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## CSFC Quarterly Market Commentary Second Quarter 2008

### Summary

Stocks and bonds both finished lower in the second quarter of 2008, though this quarter wasn't nearly as bad for stocks as the previous one. In fact, the quarter actually got started on a very good note. Many strategists believed the collapse of Bear Stearns on March 17th marked the market bottom because outside of the sub-prime mortgage crisis the economy didn't appear to be in bad shape. They expected corporate earnings to be growing briskly by the end of this year. That mindset sparked a rally of more than 10% by May 20th. From there things really fell apart. The problems in the financial sector did not go away and in fact spread from brokerage firms and mortgage insurers to regional banks. Meanwhile, the employment situation began to deteriorate. Job losses now exceed 50,000 per month. Oil prices surged past \$140 per barrel, causing gasoline to soar to a national average of \$4.10 per gallon. The high cost of oil forced prices up throughout the economy because it is used to manufacture, package and transport so many consumer goods. As a result of that upward price pressure the Federal Reserve now has a real tough choice between fighting inflation (raising interest rates) and stimulating the economy (lowering interest rates). Obviously, it cannot do both.

The only way to prosper in the second quarter was to be invested in energy, agricultural commodities, or raw materials. Demand for these products exceeded supply such that natural resources stocks performed extremely well (24.5%). The drawback from an investment standpoint is that far more companies are users (directly or indirectly) of energy, steel, fertilizer or coal than are producers. Therefore, a far greater number of corporate profit margins shrank than widened. Leading the losers list last quarter were financial services (-15.6%), consumer products, real estate, restaurants, and travel & leisure. Of the indices, the Dow Jones Industrial Average fared the worst losing -6.84%. The S&P 500 fell -2.73% and the NASDAQ posted a small gain (0.61%)<sup>1</sup>. Small stocks, as measured by the Russell 2000, gained 0.58% on average.

Foreign markets (-2.25%)<sup>2</sup> were also negatively impacted by surging oil prices and slowing economies. The dollar rose, so there was no currency benefit last quarter to owning foreign stocks. Moreover, one of the weakest foreign markets was China (-5.14%), which has been reeling from both a very harsh winter and the devastating earthquake in May.

<sup>1</sup> Sources for performance are Lipper and Morningstar

<sup>2</sup> MSCI EAFE dollar-based, net return

Emerging countries tend to be much less energy efficient than developed countries, so surging oil prices are taking a big toll on Asia (except Japan, which is very energy efficient). Brazil has benefited from its ability to export both fuel and agricultural commodities, so it continued to be among the best performing foreign markets (17.66%). Europe lost 4.38%.

Unfortunately, weakness in stocks did not translate into strength for most bonds. In the first quarter, bonds rallied as the economy weakened and the Fed cut interest rates. With energy and food prices soaring last quarter, the Fed could not cut rates any further without the risk of making the inflation situation worse. In fact, though the Fed stood pat on rates, bond investors demanded higher yields to better protect them against inflation. This resulted in a loss of 1.02%. International bond funds were hit by rising yields and a rebound in the dollar, which added up a 2.37% average loss.

### Activity

Our high cash position did not change during the quarter. We made one or two fund substitutions, but the key component of our asset allocation strategy – holding extra cash – remained unchanged. The market did rally during the first half of the quarter, as we suggested in our last quarterly report. We didn't believe the economy really was coming around but was instead experiencing a "relief rally". We were eventually proven correct, and your portfolios avoided that extra hit when the markets turned lower. The Balanced Model Portfolio was virtually unchanged last quarter, losing just 0.02% after fees. In our more Aggressive Model Portfolios, where we could hold a greater weighting in more volatile natural resources stocks, we were able to gain close to 2%. The Conservative Model Portfolio experienced an average decline of 0.7% owing to the greater percentage of bonds in the portfolio. By following our long-term investment strategy and making the appropriate decisions on your behalf, we have been able to stave off significant losses for you, our clients. This is where our knowledge and experience is of benefit to you.

### Investment Strategy

Stocks are reasonably priced assuming an average if this is a two or three quarter economic downturn. If we are headed into a 1970s-style protracted recession (which is possible because the Fed is limited in terms of how much it can cut interest rates due to inflation concerns), then stocks have further to fall. Since today's money market and high quality bond yields do not offer investors a positive return on an after-inflation, after-tax basis, stocks should be preferred as long as we are in a modest economic downturn. If the downturn is more pronounced, then we will have to hold more bonds and cash, because a small loss in purchasing power is preferable to a large loss of principal. We have adjusted portfolios toward the latter scenario, because what we have seen in the real estate and financial services sectors over the past year falls well outside any possible definition of "modest downturn".

## Outlook

Since May 19<sup>th</sup> the S&P 500 is down over 12%. Energy and materials stocks are actually the worst performing sectors since July 1, which is actually a positive sign if you are looking for the broader stock market to make a bottom (investors won't buy into beaten-up sectors unless they can no longer make money in leading sectors). The economy is struggling right now but the stock market has already taken that into consideration so any hint that the worst is behind us could spark a rally in the short term. Financial stocks have responded to government measures to curb short selling with a 20% rally, but they are still off 26% year to date.

The intermediate term from a six month to eighteen months perspective is that the Federal Reserve is caught between a rock and a hard place in terms of either fighting inflation or stimulating the economy. If they choose to stimulate the economy, we could see an economic upturn by year-end. The problem is that stock prices are likely to lag the growth in the economy because we will have done nothing about inflation. In other words, earnings could rise 25% but stocks wouldn't rise as much because P/E multiples would contract to reflect that a greater percentage of the earnings growth would be due to inflation. Higher inflation would also tend to shorten each economic cycle, because the Fed is forced to act sooner.

On the other hand, if the Fed chooses to fight inflation, the current economic downturn will persist longer. We might not see job growth until the end of 2009, but that growth would be more likely to be sustained. Moreover, once economic growth was visible the stock market would most likely respond vigorously. Of course, the behavior of oil prices is going to determine a great deal in terms of how fast the economy responds to the Fed's actions. We believe prices are going to moderate because in the short to intermediate term, we don't really have a supply problem.

We are bullish for the longer term, eighteen months to three years and longer. Today's price declines are creating very good value in financial shares. Three years from now we are going to be profitably financing, building, and selling homes again. Mergers and acquisitions are going to be announced and completed. The economy needs a healthy financial sector, and as this sector gets healthy the return expectations on all types of stocks should approach their long term averages of approximately 10% + annually.

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