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# Investment Outlook Third Quarter 2008

## Second Quarter Review

Investors have confronted a storm of negative economic news over the past year. Home prices have declined by double-digit rates in the past twelve months. Oil has spiked above $145 a barrel, up almost 50% since January. Food prices are soaring, unemployment is rising and wages are stagnating. Bank lending standards have tightened considerably as the credit crisis endures. Auto sales have plunged. And many states are faced with budget crises. The collective pessimism of these issues overwhelmed any enthusiasm the markets had garnered after the Fed engineered the sale of Bear Stearns to JP Morgan. In mid-March along with the Bear Stearns bailout, the Fed instituted a series of credit facilities and policy changes intended to avoid a complete melt-down of the credit markets. Market participants cheered these moves and initially believed the worst of the credit crisis had past and market rallied in April and May. The rally in stocks brought market averages to near break-even by the end of May. Unfortunately, as oil prices continued to soar and financial institutions throughout the world confessed to more sizable write-downs, stock prices collapsed in June. In the mean-time, a number of Fed governors began speaking out about rising inflation and the need to buttress the falling dollar.

**Oil**

**S&P 500**

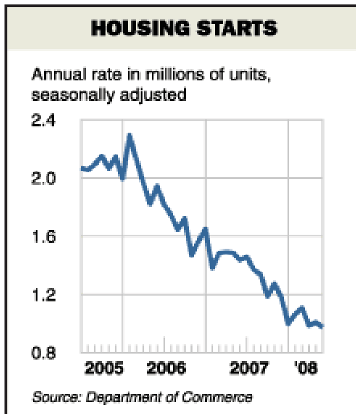
**10 Year Treasury Note Yield**

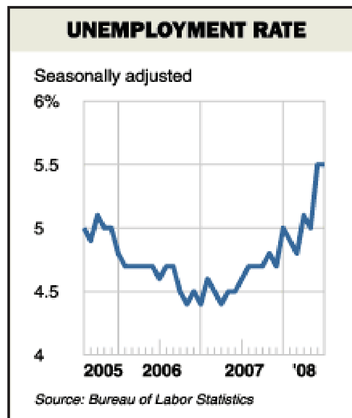
This led to the belief that the Fed may begin raising rates in the next few months and caused yields on the US Treasury securities to rise, reflected in the ten-year Note yield rising from 3.5% to 4.2% during the quarter before pulling back to 3.95% by quarter's end. Also, the race for the White House is now set as both major parties have nominated candidates to represent them in November. Strategists are already beginning to decipher what impact the election results may have on investment portfolios.

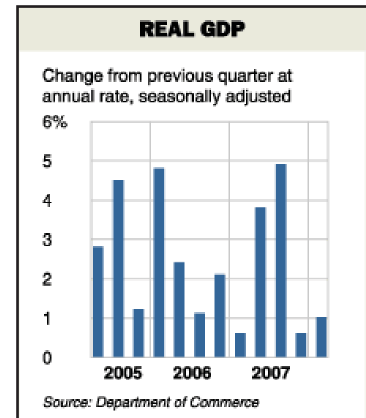
## Economic Outlook

U.S economic activity, after slowing dramatically the previous two quarters, appears to have leveled off in the second quarter as federal monetary and fiscal stimulus began to exhibit their intended effects. Housing related statistics continued to reflect recession-like conditions with the average home taking nearly eleven months to sell. The latest data indicates that while plenty of people are looking, with prices still declining, they are cautious about buying and lending standards have tightened, making mortgages harder to come by. Mortgage rate and home price declines have allowed affordability to improve. Once housing does bottom, there could be a lot of people who jump in to try to catch the bottom causing the initial upturn in housing to be rather sharp. Inventories have been eroding slowly, which is a good sign. Of more importance is the need to see an increase in the pace of sales. Once sales begin to improve, inventories will fall more sharply and force those waiting to make their purchases or risk missing the bottom. Consumer spending has perked up as a result of the

economic stimulus checks which began to be spent in early May. This stimulus will extend into the third quarter helping to offset the negative effects of rising oil prices and deteriorating employment. Job losses have now persisted for six consecutive months totaling 438,000 since the beginning of the year, facilitating the rise in the unemployment rate to 5.5%. Higher oil prices have pushed up the CPI, making inflation look worrisome.




In fact, all of the increase in measured inflation is related to food and energy. While this isn't much consolation to consumers, who must buy food and energy, the fact that all other price increases remain muted, including wage rates, suggests that underlying inflation pressures remain contained. Thus, we strongly believe that Federal Reserve will leave monetary policy unchanged until U.S. economic activity shows improvement, even if they feel obligated to talk tough about containing inflation expectations. Hawkish inflation talk may also have the added benefit of temporarily stabilizing the value of the dollar. Raising interest rates to contain inflation at this point would only compound the economy's problems making it highly unlikely the Fed would act prematurely. In this environment, GDP growth will likely remain positive, but at a very low rate for the balance of the year.

## Capital Markets Analysis

Now that the media has loudly broadcast that we are officially in a bear market, with all major U.S. stock market indexes 20% or more from their October highs, the inevitable question becomes when will the bear market end? While it is a simple, sensible question, with plenty of historical data to support a reasoned conclusion, it is impossible to answer, except at some point in the future with the full benefit of hindsight. High oil prices, more write-downs by financial firms and a soft economy continue to depress stock prices and investor psyches, so we fully expect the Fed to sustain current monetary policy while simultaneously talking tough on inflation. While most of the losses on sub-prime loans have already been taken, lenders are now suffering from the normal pressures of credit losses during consumer-led recessionary periods.

Surging oil prices have proven to be a significant problem for investors. As prices rise, they deplete household income by raising inflation and weakening the economic outlook. The tax rebate checks added to consumer incomes, but the rise in oil prices offset entirely that benefit. Thus, the announcement by the Saudis that they will hike production by a few hundred thousand barrels daily to help lower prices could be a welcome relief as the year progresses. Demand destruction, albeit modest at this point, is evident in energy consumption and certain other commodities where there are natural substitutes.

In the near-term, we would expect some abatement of the recent trends in stock and commodities prices. Sentiment indicators are extremely negative, valuation levels are reasonable and stocks are now at their lowest prices in two years. After being pummeled for weeks, financial stocks should show some life as many of the big banks begin reporting earnings and define their credit losses. Uncertainty is what causes investors to panic and sell securities. Once more clarity is delivered; we expect a bounce from significantly oversold conditions. However, we do not anticipate a sustainable rally to begin until later this year, perhaps not until after the November elections, as investors adjust their thinking to what the economic implications of an Obama presidency coupled with a strong Democratic majority in Congress may bring. Similarly, the dramatic rise in oil and other commodities prices is due for a pull-back. If supply disruptions occur for whatever reason,

this pullback may be delayed, but it is unlikely that prices will continue to surge on their current trend-line without any pause. After enduring a reasonable correction, we still believe the cyclical uptrend in oil and most other commodity prices has longer to run. Interest rates are likely to meander in their recent range until it becomes clear whether the next move by the Fed will be more simulative action or a pre-emptive move against a broadening of inflation expectations.

**Risks**

The markets have been focusing on many of the perceived risks in this environment over the past few weeks. A further spike in oil prices, another leg down on the value of the dollar and additional credit-related write-downs in the financial system are the most apparent issues with which markets are presently dealing. An escalation of saber-rattling between the U.S. or Israel and Iran would also preume financial markets as renewed concerns over oil supply disruptions would arise. The fact that Senator Obama has a good chance of winning the presidential election and that his economic policies are not viewed as being particularly good for the economy or investors is another hazard. With democrats likely to pick up additional seats in the House and Senate in November, one party control of government is always a fear. Markets seem to do best when government policies are stable. When one party gains strong control of both the executive and legislative branches of government, investors fear disruptive changes may occur and this uncertainty could prove troublesome.

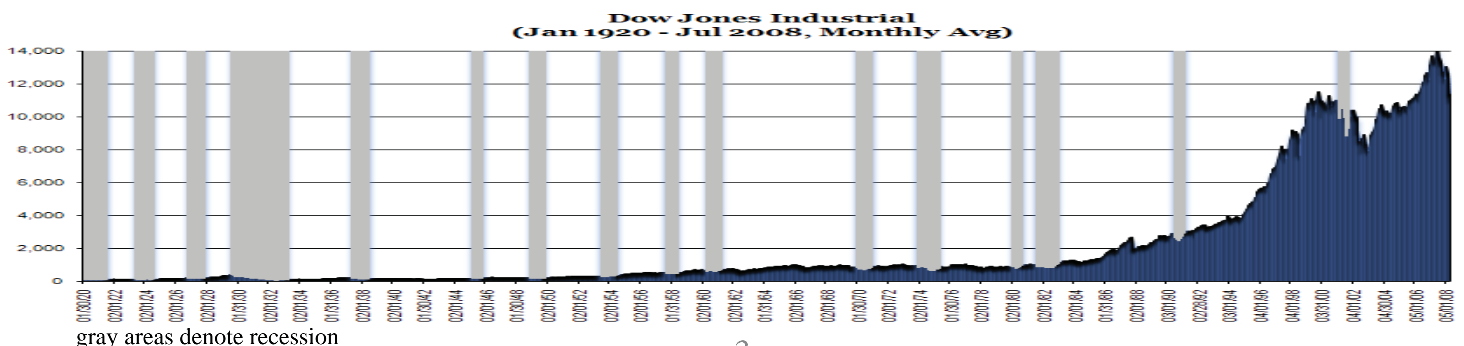
**Strategy**

Caution is in order as we embark upon the second half of the year. With corporate earnings reports likely to be disappointing and many corporations warning of difficult conditions, stock prices may remain under pressure for a bit longer. While much of the credit crisis has most likely been discounted in stock prices already, we are not convinced that the market has completely discounted the effects of recession, especially since the length and depth is not fully known. With dollar weakness continuing and the potential for rising inflation when the economy recovers, we anticipate limiting bond purchases to short-term instruments. In a slow growth environment, companies who are able to grow earnings at double-digit rates usually perform better. Similarly, since many foreign countries, particularly in Asia and other emerging market, are forecast to grow faster than the U.S. for the foreseeable future, we expect to increase our exposure to international markets.

**Advisory Comment**

It is tempting to lose perspective in this market environment with the stock prices around the globe losing ground nearly every day. While the near-term appears grim, the long term fundamentals of our economy are still sound as long as our federal government avoids the policy mistakes that have led to extended downturns in the economy and financial markets. We believe our policy-makers have enough historical references to shun the inducement toward isolationism, restrictive monetary policy or egregious taxation during the current credit-driven downturn.

We wish to draw your attention to our recently updated website www.covasset.com. It is our intention to continue to enhance this site to the point where it will become a genuine resource to our clients. In the login section you now have direct access to your custodial account information. In the future, our objective is to add pertinent market related commentary and links to reports or strategy advice. We welcome your comments or suggestions to make this as valuable as possible for your needs.



gray areas denote recession