



8053 XERXES AV S. ■ BLOOMINGTON, MN 55431 ■ 952.926-3000 ■ Toll Free: 866.926.3022 ■ www.capstratcorp.com ■ e-mail: capstrat@comcast.net

## **CSFC Quarterly Market Commentary First Quarter 2008**

### **Summary**

The first three months of 2008 were a continuation of the end of 2007, the economy got weaker, the housing crisis deepened, the financial sector got even shakier, and stocks continued their slide. About the best that can be said is that the last week of the quarter was actually fairly encouraging from both a stock market and a financial sector perspective. Stocks will decline in anticipation of an economic slowdown; that was the end of 2007. They will decline further if that slowdown turns into a period of stagnation (no growth) and even further if economic growth goes negative (recession). The decline of the first quarter of 2008 was the market discounting a scenario of no growth in the first half of this year. If things get worse, the decline deepens; if not, stocks will rally. There was the hope in recent days that the economic toll would be contained mostly in the financial sector

Despite the big gain on the final Tuesday in March, the average stock fund lost -10.1% in the first quarter. Larger companies performed only modestly better (the S&P 500 declined just -9.44%), as did foreign stocks (-9.53%). The best sector was commodities, which was the only gainer over the last three months (about +9%). Real estate also deserves a mention “rebounding” from a disastrous 2007 to slip only -1.2% during the quarter. Technology and telecommunications were the worst sectors, dropping -15.8% and -19.3% respectively.

In the case of foreign stocks, the benefit of the decline in the dollar (roughly -4.5%) was offset by the larger decline in the prices of foreign stocks in local currency (over -14%). The lesson is that during periods of pronounced instability, global markets are not as diversified as we might like. Latin America was the best world region with a -3.4% decline; China stood out in the opposite direction with a -21.2% decline.

Bond returns were very mixed during the quarter. The problems in the mortgage, asset backed, and municipal sectors caused losses during conditions that are usually favorable for bonds. High yield corporate bonds should have been the worst sector of the bond market, but actually floating rate bonds lost more. Treasury, international, and inflation protected bonds (TIPs) were the gainers, and because of the weakness in other areas those sectors performed unusually well.

## Capital Strategies Performance

We have continued to provide our clients with substantially less downside in a market environment where most sectors have taken serious losses already this year. Our Balanced Model Portfolio, which is held by the majority of our clients, declined only a little more than -2%, less than half the decline of the average mutual fund balanced portfolio.

## Activity

As a result of our remaining over weighted in cash and under weighted in stocks during the past quarter in all instances we beat our benchmarks. We have been favoring stock funds with a tilt toward energy and hard assets. On the bond side, we have over-weighted TIPs and international bonds. We haven't made any significant moves recently because stocks just haven't gotten cheap enough, and our patience on your behalf continues to be rewarded.

## Outlook

While the economy is clearly contracting at the moment, it is useful to remember that historically stocks are a leading indicator. We should expect stocks to move up before the economy does just as stocks started to decline back in the third quartet of 2007 when economic measures still showed fairly strong growth. Even if the current period of economic weakness is destined to last until 2009 or beyond, one should remember that there are often sharp rallies during recessions. Between 2000 and 2002 for example, there were three separate rallies of 10% or more. Periods of excessive concern, such as we saw in the first quarter, often set up nice rallies. It is just that we don't see the conditions for a lasting rally anytime soon.

## Commentary – We Just Can't Do It

We want to buy stocks right now, we really do! We have carried above-average cash positions in most portfolios and have been fairly defensive in our stock fund choices over the past year, and that has worked out rather well. Therefore if we get more aggressive now, we cannot fail to out-perform the averages since at the margin we will have “bought low” vs. the market. Last July we wrote about needing to anticipate market peaks before they occur and when things looked like they can't get any better they probably won't. That should now be true in the other direction shouldn't it? Shouldn't we be anticipating the market bottom now and stepping in?

What holds us back is the belief that what we are seeing now is a relative low as opposed to more significant low. Stock prices are cheap compared to 2006-7 levels, but not to 1926-2007 (1926 is the year that good statistics began to be kept) or even 1970-2007. It strikes us that if stocks were overvalued last year, the correction of 12.5% that we have experienced might make stocks fairly priced, but not cheap. The range from expensive to cheap is more like 30%, so we are not even halfway there. Buying stocks at fair value is better than buying them expensively, but if they are on their way to cheap, it would obviously be

**better to wait. History suggests that stocks don't spend much time at fair value – they just pass through it going one way or the other.**

**We would like to believe that the Federal Reserve's interest rate cuts are going to bring about a rally in the market sooner rather than later. It has generally paid to be buying when the Fed is easing, and selling when they are tightening, with about a six month time lag. It normally takes about twelve months for interest rate policy to take hold in the economy, and since the market anticipates economic change by six months, it would be reasonable to want to buy stocks now because the anticipation rally should start soon.**

**And then we have a week like last week when Alcoa and General Electric missed earnings estimates badly and the inescapable conclusion that the economy is contracting right now and corporate earnings are going to be falling. If a stock looks cheap today, i.e. selling at \$36 per share and earning \$3 per share this is a Price to Earning Ratio (PE) of 12. However, it might be expensive tomorrow if the same stock were selling at \$36 per share and was only earning \$2 per share, a PE of 18. GE missed their quarterly earnings estimate by 7 cents per share which is their worst performance in a very long time. What is disconcerting is how much GEs stock and the overall stock market dropped in response to their poor earnings. This tells you that analysts' estimates are too high. We think we've already gone through a terrible time in the financial markets, but we really haven't. We have however, gone through a serious scare in the financial sector. Prices of financial stocks are down considerably. Prices of non-financial companies in the aggregate have dropped around -9% to -10%. That isn't discounting a recession; this is just discounting a lower probability of takeovers and buyouts. A real recession would take the prices of non-financials down quite a bit further. Until last week, that seemed rather unlikely.**

**There are no certainties in the financial markets, but we like to have the odds stacked in our direction. We want to believe that we are at a point where the upside potential is much greater than the downside potential, because that would make it easy to decide to buy. Even if we were early, we would know that since we were buying good companies at good prices we were very likely to be rewarded if patient enough. Right now we just can't make that case. We see a fairly balanced picture with possibilities of a strong market rally on the basis of cheaper prices, lower interest rates and negative psychology even though investor sentiment is wrong most of the time. This may be offset by falling profits and a lack of realization that this economic downturn is because of the residential real estate debacle and rising food and energy prices which may be potentially worse than anything we have seen since the 1970s. That is why we can only bring ourselves to do a little nibbling right now on market weakness. The risk-reward tradeoff is not good enough to do anything more than that.**

**Capital Strategies Financial Corporation  
Mark A. Carlton, CFA Eric C. Graber, President**