AQUILA ROCKY MOUNTAIN EQUITY FUND
INVESTMENT STRATEGY UPDATE
Q4 2008

Economy With the National Bureau of Economic Research declaring that the economy slipped into recession in December, 2007, the U.S. economy has already been in recession for a year. With most economists forecasting negative real growth of 4-6% for the fourth quarter, it is most likely that we are currently in the worst part of the recession. Most economists are looking for declines of 2-4% in the first quarter of 2009 with a 1-2% decline in the second quarter and some slight recovery in the second half. If the recession ends in June, it will have been 18 months long. Historically, by the time the National Bureau of Economic Research declares a recession, it is usually more than half over.

There are some signs that the consumer may be rebounding slightly. Black Friday sales all came in higher than last year, with Internet sales up 1% and other sales reports up in the 2-7% range. ComScore reported that online spending rose 15% on Cyber Monday (the Monday after Thanksgiving). We have also seen some retailers guiding up earnings after lowering them too much previously. While unemployment has risen to 6.7%, over 93% are still employed. Consumers are also benefiting from a dramatic drop in gasoline and fuel prices. Consumers need to see stability in housing prices and in financial markets to rebuild confidence.

Layoffs are a concern since corporations are laying off workers not only because of the weak economic activity, but also to conserve cash due to restricted credit availability. A recent Business Roundtable survey found that 60% of CEO's planned to cut workers in the next six months, up from 32% three months ago. Although layoffs are usually a lagging indicator and unemployment often peaks after the recession is over, too many layoffs could lengthen and deepen the recession from current expectations. Some economists believe that the recession could continue for most of 2009 due to rising layoffs.

We would note that while this is a discouraging and painful period in the economy, we are seeing individuals and businesses alike building up liquidity and repairing balance sheets. Like a plant, dead and diseased wood is being pruned from the economy. The economy will eventually grow more vigorously.

As the Obama administration moves into office, we think the economy may benefit in two ways. First, we think there will be an economic stimulus package focused on improving confidence. Second, we think businesses and individuals alike are waiting to see direction on tax rates and other business proposals before committing to capital spending and investments. With improving visibility, we think economic activity could begin to pick up. We have become slightly more defensive in our health care holdings due to Obama's health care appointments. While health care demand is likely to be expanded, there may be short-term pressure on profitability as the government demands discounts.

Credit Markets There continue to be a number of dislocations in the credit market which may still hurt the economy. The flight to quality is seen in the 30 day Treasury bill which has declined from over a 5% yield in early 2007 to a 1 basis point yield, where it has been for much of the second week of December.

The most improvement appears to have been made in the mortgage market, where the government is working to lower rates at Fannie Mae and Freddie Mac. On December 4, Freddie Mac announced that average 30-year mortgage rates had been lowered to the 5.53% level. The government may push down mortgage rates another 50 -150 basis points in this program.

The TED spread, or the spread between the 90 day Treasury bill and 90 day Libor, has improved significantly but is not yet at what would be considered normal levels. The TED spread has declined from a high of 4.63% on October 10 to 1.83% on December 15.

Credit spreads are still extreme and there appears to be a buyers strike. Cash on the sidelines appears to be waiting for greater visibility. Credit spreads may also have been affected by the lack of availability of debtor-in-possession financing and changes in bankruptcy laws that move companies into liquidation faster.

Equity Markets Historically, the stock market has looked ahead six months. That would suggest the equity markets should be focusing on mid-June 2009 when some economists believe we should start to see improvement in the economy due to lower energy prices, lower mortgage rates and other government stimulation. There have also been significant international government efforts to provide economic stimulus.

Valuation measures are suggesting that the market is undervalued for intermediate and long-term investors. The dividend yield for the S&P 500 is significantly above the 10 year Treasury. The average price/earnings ratio for stocks in the Value Line data base at the end of November was 10.1 compared to 14.4 at the market bottom of the last recession, in October 2002. Market breadth suggests a low was established on October 10. On that date 2,017 new lows occurred on the New York Stock Exchange and 1,381 stocks hit new lows on the NASDAQ. Although some of the indices have punched through to lower levels since then, the number of new lows has not been exceeded.

During December, we have also seen a few days when smaller cap stocks have outperformed bigger stocks. We are watching this trend closely since smaller cap stocks often outperform in December and January and microcap stocks (below $300 million in market capitalization) often also do very well in January. A recent article from the Microcap Speculator quoted some data provided by Kenneth French of Dartmouth and the University of Chicago's Eugene Fama. They provided the annualized Microcap returns by month from July 1926 to December 2004.

January	159.82%	July	22.64%
February	25.10%	August	8.16%
March	1.21%	September	-7.75%
April	12.86%	October	-14.60%
May	6.85%	November	7.97%
June	6.57%	December	-1.94%

What is apparent from these numbers is that microcaps are most negatively impacted by tax loss selling during the months of September and October (for mutual funds) and December (for individuals). January and February are two of the strongest months as the thinly traded stocks rebound from the selling.

Our analysis of the companies in the region shows that approximately 64% of the public companies in the Rocky Mountain region are currently microcap companies. Microcaps have historically provided our best opportunity and influence our overall return. Microcaps and lesser known stocks have been some of the hardest hit in this downturn. Microcaps and smaller cap stocks often lead the market coming out of the recession because they have been hit so hard in the downturn. We are currently working to identify promising microcap companies.

The State of the Region Arizona and Nevada are clearly suffering indigestion from a speculative homebuilding boom during 2005 and 2006. However, the region as a whole still appears to be doing somewhat better than the national average. October unemployment rates for the eight Rocky Mountain States are as follows, based on U.S. Department of Labor's Bureau of Labor Statistics:

Arizona	6.1%
Colorado	5.7
Idaho	5.3
Montana	4.8
Nevada	7.6
New Mexico	4.4
Utah	3.5
Wyoming	3.3
Ave. Rocky Mountain State	5.1
National Unemployment Rate	6.5

Nevada has the highest unemployment rate in the region and is the only state in the region with a rate above the national average. States with worse unemployment than Nevada include Michigan and Rhode Island with 9.3% unemployment, California with 8.2% unemployment and South Carolina with 8.0% unemployment. We expect unemployment to continue to rise in Arizona and Nevada since we expect more job cuts at the state and local level to deal with budget deficits in both states.

While Arizona and Nevada are suffering from over-expansion in homebuilding, they are both seeing a sharp contraction in home prices which will help affordability over the intermediate to longer-term. Due to declines in interest rates and home prices, housing affordability has improved nationally and is currently at the highest level since 1973.

Colorado and Utah did not get caught up in housing speculation and may turn up sooner than other areas although Colorado does have above-average exposure to more aggressive types of mortgages. The CEO of MDC Holdings, headquartered in Denver, noted on the October earnings call that he thought Colorado housing might be one of the first states to show improvement. In addition, Obama has indicated that he intends to stimulate technology spending and job creation, and that would likely benefit Colorado due to the high level of technology related workers in the state. It would also benefit the Rocky Mountain region due to the large number of entrepreneurial incubators.

On the positive side of rising unemployment, the CEO of Merit Medical on the October earnings call noted that the weaker economy is taking off some of the pricing pressure for labor in Utah where unemployment has been extremely low. On the national level, nonfinancial unit labor costs rose just 0.5% year over year in the third quarter. When you combine declining commodity costs and slow growth in labor costs, companies that do not have variable-rate debt will generate strong profits as revenues begin to recover.

On December 5, the Mortgage Bankers Association released the mortgage delinquency rates for the third quarter. The national rate was 6.99%, up 140 basis points from one year ago. In the Rocky Mountain region, Arizona and Nevada had mortgage delinquency rates above the national average. Arizona's rate was 7.39%, but Arizona and Nevada were not among the top five mortgage delinquency states (Mississippi, Louisiana, Michigan, Indiana and Georgia) which were in the 9.24% - 11.71% range.

We believe the Rocky Mountain region continues to offer the quality of an outdoor lifestyle that is attractive to younger workers and retirees alike. While Arizona and Nevada are working through short to intermediate-term challenges, falling housing prices are likely to make the states more attractive over the longer-term. A slowdown in growth is also giving the states a much needed respite and a chance to address quality-of-life issues, such as infrastructure, over the longer- term.

Barbara Walchli
December, 2008