

THE MARKET OBSERVER

MAY 2008

At the time of our last update in February, stocks were showing some strength, stemming for a time, their decline from record highs reached in October, 2007. The markets remained volatile for the remainder of the first quarter, trading sideways within a roughly 10% range. Through April 23rd, the S&P 500 is down approximately 5% year to date after being down as much as 13% for the year during March. Six month Treasury Bills are currently yielding 1.7%, ten year Treasury Notes 3.82% and the 30 year, 4.56%.

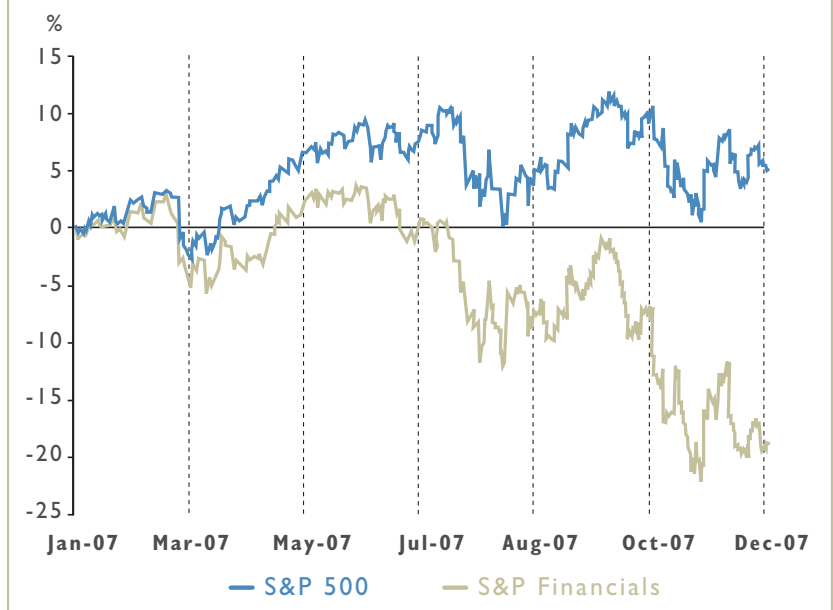
Aggressive actions by the Federal Reserve to lower interest rates and provide liquidity to the financial system appear to be preventing the credit “crisis” from becoming a panic. It is important to note that the current “credit” and “liquidity” crisis is more than just a housing and subprime problem. Losses taken by financial institutions on subprime securities currently total approximately \$175B. Bank Credit Analyst (Special Report 3/25/08) estimates that these losses could be followed by

additional write-offs of up to \$100B-\$200B. Many forecasters believe the re-trenchment in the financial sector, spurred by uncertainty and unwillingness to take credit risk, is causing these write downs to be overblown. The problem is simple. Some of these assets may be worth more, but there

down. On a positive note, banks have already replenished some of their capital with equity from Sovereign Wealth Funds and additional infusions are expected.

An article in Barron’s (3/24/07) offers a little historical perspective, as well as hope. It quotes John Lonski

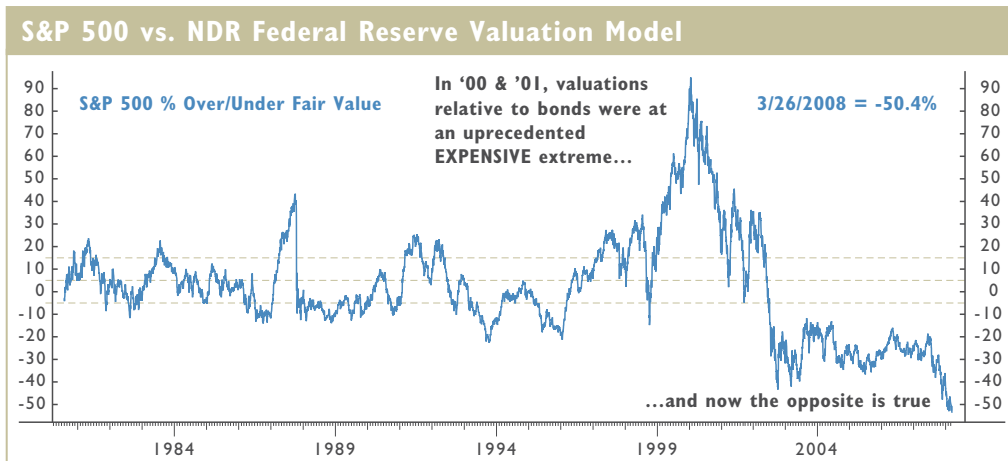
S&P 500 vs. S&P Financials 2007



Source: S&P 500

aren't any buyers. At any rate, BCA estimates \$135B-\$225B of additional potential losses related to leveraged loans and corporate and consumer debt, depending on the scope of a resulting economic slow-

of Moody's Investor Services, stating that the current positive yield curve "is telling us that we're further along in a recession, suggesting the situation will be better six to twelve months from now." Assuming



Source: www.ndr.com/FTN Midwest Securities

banks do begin to make loans, they will be able to bolster their balance sheets by pocketing the spread between short-term deposits and longer-term loans. This article (as well as the market's recovery since the Bear Stearns rescue) also reminds us that the markets have recovered after the failure of four major financial institutions in the last 25 years.

Lehman Brothers (Portfolio Advisory 3/20/08) views the world equity markets as trading at 12 times forward earnings, and with today's low, real bond yields, stocks at current levels have ample room to withstand up to a 35% decrease in earnings expectations.

Numerous charts and graphs have been distributed lately illustrating the recovery stock prices usually experience in advance of visible signs of an economic recovery. Markets simply don't wait for the all clear signal for investors to get back in the market.

Prudent liquidity management, asset allocation, and disciplined time horizon recognition are all factors that promote the confidence needed to stay the course; avoiding the temptation to time the market during periods of market stress. In their recent newsletter, Trigan Investments (Northbrook, IL) expands further on this point, addressing individual investments within a diversified portfolio:

"There is an enormous difference between a temporary loss of capital and permanent loss of capital. A temporary or quotational loss occurs when a securities price falls for a time without correlation to any corresponding permanent damage to the value of the underlying business. A permanent loss

occurs when a securities price falls to a permanent, lower level due to an economic impairment to the underlying business. To complicate the discussion further, a temporary loss can be turned into a permanent loss if one sells the security at the wrong moment in time, either voluntarily or worse yet, if one is forced to sell due to some external factor such as a margin call."

To be sure, a large amount of the losses occurring in today's market environment are permanent due to the repricing of risk that we have all been reading about. Simply put, a high risk investment shouldn't be priced to yield the same as a AAA investment. Nor should supposed prudent investors purchase these types of securities with leverage as high as 30 to 1. Little or no equity obviously leaves little flexibility but to sell these declining assets in a falling market to meet margin calls. Corporations and investors will of course continue to suffer the consequences of these types of decisions.

Meanwhile, well-managed businesses, as well as prudently allocated portfolios, can wait it out. We just may need to wait a while longer, however, before we see the all clear signal.

Equity Investors vs. The Equity Market (1987-2006)

Average Equity Investor Returns	Average Annual S&P 500 Index Returns
3.9%	11.9%

Source: Dalbar

