



MARKET REPORT

SECOND QUARTER 2008

THE ECONOMY

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As the month of June began, economists were optimistic that stronger growth in the United States would soon be evident. But that outlook soured as numerous banks announced poor results and additional write downs, causing the need to raise new capital and reduce lending. The U.S. economy was already facing a slowdown, and many economists worried that the soaring price of crude oil and seemingly endless bank write downs would cause a prolonged global recession. The Federal Reserve is now in a very difficult position. They cannot drop rates further to spur growth because this might exacerbate inflation, but they cannot raise rates to head off inflation because this will hinder already weak growth. With an uncertain jobs picture, higher prices for gas, food and utilities, falling housing prices and negative Presidential campaign rhetoric, the American public appears very pessimistic about the economy's prospects.

We believe the key factor that may determine if the Federal Reserve can steer the economy out of the current situation is the price of oil, which ended the quarter over \$140/barrel. If the price drops to around \$100 - \$110 later this year, inflation pressures would ease and allow the Fed to keep rates low in order to bolster the economy. We are hopeful this may occur as the summer driving season and the Olympics ends, reducing demand. China is holding off raising gasoline prices until after the Olympics. When the Olympics are over China will raise the price of gasoline more in line with what they are paying.

The current economic data is strong enough to support a recovery if the price of oil cooperates. GDP is solid at around 2.0%, the cost of borrowing is cheap as interest rates remain low, and the unemployment rate remains relatively low (5.5%). High gas prices have not slowed consumer spending as much as is widely believed, thanks to the tax rebate checks. Exports by U.S. corporations are strong and could provide the driving force behind a recovery to more normal levels of growth later this year. Many foreign economies are also dealing with inflation concerns thanks to soaring food and energy costs. As the second half gets under way, investors worry that central banks around the world will be forced to raise interest rates to stem rising commodities prices even though growth is slowing, especially in developed markets like Europe.

THE STOCK MARKET

The second quarter sell off that began in mid-May effectively wiped out the gains from the rally that began in March. On a total return basis the S&P 500 Index finished the quarter - 2.73%. The Dow Jones Industrial Average ended -6.86% for the quarter and posted its worst first half performance since 1970. Stocks sunk around the globe, with the worst-performing stocks those with direct exposure to the credit crisis and consumer spending. In the first half of the year most European markets were down anywhere from 2.0% to 15%, India was - 20%, and Pakistan ended -28%. Emerging markets like China and India are dealing with an economic slowdown that comes on the heels of huge stock run-ups last year. Europe is struggling with a weakened banking system. Inflation is a problem everywhere thanks to the

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increase in the price of oil, and investors are worried how well corporate earnings will hold up. The few winners were in countries that are commodity-rich such as Canada (+9.0%) and some Latin American countries (the MSCI Latin America index +10.1%).

The data does not give a clear indication of where the market is headed. On the positive side, corporate earnings have been decent, with the exception of the financial and consumer discretionary sectors. GDP growth has been stronger than expected thanks to continued growth from developing economies. The stock market remains fairly valued; based on next twelve months earnings the average P/E ratio of the companies in the S&P 500 Index is 14.6x, which is just below the historical average. On the negative side, there is gasoline at \$4-plus a gallon, a continued implosion in the housing market, and ongoing stresses in the financial sector that is causing consumer confidence to sink.

A reason for optimism can be found by looking closer at corporate earnings. The credit crisis at financial institutions is not over, but so far the earnings impact has been felt mainly by firms in the financial sector. Also, consumer spending has been boosted by tax rebate checks and was better than expected in April and May. More checks went out in June and July, so this stimulus should continue through the end of summer. According to Zacks Investment Research, the average earnings at S&P 500 companies are expected to be -10.2% for the second quarter, and financial sector earnings are expected to drop 60%. But nearly 60% of S&P 500 companies are expected to report positive profit growth. Technology, industrial, and energy companies should do well. But investors are very nervous. Over the next year the price of oil could be the biggest factor in the direction of the stock market. The tax rebates will have been spent, and a continuation of high gas prices could finally cause consumers to cut back on spending.

THE BOND MARKET

The prevailing sentiment in the bond markets was that stronger-than-expected economic growth, high oil prices and the weak U.S. dollar would spur inflation and make bonds less attractive.

Bond markets seemed to be turning around in April and May, but the rally was short-lived. In June bond investors reacted to the additional bank write downs, concerns about the solvency of bond insurers, and worries about rising inflation by pulling out of risky assets and fleeing to ultra-safe Treasuries. The prevailing sentiment in the bond markets during the second quarter was that stronger-than-expected economic growth, high oil prices and the weak U.S. dollar would spur inflation and make bonds less attractive. The result was yields rose and the yield curve flattened. The 10-year note's yield rose to 3.97% in the quarter, from 3.4% at the start, and the 30-year Treasury bond's yield rose to 4.5% from 4.3% at the end of March.

But there were signs of strength in the quarter. A record number of investment-grade bonds were issued in May. Prices of junk bonds rose in the quarter and companies with weak credit ratings began issuing new bonds after months of hardly any new deals. During the second quarter Junk-bond spreads, or the difference between the yield on junk bonds and risk-free Treasuries, fell from 8.2% to 7.4%, and Investment-grade spreads fell from 3.0% to 2.7%.

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