Market Report

First Quarter 2008

The Economy

The economy took a decided turn for the worse during the first quarter of 2008. What started as a normal cyclical economic downturn was made worse by the events surrounding the subprime market. The resultant decline in house values squeezed consumer spending and created a chain of events in the mortgage-backed security market that threatened people's confidence in financial markets. Factory production and retail sales are falling, employment is shrinking, and household income is slowing, which indicates that the economy is already in a recession. The Federal Reserve is doing everything it can to help, from continuing to push the Federal Funds rate down to opening new avenues for financial firms to borrow. Congress is helping as well, providing a $168 billion stimulus package for consumers.

The economy is on the brink of a recession due to events surrounding the subprime industry.

The primary factor that has driven the economy's health has been access to liquidity. After September 11, 2001 the Federal Reserve dropped the fed funds rate in a series of moves to 1.0% in order to encourage banks to lend and inject liquidity into the economy. For the next five or six years the Fed continued to pump liquidity in the system. This kept the economic expansion going, but also led to investments in riskier and riskier assets and ultimately to the housing bubble in the United States. Recently, due to the meltdown in subprime mortgages, banks became much more cautious in their lending practices. Many firms could not get short-term funding, creating turmoil in the capital markets and culminating with Bear Stearns facing bankruptcy. The Federal Reserve resolved the situation by providing the economy with much-needed liquidity and returned stability to financial markets. We believe these actions will help keep the recession short and mild, although parts of the United States will get hit harder than others.

While the economy is not out of the woods yet, we are optimistic that growth will return before long – possibly this year. We believe that exports will likely be the driving force behind the recovery. The liquidity provided by the Fed weakens the dollar which makes products made in the United States more competitive in overseas markets. The wild card is inflation, which could start to become a concern. Core inflation is already rising. Recent spikes in crude oil prices are already driving transportation and utility bills higher. This is not alarming yet, but we will be closely monitoring the trends.

Outside of the United States, global economies are well positioned to continue expanding. Europe and Japan face a consumer slowdown similar to the United States, but growth is strong elsewhere. Australia, Russia and Brazil, which depend heavily on exports of commodities, are still growing thanks to strong demand from India and China. China's economic growth will slow from 12% to 8%, which is still solid. And the Middle Eastern oil-producing nations are awash in profits, which they are using to build infrastructure. Weakness in the United States will have some spillover into foreign economies, but there are enough signs of strength that should keep these economies strong.

The Stock Market

The U.S. stock market was hit hard in the quarter as the economy weakened. On a total return basis, the Dow Jones Industrial Average finished down 7.0% for the quarter. The Standard and Poor's 500 Index was down 9.5%, and the small capitalization Russell 2000 Index was down 9.90%. The NASDAQ Composite fared even worse, down 14.0%. At the beginning of the year, corporate profit growth was expected to slow but remained positive, and economists were hopeful the U.S. economy could avoid a recession. But by the end of the quarter, it was clear that corporate earnings were declining more than expected and the economy is most likely in a recession.

Stock markets around the globe have shared in the pain felt by U.S. markets.

The debate now centers on how bad things will get and how long it will last. We are cautiously optimistic that conditions will improve sometime later this year.

The Federal Reserve has let it be known that they will do whatever they feel is necessary to prevent the financial system from collapsing. This has addressed one large risk to the equity markets. Despite the continuous bad news in the first quarter, the markets held up decently. This signals the bad news may have already been priced into the market, and as we work our way through the mortgage mess, the markets could improve. The market fundamentals support this view. The market's Price/Earnings ratio based on next twelve month earnings is 13.5 -- very reasonable versus historical averages. Total corporate earnings growth for 2008 in S&P 500 companies is expected to be only 2.80%, but outside of the financial sector the numbers look much better. For instance, total earnings in the technology sector are expected to be up 12.1%, industrials up 10.2%, and health care up 20.5%. Even if analysts' earnings estimates come down as expected, companies in these sectors still will post solid growth in 2008.

The problems in the U.S. financial markets did not just impact the domestic stock market. Many markets around the globe experienced their worst performance in years. In fact, many markets fared even worse than the United States. Markets in India, China, and Japan all fell between 18% and 20%. Some of the difference could be attributed to the fact that many of these markets had substantially outperformed domestic stocks for the past five years. Still, the declines illustrate how global markets have become much more closely correlated despite differences in growth prospects. Investors fear that increasing integration of the world's economies will prevent economies around the world from being immune to the financial crisis in the United States. We believe there will be a slight drag from the United States but not enough to seriously impact the expected growth overseas.

The Bond Market

The weakening economy also took its toll on the bond market, as investors turned their collective backs on anything with even a small amount of risk. Due to the subprime mortgage crises, banks became much more cautious in their lending practices and began to demand more collateral from investors. As a result, investors did not want to own the more risky mortgage-backed and municipal debt. Concerns about the economy also led investors to sell corporate bonds. In effect, investors sold any bond that had any risk attached to it and bought ultra-safe Treasuries. The Federal Reserve responded by cutting the fed funds rate to 2.25% in order to induce investment. In addition, for the first time in history the Fed opened its discount lending window to the investment banks and assisted J.P. Morgan in its takeover of troubled Bear Stearns.

Investors shun risk, causing a classic "flight-to-quality" in the bond market.

The quarter ended with the Treasury Department announcing a plan designed to prevent this type of crisis from happening again. There will be much debate in the next year or so before any plan is implemented, but the result will likely give federal regulators the power to regulate all corners of the financial system in the biggest overhaul of market regulations since the 1930's. This includes the investment banks, which have mostly operated outside the realm of federal scrutiny.

These moves have stabilized the markets for the time being. If they also calm investor's nervousness about the American financial system, someday we might look back and realize that there are some great bargains in the fixed income markets that were hit the hardest. For example, yields on tax-free municipal bonds surpassed the yields on similar Treasury bonds for the first time in decades. But until the economy recovers investors will continue to steer clear of risk and bond prices will continue to languish.

For more information on McKinley Carter, visit our website, www.mc-ws.com, or contact us at 866.306.2400.