

# The Oarsman Outlook

## Second Quarter 2008

Though less painful than the January-March period, most stock-market benchmarks suffered a third consecutive quarter of negative returns in the period ended June 30<sup>th</sup>. Following a “relief rally” that saw major indexes jump 10-12% from March lows, investors succumbed to the “old” reality of falling house values and the “new” reality of soaring fuel and food prices, sending market averages down some 10% from mid-May levels and nearly 20% from multi-year highs reached last October. Major non-U.S. markets generally followed Wall Street’s lead, although a number of emerging markets, as well as Japan’s, were essentially flat or managed small gains. Meanwhile, renewed inflation worries sent yields on longer-term Treasury notes sharply higher (prices lower), although losses were modest in portfolios of high-quality (and shorter-maturity) municipal, corporate and inflation-indexed bonds. Commodities-related investments again provided a bright spot, posting double-digit gains.

Among U.S. stocks, the best-performing sectors were Energy, Basic Materials, Utilities and Technology; lagging sectors included Financial Services, Capital goods/Business Services, and Consumer Cyclical.

### Benchmark Performance – Equities

	<u>Second Quarter 2008</u>	<u>Last Twelve Months</u>
S&P 500 Index	-2.7%	-13.1%
Dow Jones Industrial Avg.	-6.9%	-13.3%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-1.6%	-12.3%
Small-Cap Stocks (Russell 2000)	+0.6%	-16.2%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-1.4%	-8.0%

### Benchmark Performance – Fixed Income

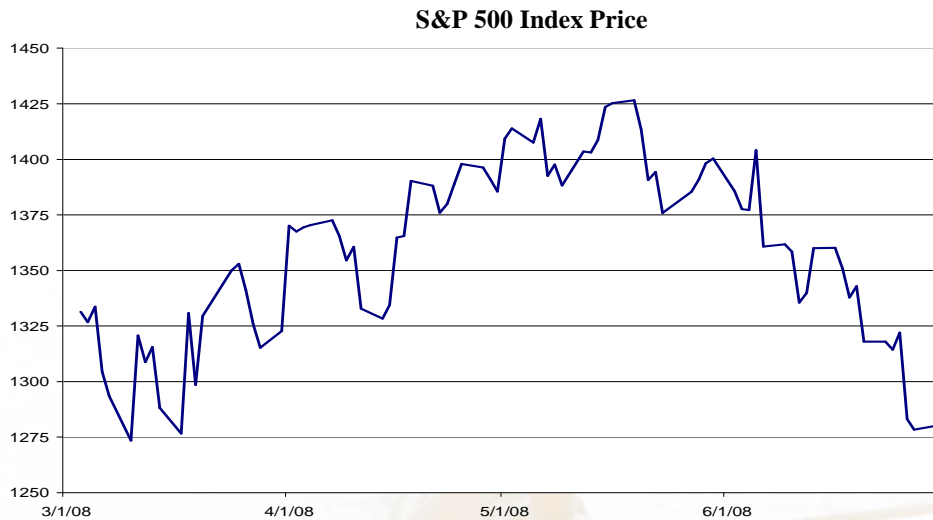
	<u>Second Quarter 2008</u>	<u>Last Twelve Months</u>
Lehman Aggregate Bond Index (taxable)	-1.0%	+7.1%
Lehman Municipal Bond Index (tax-exempt)	+0.6%	+3.2%

### Review

During the first seven weeks of the April-June period, stock prices rose and volatility subsided. Investors seemed convinced that decisive actions by the Federal Reserve during March had staved off a potentially disastrous financial-market melt-down. The rally in stocks coincided with the release of a number of reports suggesting the U.S. economic downturn might be less severe than feared (although news on the real estate front remained mostly grim).

Around the middle of the period, however, renewed geopolitical tensions followed by Midwest flooding delivered unwelcome supply-side shocks to already-tight commodity markets, sending energy and agricultural prices soaring. With headlines featuring \$4 gasoline

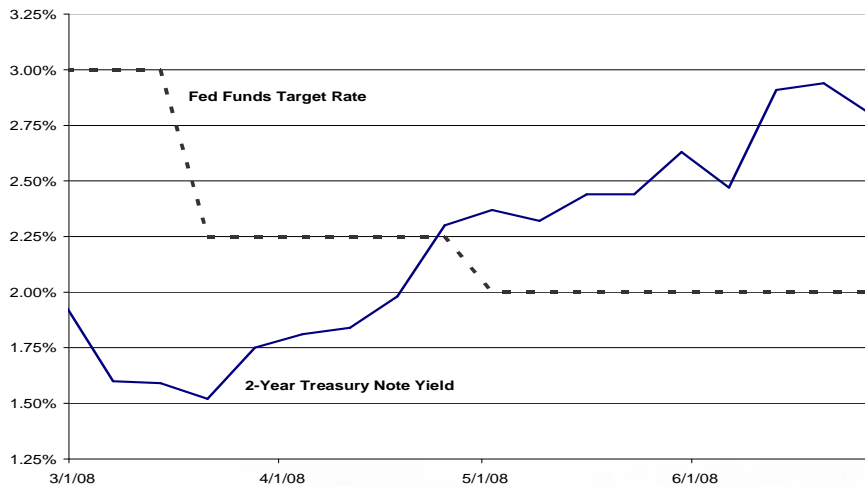
in the U.S. and food riots in emerging economies (not to mention Milwaukee's central city), investors began to fear the dread prospect of inflation. Bond yields, which had been drifting upward since late-March, spiked to the highest levels of the year in mid-June. Stock prices swooned, led lower by financial shares, many of which reached new multi-year lows.



Apart from (and related to) the surge in commodity prices, the quarter's most noteworthy development was an abrupt reversal of investors' views regarding the likely future course of Federal Reserve monetary policy. At the outset of the period, with the credit markets' near-collapse fresh in mind, investors judged the Fed would continue slashing short-term interest rates to ward off financial disaster (not to mention a deep, housing-led recession). As weeks passed without the appearance of a "second Bear Stearns," investors began to re-focus on fundamental developments beyond Wall Street. On one hand, the real-estate debacle continued, dragging consumer-sentiment measures to multi-decade lows, while financial firms continued their year-long quest to destroy book value. On the other, however, first-quarter economic growth exceeded (admittedly meager) expectations; employment and purchasing-managers surveys, while weak, did not fall to recessionary levels; first-quarter corporate profits – outside the housing, automotive and financial sectors – were mostly satisfactory; and the index of leading economic indicators stopped falling. Bond yields moved higher – generally not a harbinger of either financial Armageddon or looming recession. Atop this somewhat muddled economic picture came the surge in commodity prices.

Synthesizing these disparate inputs, and encouraged by a none-too-subtle shift in central-bank rhetoric, investors concluded that the Fed had not only finished *cutting* rates, but that rates were likely to begin heading back *up* as early as the summer. The suddenness of this shift could be seen in the yield on two-year Treasury notes (an issue that is particularly sensitive to anticipated changes in Fed policy): in late March it stood at 1.5% (well *below* the Fed Funds target of 2.25%), while by mid-June it had risen above 2.9% (well *above* the Fed target, which was lowered to 2.0% at the end of April).

**Two-Year Treasury Note Yield vs. Fed Funds Target Rate**



Unsurprisingly, stock investors were not pleased with this apparent about-face. Runaway commodity prices promise, at best, a corporate-profits squeeze if producers find it difficult to pass higher costs along to consumers. More worrisome, however, is a scenario where rising costs *are* passed on in the form of higher prices, which then beget growing wage demands. That is the sort of *wage-price spiral* that the Federal Reserve (and other central banks) would be forced to combat with a potentially growth-strangling series of interest rate hikes.

### **Outlook**

We believe the latest stock-market swoon is largely a reaction to the dramatic shift in the interest-rate outlook engendered by surging commodity prices. Soaring energy and food prices, which raise the specter of inflation, have called into question what had been a fairly benign consensus forecast calling for a lengthy period of sub-par growth accompanied by low interest rates. As a result, there is now an unusual degree of dispersion among interest-rate forecasts, ranging from a resumption of Fed easing (rate cuts) to near-term rate hikes. A return to a more normal market environment is conditional on the resolution of this uncertainty, which we believe will require a decline in concerns about inflation. (Alternatively, the uncertainty could be resolved via a rapid and surprising recovery of the real-estate and financial sectors; however, we view this as extremely unlikely.)

Two alternative developments could cause inflation worries to recede: first, commodity prices could decline; second, investors could become convinced that, despite higher commodity prices, inflation remains under control. Many commodity prices have probably reached levels sufficient to sow the seeds of their own demise via a combination of demand destruction and supply stimulation. Four-dollar gasoline is changing the way many Americans think about driving, while \$140 oil is spurring investment in both hydrocarbon exploration/production and alternative energy sources. Projected behavioral changes and slower global economic growth recently prompted the International Energy Agency to cut its 2012 forecast of global oil demand by more than 3%. It didn't take a dramatic shift in the

supply/demand relationship to send oil from \$100 to \$140; it may not take much to push it back, particularly if geopolitical tensions ease somewhat.

Even if commodity prices remain elevated, however, we believe inflation will remain under control. It is important to recognize that a one-time rise in prices is not the same as an increase in inflation; unless commodity prices *continue to rise* at something approaching recent rates, the “headline” rate of inflation will decline back toward the much lower “core” rate, which hasn’t increased significantly despite rising food and energy prices. We see little reason to fear that higher commodity costs will translate into higher core inflation on anything more than a fleeting basis. The U.S. economy is reeling from a series of *deflationary* shocks: falling real estate values; shrinking bank balance sheets (i.e., a “credit crunch”); falling stock-market prices; and a declining currency. All these factors, on top of rising food and energy costs, decrease consumers’ real discretionary income, while making it difficult for most producers to pass on higher costs. And if you think workers will begin militating for higher wages to offset their declining purchasing power, ask an auto, airline or bank employee if they currently have much bargaining power to exact such an increase. With limited pricing power and stagnant wages, there will not be a widespread or lasting increase in inflation.

We remain very concerned about the real-estate downturn and its interrelationship with the ongoing financial-sector malaise. Although an occasional glimmer of hope has been discerned among monthly home sales and supply statistics, the overall picture remains bleak. The closely followed Case-Shiller indices show that house prices in major markets have fallen by an average of 20%, and the supply of unsold homes remains near an all-time high. Disturbingly, the recent run-up in Treasury yields, combined with increased caution on the part of many lenders, has pushed mortgage rates up more than three-quarters of a percentage point from early-year levels, making houses less affordable. Until the real estate market stabilizes, we expect to see continued pressure on banks’ balance sheets and stock prices. And, of course, pressured banks mean tighter credit conditions, which remove marginal buyers from the real-estate market. This self-feeding process doesn’t seem to be near its end.

Members of the Federal Reserve and other economic policymakers are keenly aware of the above challenges; they have also asserted their conviction that inflation is likely to moderate in the period ahead. As an academic, Fed Chairman Bernanke was an expert on central bank errors that contributed to *deflationary* economic disasters like the Great Depression. Despite recent tough talk about inflation, we would be shocked if Mr. Bernanke were not actually more concerned about *downside risks* to growth. Interest rates will stay low longer than many expect, and, barring a miraculous recovery of real-estate markets, we would be less surprised by additional rate cuts than we would be by near-term increases.

Fundamental economic prognostications aside, we find reasons for cautious optimism regarding stocks. A number of classic technical indicators suggest the market is in a “bottoming” process; a 20% decline from recent highs is about average for dips historically associated with economic recessions; and the recent out-performance of small-cap and growth-oriented stocks is typical of the late stages of a cyclical downturn (or the early stages of a subsequent upturn). While caution is still warranted given the numerous challenges faced by the economy, we believe that from today’s depressed level, prospective returns over the next several years are likely to be quite satisfactory.

Finally, one noteworthy characteristic of stock market performance over the past year and a half has been a very large divergence between stocks in two major industry sectors: Financials (*down* approximately 50%) and Energy/Commodities (*up* some 80%). Historically, this kind of divergence has often reversed in subsequent periods; a recent, memorable example was the NASDAQ-technology bubble/bust of 1998-2002. Though reasons abound for a continuation of the current financials/commodities divergence, these are nearly universally acknowledged, suggesting they may be largely incorporated into *current* prices. We will be scrutinizing both sectors with special diligence in the weeks ahead, looking for signals that it is time to take profits in the latter while increasing our currently low exposure to the former.