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What Inning Is It?
Market Commentary July 1st 2008

"Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who ever have been, and ever shall be, animated by the same passions, and thus they necessarily have the same results."

- Machiavelli

You have to admire Wall Street; after being blind-sided by one of the greatest financial debacles (that they helped to create), they are now stating with absolute certainty that we are in the eighth inning of the financial crisis. Or is it the third inning? Or maybe it's the fifth inning… They'll get back to you.

History often repeats itself and Wall Street with a bit more regularity. The evolution of the current credit crisis has followed a pattern similar to those of the past. In this case, given the opportunity, liquidity courtesy of the Federal Reserve, a natural propensity for greed, and a disregard of the financial ramifications, combined to provide the necessary components for a financial collapse. The net result this time has been financial institutions writing down billions of dollars while attempting to raise new capital to bolster their balance sheets, investors realizing assets they once thought secure are now junk status at best, and individuals struggling under higher rates and declining home values.

The truly remarkable aspect of the current credit crisis is that we went through a similar bubble in equities just a short time ago. Eight years to be exact.

As discussed in our last commentary, we are entering a transitional period, one in which the financial system and the economy need to correct prior imbalances and obtain a degree of stability. This process cannot be quantified within a specific time frame; rather it will be necessary to monitor specific conditions in order to judge our progress in repairing the damage the credit crisis has inflicted on the economy and the capital markets. Unlike the market strategists and economists that are compelled to announce bear markets, recessions, or what "inning" we are in, we will instead focus on the fundamentals and patiently analyze the data as it is presented.

As of the end of June, the Dow Jones Industrials was down (14.43%) year to date and (20.60%) from its October peak placing the index officially in a bear market. For the month of June alone, the Dow fell (10.20%) making it the worst performer of the major domestic indices given its exposure to financial companies and General Motors which hit a 52 *year* low. [1]

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[1] Yahoo Finance www.finance.yahoo.com

The S&P and NASDAQ fared little better with the S&P down (12.83%) for the year, down (8.60%) for the month and the NASDAQ negative (13.55%) year to date, (9.20%) in June.[2] Though the S&P and the NASDAQ escaped bear market territory it was cold comfort to investors, many of who have had little or no gains for their efforts over the last eight years.

International equities were not immune to the selling with the EAFE falling (8.4%) in June, down (12.70%) for the year.[3] However, it was in the once highflying Asian markets where the damage was truly felt with the Shanghai Index down (48.0%) for the year so far and the Hang Seng negative by (20.5%).[4] Commodity based economies such as Brazil and Russia held up a bit better as would be expected with their heavy reliance on energy exports with Russia up 0.2% and Brazil positive by 1.7%.[5]

On a relative basis our portfolios continued to outperform the broad indices by a significant margin both year to date and during the month of June. The broad allocation of assets played a primary role, as we remained overweight cash equivalents, short-term bonds, and energy. In addition, remaining underweight financials and emerging markets provided the opportunity to side step the worst performing sectors. Finally, we took the opportunity to raise cash in many of the portfolios by selling some positions that we believed had reached near term highs, thereby locking in gains and adding additional down side protection.

However, even with our conservative stance and ability to accurately forecast the markets, returns for the most part are slightly negative year to date. Our goal remains to protect principal as much as possible during this period of uncertainty while remaining focused on the long-term. Once we have determined that the underlying fundamentals in the economy and the markets, both globally and domestically, have begun to stabilize, we will once again seek out opportunities in order to generate strong risk adjusted returns for our clients.

There were few places to hide outside of the commodities. Energy, represented by crude oil, is up 43% since the beginning of the year, almost doubling in value in twelve months with a return of 98.0%.[6] Both coal and natural gas have also benefited from the supply demand imbalance in addition to the weakening dollar and geo-political risk in the Middle East.

And don't forget crops.

Both corn and wheat are facing what traders have termed the perfect storm. Increasing demand for corn due to ethanol production and a growing middle class in developing economies combined with recent floods in the Midwest pushed prices to record levels. The ripple effects have subsequently been felt throughout the food chain with beef prices increasing due to the availability or lack thereof of feed, dairy prices increasing for predominately the same reasons, and related food stuffs being impacted by secondary causes such as the price increase for fertilizers and chemicals.

[2] Yahoo Finance www.finance.yahoo.com
[3] MSCI Barra www.msci-barra.com
[4] Reuters www.reuters.com
[5] Yahoo Finance www.finance.yahoo.com
[6] Lind-Waldock www.lind-waldock.com

Though the rising costs associated with food is impacting consumer spending and therefore additional pressure on the economy, we would consider it to be a short-term phenomena that should correct and revert to a more historical average in the coming years. Farmers have the ability to significantly increase the production of corn and wheat given the available land. Secondly, ethanol production will in our opinion be reduced, as it will be deemed an inefficient and costly means to produce clean fuel. Without current subsidies, ethanol does not make economic sense and we would anticipate other technologies to take the lead in the future.

However, with both food and energy prices hitting new highs it is no wonder that consumers have adjusted their spending patterns to emphasize non-discretionary items. Core inflation, as reported by the government, is high but contained. However, as we have discussed previously, core inflation is a nonsensical number that is not reflective of the world most people live in. It is of little value that technology prices are in decline when you can't buy gas to get to work in order to make enough money to feed your family.

Longer term, energy prices will in all probability remain elevated for several reasons. As developing countries continue to build out their economies and expand their middle class, energy demand will increase. China alone has contributed to the supply demand imbalance over the last several years and though the rate of growth may slow, it will not be enough to drastically reduce oil prices. Adding fuel to the fire is the weak dollar, which continues to build a floor under energy prices, and finally we still have geo-political risk.

It is rumored that Israel is contemplating a preemptive strike against Iran's nuclear program. When you consider that 40% [7]of the world's oil goes through the Strait of Hormuz and Iran would in all probability retaliate by closing the route, oil supplies could be disrupted for months. If on the other hand the United States took steps to keep the route open, there is the potential that the military threat could escalate. In any event, as long as the threat of an Israeli strike is on the table, additional risk premiums will be built into energy prices.

Eventually we will find cost effective alternative energy sources, reduce demand, or open up new areas to drilling and exploration. Though we may experience a further spike in energy prices, we should see price stability in the future albeit at prices higher than would be hoped for.

Inflationary pressures lead to a reduction in spending and subsequently lead to further recessionary pressures in the economy. When you take into account the four week moving average for unemployment claims are nearing the 400,000[8] level and according to Goldman Sachs, the unemployment rate will increase to 6.5%, it's understandable if consumers start to focus on debt reduction rather than flat screen TVs. Anecdotal evidence may indicate stimulus checks were used to pay down credit card balances and buy groceries rather than discretionary items.

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[7] US Energy Information Administration (EIA)
[8] US Department of Labor

As inflationary pressures in the economy increase and the job outlook deteriorates, consumer sentiment has declined hitting a twenty-eight year low. When you consider that many individuals have borrowed first from their home equity and more recently from credit cards in order to artificially support a lifestyle they could not afford, it is difficult to imagine that a stimulus check will be able to take the place of years of borrowing. Short-term, the numbers may improve, but long-term a more fundamental correction will be required.

If our analysis and forecast for the economy is correct, the likelihood of the Federal Reserve raising rates in the near future is minimal at best. When weighing the impact of inflation and a weak dollar to a further slowing of the economy, the economy should win, especially in an election year. We would expect the ten-year bond to trade near the 4% level reducing competition for equities. However, though a weak dollar can be beneficial for multi-national companies and exports, it provides a floor under oil prices keeping prices artificially high. Eventually rates will increase, but it may be pushed out to the second quarter of 2009 rather than the fourth quarter of 2008.

Aggregate earnings for the companies in the S&P are expected to decline 11%, which was revised down from a 2% drop as recently as April. The majority of the decline will be attributed to financials, which are forecast to decrease by 60%.[9] The S&P is now trading at 16 times earnings; arguably fair value on a historical basis. The caveat is whether earnings will in fact meet expectations. If earnings fall short of the forecast, it could indicate that the market is in actuality trading well above long-term averages and could have further to fall.

In recent years we have noticed a tendency for the media among others to manipulate earnings to suit their needs. For example, in the first quarter commentators would report aggregate earnings for the S&P and then exclude the financials stating they represented an aberration. Then they would compare the adjusted number to the historical average and report that all was well in the financial markets. All well and good, but then we should probably exclude energy earnings also. In doing so we would have seen the earnings reduced by a significant margin.

We mention this only to remind investors that during periods of extreme volatility there is a tendency for pundits to massage the numbers to suit their assumptions and forecasts rather than accepting the numbers as they are and comparing apples to apples. In doing so they can create a false picture of the economy and the markets that will eventually lead investors down the wrong path.

Finally, as the presidential candidates are in place, we will begin examining their platforms in an attempt to discern what their administrations could mean to investors. The most glaring difference between the candidates at the moment is regarding their position on taxes.

In short, McCain would recommend maintaining the current tax structure; Obama would recommend increasing the tax on dividends, capital gains, and marginal rates. If Senator Obama increases his lead in the polls and it becomes evident that his coat tails will provide a majority in the house and senate, we would expect rates to increase in 2009.

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[9] Standard & Poors

As capital gain rates are at historic lows, we would anticipate investors would attempt to lock in gains prior to year-end. Energy and commodities, which have enjoyed substantial gains over the past several years, would be a logical sector of the market to expect selling to occur. Depending on your perspective this could provide a long-term opportunity to buy energy or a signal to book profits prior to the selling. In any event, we will continue to monitor the election and the polls both nationally and locally.

There are significant headwinds for the markets: inflationary pressures, slowing growth, declining home values, geo-political risk, negative sentiment, and credit risk to name a few. Investors are understandably concerned when they look out at the economy and the global markets, however, with all of the negativity evident there will eventually come a point at which long-term investors will be able to capitalize and profit from the current down turn and it is our goal to help identify those opportunities when they are presented.

As always, we thank our clients for the confidence you have placed in our firm and hope you have an enjoyable summer.

Sincerely,

Brad L J Griswold
Managing Partner

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