

## Quarterly Market Commentary – Q208 July 2008

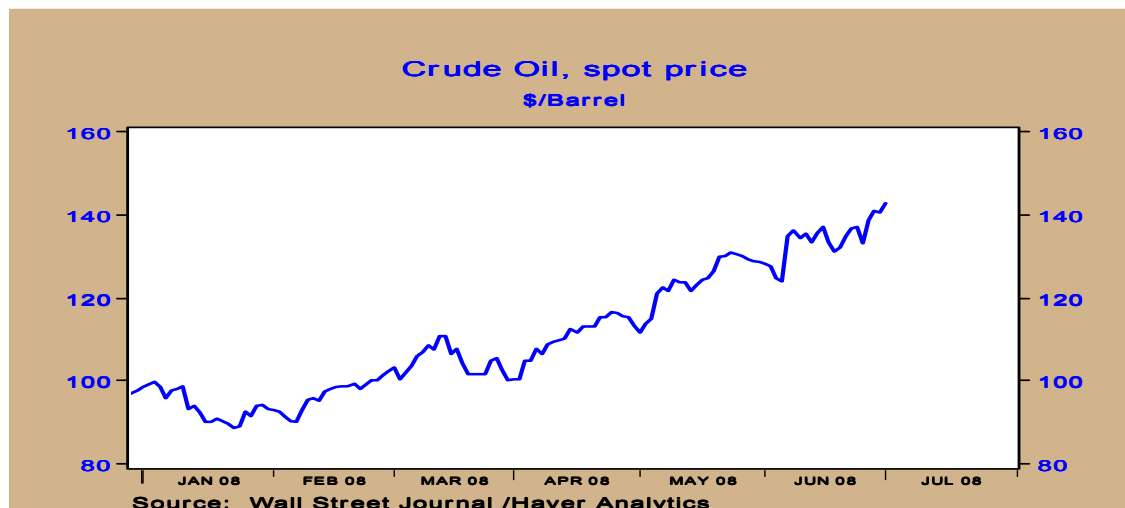
### Stocks fizzle

After rebounding nicely from their mid-March lows, stock prices rolled over in June and finished the quarter on a distinctly down note. Rising energy prices spurred concerns of a prolonged bout of inflation, and lingering mortgage-related problems among major financial institutions weighed heavily on markets toward quarter-end. Consumers, buoyed in part by the receipt of IRS rebate checks, provided some economic boost by maintaining their spending and helping the U.S. avoid the technical definition of a recession. Still, Americans are being buffeted by higher prices, weak job growth, and falling values on what is typically their largest asset—their homes—and they are casting a wary eye toward the future.

After gaining ground through April and May, the Dow Jones Industrial Average (DJIA) plunged 10 percent in June (including dividends)—and 6.90 percent in the second quarter—leaving the index down 13.40 percent year-to-date. The S&P 500 Index (S&P) sunk 8.40 percent last month, 2.70 percent in the second quarter, and 11.90 percent for the first half of 2008. The DJIA has now fallen 19.80 percent from its October 9 peak, just shy of the 20-percent loss that defines a bear market, while the S&P is off 18.10 percent from its recent high on October 10.

### Consumer challenges

Oil prices dominated the headlines last quarter, as crude oil prices spiked from \$100 to nearly \$140, setting several new all-time highs along the way. Indeed, the average price per gallon for gasoline rose 22 percent in the second quarter alone. Combined with a weak job market—initial jobless claims have been consistently above 350,000 per week since late April, signaling very soft labor conditions—consumers are being squeezed on both the income and expense fronts.



The housing market—the fuel that drove the consumption engine from 2003 to 2007—has so far provided no support for a rebound, as it continues to plod along in search of a bottom. Resales of single family homes and condos actually rose 2 percent in May, the highest sales pace since February. The percentage of those sales classified as distressed, such as foreclosures or short sales, was also higher, however, indicating that the housing correction has not yet turned the corner.

The economic strains that have mounted are clearly showing up in consumer perceptions and attitudes. Despite the tax rebate checks consumers began receiving from Uncle Sam, consumer sentiment fell to a 28-year low of 56.40 in June, according to the University of Michigan Consumer Confidence Index. The previous low was 51.70 in 1980.

For its part, the Federal Reserve (the Fed) refused in late June to reduce its target federal funds rate below the current 2 percent—a sign that the central bank has shifted its focus toward a more inflation-wary stance versus its previous pro-growth posture. The Fed has stated unequivocally that it believes recent energy-related inflation is a short-term phenomenon that will reverse itself as a sluggish global economy puts downward pressure on prices. If that forecast does not materialize, the Fed will find itself in a bind—on the one hand, needing to push rates higher to fight inflation, but on the other, potentially choking off whatever economic recovery may be under way. To be sure, central banks around the globe are grappling with these same forces, and finding the right policy balance will be their focus.

All is not gloom and doom, however. Despite some clear challenges, the U.S. economy has thus far managed to avoid slipping into an official recession. In fact, some signs point to brightening skies on the horizon. The Conference Board's index of leading economic indicators, which attempts to predict inflection points in the economy, rose 0.10 percent in May, after rising by a similar amount in April.

### **Investment implications**

As happens when stock prices hit a rough patch, the key question on investors' minds these days seems to be, "Is this time different?" We believe the answer is a resounding no. Our economy and financial system are now recovering from the excesses that had built up in conjunction with the housing and credit bubbles. While there is no quick fix, and no way to ascertain exactly when the patient will be pronounced cured, the disease is far from terminal. Problems may persist longer for some industries, such as the financials sector, where banks and brokerage firms were deeply entrenched in the foibles of the mortgage crisis. But what underpins our economy today are a host of corporations who have more cash on their balance sheets than ever before, less debt, and more productive operations than at any time in history.

Recent stock price declines have garnered much attention. But since stocks make up only a portion of a well-diversified portfolio, the oft-quoted index losses may not represent the performance of most investors' portfolios. Many types of bonds provided a slight positive return in the second quarter, and investors who dedicated a portion of their portfolios to commodities and natural resources got an even bigger boost, as that narrow sector benefited from recent energy price gains. We caution investors to fight the urge to invest through the rearview mirror, however, as investing is a decidedly forward-looking endeavor. Though tempting, jumping on the bandwagon of investments that performed well last year, and avoiding those that didn't, have proven to be dubious strategies over the long term.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.*

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