

Q1-2009 Small Cap Sector/Industry Outlook **Bluegrass Portfolio LLC (bluegrassportfolio.com)**

Scope: This report is intended to provide potential results from small cap stocks within specific industries. The suggested timeframe is through the end of the first calendar quarter of 2009. Invariably, however, many of these trends persist well beyond the suggested timeframe.

Users should bear in mind these are strictly forecasts, are subject to change, and by no means should be considered a specific recommendation. Consult your financial professional to determine the suitability of any or all of these forecasts.

Methodology: A blend of technical, fundamental, sentiment, and economic data is considered during the creation of this forecast. The actual methodology is proprietary, though it is conventional by most standards.

In all cases, we used Standard & Poor's classification of small caps as our study subjects. They also offer industry-level and market cap-level indices, which allows us to review technical as well as fundamental aspects of these groups.

Overview

It's not likely that anybody will be saddened to flip their calendar to the year 2009. Not only were stocks technically derailed in 2008 (in record time), the beleaguered economy also meant fundamental values were badly damaged. Now, with technical and fundamental forces frequently at odds with one another, even making a well-rationalized decision doesn't mean success is excessively likely.

To combat that challenge, we've taken a deliberate step back to specifically look at longer-term charts, in order to find industries with the best technical odds of appreciating. Of course, we still wish to see promising fundamentals.

This report is divided into three sections...

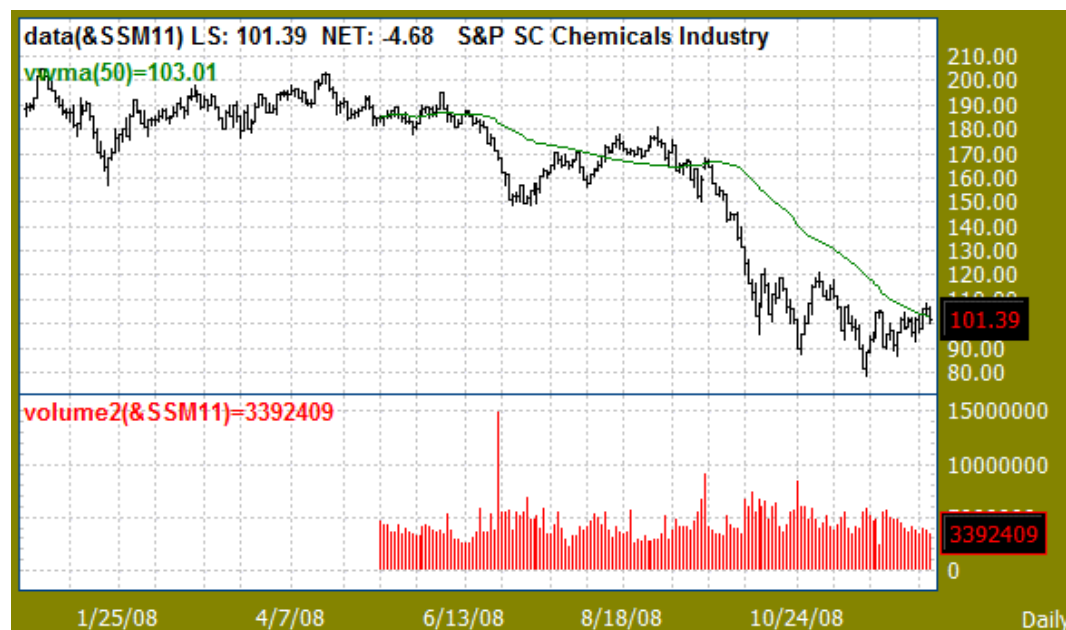
1. Q1-2009's Most Compelling Small Cap Groups
2. Q1-2009's Least Compelling Small Cap Groups
3. Small Cap Industries to Watch (groups that may improve in Q1, but are not healthy yet)

It is also worth noting a sector rotation strategy such as this one constantly changing, as one industry falls into favor at the expense of another industry. For that reason, this study should not necessarily be considered a permanent projection (even in the short term), but rather a starting point. Be sure to visit the site bluegrassportfolio.com for ongoing updates to this small cap industry outlook.

Most Compelling Small Cap Industries for Q1, 2009

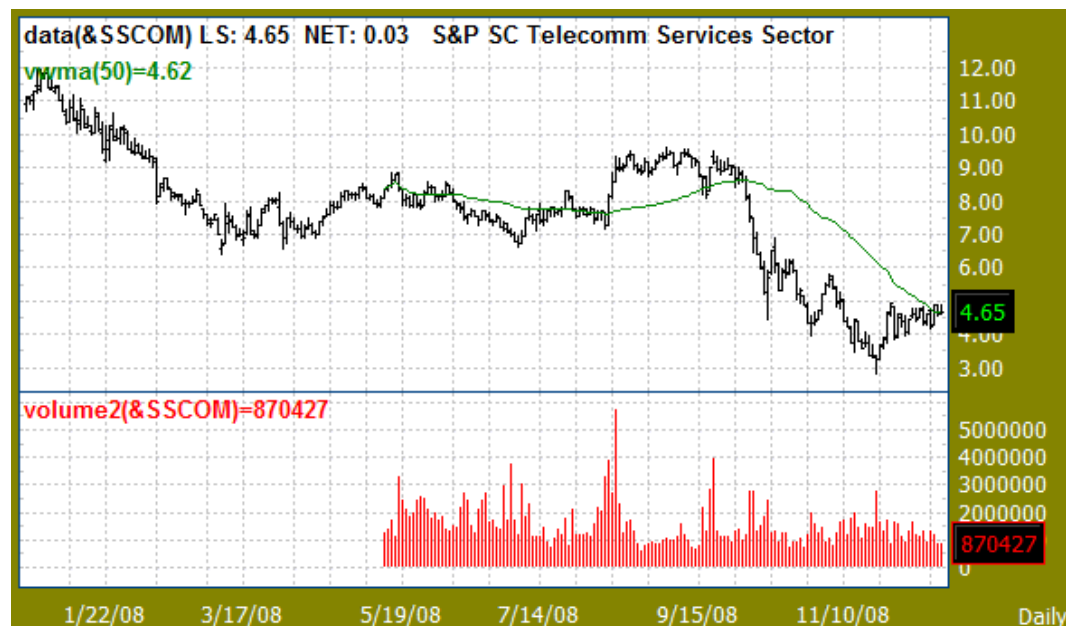
Chemicals

The primary concern regarding the recent strength is the lack of volume behind those gains... though it's a marketwide problem as well. Nevertheless, this group trades independently of the market, and these companies continue to fare well in the face of continued economic turbulence. Prominent small caps in this group are Ashland Inc (ASH), Celanese Corp. (CE), and FMC Corp. (FMC). The average price/earnings ratio of these three stocks is a stunning 6.2, and margins are respectable (though Ashland's been struggling on the earnings front lately). Updated analyst estimates for next year are now in, and the bar has been set very low compared to 2008s actual results.



Telecom

The large cap brethren in this group have actually led the way over the last month, though the smaller names have perked up more recently. The companies in the 'small cap' slice of this sector are primarily the local carriers, such as Shenandoah (SHEN), Iowa Telecommunications (IWA), Cincinnati Bell (CBB), and Alaska Communications Systems (ALSK). We're also throwing TW Telecom (TWTC) into the group. The average P/E for the four local carriers is 14.2. Margins are ok, but dividends are huge in some cases.



Paper/Packaging

After a wave of consolidations, and pain created by sky-rocketing materials costs, paper and packaging stocks are surprisingly holding up better than most. In fact, they've led the way since early November. Prominent small caps in the industry include Potlatch (PCH), Domtar (UFS), Aracruz Celulos (ARA), Sappi Ltd. (SPP), Wausau Paper (WPP), Temple-Inland (TIN), and PH Glatfelter (GLT). Caution – there are more misses than hits when it comes to earnings, though we expect that trend to shift for the better now that expenses are being reigned in somewhat.



Home Furnishings

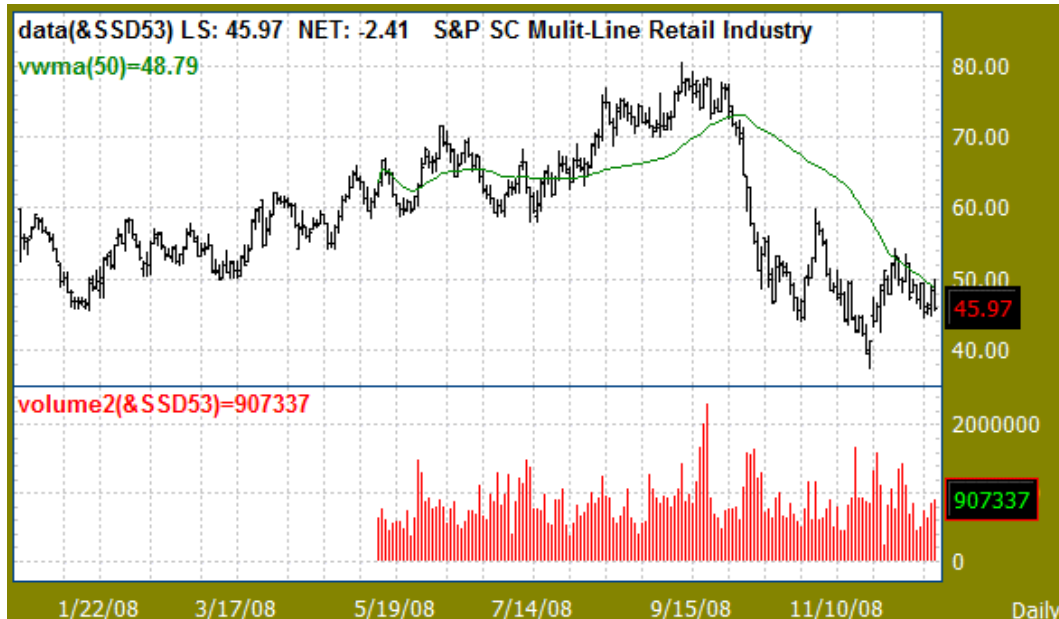
Like paper and packaging stocks, this group hit its low in late October, and has been rolling ever since. Are consumers actually spending more to update their current homes rather than (obviously) not buying a new home? That's the theory, though the revenue numbers haven't verified that hypothesis. Nevertheless, the small caps in this cluster are breaking out. The key small caps in the home furnishings segment are Tempur Pedic (TPX), Ethan Allen (ETH), Sealy (ZZ), and La-Z-Boy (LZB)....and all are reasonably priced.



Least Compelling Small Cap Industries for Q1, 2009

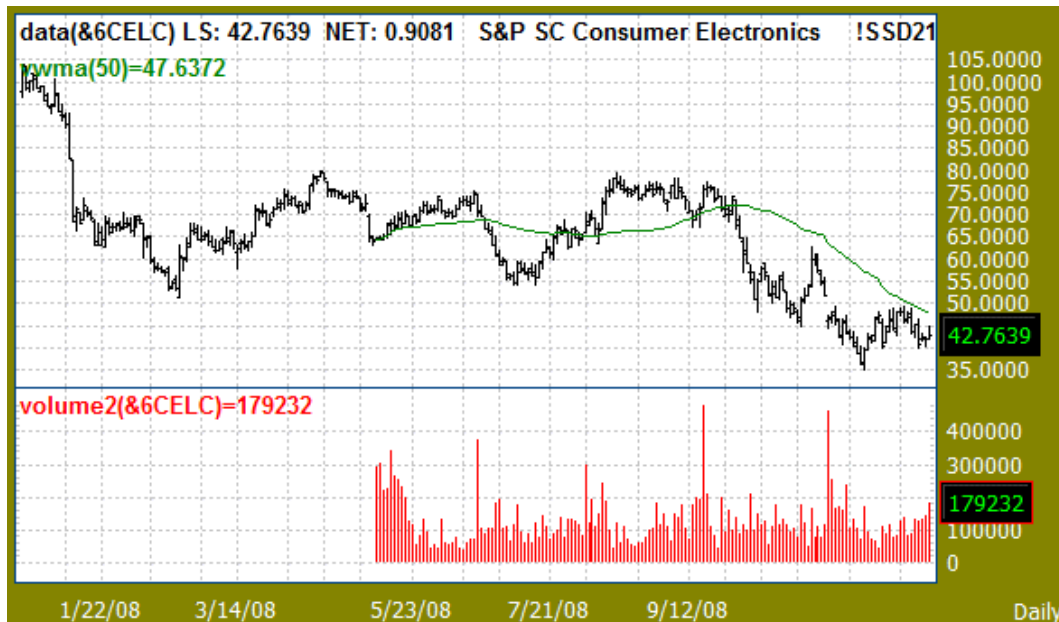
Multi-Line Retail

This group encompasses the true discounters, as opposed to the broad line retailers that are more fashion oriented than value oriented. In other words, we're talking about Dollar Tree (DLTR), Duckwall-ALCO (DUCK), Family Dollar (FDO), Fred's (FRED), BJ Wholesale Club (BJ), and Big Lots (BIG). These stores were supposed to benefit from a recession... better values means more demand when a dollar needs to be stretched. The stocks have rallied, but the stores haven't exactly pulled in more customers.



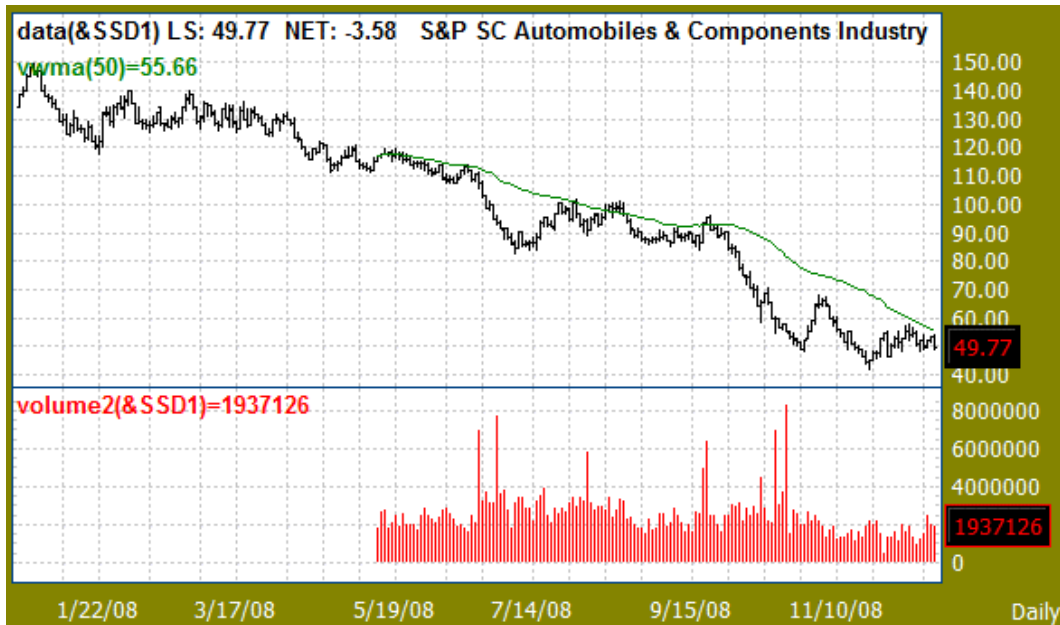
Consumer Electronics

No surprises here – 'toys' are the first thing to suffer when the economy contracts. There are too many names in the industry to even list the small cap ones; very few are profitable for the last twelve months. The index chart hasn't even attempted to rally with the market.



Automobiles & Components

As far as small caps go, this group doesn't actually include any auto-makers... it's just the component side of the auto business that's made up of small cap stocks. Needless to say, with the big three on the verge of collapse, there's not a lot of trickle-down demand for most of the smaller fish in the pond. Autoliv (ALV), Gentex (GNTX), and WABCO (WBC) are a few examples of the names in this cluster. A snapshot of their books really isn't all that bad, but there's just so little hope right now for an early end to the crisis.



Small Cap Industries to Watch

Aluminum

This is more of a value idea than a momentum or fundamental idea right now – the S&P small cap aluminum index is down nearly 90% since May. The chart's best rebound effort since then was in mid-November, but the buyers faded before any real progress was made. In some regards it makes sense – 2 of the 3 small caps in the group are net losers for the last twelve months. However, Alcoa has remained profitable, as has Kaiser Aluminum (KALU). The actual small caps in the aluminum industry are Century (CENX), Tredgar (TG), and Aluminum Corp. of China (ACH). A small profit from any of them could go a long way (though easier said than done).



Airlines

Yes, this is a play on the plunge in oil prices... to a degree. In the short run, airlines move inversely to oil prices. In the long run though, they move independently. As long as oil stays reasonably inexpensive (and it looks like it will), airlines can operate profitably. Just be prepared for turbulence (no pun intended) if you get on board... there's still the day-to-day bout with oil prices.



Electronic Equipment & Instruments

This group represents the manufacturers of industrial electronics and instruments... names like Thomas & Betts (TNB), General Cable (BGC), Regal-Beloit (RBC), GrafTech International (GTI) and Woodward Governor (WGOV). None of those names are household names, and their recent rally has been completely unnoticed thanks to their obscurity. However, the fundamentals more than merit a closer look. The average P/E for all those stocks is a mere 7.0, thanks to a fairly unmerited 50% plunge in the third quarter of this year. In that light, this is a potential undervalued idea....technically and fundamentally. It's not quite there yet though.

