

Second Quarter 2008 Market Commentary

A Light at the End of the Tunnel, Part II

In early April I wrote a piece entitled, “A Light at the End of the Tunnel”. We felt at that time a bottom to this market had been put in place with the Jan/Mar lows based on stock price action. Since that time the markets rallied about 12% off their lows, peaking in May. After making their May highs, the market averages have fallen again and are currently re-testing their Jan/Mar lows. It was a good short-term call, but in retrospect, I appear to have been wrong and that light at the end of the tunnel now looks like another oncoming train!

What this proves is how hard it is for anyone to look into their crystal ball and predict the future when it comes to stock prices or the economy itself. The opinions of the “experts” and their scenarios go on and on. Their ideas and forecasts are plastered all over the media. While these are all smart people, and their opinions are usually well founded based on the fundamentals as they see them. If you take them all to heart, they will drive you crazy. Since last year virtually every economist was predicting a recession in 2008. The economic numbers simply show that their predictions were wrong. The definition of a recession is two consecutive quarters of negative growth. While the economy has definitely slowed since the third quarter high water mark of 4.9%, the economy is still growing. The US economy, as measured by GDP, grew 0.6% in the fourth quarter of 2007; it grew by 1.0% in the first quarter of 2008; and it appears grew by between 2% and 3% in the second quarter of 2008. The first preliminary estimate on second quarter GDP should be released at the end of July. As a result the experts have been scrambling to “update” their forecasts, although some simply claim that the statistics are wrong.

Conventional wisdom has been that the recession would be triggered by an over extended consumer, and the failure of the real estate market would drag everything down. Conventional wisdom appears wrong. Consumer spending continues to grow, undermining the theory that the US is in a consumer-led recession. Real consumption is up at a 3.1% annual rate in the past three months. “Core” retail sales (excluding autos/building materials/gas) increased a respectable 0.3% and are up 4.2% versus last year. Shipments of “core” capital goods (which exclude defense and aircraft) are up at a 9.4% rate. The housing market topped out in 2005. This is in effect old news. We are over three years into this weakness and depending on what statistics you look at, there is evidence that things are beginning to stabilize. Home sales seem to be bottoming. Interestingly, the best performing asset class in our portfolios this year have been the REITs (Real Estate Investment Trusts).

Sure, we have many things to be concerned about in our economy. And, there are many “experts” eager to point these problems out to us. However, I have learned through the years, that once a problem is identified, forces come into play to correct the problem. This process is underway right now on many different fronts. There are no simple solutions because these are very complex problems, and the process takes time. From that perspective the free exchange of thoughts and ideas is a very important part of finding solutions.

I always prefer to take an optimistic view of our situation. We have a very broad, multifaceted economy. If you bet against our economy, you may benefit in the short term, but over the long haul our economy has demonstrated the ability to correct itself, change, and move forward. Witness the aftermath of the September 11, 2001 terrorist attack on New York City. Our nation and its economy absorbed a tremendous body blow, and we not only survived but were able to come back better than ever. As long as we have a free enterprise based economy, we should expect a capital rate of return of approximately 7% per year over time.

This is not the time to lose faith. From a technical perspective, the stock market is extremely oversold. It is like a coiled spring. There are positives which could and will trigger a bounce in stock prices. We are entering second quarter earnings season. Earnings in the first quarter, as a whole, exceeded expectations, and I expect the same thing to happen in the second quarter. From an investor's perspective, you need to be concerned that you invest in tennis balls as opposed to eggs because tennis balls bounce while eggs do not!

We continue to believe that our investment approach is the very best way to invest your financial assets. As an investor you must focus on the long term. If you don't, you are engaging in a form of speculation. A properly structured portfolio allocation is critical to investment success. Our focus on a broadly allocated portfolio allows us to capture the capital rates of return of the market place over time. A broadly diversified portfolio is the key to controlling risk. No individual can with certainty predict future events. Therefore, spreading assets over many different asset classes avoids the trap of a concentrated position as anyone invested heavy in banking and brokerage house stocks recently can attest to. Diversification not only provides a cushion for your portfolio during times of economic distress, but also insures that you will be invested in tennis balls when the market reverses to the upside. Finally, you must have patience. Remember, no matter how negative the news may seem, it does not mean that the world is coming to an end. It means only that the world is changing. Our investment approach will discount change, and our pledge to you is we will always exercise the patience and discipline necessary to make you a successful investor.

Yours truly,

James W. Kyle