



Quarterly COMMENTARY

FIRST QUARTER 2008

FROM THE DESK OF J. WILLIAM WALTMAN, JR., CPA CFP®

Wow! What a quarter it has been. The credit crunch that manifested itself last July with the collapse of two Bear Stearns' hedge funds continues to intensify. Problems that were once thought by Ben Bernanke, the Federal Reserve Chairman, to be contained clearly were not. Investment and



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Reserve agreed to assume \$30 billion of collateralized debt obligations (CDOs) held by Bear to incentivize JP Morgan to complete the deal. The original deal terms called for an acquisition price of \$2 per share. JP Morgan has now agreed to up this figure to \$10 per share. Regardless, the swiftness of Bear Stearns' demise was amazing. It went from a rumor on Tuesday to insolvency on Friday. A venerable Wall Street institution with an 80-plus-year history that was trading at \$170 per share within the last 12 months was brought to its knees within a matter of days. This is a clear example of the seriousness of this credit crisis. The stock market reflected this turmoil with the worst quarterly losses (see chart below) since 2002.

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commercial bank write-offs for bad loans and losses on securities tied to real estate have been nothing short of staggering, totaling approximately \$150 billion. The credit crisis reached a crescendo with the run on Bear Stearns. Essentially, many of the counterparties that conduct business with Bear Stearns decided to pull all of their business at

the same time, effectively creating a run on the bank. Since Bear Stearns was highly leveraged, this run caused critical liquidity issues within the firm that it could not overcome. Thus, over a weekend, the Federal Reserve orchestrated a hastily-arranged merger with JP Morgan Chase. The Federal

Our Take

We believe the U.S. economy is in a recession and that the current deleveraging taking place in the credit markets may prolong the length of this contraction. While the Federal Reserve has injected massive amounts of liquidity into the financial system, many banks are still reluctant to lend as they shun risk in an effort to protect their balance sheets. If this continues it will affect not just Wall Street but Main Street, as many things in our economy are purchased via credit including cars, electronics, and homes.

Expect further write-offs from banks on home, auto, student, and credit card loans as default rates increase. How much more? No one knows for sure but Goldman Sachs recently issued a report saying the global number could total \$1.2 trillion. Look for real estate prices to continue to decline until foreclosures slow and enough buyers are enticed into the market by falling prices to adjust the supply demand imbalance. Thus, we do not expect real estate prices to stabilize before early 2009.

Inflation remains a threat from the Fed's recent slashing of interest rates. The Federal Reserve's easy money policy in the early part of this decade led to the real estate bubble and they may be risking the same mistake

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Stock & Bond Benchmark Indexes (All total return)

	Performance (%)			
	MARCH	1ST QTR.	1-YR.	5-YR.*
Major U.S. Market Indexes				
Dow Jones Industrial Average	0.1%	-7.0%	1.6%	11.5%
S&P 500	-0.4%	-9.4%	-5.1%	11.3%
Russell 2000	0.4%	-9.9%	-13.0%	14.9%
Lehman Bros. Aggregate Bond	0.3%	2.2%	7.7%	4.6%

*Annualized

SOURCE – Wall Street Journal, April 3, 2008



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Are all the problems behind us? Probably not. It took years for this credit and real estate bubble to build and it will take some time to correct. Housing continues to worsen. Some of the major homebuilders that released earnings in March report that inventories continue to rise due to foreclosures. Interest rate resets on adjustable rate mortgages will likely peak sometime this summer which may cause another spike in foreclosures. Many small builders across the country are filing for bankruptcy. While the strongest, well-capitalized builders will survive and even thrive coming out of this, it may well be 2010 before we see a significant uptick in residential real estate construction. Until the housing market stabilizes, expect to see more write-offs from banks. Home prices, as measured by the S&P/Case-Shiller Index, fell by over 10% from January 2007 to January 2008. Many economists are predicting another such decline this year. While this decline is painful, it is necessary. The ratio of income to home values had reached an historically low level. Home price declines are bringing this ratio back in line with historical norms and reflect an improvement in the affordability of housing.

What about the Federal Reserve's actions? Will the Fed be successful in its efforts to revive the credit markets and the economy? The Fed is certainly pulling out all the stops. From assuming Bear Stearns' CDOs to providing liquidity to primary dealers through the discount window and accepting various forms of mortgage paper as collateral, the Fed is fully engaged. To date the Federal Reserve has used approximately half of its \$900 billion balance sheet in an effort to curtail the damage from this credit crisis. The longer this crisis persists, however, the less ammunition they have to stem the bleeding. With real interest rates now in negative territory, the Fed doesn't have much more room to cut rates.

In spite of an economic slowdown in the United States, commodity prices remain elevated. Oil, natural gas, corn, soybeans, wheat, and rice all trade near recent highs. Underlying demand from emerging economies such as India and China, a weak U.S. dollar and speculative buying by hedge funds has kept prices firm. Many economists believe the long-term trend for most commodities is still higher unless the U.S. sustains a deep recession that spreads globally. Gold, reflecting a weakening dollar and inflation concerns, briefly broke through \$1,000 an ounce before falling closer to \$900 an ounce at the end of the quarter.

Our Take

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again or something worse, inflation. The Fed's actions have contributed to the debasement of our currency and may be stoking inflation. If inflation pressures persist, both soft and hard commodities such as wheat and gold should continue to perform well. Treasury bonds may well underperform in such an environment. With inflation currently running close to 4% per year and the 10-year Treasury note yielding a paltry 3.5%, we would avoid treasuries. Better opportunities may be found in municipal or investment grade corporate bonds.

The Federal Reserve's policy actions coupled with the economic stimulus package should have an effect on the U.S. economy later this year. While the mailing of checks to Americans will most likely not have lasting impact, the Fed's actions will. The backstopping of the financial system should help to slowly rebuild confidence in the markets. In the absence of another economic shock, we expect the credit markets to begin to function more normally as the year progresses.

Wall Street earnings estimates remain too high in our opinion. We expect corporate profits to continue to slow for at least the first few quarters of this year. Fortunately, it appears that the market has discounted this in the stock prices of many companies. Financial and consumer discretionary stocks have experienced sharp declines, some falling as much as 60% in the last year. While consumers are being hurt by high energy and food prices and the reduced availability of credit, all spending will not disappear.

Expect volatility to continue as the markets reprice risk. Avoiding the day-to-day noise of the market and focusing on long-term fundamentals is essential. This environment will create opportunities to buy great companies at discount prices. When purchasing securities we ask ourselves this question, "Will this business be more valuable 3 years from now?" When everyone fears financial Armageddon, they sell good and bad companies alike, creating opportunities. Please know that we remain vigilant in finding such opportunities.

We appreciate the trust you place in us and remain committed to helping you achieve your objectives.



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