



The Shoulder Seasons Market Commentary April 1st 2008

A peculiar phenomenon occurs at the end of winter in the North Country. As the snow melts and the streams return to a liquid state, the ice that has been trapped underneath the roads begins to expand and contract pushing on the pavement above until the road buckles and heaves. Road crews dutifully put up small orange signs along the road that have neatly printed the words "Frost Heaves". To the locals, this means spring is just around the corner and driving like a drunken sailor is acceptable as you try to avoid the worst of bumps and dips in the road. To someone from out of town, it probably means a front wheel alignment at the very least.

Transitional periods in the financial markets can be both trying and filled with opportunities. Identifying the transition from one market or economic cycle is in itself a difficult proposition; correctly identifying the turning point is a near impossibility. Market history is filled with prognosticators who at one time or another in their career picked a turning point, Elaine Garzarelli is famous for calling the 1987 crash or Robert Schiller for forecasting the peak in 2000. However, the likelihood of a repeat performance is rare if not unheard of.

That the markets are in a transitional phase is evident; the question is: where are we along the timeline of recovery? Investors are struggling with a number of conflicting questions. Have the recessionary pressures eased or is there a period of slower growth ahead for the economy? Are corporate profits a quarter or two away from bottoming or are stocks still over valued? Was the collapse of Bear Stearns an indication that a bottom is near or a harbinger of things to come?

The shoulder seasons can be a time of rough going, but as we maneuver among the frost heaves, we know spring will *eventually* come. The question is *when*?

For the month the major equity indexes were flat to slightly up, however, for the year the indices are still firmly in negative territory. The Standard & Poor's is down (9.92%)¹, the EAFE index faring a bit better is negative by (9.53%)², though the NASDAQ with continued weaknesses among its leadership has fallen (14.07%)³ for the year. While the indexes experienced little change on a month over month basis, the underlying volatility on a daily basis was extreme in the least.

For some time now, investors have greeted the daily volatility of the financial markets with trepidation. An announcement by the Federal Reserve would trigger a four hundred-point rally in the Dow and just as quickly a rumor would circulate of another financial institution on the brink of collapse, which would drive the markets back down to new lows. Given the lack of direction, many investors have become like deer in headlights, they just stand there waiting to get run over.

¹ Source: Wall Street Journal

² Source: MSCI Barra

³ Source: Wall Street Journal

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Some pundits have pointed to the increased level of volatility as an indication that the markets are in the process of putting in a bottom. This statistic coupled with the retesting of the January lows, or the double bottom that chartists like to see, has the bulls stating the worst may be over and investors should begin reallocating cash holdings back into equities. We would agree that volatility has increased, but the emotional selling or true capitulation that is historically identified with market lows has not been severe enough to signal the all clear in our opinion.

Another point of discussion is stock valuations. Both bulls and bears agree that stocks are more favorably valued today than in recent memory with the S&P trading at 17 times current earnings⁴. The conflict occurs when future earnings are considered. The bulls, calling for a resumption in corporate profit growth, can reasonably state that equities are, if not under valued, fairly valued. The bears, however, are forecasting a further decline in corporate earnings given the deteriorating economic conditions and therefore P\|E ratios are not truly reflective of actual value. It should be noted though, that even the bulls are cautious at this juncture calling for increased equity exposure, but only incrementally.

This cautious tenor to the equity markets by both professional and individual investors leads us to examine market sentiment readings. Negative sentiment levels are considered to be a contrarian indicator for the financial market. As investor confidence declines, cash positions traditionally rise, increasing future buying power for when sentiment changes. The higher the negative reading, the theory goes, the closer to a bottom we are in the financial markets.

Historically this has been a reliable indicator of the bottoming process, but from a timing standpoint it is not very precise. Only when negative sentiment is combined with a sharp contraction in equity prices, such as in 1987 or 1998, can a reasonable case be made that at the least a near term bottom has been formed.

Shifting gears so to speak to the economic front, we are faced with all manner of issues. The housing market, with the exception of a recent seasonal up tick, is still attempting to find a bottom and could be at least ten percent and a year away from finding one. As home values decline and adjustable rate mortgages reset, consumers are confronted with higher payments, declining asset values, the tightening of credit, and therefore a sharp reduction in spending.

Further disruptions to the global economy are well within the realm of speculation. The current bubble in real estate is no different than that of the equity bubble of the 80s and 90s, or the commodity bubble of today. In each case, a loose monetary policy was responsible for providing the ability to leverage a specific asset class. Eventually, the asset class reverts to the mean average and the asset is subjected to either a prolonged period of little or no growth or as is sometimes the case, a more violent contraction can occur.

The depth and duration of the credit crisis will be indicative as to how long the economy and the financial markets could remain vulnerable. The Federal Reserve to their credit (or desperation) is doing everything they can possibly think of to provide liquidity and stability to the financial markets. Chairman Bernake being a student of market history is making a valiant effort not to repeat the mistakes of his predecessors.

⁴ Source: Bigcharts.com

An apt comparison is that of the 1907 financial crisis and that of the crash of 1929, which precipitated the great depression. In 1907, in lieu of a Federal Reserve, the leading bankers of the time (lead by J.P. Morgan, the banker not the institution, though at this time they were one in the same) infused the monetary system with massive amounts of capital and in effect guaranteed a modicum of stability to the financial markets. The markets eventually stabilized and returned to previous levels. However, in 1929 a more laissez-faire approach was used and without direct intervention, the markets and the economy entered a prolonged period of decline.

The Federal Reserve will do whatever is necessary in our opinion to avoid the latter scenario even if it means creating inflationary pressures down the road. To that end we fully expect the Federal Reserve to continue increasing the money supply, lowering rates if needed, and guaranteeing or creating a market for illiquid securities, all in an effort to restart the capital market and insure price stability. Eventually this should help the markets stabilize, but not before further erosion of capital.

The markets and the economy are in a tight spot and will in all probability remain there for some time to come. While it is not unusual to experience strong rallies in the midst of a bear market, we would caution against fully committing to any rally until such time as there is a more significant improvement in the fundamentals. As we stated earlier, short-term forecasting is a dangerous occupation, but we fully expect a new low to be achieved in the coming months. When and if that low occurs, we anticipate a more attractive entry point for equities and fixed income.

The credit markets are still in desperate shape and even with the assistance of the Federal Reserve it would not be surprising to hear of other financial firms encountering difficulty in raising capital or maintaining access to liquidity. The consumer will continue to come under pressure in light of declining home values, and inflationary pressures in the commodity sector, specifically food and energy. And finally, a lack of confidence in both the private and financial sectors will support a degree of caution that leads investors to a more subdued attitude towards risk.

On average, we continue to out perform the major equity indexes by a substantial margin, given our conservative allocations and patience in purchasing new positions. Periodically as long-term opportunities are presented on an individual basis, we will recommend adding financially strong companies that trade at a discount to the fundamentals, but as we stated at the beginning of the year, buyer beware. Spring is coming; we just need to wait a little bit longer.

As always, we appreciate the confidence you have placed in our firm and look forward to speaking to each of you regarding your personal financial position.

Sincerely,

Brad L J Griswold
Managing Partner

Kathryn M. Brown, CFP®
Partner

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