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Bear Claws

Quarterly Newsletter
Period Ending 06-30-2008

With the markets down 10% in June, the overall markets have entered bear market territory. The June numbers were the worst for the month of June since the Great Depression. Since the markets are a leading indicator of the economy, usually when the markets enter bear market territory that signals further erosion in the economy. With the economy already under stress because of housing and credit market issues, any further erosion in the economy could be serious. Even worse, it was believed for a while the global economy would do better than the U.S. and buoy the U.S. economy, but now signs are appearing of a Global slowing. After a big run up last year, stocks in Shanghai were down 21% for the quarter. Year to date Shanghai is down 48%, and now at 16 month lows. Year to date, India is down 33%, while London Germany and France are down between 13 and 21% on the year.

Housing and credit market problems are further heightened by high oil prices, a weak dollar and the threat of inflation. Indeed Fed speakers have talked a lot recently, probably too much, about the threat of inflation and the need to raise interest rates. At the last Fed meeting the policy statement had something to offend everyone, but the emphasis was on the risk of inflation. Normally one would expect the Fed to raise interest rates under these circumstances, which would have the effect of strengthening the dollar. But because of the fragile economy, the Fed cannot raise rates now. Indeed, in spite of all the Fed talkers, the Board seemed to move interest rate increases further into the future, which had the effect of lowering the dollar and raising the price of oil.

After the Fed decision, Goldman Sachs analysts discovered the Citibank and General Motors had problems and placed them on their conviction sell list. (One wonders how they learned this startling information). This was more than the market could handle and the markets sold off. With each downturn, more problems are uncovered. Citibank has now lost 66% of its value since Jan 1 2007, with Washington Mutual losing 87% of its value in the same time frame. In the quarter General Motors dropped 40% and now trades at levels not seen since the 1950's. Also, in the quarter, Bank of America fell 37%.

For the quarter all financials were down 25% on top of already steep declines. Defensive sectors such as healthcare and consumers staples were down. Even utilities declined 5%. Hi yield bonds were the only bond sector to rise.

Inflationary pressures are high. While the government statistics show inflationary risk, they also purport to show inflation under control. Few people still believe the government's position. Economists at Merrill Lynch estimate global inflation at 5.5% while actual rates are running at 6.5% or higher in emerging markets. Not only energy costs, but food costs are increasing. Food shortages have appeared and even governments are hoarding food.

We cannot mount a recovery in the U.S. until home prices begin to recover, and yet congress and the executive branch dither over who is to blame while mortgage foreclosures surge by 15,000 per day.

Our strategy remains largely unchanged. We continue to be defensive, with exposure to energy and food. Finding growth stocks is becoming increasingly difficult, but we also know that the market will turn and we want to be positioned for the recovery. The market will anticipate the economic recovery so we may see the market turn up even before the economy.

William D. Rutherford, President
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