2008 MID YEAR REVIEW OF MARKETS: COLLIDING FORCES

"In recent days, investors became particularly concerned about the financial condition of the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. In view of this development, and given the importance of these firms to the mortgage market, the Treasury announced a legislative proposal to bolster their capital, access to liquidity, and regulatory oversight. As a supplement to the Treasury's existing authority to lend to the GSEs and as a bridge to the time when the Congress decides how to proceed on these matters, the Board of Governors authorized the Federal Reserve Bank of New York to lend to Fannie Mae and Freddie Mac, should that become necessary. Any lending would be collateralized by U.S. government and federal agency securities. In general, healthy economic growth depends on well-functioning financial markets. Consequently, helping the financial markets to return to more normal functioning will continue to be a top priority of the Federal Reserve."

Federal Reserve Chairman Ben Bernanke, July 15, 2008, remarks from the Semi-Annual Monetary Policy Report to the Congress

The dominant story by far for the first half of 2008 is the stunning rise in the price of crude oil: up 45% from December 31's closing level of $97.90 to end the quarter at $142.00. At the same time, there has been an ongoing collapse in the prices of bank shares and other financial assets. Real estate values also continue to fall. This tug of war between raging inflation in some areas and gut-wrenching price declines in other areas represents the two critical colliding forces at work in today's markets.

It is important for investors to be positioned for what we continue to believe is a massive and ongoing de-leveraging of the world's financial system. In the end, the value of what we have been calling "strategic assets" these past several years will trump the specious balance sheets and income statements of what were once formerly considered to be "blue chip" investments. Rather than viewing the process as nearly complete, we believe the first phase has now passed and we are now entering the most dangerous period of this adjustment process, as the need to cleanse the system of bad debts and paper will be challenged by government efforts to re-liquify (i.e. "bailout") the system, producing additional stress and potential fracture points. The epicenter of this process is the organizations chartered by Congress known as "GSE's", or Government Sponsored Enterprises, namely Fannie Mae and Freddie Mac, of which we will have more to say later in this letter, and to which the opening quote above is addressed.

Broad market returns were abysmal through the first half of 2008, with the S&P 500 return of -8.43% for the month of June the worst in nearly a decade (investors would have to look back to the -14.46% decline in August of 1998 to find the most recent sharp one month decline in US stocks). Here's the run-down on some important indices at June 30:

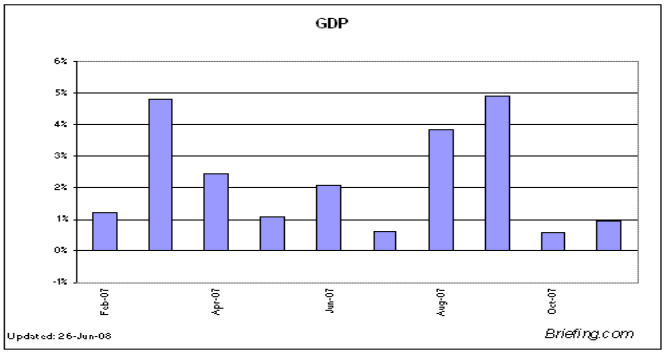
	2008 YTD	Last 3 Years	Last 5 Years	Last 10 Years
S&P 500	-11.91%	13.80%	44.09%	32.85%
Value Line Composite	-15.50%	-5.83%	29.38%	-21.96%
MSCI EAFE	-10.58%	45.61%	120.77%	82.99%
MSCI Emerging Markets	-11.64%	107.35%	273.42%	322.89%
Citigroup 5 Year T-Note	2.27%	14.24%	17.10%	68.97%
Lehman Five Year Muni	1.11%	10.07%	15.20%	54.50%
DJ AIG Commodity Index	27.22%	72.09%	134.68%	239.64%
CPI	3.14%	11.38%	17.93%	32.91%

The returns above are cumulative, and investors should note the wide disparity between the returns of emerging markets equities and foreign developed markets (MSCI EAFE) versus the US. Commodities have also provided very strong returns versus stocks and bonds. Bonds have provided greater returns than US stocks, and the average US stock (Value Line Composite) has fared much worse than larger cap US stocks (S&P 500).

All US indices are now off more than 20% from their highs of last October, fulfilling a traditional definition of "entering a bear market". Because of the unique nature of the current downturn, we don't believe it is useful to make references or comparisons to an average bear market decline or length (duration). We are in truly uncharted waters at this point.

Macroeconomic Outlook

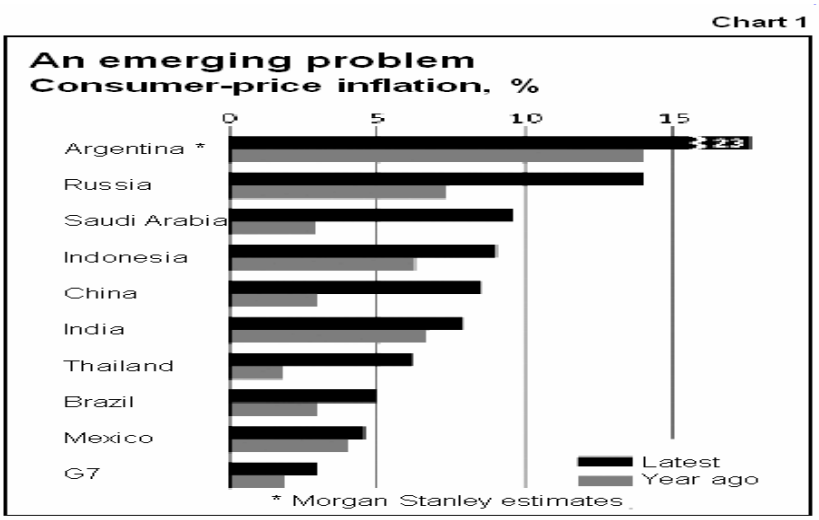
US GDP growth continued to defy the critics, rising 1% in the first quarter even as talk of recession dominated the headlines:



Despite the decline in housing and rising gas prices, consumption expenditures grew at a 1.1% annualized rate, and exports are very strong. Business investment remains surprisingly resilient, and government spending (at almost 20% of GDP) continues to rise. So the "recession" (negative GDP growth for 2 quarters) has been postponed.

However, the US is running a significant Current Account Deficit (CAD), which is the net balance of trade payments. Most recently standing at $791 billion, this represents almost 7% of US GDP, a record amount. The CAD is deteriorating faster as oil, the most important imported product, rises in price, sending ever greater numbers of US Dollars overseas. While most market prognosticators believe the US Dollar is "washed out" and due for a rebound, we are of the view that this continuing flood of Dollars into the global forex markets will drive the Dollar lower, and Gold higher.

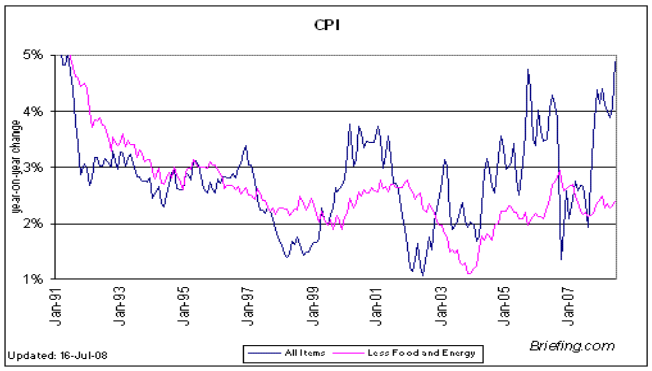
Inflation has also re-emerged on the radar screen as a potentially serious threat, not just in the US, but globally (we wrote about this emerging threat last summer in our review entitled "The Four Inflations"):



It is our view that the emerging market countries (who had been lauded for exporting deflation to our shores earlier this decade) will now be sending us another "present" in the form of higher cost goods and services. Already Europe, India, and China have raised interest rates (are in a "tightening mode"), while the US accommodates Wall Street by lowering rates. (This is another sign of further US Dollar weakness, as global capital will seek higher returns elsewhere.)

It is also not healthy for the functioning of markets (despite Bernanke's protestation to the contrary) when the Fed and ECB, and other major central banks around the world are so completely out of sync with each other and with movements in inflation.

As an example, in the US, CPI recently reached a 5% year over year increase:

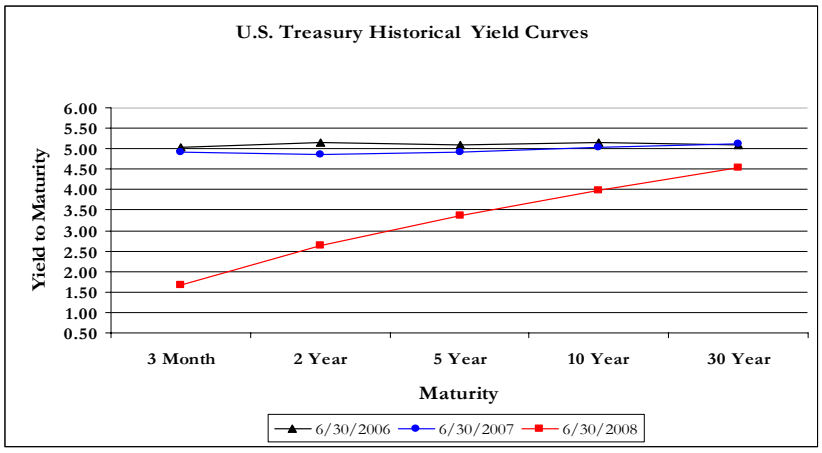


That means that <u>ALL US Treasury securities (risk-free rates of return) are now producing negative real rates of return</u> (after inflation), a condition which will produce potent increases in inflation expectations over time unless addressed. The proper policy response would be to raise interest rates. However, at the US Fed, hands remain tied. As the latest FOMC release states "the Committee expects inflation to moderate later this year and next". They do admit though (perhaps after perusing the above chart) that "upside risks to inflation and inflation expectations have increased". Actually, the Fed has no choice. The US economy, and especially the banking system, cannot tolerate higher interest rates. Because the Fed has a dual mandate of promoting growth and maintaining price stability, they have been forced to choose between what they perceive to be the lesser of two evils. Higher inflation will be the price we all pay.

The Bank of England, the European Central Bank, and other major monetary authorities do not have this dual mandate: their official mission is price stability at all costs. It is our view that <u>these institutions will sacrifice growth in their domestic economies to the point of recession as they continue to raise interest rates</u>, leaving the US alone to try and re-invigorate growth.

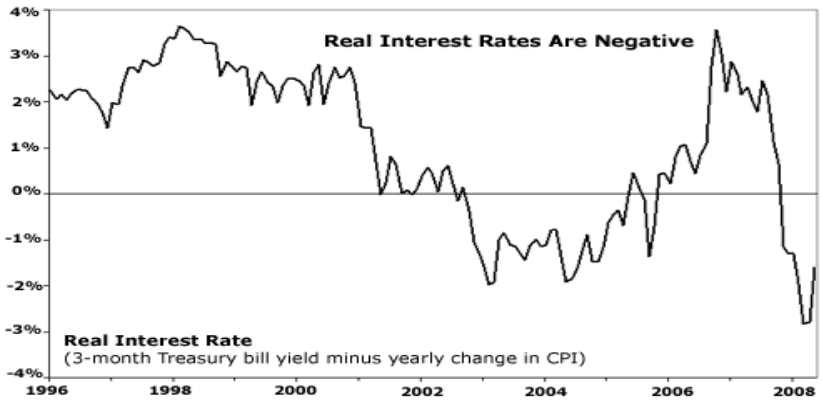
<u>Bonds</u>

The US yield curve has been violently re-oriented over the past year by aggressive Fed easing:



This is what is known as "re-liquifying the system", with the theory being that banks can borrow at lower short term rates, and lend money at longer rates, thus producing profits through the "spread" or difference in yields.

The problem is that short rates are back in an irrational position of not compensating investors for inflation. This is what is called a "negative real rate", and the chart below shows how it has become a frequent phenomenon this decade:



Negative real interest rates have been blamed for creating the real estate bubble, and now, the commodity bubble. But perhaps the more pernicious impact is in their effect on major developing countries, who "peg" their currencies to the US dollar. Most recently, they have been forced to lower their domestic interest rates in sympathy with the US to protect their currency, during a time of very dramatic price increases in basic foodstuffs, and to some extent fuel. As a far higher proportion of their consumers disposable income is devoted to these essential purchases, their purchasing power has plummeted, causing increasing social unrest and demands for higher wages. Until monetary policy responses address this real yield deficit, these negative real rates will serve to stoke inflation even further.

US high yield credit spreads, meantime, contracted briefly in the second quarter, but are once again on the rise, indicating rising risk aversion on the part of bond investors:

Source: Merrill Lynch

Our view remains that corporate default rates will be rising for some time to come, and thus spreads will approach or even exceed those seen during the last recession of 2001-02. Domestically, high quality issues should be favored. In general though, we find fixed rate bonds to offer insufficient returns given the current inflation backdrop. We are much more interested in inflation-protected bonds when they offer appropriate real rates of return (what are called "break-even yields spreads".)

Internationally, investors should focus on issuers or countries with healthy balance sheets, i.e. if sovereign debt then invest in countries with a growing current account surplus and strong currency (Canada comes quickly to mind)

Equities

Almost all major equity sectors produced negative returns for the first six months of 2008:

Basic Materials	9.64%
Energy	8.31%
Utilities	-5.41%
Consumer Discretionary	-10.80%
S&P 500	***-11.91%***
Technology	-12.34%

Industrials	-11.86%
Technology	-12.34%
Health Care	-13.47%
Consumer Goods	-13.71%
Telecommunications	-21.11%
Financials	-26.87%

Globally, the US was one of the top performing bourses, with Europe off by 14.97%, Hong Kong down by 25.29%, India down by 31.97%, and China off by 42.85%. This will hopefully quell any further talk of a global "de-coupling", as problems in the US have most certainly reverberated around the world. And while the emerging markets have a bright future long term, they are now experiencing a "correction" which could take some time to play out, especially if their respective central banks are unable to quell inflation expectations that are growing by the day. (As we write this, Pakistanis are rioting at the gates of the Karachi Stock Exchange, as they blame the government for not interceding to stop incessant stock price declines. This could be a taste of things to come.)

In US markets, earnings for the second quarter, if one removes the exaggerated impact of the financial and energy sectors, are estimated to rise by 3.8% according to the latest Thomson Reuters poll of analysts. That is quite a drop from the heady days of 2003-6, when double digit gains were the norm. And while that may prove to be a shade too optimistic, equity share prices have adjusted meaningfully, with the trailing PE ratio for the MSCI World Equity Index at below 15 times earnings, less than half its level of 2000.

Despite this more reasonable valuation, we are uncomfortable with a full allocation to equities because of the staggering systemic problems faced by investors worldwide. We advised in our year end letter that risk management (managing the downside) would be a very important focus for 2008, and we feel even more strongly about that now. Investors should use caution in their asset selection, making sure to include a broad variety of instruments that are not all highly correlated to stock price movements.

Commodities

The future for energy prices remains unchanged: higher prices to come, with no return to "normal" levels. What we are seeing now is the new "normal". As we have advised in every one of these reviews since 2004, the issue is quite simple and investors should not waste their time trying to inveigh against some conspiracy or plot by Big Oil or Militant Mullahs: supply is diminishing and demand is growing. That creates an imbalance, which is only getting worse.

On the supply side, Russia's deputy minister for energy recently said "oil production will grow only marginally this year and in the near term"; it has, in effect, hit a plateau for now. (Russia is the world's 3rd largest oil producer.) Meanwhile, in Khazakstan, the next great hope for plugging the global gap, the massive Khashagan field, has now been delayed for another two years due to "technical difficulties". And so it goes, as China races from 1 car per 400 people to 1 car per family (that's another 400 million autos coming online in the next 5 years).

Or, as the Paris-based International Energy Agency warned recently, "the world will find itself increasingly pressed over the next five years to produce enough oil to meet surging consumption". In its annual medium-term outlook, which forecasts conditions through 2013, the agency said it sees world oil supplies tightening more than it previously expected due to sluggish growth even though higher oil prices and weaker economic growth are set to trim demand. That is the kicker: record high prices are not tamping demand ("reacting to price signals") except in the US and other developed OECD countries. Supply reacts much more slowly, and the world has reached a tipping point where every available resource needs to be engaged (yes even ANWR and offshore US drilling will be opened up at some point.)

Our clients and friends should not be surprised at this trend, as we have been warning for the past several years that demand was outstripping supply. Fortunately, we have positioned our strategy and asset selection to benefit from this, whether it is owning one of the largest known supply reservoirs on the planet (Canadian oil sands), large independent oil & gas exploration and production companies who are actually INCREASING their reserves (unlike the majors, whose reserves are dwindling), or the oil services companies whose products and services are essential in the coming age of oil scarcity.

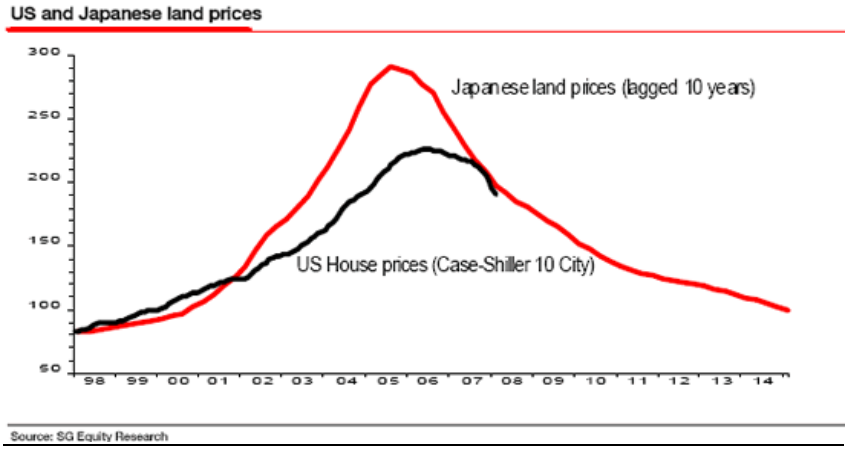
We also sense that the world is beginning to re-awaken to the benefits of nuclear energy. France has proven that a national power grid powered by processed uranium can be operated in a safe, cost-effective, clean, and durable manner, as it supplies 75% of their national energy needs. (The main benefit though is that it provides national energy security as the era of Resource Nationalism approaches.) China is leading the way among the world's most populated countries in converting to nuclear energy, with a national plan

to increase the gigawatts supplied to its grid by a factor of six by the year 2020, then tripling again by the year 2030. Uranium orebodies are extremely scarce, and uranium producers may one day become among the most highly valued of all investment assets. We note that the very small universe of uranium investments have been significantly marked down in price from last years highs. As oil prices continue to rise, the recognition of the value of uranium may be swift and startling in its ascent, and we think investors would be well advised to gain exposure to this area.

In the US Farm Belt, a soggy spring delayed the planting season, and corn, wheat, and soybean prices all hit record highs before settling back somewhat. As in the oil markets though, the key issue is that demand is outstripping supply. Essentially, there is no crop carryover left in any of the major complexes. Drought continues to affect Australia, further tamping supply. Our view remains unchanged that fertilizer, seed and crop protection, and farm machinery will be among the strategic assets that investors must own to profit in coming years.

The Bigger Picture and Outlook

The US real estate bubble has popped, and many commentators have proclaimed that "it's safe to get back in the water" (or close to it anyway). We disagree. As the graph below shows, a epochal bust in land/home values takes a decade or more to fully play out (not that the USA is Japan but the general trend looks the same, and Japan set the all-time record for a mania in land prices in the 1980's).



If you're skeptical, ask your local banker (if they actually retain any loans on their books anymore) "how's your appetite for making new real estate loans?" Most likely, they're too busy managing their delinquent and foreclosed loan books to even think about new projects (and too busy trying to raise capital to replenish what they squandered during the "good times").

In fact, since the "credit crisis" began last summer, banks have announced losses of some $350 billion (and counting). (The worst hit of all the banks, Switzerland's once venerable UBS, has alone recorded $38 billion in write-offs since last October, and seen its shares sink 65% to a 10 year low.) At the same time, these wayward banks have raised some $330 billion in fresh capital through dilutive share issuances, private placements and the like. In a recent Goldman Sachs report, it was noted that of the 42 equity issuances since July 2007, 39 are trading below their issue price, with implied losses of roughly $35 billion. The phrase "once burned, twice shy" comes to mind. Not the kind of stuff to bring investors back for more, eh? Banks are going to have enormous problems recapitalizing at this point, and existing shareholders are going to be significantly diluted. Bank mergers and consolidations to come will occur at discounts, not premiums.

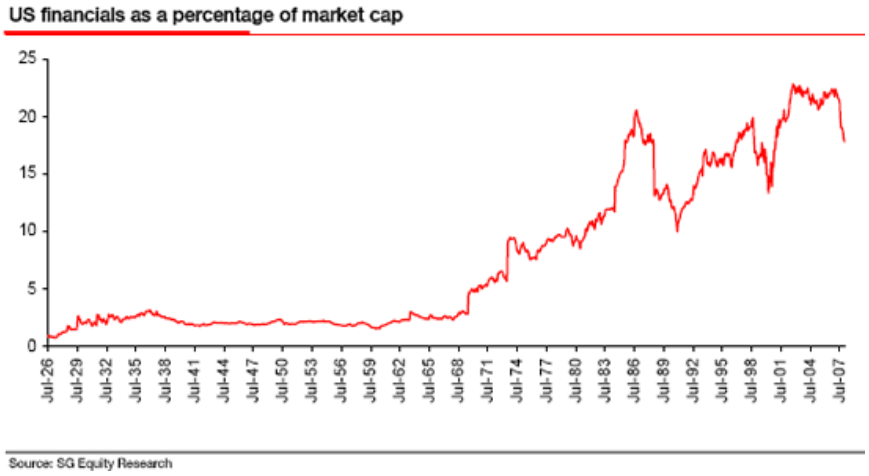
And yet the potential losses still to come are unknowable due to all of the "off balance sheet" activity that mushroomed during the last decade. The International Monetary Fund recently estimated another $600 billion in losses yet to be recorded, and some economists' estimates are north of $1 trillion. Our contention throughout this mess has been that the notional value of all the derivatives lurking in the ether has created enormous and unknowable counterparty risk that knows no national borders. It is a truly global risk, and central banks and monetary authorities are conducting differing and sometimes counter-acting "solutions" to address this problem. The NY Fed, led by President Tim Geithner, is urgently pursuing a global program of "commutation", whereby counterparties who hold offsetting contracts are persuaded to cancel them out. But with over $48 trillion in Credit Default Swaps (CDS) outstanding (and that is just one sector of the derivatives market), it is a daunting task where the time required to implement a global fix is a dwindling resource. That is one of the reasons why, as we write this, that LIBOR

rates remain so highly elevated. Fear continues unabated in the worldwide lending markets, and credit availability is diminishing.

In fact, this credit contraction is the root cause of what is going to be a very weak US, and eventually, global economy for some time to come. Not only are banks not making loans (supply), the demand has evaporated as consumers are melting under the weight of debt and no real income increases. (Just this week, the Bank of Ireland announced a three month moratorium on making new commercial loans while they "assess the deteriorating UK markets". They are one of the top 5 commercial lenders in the UK, and the spigot just went dry.)

On July 11, the US Office of Thrift Supervision seized the assets of IndyMac Bank ($32 billion), in the second largest bank failure in US history. Angry depositors clashed with police all over Southern California in an attempt to get their money out when the Bank re-opened. This is a scene right out of the Great Depression. If investors think bank shares are a good value at these prices, they'd better wake up and smell the coffee. The next shoe is dropping as we write: smaller banks are going to suffer mightily under the weight of souring loans to real estate developers and home builders, with many failures to come. A recent Wall Street Journal article noted the rapid rise in delinquencies on construction loans, and the extreme difficulties small banks were experiencing in trying to sell these loans, with bids of $.70 and less on the dollar being rejected. There is going to be a wave of small bank failures coming as a result of this, and the FDIC knows it, as they have been beefing up their inspection staff at breakneck speed (for the government anyway). This will put additional pressure on a financial system that is already "stressed out", and it fits perfectly with the script of the fallout from de-leveraging: a protracted period of credit contraction. It is most assuredly not a good thing for economic growth.

The implosion in bank shares speaks to an important driver of investment returns, and that is the shifting weightings of sectors and industries in the "pecking order" of economic activity. "Demographics is destiny" is an old saw in the investment world. We have been advising against holding much in the U.S. finance sector (banks, insurers, brokers, etc.) as the Baby Boomer-fueled demand that began in the late 1960's reached its apex recently. The game is over and this relative loss of market cap has a long way to run in our view (notice the time scale):



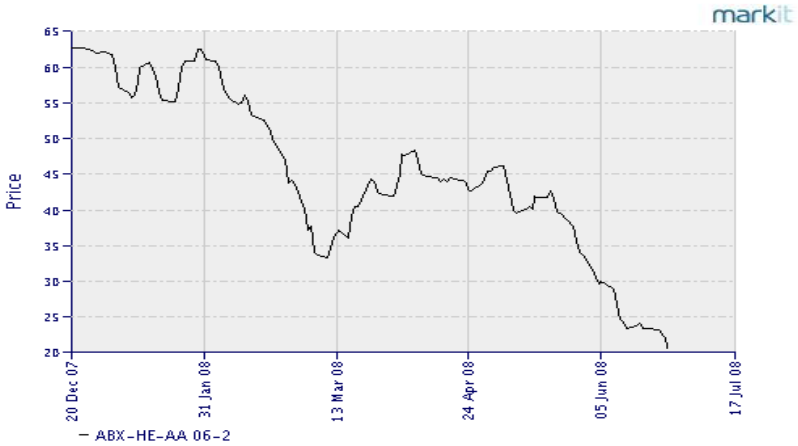
As if the bank issues were not enough, the markets are now facing the immediate threat of the potential insolvency of Fannie Mae and Freddie Mac, perhaps the two most important financial institutions in the US. We have been warning investors about this danger for some time. These institutions were created by Congress to provide funds to the mortgage market. In exchange for an "implicit federal guarantee" against default, borrowers paid a slightly higher interest rate, and the banks and mortgage originators were happy to make fees on all the transactions. Fannie and Freddie now own or guarantee $5.2 trillion in mortgages. The problem is that the losses are mounting and the capital, or reserves, held by Fannie and Freddie is shrinking rapidly.

For the nine months ended March 31, both companies had recorded combined losses of $11 billion, versus combined capital of $81 billion, not much of a cushion. This capital is in fact equal to only 1.6% of their outstanding liabilities (mortgages). That is what is called "skating on thin ice".

To make matters worse, many of the private mortgage insurance companies that provide a buffer against losses are seeing loans sour at an alarming rate, leaving them on the hook to make up the missed payments. These are for the most part "monoline" insurance companies, with names that the average investor is unfamiliar with – MGIC, PMI Group, Radian and others. Almost all of these institutions have been downgraded to less than AAA status by the rating agencies, and some have been taken off Fannie and Freddie's approved list, forcing them into "run-off" status, where no more policies are written and the company winds down as policies are cancelled (here in Winston-Salem, Triad Guaranty – TGIC – is a victim of just this fate).

The problem is that Fannie and Freddie count on these insurance companies to help limit their loss on loans. That buffer is now greatly diminished. When combined with the continuing decline in property values, a toxic brew is created for thinly capitalized companies, as losses on prime grade mortgages increase to join that of their sub-prime cousins. It is our view that it is only a matter of time before the government will have to step in and pass an "enabling act" which will create a direct line of credit to the US Treasury to rescue Fannie and Freddie. The liabilities of Fannie Mae and Freddie Mac will be moved onto the Balance Sheet of the United States. (This is precisely what Chairman Bernanke was referring to in the quote which opened our Review.)

When this happens, the federal debt will increase by $5.2 trillion, a massive increase considering its current size of $9.5 trillion. At the same time, the Fed is debauching its own Balance Sheet through its Term Auction Facility (TAF), which it set up to exchange US Treasury securities for the near worthless paper residing on the books of the banks (the Fed has already swapped almost $400 billion.) Here is a picture of the value of some of what is now on the Fed's books:



Source: Markit Group Ltd

As losses mount, the Fed will issue more Treasury securities, thus creating money out of thin air (or electrons, since all Treasuries are book-entry computer transactions). That is the textbook definition of inflation, which is an increase in the money supply, not rising prices.

At the same time, US fiscal policy is entering its most challenging time ever, as the Baby Boomers retire en masse and entitlement payments are set to skyrocket. One must also consider the ongoing costs of a US military presence in various world hot spots. When investors fully understand the implications of all this, it is quite possible that a collapse in the US Dollar will ensue, which is why we have a significant allocation to gold and precious metals in our Managed Portfolios. This thesis is not a mainstream view, and we hope that we are wrong. However, we are not willing to be unprotected and investors should consider carefully how their portfolios would behave should this possibility come to pass.

But the secondary, or knock on effect, of these monolines being downgraded is a source of almost greater concern than the rescue of Fannie Mae and Freddie Mac, as the credit default swap (CDS) market has been decimated. At $48 trillion, the size of this market is nearly 10 times the value of all mortgages in the US. Those who foolishly agreed to make payments should these monolines fall to less than AAA status are not suffering once, but multiple times, as each downgrade (from AAA to AA to A to BBB etc.) requires even greater payments. This is the gasoline on the fire of credit contraction, and it is growing as they scramble to sell good assets to raise make these growing payments. That is in large measure why stocks have had such precipitous declines recently.

In sum, we find current market conditions to be extremely challenging. We believe that volatility will increase, and that the clamor for government intervention will grow (just this week, the SEC moved to ban improper short selling in a just a few favored industries, namely banks and brokers). There is a strong movement to curtail "speculation" in the futures markets for energy and commodity contracts (but not stock or bond futures. Wonder why?) A "windfall profits tax" on energy companies is being seriously debated. And most feel that tax rates are set to rise.

Against this backdrop, our efforts to diversify internationally and seek out non-correlated assets have borne fruit and protected our portfolios from significant declines. We believe this approach is the most sensible path investors can pursue, in addition to maintaining healthy cash reserves. We expect that markets will rally from time to time, but the conditions are not in place for broad based advances. Over time, solutions will be found and markets will adapt. For now though, selectivity, patience, courage, and focus are an investors best friend.

Robert E. "Emery" Pike, CFA
Managing Principal and Chief Investment Officer
July 17, 2008