

# THE MARKET OBSERVER

AUGUST 2008

After falling 15% from their October 2007 peak through early March, stock prices appeared to have bottomed, as indicated by the 8% recovery in prices that occurred in April and May. Soaring oil prices, declining home values and growing concerns over not only corporate earnings but also rising inflation and unemployment, however, translated into a decline of over 8% in June. In July, growing concerns over whether Fannie Mae and Freddie Mac (Government Sponsored Entities (GSE's) who hold or guarantee almost one-half of all U.S. residential mortgages) would be able to weather the mortgage crisis contributed to a subsequent decline of 15% from June levels, a cumulative decline of over 20% from their October '07 highs. The Treasury subsequently announced it would seek Congressional consent to directly support the GSE's. Stocks then advanced sharply after the August 5th Fed decision to maintain the status quo on interest rates, with the S&P 500 now down 12% for the year through August 8th, and 17% from the October '07 peak. Treasury Bills are

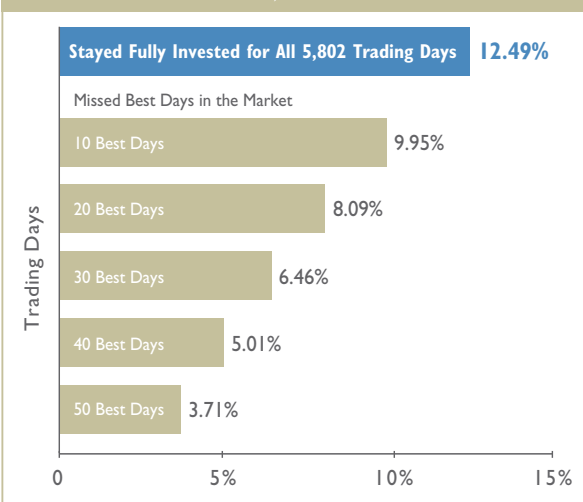
currently yielding approximately 2.2%, and the 10-year Treasury note yield is at 4%.

With bad news coming at us seemingly from all sides, it is difficult to take a step back to consider that in time this will too pass. Only eight years ago we watched the Tech Bubble burst, resulting in a 50% decline in stock prices between 2000 and 2003. Bank failures and government sponsored bail-outs (e.g. Bear Stearns) are not something new. Remember Penn Square in 1982, Continental in 1984 and Citigroup in 1991. Most true long-term investors are pondering not "if" the markets will recover, but "when." In July, stocks officially crossed into bear market territory by declining slightly over 20% from their October peak. While it is possible that stocks could decline further from current levels, it is important for investors

to also be aware of the risk of missing out on a market recovery (see table below).

## The Perils of Market Timing

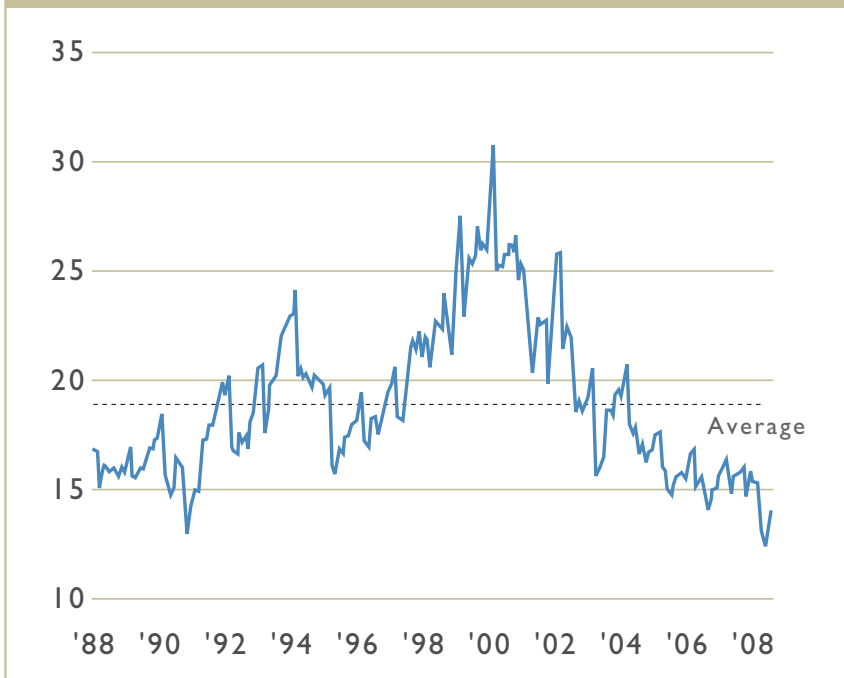
S&P 500 Index Annualized Return, 12/31/84-12/31/07



Source: Ned Davis Research

On the positive side, while Gross Domestic Product has declined, we have not officially passed into recession territory (defined by two or more consecutive quarters of negative growth). First quarter GDP came in at 1% after eking out a 0.6% increase in the fourth quarter of 2007. Estimated second quarter growth is also expected to be positive, aided, of course, by earnings in the energy sector. World stock prices appear to be at fair valuation levels when

**Attractive Stocks Valuation** The price/earnings ratio for the MSCI All Country World Index based on the next 12 months' earnings forecasts is 14, significantly below the 20-year average of 19.



Source: MSCI, Thomson Financial as of 30 May 2008

**World Earnings Yield - Bond Yield Spread**

	as of 12/31/2007	as of 6/30/2008
MSCI World Earnings Yield	7.4%	8.0%
GDP Weighted Bond Yield (World)	4.0%	4.1%
<b>Spread</b>	<b>3.4%</b>	<b>3.9%</b>

Source: Thomson One Analytics, Bloomberg, IMF; as of 12/31/2007.

compared to the alternative yields offered by Treasury Bills and Treasury Notes.

Standard & Poors has reported that operating earnings were down 26% in the first quarter of 2008 (versus the first quarter of 2007). Excluding financials (down 108%) earnings were up 9%. In the 2nd quarter, earnings in the Fi-

ancial sector are estimated to have declined 98% (due to write-downs) while the Technology (+16%) and Energy (+28%) sectors both advanced. When excluding both the best (Energy) and the worst (Financials), 2nd quarter earnings growth is expected to be 2.9%.

Suffice it to say, not all the news out there is bad. We have seen times like these (even worse) and not only survived, but prospered. It is important to keep an eye out for and acknowledge the good news. Gregg Easterbrook of the Brookings Institution recently wrote an article, "Life Is Good, So Why Do We Feel So Bad?", commenting on the trend in our society

to dwell on the negative:

*"The relentlessly negative impressions of American life presented by the media, including entertainment media, explains something otherwise puzzling that shows up in psychological data. When asked about the country's economy, schools, healthcare, or community spirit, Americans tell pollsters the situation is dreadful, but when asked about their own jobs, schools, doctors, and communities, people tell pollsters the situation is good. Our impressions of ourselves and our neighbors come from personal experience. Our impressions of the nation as a whole come from the media and from political blather, which both exaggerate the negative."*

So, if we look around and acknowledge the positive signs around us, while also recognizing that the negative investor sentiment and faltering consumer confidence out there are contrarian indicators, we can draw courage and confidence from the diversification and liquidity designed into our portfolio allocations and ride this out. Don't, however, expect a sharp recovery and don't be surprised by more bad news in the months ahead. Many prognosticators see the cleansing going on in our financial sector taking us into next year or possibly 2010. How much this bad news has already been discounted into stock prices is the question, as is the timing of when the market will begin to focus on the next recovery.

