Quarter Notes

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Fed Actions

The Fed took no action at its most recent meeting. The Fed funds rate has stood at 2% for the last two meetings. Further cuts are not expected. In fact, there is concern that the Fed should be raising rates to fend off inflation. Chairman Bernanke is walking a delicate tightrope between the pressures of a slowing economy with growing inflationary pressure from commodity and food prices.

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Economic Woes Work Their Way Through the System

Even if we have not technically entered a "bear market," no one can deny that the markets have been ugly. Year-to-date the Dow Industrial Average has fallen 14.4%; the S&P 500 is off 12.8%, International stocks are down 12.7% and the NASDAQ and the Russell 2000 have declined 11.9% and 10%, respectively. Only the DJ-AIG Commodities index rose by 26%. Oil rose as high as $143 per barrel.

Actually, the decline started about nine months ago, and there has really been no place to hide. Stocks, both domestic and foreign, have taken a beating; bonds have suffered from credit concerns; and money markets are not even keeping pace with inflation. Only commodities and certain hard assets have made any positive contribution to returns.

At the heart of the problem is that years of excess worldwide liquidity, provided to help get us through Y2K and the bursting of the tech bubble, resulted in easy credit. This allowed individuals and companies to take on too much debt. Over-leveraged borrowers and lenders disregarded the risk numerator of the risk/return trade-off. A difficult period of de-leveraging, the process of cutting back on borrowed funds, is the result.

This has been most apparent in the financial sectors, especially those involved with mortgage credit. In the final throes of excess, lenders got to the point where mortgages were being issued without regard to income or asset values, seemingly without regard to whether the borrower could ever repay the loan. As long as home values were rising, what difference did it make to lenders who were packaging the loans and reselling them as high-grade bonds?

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Index	Close on 6/30/2008	YTD % Change
Dow Ind.	11350.01	-14.40%
S&P 500 Index	1280.00	-12.80%
Nasdaq Comp.	2292.98	-13.50%
Russell 2000	689.66	-10.00%
MSCI EAFE	1967.19	-12.70%
10Year Treasury	3.98%	2.36%

One result of this shakeout is that financial companies have had to attract investors to provide more capital in order to strengthen their balance sheets. This process is known as recapitalizing. The process has been painful. Companies have had to sell assets (often to foreign entities and at depressed prices), cut expenses by laying off employees, close facilities, and ration resources.

For American households up to their eyeballs in debt and living from paycheck to paycheck with access to credit cut off, the same debt reduction process must take place: sell assets at depressed prices, cut expenses, and ration resources. This is most noticeable in the residential housing market. Values continue to decline as borrowers try to get out from under their mortgage debt by selling their homes in a falling market. The National Board of Realtors reports that the price of single-family homes has fallen about 10% in the 12 months from April 2007 to April 2008. Of course, in areas where the run-up was most extreme (like South Florida) the pullback is more severe.

There is no guarantee that the worst is over, but it appears that moves taken by the Federal Reserve and Central Banks worldwide have succeeded in stabilizing the systems. Restoring confidence, however, will probably take a little longer.

Side Bits

Exports: The US is expected to export $71 billion to China in 2008. By comparison, the 2004 figure was just $35 billion. *-US Department of Commerce*

Tax Stat: Americans with less than $100,000 in adjusted gross income have an effective federal income tax rate of 8%. *-IRS*

Home Mortages: The total home mortgage debt held by Americans was $10.5 trillion at the end of 2007. This is double the amount of six years earlier. *-Source: Fed Reserve Flow of Funds*

It Could be Worse
If the price of gasoline had risen as much as a barrel of oil over the last year (5/31/08), we would currently be paying $6.35 per gallon. -BTN Research

Investment Risk

We ask several questions in our initial meetings to help clients understand the concept of risk and how they feel about it. The most pointed question is, “What is your Maalox moment?” To clarify what we mean, we explain that markets will go down as well as up and that periodic investment losses are to be expected. We strive to determine whether downside risk in the portfolio is tolerable enough for each client to stay the course during difficult markets and avoid selling out at the worst time. The idea is to create a portfolio that grows over time, where we rebalance to take gains as they occur and we have staying power when markets are depressed.

What is the biggest fear expressed by investors today? It is probably the fear of losing money in the stock markets. True, the markets have been frightfully volatile. The media blast us daily on what happened in the Dow and the internet reports moment by moment. Added to this pain is the realization that the value of most investors’ largest asset, their home, has also dropped, perhaps even more than their investment accounts. It is natural to have the feeling, “I just want to get out of stocks entirely.” This is precisely the time, however, that we need to focus on what we determined we could accept as down-side investment risk.

Historically, markets are cyclical. This means they will go up and down in wave-like fashion. Stocks can be overvalued, as we experienced earlier in the decade, or undervalued as when they bottomed out in the spring of 2003. Market timing is unreliable and works perfectly only in 20/20 hindsight. If we want to enjoy the benefits of growth in stocks, we must be invested when markets are weak. The hardest job for investment advisors is convincing clients to invest when markets are uncertain and to stay invested in beaten-up markets. As Warren Buffet observed, “Stocks are the only things consumers don’t want to buy when they go on sale.”

Our biggest investment fear does not necessarily translate into our biggest investment risk. What risk should we fear most at this point? We would suggest it is purchasing-power risk or, put another way, inflation risk. That is the risk that the dollars we have saved won’t buy the same goods and services in the future as they would have in the past.

Formal government statistics tell us that inflation is not really affecting the consumer price index (CPI). But as anyone who drives, eats, or travels can attest, our depreciating dollar buys less and less daily. To maintain the standard of living we have become accustomed to, our dollar-based investments must be designed for growth

Where does that leave us? Growth assets, represented by diversified stock portfolios, are necessary to our long-term financial security. We endeavor to balance the risks through diversification and low correlated investment selection. These strategies have caused our portfolios to hold up much better than the index returns. Market risk is part of investing. Without it, there would be no potential for long-term growth.

Taxes After the Election

The Tax Policy Center analyzed the tax proposals of both candidates. Senator McCain proposes to keep the Bush tax cuts except the elimination of the estate tax. His plan lowers taxes for all taxpayers, but benefits high earners more than those with low or middle incomes. McCain proposes to lower top marginal rates (35% for individuals and 25% for corporations).

Senator Obama’s plan keeps most of the Bush tax cuts for those earning less than $250,000. His plan would raise the top marginal bracket to 39.6% from 35% and would increase capital gains rates to at least 20%. Some discussion is pending on raising the cap on wages subject to Social Security for the highest earners.

Both candidates want to decrease the number of taxpayers subject to estate taxes but are reluctant to do away with them altogether. McCain has mentioned a $5 million per person exclusion and a decreased rate on the remainder. Obama favors freezing the exclusion for estate taxes at 2009 level of $3.5 million per person with a 45% top tax rate.

Both policies are expected to raise the national debt over the next 10 years : McCain’s by $4.5 trillion and Obama’s by $3.3 trillion. These proposals do not include revamping Social Security or Medicare or make provision for a national healthcare policy.