Market Commentary and Review

July 2008

"The best way out of a difficulty is through it"

SUMMARY:
The market officially entered Bear Market territory in the quarter, but based on historical Bears we're probably 70% through it.

Stocks typically show high returns in the 12 months after recession.

Of the eleven factors we identified as determining market direction this year, only one or two could be seen as positive.

The Fed and Treasury Chiefs, however, seem to finally get it; so we have at least two government figures showing leadership.

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Dear Clients and Friends,

Anatomy of Recessions and a Bear Market…. And, should you/we raise more cash and sit on the sidelines or stay invested (albeit at a lower than normal level)?

We began writing about the economic downturn last fall, and preparing both you and ourselves for a market decline. We have now officially entered bear market territory as defined by a drop of 20%. We've never been big fans of these "official" definitions of recessions or bear markets. Is a drop of 19.9% much different than 20.1%? Also, the idea that a bear market has begun at a 20% loss is ludicrous. Based on the average bear market decline of 28 % since 1900, the bear is more than two-thirds over.

The following table summarizes returns for the second quarter and the last few years:

	2nd Qtr 2008	Year to Date	Last 5 Yrs Annualized
Large Cap (S&P 500)	-2.5%	-11.6%	4.3%
Large Cap (Dow Jones Industrials)	-7.4%	-13.4%	5.7%
Mid Cap (S&P 400)	5.7%	-3.5%	7.2%
Small Cap (S&P 600)	0.7%	-7.1%	3.9%
Nasdaq 100	3.4%	-11.7%	7.5%
Foreign Stocks (EAFE)	-2.7%	-10.9%	12.5%
Bonds (Lehman Aggregate)	-1.1%	1.1%	3.8%
Emerging Markets	2.1%	-8.7%	25.9%
REITs (Vang. REIT index)	-5.4%	-3.4%	4.7%
High Yield Bonds (Vang. High Yield)	0.3%	-2.1%	3.3%
Commodities (AIG Index)	16.5%	27.2%	19.9%
Alternative Assets Group (AAG) (11 Fund Avg)	7.0%	6.8%	12.2%
65% Equity/ 35% Fixed-Benchmark	-2.1%	-7.4%	6.3%
50% Equity/ 50% Fixed-Benchmark	-1.9%	-5.4%	5.8%
35% Equity/ 65% Fixed-Benchmark	-1.6%	-3.4%	5.2%

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While the Bear is official, a recession is not. The official arbiter of recessions is the National Bureau of Economic Research (NBER). It's fair to say they act more for the benefit of historians than for providing investors with useable information in real time. NBER's definition of a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. NBER is always late in declaring both the beginning and end of recessions.

Since 1980 there have been four recessions. The average lag time for announcing the beginning of the recession has been 7 months. The average lag time for announcing the end of the recession has been 15 months. So, if we wait for an official announcement by the NBER we will be very late. Does this matter? The answer if you are an investor is yes. For the last 60+ years, the average recession lasted 10 months, and stocks typically bottom about midway through a recession.

What, if any, guidance can we get from economic indicators to signal the recession before hearing from the NBER? There are four indicators that compose the Index of Coincident Economic Indicators. Of these, three signal a recession began in the fourth quarter of 2007, and that we are now somewhere in the second half of the downturn. The indicators are: i) Non-farm payrolls – peaked Dec-2007; ii) Industrial production – peaked Jan-2008; iii) Manufacturing and trade sales – peaked Oct-2007; and iv) Personal income – still rising, but began flattening Jan-2008.

Summary: If we wait until the recession is announced and over, we will have missed the bear market low and beginning of the new bull.

Some clients have been asking: What are the implications of sitting on the sidelines and waiting? After all, the economic, financial, and political headwinds are daunting. Here are a few of the risks associated with not being invested when the market turns:

- Growth of $1 in the stock market since 1988 => $9.33
- Growth of $1 missing the best 18 months => $2.36 (less than T-bills)
- Avg. 6 months return since 1945 after recession => 20.1%
- Avg. 12 months return since 1945 after recession => 33.7%

In our last two newsletters we outlined eleven factors that would drive performance this year; or put another way – concerns that need to be put behind us before the markets begin improving. We have stated over and over again that investors should expect increased volatility until some of these clouds clear. A quick review of the eleven factors follows:

1. Politics / Government. The government has been slow moving in dealing with the crisis, but we think Henry Paulson, Treasury Secretary, and Ben Bernanke, Fed Chairman are doing a pretty good job under the circumstances. Congress, on the other hand, has been ineffectual as usual. The stimulus package gave us a short boost to GDP, but there have been no significant efforts to deal with the housing crisis. We finally have two presidential candidates and the markets can begin focusing on their policies, even though these are likely to change as we approach the election and afterwards.
2. Federal Reserve policy. The Fed lowered rates to 2% and then stopped. This was exactly what we expected. There has been speculation they would raise rates later this year, but we put a very low probability on that outcome. There is a lag of 6 – 12 months before fed policy affects the economy, so it will be later this year before we see much stimulus from these actions.
3. Credit Crisis. We predicted the write-offs would be largely finished by mid year, and that is still probably true. However, there will continue to be some high profile write-offs and banks have tightened lending standards significantly. This will slow economic growth.
4. Oil prices have continued to climb to record after record. Several indicators suggest a peak is near, but no one can predict exactly at what price or how much oil will decline after the peak.
5. Slow economic growth and rising unemployment – still no signs of a turnaround.
6. Slower earnings growth. We have estimated growth in operating earnings of 3% this year, but there is a great deal of uncertainty in the numbers. Investors will soon begin to focus on 2009 and what type of recovery, if any, to expect.
7. Housing. There are some early signs of a bottoming in prices, but a recovery is still a year or more away.
8. Foreign trade continues to be a positive. Exports are at an all time high as a % of GDP.
9. The weak dollar has shown some signs of stabilizing since March.
10. Like oil, commodity prices have continued to climb but have shown signs of topping.

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11. Inflation has increased to 4% and may top out this year close to 4.5%. However wage inflation has been declining since 2006 and we do not expect broad based inflation indicators to continue rising much beyond the 2.5% rate.

Strategic Allocation Decisions

Since the beginning of the year we have been under-weighted equities and bonds, and over-weighted cash and alternative assets. These positions have been correct and the only mistake was not being even more conservative. However, as long time clients know, our process is to make tactical allocation changes on the margin. As the earlier discussion shows, the risks to long-term performance by market timing is huge. Some short term volatility must be accepted to achieve long-term goals. Balanced accounts are down 5%-8% this year while equities indexes are down 10%-14%. We've been fortunate (or wise) to miss the major catastrophes. We've underweighted financials, held no exposure to sub-prime debt, had no positions in auction rate preferreds, nor held mutual funds or money market funds exposed to these. Our Alternative Assets Strategy has benefited from exposure to commodities, gold, and contrarian managers.

U.S. Stocks

Our model continues to show the market to be 20% or more undervalued. We estimate $85 in operating earnings for the S&P 500, which puts the P/E ratio at 14x. Unless inflation rates stay at a high level this is very attractive. The following table summarizes P/E ratios since 1960:

Inflation	Average P/E
<2%	23.5
2-3%	19.7
3-4%	17.6
4-5%	14.8
5-6%	13.1
6-7%	9.5
>7%	8.5

Core inflation and the GDP price deflator are currently below 2.5%.

Investment Grade Bonds

During the second quarter, interest rates rose and bond prices fell. The total return was -1.1% bringing the year to date performance down to +1.1%. There will continue to be a tug of war between investors worried about inflation and those seeking a safe haven. We continue to see little value in Treasury bonds. Municipal bonds, however, do offer attractive value - especially compared to Treasuries. Often we can find munis yielding more than Treasuries, which is uncommon because muni interest is tax-free and Treasury interest is taxable. Turmoil in the muni bond insurance companies, the rating agencies, and the auction rate preferred market has created opportunity in the high yield muni market. Tax free yields of 5% or more can be found sometimes in Colorado issues, but also in mutual funds.

Dividend / Defensive Group:

As previously reported we began investing in three preferred stocks earlier this year issued by Wells Fargo, Fannie Mae, and AIG. As we write, the shares of Fannie Mae have been under tremendous pressure, and we are nervously holding on to our positions. It is no surprise to us that there is discussion of a government bailout of some kind. That was part of our premise going in. However, we are surprised by the market's actions, especially in light of statements by the Federal Reserve and Treasury Secretary. We are monitoring the situation closely and evaluating our alternatives.

Another addition in this group last quarter was an investment in a company called Tortoise Energy Infrastructure Corp. This is a basket of companies including oil and gas pipelines, propane distribution, coal, and shipping; and has a dividend yield of 8%. We believe this is an attractive way to get yield and benefit from the growing demand for energy.

Alternative Assets Group:

Commodities drove performance in the second quarter to a 7% gain for the 11 fund index. The market neutral fund also had excellent gains of 9%, and 10 of the 11 funds had positive results. This category continues to exceed our expectations by providing positive returns even in down markets.

We're happy that one of our favorite managers in this category, Leuthold Weeden, has opened a new fund. This quantitative, somewhat contrarian, balanced manager is now managing a global fund using a technique successful in US stocks and bonds. Their US fund has been closed to investment for a couple of years.

Model Equity: *Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance.*

However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.

The model equity account outperformed the market in the second quarter. It is down 9.2% for the first half of the year, which is 2.4% ahead of the S&P 500. Energy continued its outperformance, gaining 26% for the quarter. Technology also had a positive return of 5% led by gains in Google and Apple. The worst performers were in the industrial machinery category as investors came to fear a longer and/or deeper recession. Oshkosh Truck, Terex, and Toro had significant declines.

We took some profits in the energy sector – trimming positions in Chesapeake Energy and XTO, and selling our coal company. We eliminated our holding in Lazard, reducing our allocation in Financials to only 4% of the portfolio. We also reduced our allocation to Technology by eliminating the technology ETF holding.

Foreign Equities and Fixed Income:
As we reported last quarter, we made a few changes to holdings during the recent period based on new research, but we did not change allocation targets. As we look at the world, we are concerned that Europe's economy is likely to slow in the coming months, and even the fast growing developing countries will come off the boil. With the dollar having dropped 40% over the last 6 years, US companies are in an excellent position to compete as shown by the improvement in the trade figures. Europe, on the other hand, is now at a competitive disadvantage. Furthermore, several European countries have housing problems as bad or worse than ours, and economies that are not as diversified as ours.

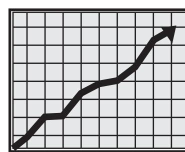
Asia has a long way to go in the process of transforming from an agrarian to an industrial society, but it is nonetheless having growing pains. The increase in prices of food and energy can largely be explained by the increased demand from these fast growing economies. Inflation there has become a significant problem. We are taking a close look at reducing allocations to foreign equities.

Company News:
Last quarter we announced the addition of Gary Powell as Director of Financial Planning. He has made an immediate impact by bringing new ideas and expertise to our process. Many clients have come in to update their financial plans, and if we have not reviewed yours in a while please feel free to call for an appointment.

A few new faces joined us last quarter. Jenny Trindel comes with 11 years of experience in financial services and will be supporting clients' service needs. With the end of the school year we had several changes in our interns. We wish Christian Seiferth and Sheldon Lewis good luck as they head off to jobs in Denver and San Francisco, and we welcome Mike Aboussie, Will Brand, and Jonathon Terela.

As we previously announced, 2008 is our 20th anniversary. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at www.sargentbickham.com.

Many happy returns,



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