MARKET OUTLOOK

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Oil ballooned over 40% during the 2nd quarter adding to the worries of a credit and housing bedeviled market. With the added burden of oil, most equity indices slipped into bear market territory falling 20% from last October's peaks. The Fed lowered interest rates once more in April to 2% but put rate changes on hold at the June meeting as inflation risks came into balance with the possibility of slower growth.

The Economy

Even with multiple headwinds, GDP managed 1% growth in the 1st quarter after an anemic 0.6% in the 4th quarter of 2007[1]. Growth for the 2nd quarter will continue to benefit from the tax rebate and strong exports. The US seems to have dodged recession for the first half of 2008 but remains threatened by elevated commodity prices.

Housing showed some signs of leveling. The Commerce Department reported a 2.5% decline in new home sales in May from April, but May sales remained above March's level. Existing home sales, about 85% of all sales, rose 2.0% in May; the median price fell 6.3% from a year ago[2]. At a minimum it seems lower prices are drawing buying interest. Elevated inventories and rising mortgage rates mean a substantive turn-around is uncertain.

Personal Income and Consumer Spending for May rose 1.9% and 0.8% respectively[3]. Most of the rise was due to the tax rebate cutting personal taxes by 24.7%. Rebate effects should keep 2nd quarter GDP growth above 1% and have lingering positive impact into the 3rd quarter.

Manufacturing grew at the end of the quarter as the ISM's PMI rose to 50.2[4]. Levels above 50 indicate expansion; the previous four months of the index were below 50. Strength came from exports and inventory build. Of concern were a drop in the Employment Index to 43.7 from 45.5 in May and a nearly 30-year high for prices paid of 91.5. The former indicates slow hiring, the latter a dramatic rise in input costs.

The labor market weakened further as the four-week moving average of new claims for unemployment rose to over 390,000 by the end of June. Levels above 400,000 for a prolonged period are consistent with recession. Payrolls fell in each month of the quarter for a cumulative job loss of 438,000 in 2008[5].

With a weak labor market, wages remained under control leading to a relatively benign core PCE level of 2.1% year on year[6]. Headline inflation, which includes energy and food, remains troubling with that CPI measure at 4.2% year on year for May[7].

The Federal Open Market Committee reduced the Fed Funds Rate a quarter point in April. Rates were put on hold at the June meeting given the Fed's rising concern over commodity driven inflation.

1. US Department of Commerce press release 6/2008
2. National Association of Realtors 6/2008
3. US Department of Commerce 6/2008
4. Institute for Supply Management 7/2008
5. US Department of Labor press releases 2008
6. US Census Bureau 6/2008
7. US Department of Labor 6/2008

Markets

Treasury yields rose roughly half a percent during the period reversing the fear based rate decline of the 1st quarter. The 10-year treasury yield rose from 3.45% at the end of March to 3.99% at the end of June, almost back to where the year began[8]. Equity markets were volatile and most indices fell into bear territory at the end of the quarter, falling more than 20% since the highs of October 2007.

Outlook

For 2008 we feel the S&P 500 could still see positive performance in the low single digits, below long term average returns, volatility levels are likely to remain elevated. Within equity we favor large cap growth stocks due to their attractive relative valuation and typically superior performance in uncertain economic times. Given the expectation of a moderate economic environment bonds could have total returns of slightly greater than coupon yields or between 3.5% and 4.5% for intermediate government bonds.

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8. U.S. Treasury Department June 2008, ustreas.gov