Investment Watch

2nd Quarter, 2008

Doctor, Doctor

Less than a year ago, the world seemed to be in perfect economic health. The global economy was robust and expanding due to the reawakening of developed economies and the integration of emerging markets. And at the same time, this integration, this globalization, bolstered productivity gains while keeping inflation in check. More goods, less cost. The rich were getting richer and the poor less poor. Perfect fiscal health!

Then before our markets opened on August 16, 2007, in London the global financial systems went into cardiac arrest. Commercial paper, the lifeblood of global credit markets, stopped flowing. This paper supplies working capital for banks and companies. Much of this asset-backed commercial paper was improperly diagnosed as very safe investments by the rating agencies. But then, fear of defaults of the subprime mortgages backing the paper, blocked the blood flow in our financial arteries.

Dr. Ben Bernanke, Chairman of the Federal Reserve and chief cardiac surgeon for the US economy, immediately rolled out the crash cart to jolt life back into the US financial system. His unprecedented treatments included loaning funds to banks guaranteed with questionable subprime mortgage backed collateral, directly lending funds to Wall Street and primary dealers and culminated with the Fed's intervention to prevent the collapse of Bear Stearns, one of the largest global investment banks.

These emergency remedies were backed up by the more conventional, albeit dramatic, therapy of slashing the Federal Funds rate from 5.25% to 2%. A faint heartbeat was restored causing a meager 1.0% increase in the Gross Domestic Product (GDP) for the 1st quarter of 2008. The economy is still anemic, but the tax rebates and continued export growth are expected to push the GDP up 1½%-2% for this quarter according to Dow Jones Newswires.

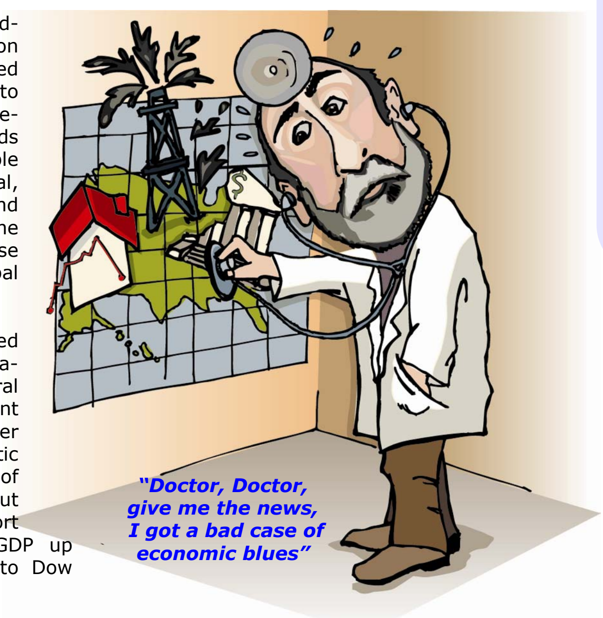
Banks are at the heart of the US economy and many of them are in need of a transfusion. According to Friday's Wall Street Journal, "*Citigroup, once the largest banking company, has seen its stock fall 69% from its 2006 high, to a 10-year low. Washington Mutual, a leading mortgage lender is down 89%...Merrill Lynch has tumbled 66% and Lehman Brothers is down 74%, at its lowest since 2002.*" The worst banking crisis in decades.

During the last year, many banks had to shore up their balance sheets by raising capital from institutional investors and foreign governments but most of those investments are now underwater due to the crumbling health of the banking system. Since that supply of money may have run out, the Fed is now considering allowing private-equity firms and others to invest in the nation's ailing banking system. The Fed and regulators are concerned that without a lifeline of fresh capital, some banks who need cash will have a tough time attracting new investors.

The Fed, under Dr. Bernanke's leadership, has effectively administered a variety of creative, innovative remedies to alleviate the stress in our financial system. The credit markets staged a strong recovery in April and May, but record home-price declines, weak home sales and the seemingly unending rise in mortgage delinquencies are all contributing to a credit relapse that may result in even more write-downs by financial institutions.

If the housing downturn and the credit crisis weren't enough to make us feel sick, oil gushed skyward to a near record closing at an even $140 a barrel at the end of the quarter - twice what it was a year ago and up from around $100 from the beginning of the quarter! Both the House and Senate are aggressively exploring ways to nurse oil prices back down.

Oil not only directly affects our pocketbooks due to higher gas pump prices, but it also weighs on our mental health. Although still spending, consumers feel the economy has a long road to recovery. The Conference Board Consumer Confidence Index plunged to 50.4 in June, its lowest level since 1992 and the 5th lowest reading ever. Future expectations plunged even more to an historic low since the surveys began in 1967. Falling home prices, soaring gasoline prices and a bleak outlook for jobs is giving the consumer an upset stomach.



"Doctor, Doctor, give me the news, I got a bad case of economic blues"

The stock market's reaction to the negative news has been severe, ending the quarter with one of the worst monthly downturns in June and with most major indexes on the cusp of a bear market, which is defined as a 20% decline from the October peak. Uncertainty creates volatility and on a daily basis the volatility of the stock market looks like an EKG gone wild.

The Fed, Congress and the regulators know that the wellbeing of our battered financial firms is vital to our economic health. Although the authorities won't let them collapse, it may be a long road to recovery to cure their ills.

Although central banks around the world are expected to raise interest rates to curb inflation, the Federal Open Market Committee ended it's aggressive rate cutting therapy and left its target rate at 2%. Here's *"the news"* Dr. Bernanke's Fed released last week:

"Recent information indicates that overall economic activity continues to expand, partly reflecting some firming in household spending. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters.

The committee expects inflation to moderate later this year and next year. However, in light of the continued increases in the prices of energy and some other commodities and the elevated state of some indicators of inflation expectations, uncertainty about the inflation outlook remains high.

The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased." *06/25/2008*

The *"doctor's news"* isn't all bad, initially citing continued economic expansion. Although it feels like a recession, the GDP did increase by 1% in the 1st quarter and is expected to be stronger in the 2nd quarter aided by the tax rebates. However the doctor's concerns of our economic health are apparent—soft labor markets, stress in financials, ongoing housing contraction and rising energy prices.

The economy's ailments are very complex, making a diagnosis tricky. Oil and other commodity price surges and the decline in the dollar, exacerbated by the low interest rates, have added to inflation risks. The Fed may need to raise interest rates to fight inflation but, at the same time, may be reluctant to do so for fear of stifling the overall economy and derailing the rebound in the housing sector.

Dr. Bernanke will now be patient and treat the economy's symptoms trying to achieve that delicate balance of sustainable economic growth with price stability. The doctor knows best. Be patient. The road to recovery will not be smooth but once there the US economy will emerge leaner and meaner.

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