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The Stock Market

Recalling the line from the Rudyard Kipling poem ***If***, "If you can keep your head when all about you are losing there's…" provided good advice for investors in the first quarter of 2008 as equity markets posted the worst first quarter since 2001. Hey, weren't we in a recession then? You know the saying, history doesn't repeat itself, but it rhymes. So while we could spend hours debating whether we are actually in an official "recession", the stock market seems to have decided the answer as the slide that started in the fourth quarter of 2007, continued in the first three months of 2008. To look on the bright side, the trend was better in March vs. February and February was better than January. Perhaps Spring will bring with it more than better weather – maybe we can get our first positive month of the year. For the full quarter ended March 31, 2008, the S&P 500 ended down -9.9% (-9.4% including dividends). For comparative purposes, the Russell 1000 Growth was down -10.5% for the quarter while the Russell 1000 Value Index ended down -9.4%, both large-cap indices. The Russell 2000 Index, representative of small-cap companies, ended down -10.2%. International stocks did not escape the downdraft either, with the Morgan Stanley EAFE Index, a measure of developed international markets, down -9.2%. Select developing countries, such as China, India and Russia, were all down double digits for the quarter as well.

Sector returns were mixed as half of the 10 economic sectors outperformed the broader market. Consumer Staples was the best performing sector for the quarter, not surprising given its normally defensive characteristics. Energy and Materials were also in the top five, again not a shock given what commodity prices, in particular oil, has done so far this year. It is interesting to note that the Consumer Discretionary sector also outperformed the market despite all the negative headlines surrounding the U.S. consumer. Perhaps, after underperforming in 2007, this area is providing a glimpse into a recovery that we could see later in 2008 or early 2009. Financials continued 2008 where they left off 2007, climbing out of a very deep hole. Technology also suffered during the first three months as some of the extraordinary gains experienced in the fourth quarter of 2007 were reversed in this sector.

We ended this section in last quarter's newsletter with this conclusion: "Bottom line, the equity markets are likely to remain volatile over the coming months as investors adjust to slowing economic and earnings growth." I'm not sure we knew just how accurate that statement would be. As we enter the earnings reporting season in April, the choppiness in the equity markets will most likely remain; however, given the unprecedented amount of fiscal and monetary stimulus now in the system, prospects should improve later in the year. We continue to look for opportunities in all sectors of the market that have been created by this sell-off and hope to continue adding value to our clients in this difficult investment environment.

The Bond Market

The Fixed Income markets were not spared the volatility of this quarter. As one would expect, US Treasury bonds performed well as investors sought a "safe haven" from the equity market. The 10-year, 5-year, and 2-year Treasury bonds had total returns this quarter of roughly 5.74%, 5.23%, and 3.26% respectively, their best performing quarter since 2002. Fueled by concerns over the economy and future corporate profits, investors shunned corporate bonds causing their spreads to widen. Given the negative headlines surrounding the financial sector, spreads of bank and broker bonds were affected the most.

Municipal bonds prices were pressured in the first quarter causing the unique occurrence of municipal bonds having higher yields than treasury bonds before factoring any tax benefits. High quality municipal bonds that have historically yielded 75% to 90% of comparable Treasury bond yields currently are greater than 125%. Several factors contributed to this phenomenon. First, Municipalities get a fair amount of revenue from real estate taxes. To the extent property values are lowered and/or less property transfers occur, the municipalities will receive less revenue. Second, bond insurers came under fire for providing insurance to subprime mortgage portfolios which resulted in some of these insurers being downgraded by the ratings agencies. Third, in order to meet redemption requests from investors, hedge funds sold the higher quality assets in their portfolio, including municipals, causing more supply in the marketplace. Finally, the Auction Rate securities market - a short term borrowing tool used by municipalities and funded by banks - saw a retreat by investors and a lack of support from the banks. The result of this is likely to be a new supply of long-term debt to repay the short-term facility.

These anomalies in the market have created a unique opportunity for municipal bonds investors. Given our active approach to fixed income management, we were able to capitalize on this situation for our clients. In addition to municipal bond prospects, we currently see US Treasury bonds as fully priced and continue to look for acceptable swaps into high grade corporate bonds.

Economic Outlook

Uncertainty! This is probably the best description of the current economic environment. Are we in a recession, heading into one, or likely to avoid one? Nobody knows the answer and recent data could support any of these outcomes. Truthfully, there is not a major difference between an economy growing between 0% to 1% – GDP growth in fourth quarter of 2007 was 0.6%- and an economy that may be declining at a similar rate. In either case we have a problem. Economic growth is not at a level that can support the type of business environment and employment growth needed to improve our overall well being, including positive performance by the equity markets.

Weakness in our economy has been evident for some time, but the collapse of the investment giant Bear Stearns brought into focus the severity of the problems faced by our financial system, not only in the US but worldwide. Without the aggressive intervention during the quarter by the Federal Reserve (Fed) and the Government, the U.S. could have experienced a major economic catastrophe.

The Fed lowered interest rates (Federal Funds) by 2% during the quarter, and over the past seven months they have reduced rates by a total of 3%. In addition to reducing rates, the Fed has basically opened its doors to borrowing by all financial institutions, even taking as collateral debt that has no current market – subprime debt. For the first time since the Great Depression the Fed has offered direct loans to Wall Street investment banks. In addition, the Government has been providing fiscal stimulus through tax rebates to consumers and relaxing the capital requirements for Fannie Mae and Freddie Mac to buy mortgages from other financial institutions.

Looking forward, as always, the key to how the economy performs will fall on the back of the consumer, and currently consumer sentiment has been shattered. Higher energy prices, a perceived deterioration in the labor markets and declining housing prices along with household wealth have caused consumer confidence to reach recessionary levels. Hopefully, and we do believe this to be the case, the aggressive actions by the Fed and the Government will help spare us from a recession. It generally takes some 12 to18 months for the benefits of lower interest rates for businesses and consumers to work their way through the system, and the first reduction in rates was only last August.

Government rebates should also begin to help during the second and third quarters. Even if rebates are used primarily to pay down debt as some believe, they will still have a positive effect on consumer confidence and future spending decisions. The weak dollar will likewise continue to support the economy as our goods are inexpensive for foreigners to purchase. In conclusion, uncertainly will be the theme of the next couple of quarters, but we know that we will weather the storm and a recovery will ensue. We look forward to the markets recovering in anticipation of better economic times.

Market Indicators

	YTD 2008 Total Return	52 Week Total Return
S&P 500	-9.45%	-5.08%
DJIA	-7.00%	1.58%
NASDAQ	-13.88%	-5.12%
RUSSELL 1000	-9.49%	-5.41%
RUSSELL 1000 Growth	-10.18%	-0.76%
RUSSELL 1000 Value	-8.72%	-10.00%
Russell 2000	-9.90%	-12.99%

Source: Bloomberg