traded index funds (ETFs), and may invest in other carefully selected securities. ELF may also employ hedging techniques, through the use of short positions and options. ELF manages individual portfolio accounts for both individual and business clients.

The ELF ETF Strategy returns presented herein represents a composite of actual results from all client portfolios managed by ELF. Currently, it is the only composite presented by ELF and separate client account portfolio positions are substantially similar, except as may be modified for retirement plan accounts and accounts with net equity of \$60,000 or less. There is no minimum account size for inclusion into ELF's ETF Strategy composite and accounts with net equity of \$60,000 or less have a tendency to downwardly skew the combined results.

The performance data presented herein includes the reinvestment of dividends and capital gains; as well, ELF's ETF Strategy composite returns are presented after deducting actual management fees, transaction costs or other expenses, if any. ELF charges an annual investment management fee as follows: 1.25% on the first \$250,000; 1.00% on the next \$750,000; 0.95% on the next \$4,000,000; and, 0.75% thereafter.