

Caught in the Crosshairs

The first half of 2008 was a difficult one for the stock market by just about any measure, and it ended fittingly with the worst June since 1930. Broad declines in all sectors except for energy and materials sent the market real close to the lows for the year. Financial stocks bore the brunt of the selling, again, falling sharply for the fourth quarter in a row. The damage was not limited to major banks, as regional banks, insurance and mortgage companies hit new multi-year lows. Airline and auto stocks, both of which are highly dependent on fuel costs, were especially hard hit, falling to levels not seen for decades.

As the title of this piece implies, there is a deer caught in the headlights of the US economy, and that deer is the Federal Reserve Board. It is no mystery to most market watchers that energy costs and residential housing are the primary source of the stock markets angst. With crude oil over \$140 per barrel and home prices continuing to fall in almost all locations, the overall US economy can be described as fragile at best. Whether or not we have a classic recession with at least 2 consecutive quarters of negative growth, or one where profits and business conditions slow but do not stall out, is not worth arguing. At days end, we all know that there are headwinds facing economic growth in the US today.

So what's a Fed to do? The crux of the matter is this. Action they may take that would favorably affect one market could create an even larger problem for the other. Higher interest rates could well result in a stronger dollar as money flows back into the US, which in turn could send energy prices lower, which in turn would be a welcome relief to consumers and in all probability the stock market as well. But wait a minute, what about the residential housing market? Higher interest rates are no way to resuscitate a market in which prices are falling and has an 11 month inventory of product to work thru. Perhaps they will continue to do nothing, as they did last week when they left rates unchanged while signaling that they remain concerned that inflation is taking hold. The decision to stand pat was not unanimous as one member voted in favor of raising rates. The board will look closely at economic releases during the summer months, and if new data definitively shows that inflation is less of a problem than expected, the Fed will stand pat.

So where does this leave investors in the stock market? As previously noted, financial stocks have led the market down. This one important group has declined over 30% in 2008 alone, and now represents approximately 14% of the S&P market value, down from 22% within a year ago. However, we should also recognize that many other sectors of the economy have strong businesses with growing revenue and earnings. The demand for goods and services from developing economies has remained strong. US based companies are developing long-term strategies that will pay dividends in the future. As we have pointed out in previous newsletters, several companies have shifted their focus

from relying heavily on domestic sales to where they are now deriving over 50% of their revenues from overseas. And, this number continues to grow. We have all heard about demand from China and India, with not much as being said about the N-11. These are the “Next 11” countries who may not have the potential of the “Bric’s, (Brazil, Russia, India, China), but still will have a very significant impact on the world economy for companies that plan ahead. This block consists of diverse countries like Indonesia, Philippines, Pakistan, and Mexico, all having large populations striving to catch up to developed economies.

It is often said that bad news sells, and there is no lack of material for the media these days. We have all seen the talking heads thriving on the negative news that permeates today’s airwaves and headlines. The recent market decline brings to mind the fallout from the bursting of the tech bubble and the bear market in the early part of this decade. In the fall of 2002, the S&P 500 set a low of 776 amid talk of an economy that would never recover. From that low, the index advanced to 1550 in July of 2007, doubling its value. Recognizing that bear markets are painful for all, we should be mindful of past lessons. The recent downturn in the market has created many attractive opportunities in stocks. We are looking for those companies that are positioning themselves to prosper from the future global growth and because of the recent sell-off offer significant long-term value. Despite all the bad news out there, betting against the US stock market has historically been a bad bet, and we strongly suspect that it will be again this time.

We hope that everyone has a great summer, and as always, please call if you have any questions or concerns.

Scoreboard 1st Half 2008

Dow Jones: - 14.4%

S&P 500: - 12.8%

NASDAQ: - 13.5%