

# INVESTMENT OUTLOOK

## Second Quarter 2008 Review and Outlook by Whitney Brown

- ◆ Stocks in cyclical correction.
- ◆ Financial stocks hit hardest.
- ◆ Commodity inflation on the rise.
- ◆ Lagging economic indicators signaling weakness.

After a five-year stretch with little worse than moderate pullbacks, the stock market's performance during the past two quarters leaves little doubt that we are in the grip of a cyclical downturn. The market has offered few opportunities for gain other than energy stocks and a narrow group of agricultural and materials issues. Even those may be running out of steam now.

Reporting and commentary is overwhelmingly gloomy. Virtually no one is expecting anything good to come of this market or this economy for quite a while. The housing market has yet to show any signs of stabilizing. Unemployment is rising and oil prices refuse to top with record highs coming week after week. While all the bad news may actually be good from a contrarian standpoint, we have not yet seen the type of selling climax that usually marks the bottom of a cyclical decline.



Just a few months ago a bear market had not seemed the most likely outcome of the problems with the housing and credit markets because the Federal Reserve appeared to be on the case and dealing with the issues creatively and aggressively. Unfortunately, financial institutions have continued to take multi-billion dollar write-downs after assurances that the worst was past. The financial world is suffering from a severe break in confidence and trust, and the latest round of write-downs served to remind investors that the problems are far from over.

The unintended consequences of the Fed's aggressive rate cutting include compounding the weakness in the U.S. dollar and fueling a surge in oil and commodity prices that has touched off a global inflation scare. In the  
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<u>Market Measures</u>	<u>2<sup>nd</sup> Qtr</u>	<u>YTD</u>	
S & P 500	-2.7%	-11.9%	
Dow Jones Industrial Average	-7.4%	-14.4%	
NASDAQ Composite	0.6%	-13.5%	
Russell 2000	0.6%	-9.4%	
MSCI EAFE	-3.5%	-12.7%	
Lehman Bros. Aggregate Bond Index	-1.0%	1.1%	
	<u>6/30/08</u>	<u>12/31/07</u>	<u>6/30/07</u>
10-Year Treasury Bond Yield	3.98%	4.04%	5.03%
Three-month Treasury Bill Yield	1.90%	3.23%	4.79%

Stocks in the financial sector have led this market decline off the peak from last October. Banks and brokerage stocks have seen unrelenting sell-offs. The financial sector as a whole is down 30% for the year so far and 47% from the highs in 2007.

Foreign markets had generally outperformed the U.S. for a number of years, but so far this year they have fared worse. In U.S. dollar terms the foreign market declines are on par with the U.S., but in local currency terms the declines have been even worse.

There is a striking absence of any good news.

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## Second Quarter 2008 Review and Outlook (continued)

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short term, inflation has spiked, but longer term inflationary expectations remain tame. The forces unleashed by the housing bust and credit contraction are inherently deflationary, causing contraction of economic activity not an acceleration of it.

We expect the economy to limp along for the rest of the year rather than bounce back quickly. There is likely to be an extended period of deleveraging in the economy as businesses and consumers reevaluate their appetites for and access to debt. A retrenchment in consumer demand is underway as consumers hunker down and curtail discretionary spending.

On the bright side, the weak dollar has been good for U.S. exporters, and increasingly higher transportation costs are causing some manufacturing to come back to the U.S. from overseas.

Also, there are indications that the dollar may be stabilizing. Recent tough talk from the Fed and the latest decision to stand pat on interest rates are intended to firm the dollar and quiet concerns globally that the Fed will stoke inflation by keeping monetary policy too lax.

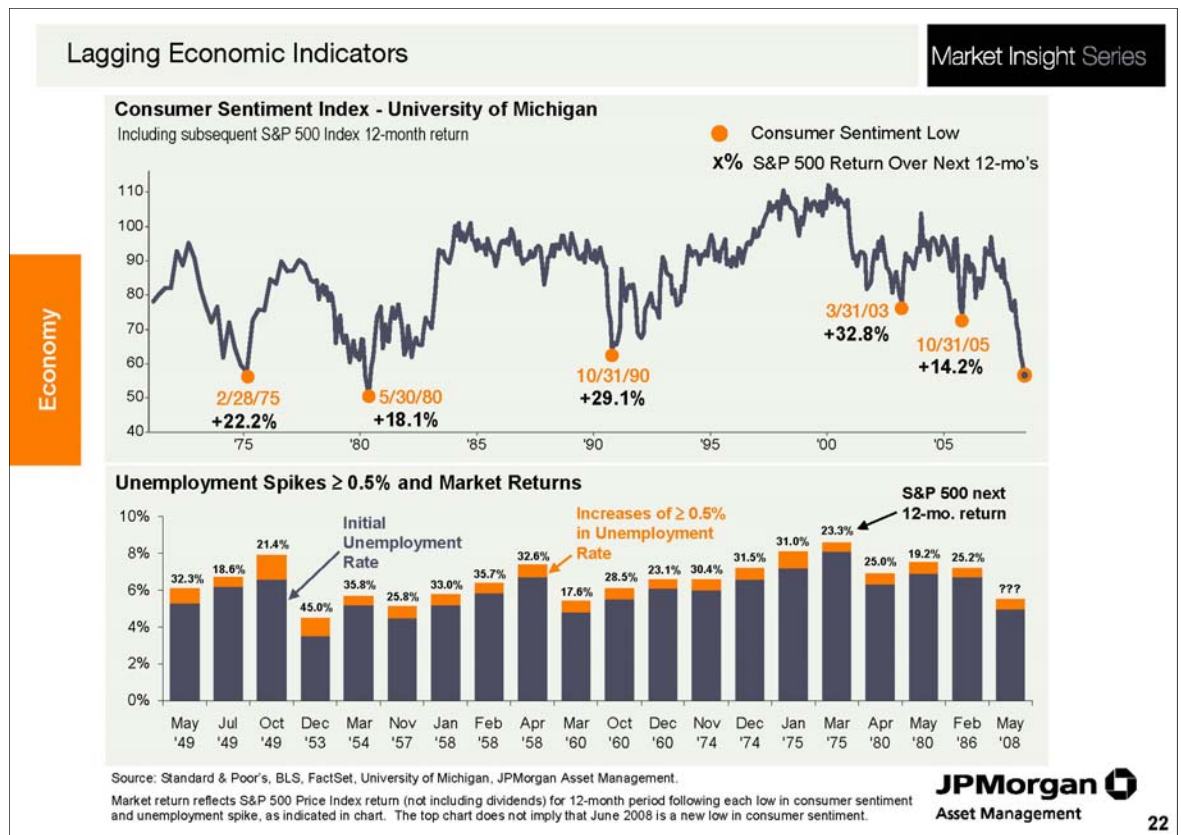
In the longer run, commodity-based inflation usually moderates as supply catches up to demand. There is a lengthy lag time for producers of most agricultural and resource

commodities to bring additional supply on line. Also, users change their habits and find substitutes for the commodity in high demand. We are starting to see that with gasoline. In the U.S., fewer miles are being driven and consumers are switching to more fuel efficient vehicles.

We do not know when or at what level the market will find a bottom. We do know several things that give us reason to look forward to a more constructive period in the near future. First, bear markets are shorter

run nine months and brought the major market indexes 20% lower.

Most importantly, we have seen a spike in the unemployment rate and plummeting consumer sentiment. Since these events are lagging economic indicators, their occurrence has usually heralded higher stock prices in the months following. The chart below presents both of these indicators and the corresponding stock market returns over the subsequent 12 months. In the top graph, each date of a major low in consumer sentiment is



than bull markets. Data for the Standard & Poor's 500 Index indicate that the median, or typical, bear market since 1929 has produced a 27% decline over nine months. The median bull market has produced a 63% gain over 16 months. The current decline dating back to early October, 2007 has

marked with a dot and the date of the low. The corresponding S&P 500 return over the next 12 months appears below the date in bold type. In the bottom graph the occurrences of spikes in unemployment of 0.5% or greater are shown added to the bar

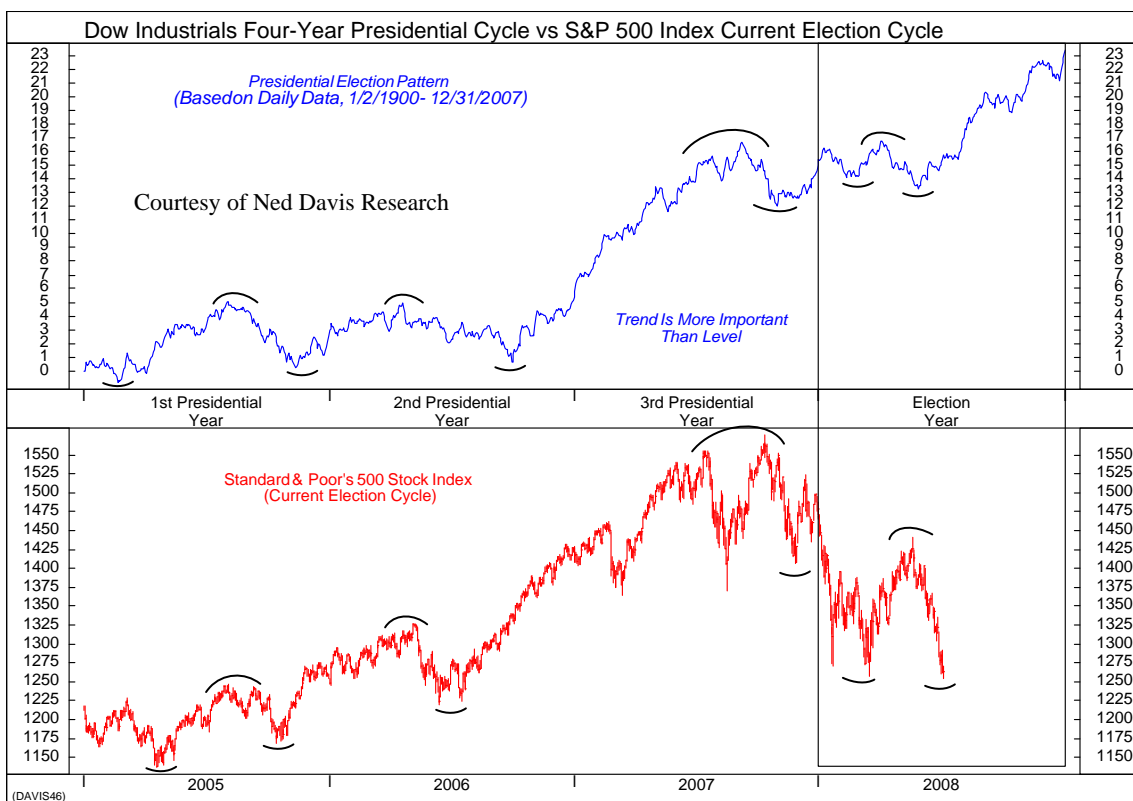
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## Election Year Update

Our work has always emphasized the cyclical nature of the stock market, and readers may recall our January article on the four-year Presidential election cycle. That pattern anticipates an important market low around the middle of a presidential election year. At right, we have included an updated chart of the pattern. The significant lows and highs in the S&P 500 Index corresponded very closely to the anticipated pattern throughout 2005-2007. We have marked the highs and lows for your reference.

While the fallout from the current financial crisis has brought the market lower than the pattern would indicate, we can still see that the sequence of lows and highs continues to follow

the pattern for 2008. Of course, the pattern is no guarantee of what the market will actually do, but we can make the case for a more favorable market in the second half of the year.



## Second Quarter 2008 Review and Outlook (continued)

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indicating the pre-spike rate of unemployment. The corresponding stock market return for the next twelve months appears over the top of each bar as a percentage. In all cases of the consumer sentiment lows and the spikes in the unemployment rate, the stock market produced double-digit gains over the following twelve months.

For the market to move higher in the wake of such negative data is a counterintuitive notion, but it serves as a vivid reminder that the market always looks ahead and anticipates improvement in the economy and the positive implications for stocks long before the data make it obvious.

Fortunately, difficult economic times and bear markets have been infrequent enough that people sometimes forget how painful they can be. This time around, there is a growing realization that the rising economic power of countries such as China, India, Brazil and Russia has made the global economy a less American affair. But historically, none of those countries has demonstrated the ability to continually adapt and innovate that has always been the greatest advantage of our uniquely free and open economy.

The market will work through this correction, and when ready, a new group of leading stocks will emerge to take the market higher. For now though, patience and caution are in order.

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## 529 College Savings Plans by Ted Feinour



On August 17, 2006, President Bush signed the Pension Protection Act which had a provision making permanent a federal tax break for earnings withdrawn from certain investment accounts used for higher education expenses. These accounts are known as 529 college savings plans, and the money withdrawn may be excluded from income for federal tax purposes. The 529 plan is named for the

section of the Internal Revenue Code which established it.

For nearly two years since that legislation, the assets deposited to these investment accounts has increased dramatically. The tax incentives were originally to expire in 2010, but now due to the permanence of the tax breaks, the marketing of these plans has soared.

We have seen growing interest in these plans and have helped a number of our clients establish plans for their children and grandchildren. A single account may be established with as little as a \$250. The maximum contribution limit is \$250,000. Anyone may contribute to the account, but only the account owner may make decisions regarding the investments, withdrawals, or change of beneficiary. Only one individual can be designated as a beneficiary, however the beneficiary may be changed if necessary.

Withdrawals may be used to pay for qualified higher education expenses including tuition, room and board, and certain other fees at an eligible educational institution. Earnings of the fund

accumulate tax free, and as mentioned, withdrawals of earnings for higher educational expenses are excludable from federal income taxes.

CollegeAmerica® is a 529 college savings plan offered by the Virginia College Savings Plan, which is an independent agency of the Commonwealth of Virginia. CollegeAmerica® allows savings for higher education through a tax-advantaged 529 account invested in mutual funds offered by the American Funds.

CollegeAmerica® allows the account owner to choose from twenty-one of the American Funds mutual funds. The funds are offered in various share classes based on investor preference and the type of financial adviser involved. By investing through a Registered Investment Adviser such as our firm, a plan owner may make purchases of low cost class 529-F shares. The F shares have fees that are among the industry's lowest, greatly reducing overall plan expenses.

Other tax considerations are that a Virginia resident who is an owner of a CollegeAmerica® Account may deduct contributions of up to \$2,000 from his or her state taxable income. There is, however, no federal tax deduction for contributions. For account owners 70 and older the entire amount of any contribution may be deducted on a state tax return.

We would welcome the opportunity to discuss how a 529 savings plan could fit into your investment strategy and provide a tax-advantaged way to help pay for the ever-rising costs of a college education.