



## *1<sup>st</sup> Quarter 2008 Commentaries*

April 1, 2008

We live in interesting times. January 2, the first trading day of 2008, saw the Dow Jones Industrial Average fall 220.9 points, 1.67%. It the largest drop for the broad market since 1983. On the same day, crude oil briefly hit \$100 per barrel. In many ways, the first day of trading set the tone for much of the quarter. The first half of January proved to be the worst start for U.S. stocks since 1978. February saw the 4<sup>th</sup> straight month of stock market declines. Volatile markets and new records left their mark.

Domestic stocks were under pressure much of the quarter and only appeared to find their footing late in the quarter. The S&P 500 stood at 1,468.36 on 12/31/07, on 3/24/08 the index printed a low of 1,276.60 (a decline of 13%). Financial stocks led the markets lower. Citicorp/C posted the biggest loss (\$17.4 billion) in the company's history and cut its dividend 41%. The first of the financial casualties was mortgage lender Countrywide Financial Corp. that only three days after commenting that there was "no substance" to bankruptcy rumors was acquired by Bank of America. However, the sacrificial lamb in the financial group became Bear Stearns. Just several days after Bear Stearn's Chairman Andrew Schwartz assured the financial markets that the firm had deep capital resources the once Wall Street giant fell into the clutches of J.P. Morgan, initially for \$2 per share (later increased). Bear Stearns may have been the financials low tide watermark.

The broad US stock market has been experiencing one of its longest periods of below average returns in history. As measured by the S&P 500, which stood at 1352.99 on 3/25/08, stocks adjusted for inflation and dividends, are up a meager 1.3% since April, 1999 when the S&P stood at 1362.8. In fact the broad market has been the worst performing asset class of all those we track. Since 1999 (unadjusted for inflation), developed foreign market shares have risen 7.18%, US small stocks produced a return of 11.92%, gold has gained 14.51%, REITs are better by 14.11%, commodities (other than gold) have risen 17.92%, and shares of emerging market securities led in returns, up 18.5%.

These historic returns underscore the need for proper asset allocation and close scrutiny of valuations. Any of the asset classes listed have, and will, enter long periods of below average returns. Our portfolios have varied allocations to US equities determined by our client's risk tolerance and investment objectives. And for all but the most conservative clients, portfolios have been and continue to be allocated to small cap stocks, the class of US stocks which has been producing the highest return.

What began as a sub-prime mortgage crisis became a capital markets crisis. Financial firms posted huge losses, Congress held hearings, and perhaps most importantly, the Federal Reserve Bank took unprecedented steps to stabilize the markets. Early in January, Fed Chairman Ben Bernanke opened the door to "substantive" rate cuts. Rate cuts continued through the quarter with the Fed Funds rate pegged a 2.25% by March 17. In addition, the Fed took unusual steps to restore liquidity in mortgage securities. One unusual step was to allow J.P. Morgan (just prior to J.P. Morgan's takeover of Bear) to offer a 28-day loan to Bear Stearns that was guaranteed by the Central Bank. The rule that allowed this type of lending was created during 1932 and rarely used. As we begin the 2<sup>nd</sup> quarter, it appears the Fed's efforts have proved successful as the credit markets have begun to return to some normalcy.

In addition to the Central bank's efforts, politicians had to weigh in. On January 18, President Bush announced a bi-partisan economic stimulus plan. This plan calls for \$150 billion to be pumped into the

economy via disbursements to qualifying tax payers. Many would argue that by the time the checks are actually mailed, the crisis will mostly be over.

Despite the mortgage woes of the real estate sector, real estate securities as measured by the Cohen & Steers Realty Trust/ICF held up reasonably well. In fact, the sector managed a small gain for the quarter. Admittedly, this security is comprised of mostly commercial real estate and much of the recent problems have stemmed from residential real estate. However, the commercial sector does now appear to be weakening. In fact, Goldman Sachs projects commercial real estate values to decline by 21% to 26% over the next two year. Recent statistics show new home sales at a 12-year low. In addition, prices have been falling. According to the number crunchers, the median price of a new home is down over 10% from a year earlier. In fact, the S&P/Case-Shiller index posted its largest price decline in its 20-years of data. It appears we have a ways to go before real estate prices hit bottom. However, there was at least one point of hope. Existing-home sales driven by lower prices climbed 2.9% during February. In those portfolios holding real estate securities, our allocation remains below 10%.

And then there was the Presidential Campaign. Remember Mike Huckabee, Mitt Romney, Fred Thompson, Rudy Giuliani, and John Edwards? Oh yes, don't forget Ralph Nader. While just days ago they were Presidential candidates, today they are distant memories (except Nader who recently entered the race). And of course there is Barack Obama and Hillary Clinton. Maybe, before the second quarter ends we'll have a Democratic candidate. Then John McCain and the Democratic nominee can finally get down to the issues. As for the markets, it probably makes little short-term difference regarding performance. Historically, when a Republican is elected President, the average gain during an election year has been 14.9%. The average return when a Democrat is elected has been 13.6%. Clearly after this year's difficult beginning we have considerable distance to go to make the averages. The good news is that in 20 election years since 1926, historically, 80% of the returns have occurred in the 2<sup>nd</sup> half of the year.

Commodities have been the headline story for the quarter. Inflation continues to be a major concern. The U.S. Federal Reserve Bank continues to pump liquidity into the system and has been turning a blind eye towards the inflationary impact. While many economists belief inflationary pressure will ease, it is far from a certainty. There is some speculation driving prices but, inflation is a world problem. For example, U.S. consumer inflation, according to the Labor Department, rose 4% year-over-year through February. European Central Bank ("ECB") countries are running at 3.3%. China's inflation rate is above 6%. Saudi Arabia is up 8.7% (a 27-year high). Driven by a weak U.S. dollar and record crude oil prices, but for some quarter-end profit taking, most commodity prices have steadily moved higher. Crude oil briefly touched \$100 on January 2, then marched to over \$110. By late March, the average price of a gallon of regular gasoline was \$3.26. Diesel was selling for \$4.00 plus. Gold printed a record high on January 14, at \$907.30 and proceeded to ultimately trade over \$1,000. Gold prices last August 16, 2007 stood at \$666.40. By November, the price had risen to \$805.70. Nine years ago, one ounce of gold sold for \$253. Food products were no exception. In fact, wheat prices have been rising so quickly that daily trading limits were increased three times during one week in February.

Late in March, we experienced what could best be described as a commodities rout. We view the sell-off to be normal profit taking; simply shaking out weak positions. Prices have since firmed, perhaps pension-fund buying or demand from China. Longer-term, commodities remain a great hedge against inflation and a portfolio stable. Our allocation to commodities averages 30%, diversified between various tangible assets including metals, agricultural products, energy products, and currencies.

During the quarter, largely because of significant price increases, we modestly reduced many commodity positions. The position reductions essentially bring the total size of the allocation back to 12/31/07 levels. In most cases, the funds generated from the sale of various commodity positions have been reinvested in US small-cap stocks.

Perhaps the biggest impact on short-term market performance will be the U.S. dollar. The dollar has been in an extended bear market. Historically, bear markets have lasted seven to ten year. The euro

(cme June contract) is trading over \$1.56 and appears overvalued. Fair-value for euro-dollar is around \$1.13. If the dollar continues to weaken (largely because the United States has been reducing interest rates while the ECB has not, the weak dollar becomes a bigger problem for ECB countries and for OPEC countries that peg the price of oil to the dollar. As the dollar weakens, pressure increases for the ECB to begin easing and for OPEC to re-peg their currencies against the dollar. The effect of either of these actions could be a stronger dollar and an easing of inflationary pressures. In the short-term we expect dollar weakness to continue, however later this year we expect one, or both, of these events to transpire. When the dollar stabilizes it will have an impact on our asset allocations. The most pronounced would be a reduction in commodity positions and an increase in domestic equity holdings.

Despite weakness in the U.S. economy, there is little hint that growth has slowed outside the US. Yes, there is a case that weakness in the U.S. could spread. However, the impact on emerging market countries would be mixed. We see China as being least at risk. India, Korea, Malaysia, the Philippines and Thailand have some risk. At greatest risk would be Hong Kong, Singapore, and Taiwan. While over the last 12-months, we have paired down our emerging market holdings (mostly because of valuation). We continue to expect long-term growth to exceed US growth in many countries. Our buy list continues to be the countries with stronger economies including Brazil, Argentina, Peru, Kazakhstan, Nigeria, Poland, Romania, Russia, Ukraine, China, India, Indonesia, Malaysia, Philippines, and Singapore.

Volatility in the equity markets has driven many investors to US Treasury securities. Three-month Treasury bills are now yielding less than 1%. The benchmark 10-year note is yielding near 3.5%. US interest rates are currently the second lowest of all the major economies. The US Federal Reserve Bank has indicated that more interest rate cuts are possible and the markets are pricing in a 50 basis point cut in the Federal Funds rate during April. If this cut does occur, it's possible the central bank may hold steady for sometime to assess the impact of recent cuts. In the central bank's latest statement on the state-of-the-economy, strong emphasis was placed on the need to contain inflation. At the moment, the central bank has been focusing on economic stability as its priority. Inflation fighting has been secondary. When the credit crisis has passed, the central bank will once again return its attention to inflation that could usher in a new round of rate increases that could be a depressant on bond prices. At current yield levels, we remain underweighted in investment grade fixed income.

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The return and other projections for each asset class are hypothetical estimates and are for illustrative purposes only. There is no guarantee such return projections may actually be realized. The asset classes listed are not subject to fees or transaction costs.

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