

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

The bear has taken hold. The combined effects of the credit and real estate crises, surging food and energy prices, and increasing layoffs have finally begun to take their toll on the economy. In April when the markets rallied some thought the worst was over. In hindsight, it appears this was nothing more than



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flat screen televisions. Since personal consumption accounts for approximately 70% of the economy, this deleveraging is being reflected in sluggish gross domestic product readings.

For the economy and markets to find a bottom the following items will most likely need to occur.

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a bear trap ensnaring investors who jumped back in thinking the recovery was at hand. As the table indicates below, the Dow Jones Industrial Average and Standard and Poor's 500 Index lost more than 13% over the past twelve months. In fact, the Dow Jones Industrial Average declined 10% in June, its worst such decline since the great depression. The worst performing stock in the Dow was General Motors (GM) which lost 40% during the second quarter. GM is trading at levels not seen since the 1950s.

Why the sudden selloff in equities during June? Investors have begun to realize the hoped-for second half recovery in the economy looks to be fading fast. With persistently high oil and food prices, continually surfacing credit problems, and faltering consumer spending, hopes for a recovery have turned into fears of stagflation, 1970s style. Jimmy Carter anyone?

Energy, mining, and precious metals were among a handful of sectors that managed to perform reasonably well. Continuing demand for energy and food from emerging markets kept propelling prices higher.

For some time, America has been borrowing from the rest of the world to fund its desire for consumer goods. Low interest rates and easy money policies contributed to one of the biggest credit bubbles in history. Now the painful deleveraging process has begun. What does that mean? It means both individuals and corporations are reducing debt and becoming more risk averse. Examples include major U.S. investment banks taking down their leverage from 30 to 20 times equity, and individuals deferring purchases until they have the cash to pay for items and using economic stimulus checks to pay off debt instead of purchasing

Housing

Housing prices must fall further to entice more buyers into the market and reduce the 11 month supply of inventory. Builders as well as individuals are increasingly being more aggressive in cutting prices. This trend, although painful, is healthy and necessary before the healing can begin. We expect home prices to decline another 10-15% nationally before stabilizing sometime in 2009. Further price declines will have a negative impact on consumer spending, financial institutions, and homebuilders.

Financial Institutions

Investment and commercial banks have seen their stock prices ravaged. Many have fallen in excess of 50% with some falling 80-90% in the past year. Investors have heard ad nauseum that the worst of the write-offs are behind them. And yet the drip, drip, drip of further write-offs continues and, in some cases, increases. When will this downward spiral end? Not until the underlying

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Stock & Bond Benchmark Indexes (All total return, 5-year annualized)

	Performance (%)			
	JUNE '08	2ND QTR.	1-YR	5-YR
Major U.S. Market Indexes				
Dow Jones	-10.0%	-6.9%	-13.3%	7.2%
S&P 500	-8.4%	-2.7%	-13.1%	7.6%
Russell 2000	-7.7%	0.6%	-16.2%	10.3%
Lehman Bros. Aggregate	-0.1%	-1.0%	7.1%	3.9%

SOURCE – Wall Street Journal, July 3, 2008

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collateral, real estate, begins to stabilize in price. In order to weather this storm, many institutions have raised additional capital to repair their balance sheets. And yet, due to the prolonged nature and severity of this real estate downturn, many will have to raise capital again to survive. We expect some smaller regional banks to fail. Once real estate stabilizes and financial institutions have recapitalized their balance sheets, the recovery may finally take hold.

Energy Prices

The price of oil has doubled in the past year and continues to surge higher. Demand destruction for gasoline is taking place in the U.S. as high prices force motorists to reduce their driving. Further, the purchasing habits of automobile consumers have turned on a dime. Starting in May, consumers suddenly stopped buying sport-utility vehicles (SUVs) and trucks and began to purchase small, fuel-efficient cars. This caused the trade-in value of large trucks and SUVs to plummet. There are even stories of Americans abandoning their SUVs as the trade-in value is far less than the outstanding debt. Thus the bank ends up holding the bag and writing off the loss.

Is there any end in sight to the rise in oil prices? Yes. While oil may continue to advance higher, we do not expect the parabolic rate of advance to continue. One plausible scenario is that oil will cause a global slowdown and this will be what finally breaks the upward price spiral. The Purchasing Managers Index for the Euro zone's manufacturing sector contracted in June for the first time in three years. Asia, while still growing, is beginning to slow due to declining demand for exports from the consuming nations of the West. Barring a conflict in the Middle East, we expect oil prices to moderate later this year into 2009 as demand for the commodity eases and supplies increase marginally. Breaking the upward price spiral will be necessary to keep inflation fears from becoming entrenched in the mind of the consumer.

Our Take

The Federal Reserve is in a tough spot. They have aggressively lowered interest rates in an effort to stimulate the economy and in the process stirred up inflation. Now they are in a tight box, unable to raise rates as the economy is weak and unlikely to cut rates for fear of further devaluing the U.S. dollar and fanning inflation. Thus we expect the Fed to hold short-term interest rates steady for at least the next few meetings.

The healing of the economy will take some time as the global deleveraging process unfolds. While the policymakers in Washington may resort to another stimulus package later this year or early next year, it may only help marginally if passed. We expect further weakness in the U.S. and global economy through 2008 and into 2009. Expectations for corporate profits remain too high in our

opinion and will most likely be reduced as the year progresses. Stocks may continue to be under pressure in this environment.

While the headwinds facing the economy are many, opportunities for long-term investors are becoming more numerous. The time to go shopping for stocks is when they are on sale, and stocks are getting cheaper by the day. We believe we will have opportunities over the next year to purchase outstanding businesses at prices not seen in a decade or more.

Patience is a virtue. Those with the discipline and patience to seize opportunities and buy great companies at discount prices should be well rewarded long-term. As always, we appreciate your trust in our services and remain committed to helping you achieve your financial objectives.

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