

BARNETT & COMPANY

INVESTMENT COUNSEL

Quarterly Review and Outlook

2nd Quarter 2008

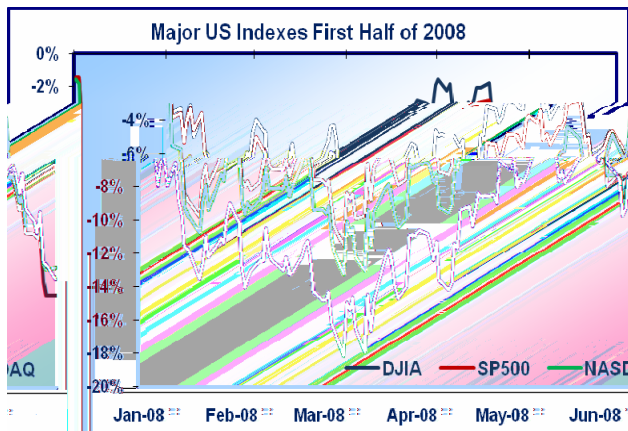
American Idle

Forget the procession of mindless new reality shows due to hit the small screen this fall. For pure excitement, suspense and drama, it would be hard to match the cinéma vérité of the US economy and the vicissitudes of the stock market. Buffeted by a headwind of nearly unprecedented proportions, the American economy has somehow managed to skirt the edge of recession without slipping over the cliff, at least so far. Financial institutions have suffered colossal losses, stock and bond markets are aggressively re-pricing risk, and energy and food costs have skyrocketed to record levels. And yet the economy is running at idle when it might be expected to lie smoldering in a ditch. The rest of the year may prove to be just as compelling; don't touch that dial.

The US stock market started out the second quarter on something of a roll. Following on the heels of the Federal Reserve action to

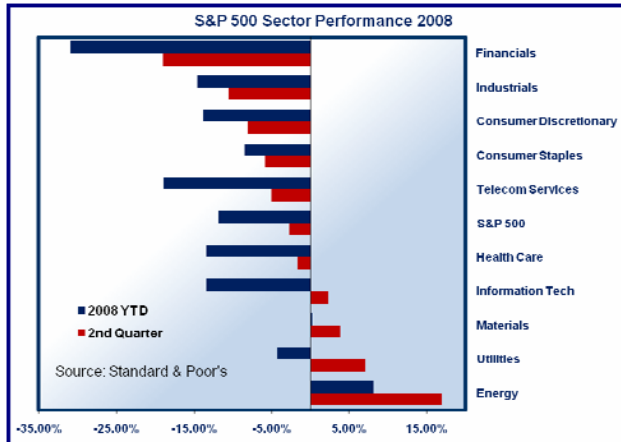
backstop Bear Stearns, investors seized on the belief (or the hope) that the worst was over and came back into stocks, fueling a 13% rally through the middle of May. But with more bad news from the beleaguered banks and brokerages, the selloff began in earnest and accelerated through the end of June (slipping into bear territory in early July). The Dow Jones Industrials fell 10% in June alone and logged a 6.9% decline for the quarter. The S&P 500 index dropped 2.7% for the quarter and ended up down 11.9% for the year to date. Foreign markets suffered as well; the MSCI EAFE index of international stocks gave up 2.3% in the second period and 11% so far in 2008. Some of the highest fliers from last year in the emerging market space are the biggest losers this year; China's primary exchange has fallen by 48% since December. Only Canada and Japan among our main trading partners managed to post positive returns for the second quarter. Even the masters of the universe in the hedge fund world took a licking, turning in the worst half-year performance since 1990.

There were a couple of bright spots, notably in the commodity sector as demand growth from emerging markets continued to outpace the increase in supply for oil, agricultural products and minerals. Energy, materials and utilities all turned in positive performances. However, the overall theme continued to be the reduction of risk by



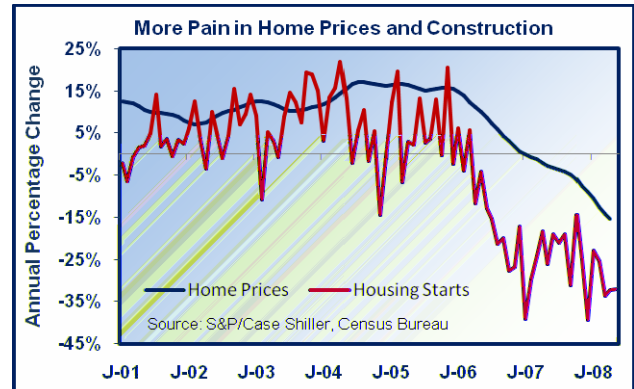
Quarterly Review and Outlook

investors, manifested especially in the ongoing carnage among the banking stocks. The financial sector posted a 19% drubbing in the second quarter and has lost 39% so far this year, with not much hope for a near-term reversal.



There is no doubt that the prevailing attitude of investors is fearful and trepid heading into the second half of 2008. Consumers, the primary engine of domestic economic activity, are more pessimistic than at any time since 1980 as measured by the Michigan Consumer Sentiment Survey. Credit losses logged to date total a staggering \$430 billion, with additional write-downs nearly certain. Food and energy price spikes are clearly affecting the behavior of households and businesses, to wit: total miles driven by Americans declined 4.5% in June versus a year ago, the largest year-over-year decline since recordkeeping began in 1942. Sales of large (and profitable) pickups and SUV's have nosedived, causing the US auto makers to scramble and driving GM stock to a 50-year low. Meanwhile, the housing sector continues to deteriorate as the worst home-building market in a generation has not yet found a bottom. Home prices and new housing starts are still falling and the excess inventory overhang has barely been dented. With such a high percentage of job-creation

tied to construction and finance, it came as no surprise when the unemployment rate remained at 5.5% following the loss of



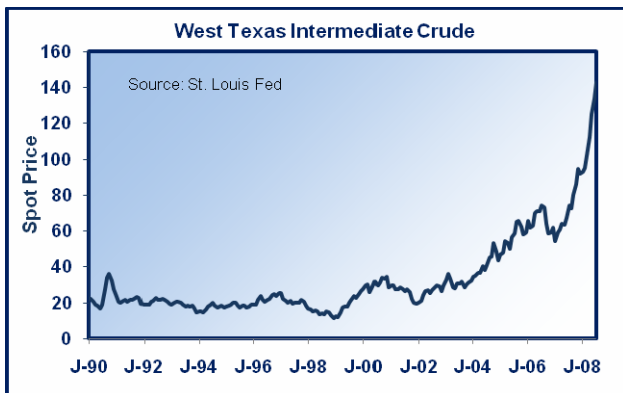
62,000 jobs in June. Meanwhile, the relentless assurgency of commodity prices and the continuing weakness in the value of the US dollar finally produced a sustained increment in inflation, with the CPI registering a 4.2% increase in May. With all of these many encumbrances, one would expect the economy to buckle under the strain. Instead, it has held on to a narrow expansion for the year so far. Predictions of coming recession are gaining currency as conventional wisdom, especially among the chattering classes on 24 hour cable. Yet while it is certainly possible that the economy will deteriorate over the next few months, it is not at all certain that this must occur.

Consider for example the commodities boom (or bubble). Oil prices climbed another 25% just in the three months since March, setting new records all along the way. The rapidity of the increase, along with the lagged effect of so-called "demand destruction" (reduction in demand due to behavioral changes of consumers) and the likelihood of profit taking by non-consumer market participants (read "speculators") suggests the possibility of a significant pullback before year-end. There has been

Quarterly Review and Outlook

much ado about the role of speculators in the commodity markets, most of which is misinformed. Speculation is a contributing factor in the rapid ascension of commodity prices; the total outstanding dollar value of commodity derivatives contracts has increased eightfold since 2004. However, the role of speculators in the market is not nefarious; rather it is essential to provide liquidity to markets where other participants seek to hedge their real exposure.

Against this backdrop, a retrenchment of commodity prices seems likely and would be a welcome development in stemming the incipient slowdown in US economic growth as well as providing psychological relief to beleaguered investors.



Another rationale for a no-recession scenario lies with the nature of the current decline in growth compared to previous slowdowns. Generally, recessions occur in an environment of broad-based inflation (including galloping wage inflation), and the attendant (over)tightening by Federal Reserve policy makers. The current scenario is obviously quite different. Although CPI headline inflation has increased markedly, the wage component has barely budged as productivity gains continue to hold down payroll growth

relative to output. Furthermore, the Fed has been, shall we say, “preoccupied” with liquidity issues and keeping the banks, brokerages and mortgage agencies out of the soup and trying to reboot the housing market, so benchmark interest rates remain at very low levels with no tightening on the immediate horizon. Although the Fed is clearly concerned about inflation, and has even taken up the Treasury Secretary’s role of jawboning the dollar, it is currently more absorbed with the credit markets, and believes that the inflation problem is likely to rectify itself as commodity prices pull back and the impact of four quarters of slow growth feed back through the price discovery mechanism.

It might also be worth remembering that even if we do fall into the technical definition of recession, the event is likely to be relatively benign. The last full-blown consumer-led recession occurred in 1981-1982, a past too distant for many analysts and forecasters to remember. During that slowdown the unemployment rate reached a devastating 10.8% as we came off of an extended period of double-digit annual inflation. The remarkable resilience of the American economy and the moderating influence of global trade and interdependence have allowed us so far to survive the worst threat to the financial system since the Great Depression with a jobless rate half that magnitude and a positive (if anemic) growth rate. The outlook for the rest of the year is cautiously and mildly optimistic.

As for the Fall TV lineup, perhaps it’s time for a New Deal.

Christopher A. Hopkins, CFA, CFP
© 2008 Barnett & Company