

# INVESTMENT OUTLOOK

## First Quarter 2008 Review and Outlook

by Whitney Brown

- Stocks decline.
- Credit crunch continues.
- Federal Reserve acts to stabilize credit markets.
- Economy in or near a recession.



Stocks of all stripes fared very poorly in the first quarter of 2008. All of the major indexes declined substantially. From domestic to foreign, small to large, and growth to value, equity investors found few places to hide. A very selective portfolio concentrated in the

unlikely areas of consumer goods, real estate and transportation would have fared well, but the typical diversified stock fund lost around 10% for the period. International markets that had outdone the U.S. for five years in a row suffered the same punishment. Combined with losses from the last quarter of 2007, the major market indexes have seen peak-to-trough declines on the order of 15-20%.

Financial asset markets are cyclical, and after a five-year run, a significant correction was due. The seeds of the stock market damage go back to the bust in the U.S. housing market. For a while, the economy and markets seemed to be coping rather well with falling home prices and reduced activity in the housing arena. Then, the unexpectedly high and rising default rate on sub-prime mortgages called into question the value of those mortgages and the securities derived from the combining and repackaging of them.

Regulatory concerns, and realism, have forced holders of these mortgage-backed securities, mainly large financial institutions and their related entities such as hedge funds and other investment vehicles, to write down their values. The resulting losses have pressed those institutions to maintain required levels of

<u>Market Measures</u>	<u>1<sup>st</sup> Quarter</u>		
S & P 500	-9.4%		
Dow Jones Industrial Average	-7.6%		
NASDAQ Composite	-14.1%		
Russell 2000	-9.9%		
Morgan Stanley EAFE	-9.5%		
Lehman Bros. Aggregate Bond Index	2.2%		
	<u>3/31/08</u>	<u>12/31/07</u>	<u>3/31/07</u>
10-Year Treasury Bond Yield	3.43%	4.04%	4.65%
Three-month Treasury Bill Yield	1.38%	3.23%	5.04%

capital by seeking funds from outside sources and, more critically, curtailing lending activity.

The real problem now is one of confidence and trust. There has been a headlong retreat from risk. Institutional lenders are unsure of the creditworthiness of borrowers or the value of their collateral. The ability of many financial players to fulfill their roles as counterparties in complex credit derivative securities is also in question. By the same token, investors are wary of more mega-billion dollar write-downs yet to come. The sordid details will fill many books yet to be

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## First Quarter 2008 Review and Outlook (continued)

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written, but suffice it to say that no arena in which borrowers and lenders come together has been unaffected.

The crux of the matter as it relates to the economy and investing is that when financial institutions won't or can't lend money, it has a chilling effect on the economy. That is how we now find ourselves at the doorstep and probably even across the threshold of recession.

The Federal Reserve's number one objective until further notice is to restore confidence in the credit markets in order to keep the economy growing. The Fed will do whatever is necessary to prevent a deflationary spiral wherein

investors dump assets on the market at ever lower prices in order to pay off debt while, at the same time, consumers and businesses drastically curtail discretionary spending. The extraordinary measures taken by the Fed, such as preventing the failure of Bear Sterns and accepting impaired mortgage-backed securities as collateral for loans from the discount window, are evidence of the Fed's resolve to act decisively in this crisis.

Concerns about inflation, at least in the near term, may be misplaced. Most of the inflationary pressures experienced recently have been due to rising commodity prices, not usually the source of long-term inflation. The recent

surge in commodity prices has come after they have already experienced a multi-year bull market.

The fundamentals of limited supply and burgeoning global demand support the notion of a long-term bull market for commodities, but the latest spike has been exacerbated by the falling dollar. The dollar weakness has, in turn, been aggravated by the Fed's rates cuts. Simple speculation has played a part as well. As the U.S. economic slowdown spreads to other parts of the world, commodity prices should correct and allow the dollar to stabilize.

In the chart below, the top graph tracks the progress of the U.S. dollar since 1979, and the



bottom graph tracks gold. For our purposes, we can use gold as a proxy for the broader commodities market. The graphs clearly illustrate that since 2002 the steep decline in the dollar has coincided with the boom in commodity prices. Please see the related article on page three.

Investors will closely  
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## Concerns for the Commodities Market

by Watt Dixon



With the major stock averages all struggling since last fall, some focus has shifted to commodities as an alternative investment. Commodities are raw materials used to create finished products, from food to furniture to gasoline.

Commodities include agricultural products such as wheat and cattle, energy products such as oil and gasoline, and metals such gold, silver, and aluminum. There are also “soft” commodities, which cannot be stored for extended periods of time, such as sugar, cotton, and coffee. Investing in commodities has evolved from the simple days of farmers selling their goods into a complex asset class that trades through electronic exchanges. Returns on commodities as an asset class are usually tracked by a commodity index such as the Dow Jones- AIG Commodity Index.

As an investment, commodities react to changing economic conditions differently than stocks or bonds. Unlike stocks and bonds, commodities tend to do well in periods of rising inflation. As demand for goods and services increases, the prices of those goods and services increase, as do the prices of the commodities used in producing those goods or services.

The price of a commodity is largely determined by futures contracts on the underlying commodity. A futures contract is a derivative investment that calls for the delivery of a certain quantity of a commodity at a certain price at a certain date. These futures contracts are priced based on the anticipated future demand for the specific commodity that is still in the ground or in the field.

In the last few years, the returns on many commodities have out paced the returns on stocks and bonds. The current boom in commodities prices is generally attributed to robust economic growth in China, India, and other rapidly developing countries. This overseas growth is only part of the reason commodities prices have come so far so fast. Until lately, commodities investing has been confined mostly to institutional investors. However,

there has been a surge in the number of mutual funds and Exchange Traded Funds (ETF's) specializing in commodities.. This easier access to commodities investing has opened the door to a whole new class of investor: the little guys.

The growth of investment vehicles for commodities has pushed the volume of commodity trading into uncharted territory. Furthermore, many of the largest hedge funds, commercial banks, and brokerage houses that have taken huge losses due to the subprime lending chaos, are also traders and lenders in the commodities markets. Any spillover of the credit crunch to the commodities markets could cause a huge wave of forced selling by these large institutions, crushing the small investor in the process. Also, fears of an economic slowdown in developing countries could send commodities prices plummeting very quickly.

Another potential trigger for a reversal in the commodities markets could be a shift in sentiment on the U.S. dollar and the economy as a whole. While the weak dollar has made commodities less expensive in foreign markets, any firming in the dollar and the U.S. economy could reverse that process. Also, economic recovery in the U.S. would make domestic stocks a relatively more attractive, and less volatile, investment than commodities. A rush out of commodities and into stocks could be a real possibility.

More immediately, there is a huge discrepancy between the investment positions of the so called “smart money” comprised of the farmers, the food producers, and the energy producers who trade daily in the commodities market and the “dumb money” comprised of speculators and those investors just jumping on the band wagon. By short-selling commodities futures, the smart money is betting heavily that commodities prices will fall. Their net short position is running about 30% higher than it was at its record peak back in 2004. Conversely, speculators currently are making record bets that prices will continue to climb. While commodities prices could have more room to run in the long-term, there are some compelling reasons to steer clear for now.

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watch economic data in coming months to determine whether or not the market has adequately priced in the appropriate extent of recession and the corresponding decline in corporate earnings. A severe recession may be avoided, but the recovery could appear sluggish as consumers and businesses reassess their appetites and capabilities for handling high debt loads. A period of debt reduction may allow the Fed to keep short-term rates low for longer than the inflation hawks are presently expecting. Low rates should provide an offset to reduced corporate earnings and help stocks find a measure of support.

There are some indications that the market has neared the end of its decline, but stocks have yet to experience the kind of throw-in-the-towel sell-off that is almost always associated with significant market bottoms. We do expect that the market will regain its footing and recoup the recent losses as the year

progresses, but until the credit markets stabilize, caution is in order.

Finally, the ongoing credit crisis, while painful for many, appears to be typical of the periodic financial debacles produced by easy money, greed and good old American ingenuity. Certainly, this crisis has exposed flaws in the financial system, but no regulatory scheme that promotes free and open markets can also anticipate every contingency and close every loophole. The financial crisis of the next decade will arise in some other area under very different circumstances. The basic financial system that allowed this most recent stumble is the same one that has allowed the United States to develop the world's largest and most dynamic economy. The challenge ahead for Congress and the Treasury will be to craft meaningful adjustments to the regulatory framework that address the flaws but don't stifle the innovation and risk taking that are the hallmarks of our system.