



## 2008 – 2ND QUARTER REVIEW AND PREVIEW



### BOB'S CORNER

#### Looking Back – Right or Wrong?

If I were in your shoes, the most important question for me would be “has my investment advisor put me in a position to be one step ahead of the market?” Let me give you a summary of what our newsletters and **Bob's Corner** have focused on over the past six quarters and you decide.

- 4 Q '06 Stocks surge amid signs of slowing economy. We started taking chips off the table!
- 1 Q '07 Markets show severe volatility due to greed and fear. We invested in commodities and a long/short fund!
- 2 Q '07 Summer surprise, International mkts lead the charge. We invested 5% more into the emerging mkts – up 25% to 30% for 2007!
- 3 Q '07 Volatility continues – housing credit woes revealed. We took all of large cap value (financials) off the table.
- 4 Q '07 Economic uncertainty leads to more volatility. Sitting on 30% to 60% cash, bonds, and alternatives, ready to buy bargains!
- 1 Q '08 Patience is key as mkts continue to fall. Closer to the bottom than last quarter – patience!
- 2 Q '08 Energy and commodities create inflation concerns. Getting ready to buy small cap. Our first bargain hunting!

I believe we/you are in a great position to start buying when everyone else is wanting to run and hide!

## ENERGY PRICES FUEL RENEWED INFLATION THREAT, DAMPENS MARKETS

### MARKET OVERVIEW

Just as the stock market showed signs that it was ready to turn a corner (following six consecutive months of negative performance), the environment worsened again and the 2<sup>nd</sup> quarter ended as another negative period for most investors. The markets could not overlook continued economic weakness as well as increasing consumer and investor wariness caused by the ongoing rise in oil prices.

Along with declining investment portfolios, most Americans are seeing the value of their homes drop as well. Housing prices continued to fall and tighter lending standards are being implemented resulting in fewer potential buyers qualifying for the market than was previously the case. There is little sign the housing market is on the verge of a recovery in the near future.

At the same time, oil prices continue to rise. After beginning the year at \$95/barrel, oil prices skyrocketed throughout the first half of 2008 and now top \$140/barrel. As a result, gas now sells for around \$4/gallon, a record high. Inflation doesn't end with oil. Other commodities, including food and services such as transportation, are also becoming significantly more costly.

Consumers were aided in small part by tax rebates that began arriving in May, but it is not clear what impact the money had on different segments of the economy outside of helping to pay for higher food and fuel costs. Washington is again talking about an additional stimulus package to help keep the economy above water.

After lowering interest rates in April (a continuation of previous actions) as part of its effort to help ignite the economy, the Federal Reserve (the Fed) has shifted to a more neutral posture with an eye toward stemming the risk of higher inflation. Other central banks around the world are already boosting interest rates in an effort to deal with rising prices.

With an exception of a spring rally in stocks, the first half of the year from an economic and investment standpoint was not pretty. On the bright side, stock values are much more attractive heading into the second half of 2008.

### ECONOMY

#### THE 2ND QUARTER

While many anticipated the U.S. economy would fall into a recession (defined as two consecutive quarters of negative growth in the Gross Domestic Product), that has not happened to date. The measure of growth in the 1<sup>st</sup> quarter was 1.0%, not robust but not yet a recession. Second quarter numbers, to be released in July, are expected to stay in narrowly positive territory.

Yet there are plenty of challenges facing the economy. The housing market continues to be one of the weakest links. Housing prices declined by 15% on a nationwide basis over the past year according to the most recent reading of the S&P/Case-Shiller Home Price Index.

Banks that were hit hard by the emergence of the sub-prime mortgage crisis last year are still facing challenges in that arena. More than \$400 billion in mortgage-related losses have already been written off. Delinquency and foreclosure rates continue to rise.

Another industry facing headwinds is the automobile business with all carmakers showing major declines in sales. Ford, General Motors and Chrysler are downsizing and shifting production to more fuel-efficient vehicles.



Manufacturing and service sectors showed some improvement in recent economic data. Dollar weakness continues to benefit domestic producers who are able to sell goods abroad at cheaper prices. Yet factories remain underutilized, a sign that the economy is slower than normal.

Unemployment climbed to 5.5% in the 2<sup>nd</sup> quarter and the economy has lost jobs in every month so far in 2008, a total of 438,000 fewer jobs than at the beginning of the year.

While slow economic growth is one issue, escalating inflation is just as critical. Raw material prices have risen dramatically so far in 2008. Some examples include gasoline up 31%, natural gas up 71%, corn up 51%, and aluminum up 25%. The official measure of inflation, the Consumer Price Index, rose 4.1% over the past year, a number that many feel doesn't reflect the real pain felt by consumers.

### **LOOKING AHEAD**

Most signs point to continued weakness in the U.S. economy for the near term. Growth may improve in the second half of the year, but few anticipate a dramatic upturn. While the official government numbers do not yet reflect that a recession is underway, 9 of 10 Americans believe we are in a recession. Consumer confidence levels have dipped to the lowest point since 1980.

The Federal Reserve appears to have done as much as it can to stimulate growth and now will have to focus on fighting inflation. This could result in interest rate hikes in the months to come. That may leave it up to Congress to implement a fresh fiscal stimulus to help deal with weakness later in the year. Given that we are in the midst of another election cycle and the incumbent President is stepping down in January, it is not clear how much action to expect out of Washington yet this year.

## **BOND MARKET**

### **THE 2ND QUARTER**

The Lehman Aggregate Bond Index, a recognized measure of overall bond market performance, declined 0.61% in the second quarter. Bond investors are clearly concerned about the potential impact of higher inflation in the months to come, which typically results in more challenging times for bond markets. Hardest hit in the market were long-term Treasury bonds which declined 2.9% during the quarter with World bonds down 2.8%

On a positive note, the Fed actions to help stabilize credit markets were successful. High-yield corporate bonds gained 1.5% and bank loan credit rose 4.5%. Municipal bonds also managed a modest positive performance while multi-sector and emerging market bonds were essentially flat for the quarter.

### **LOOKING AHEAD**

Just as we stated three months ago, municipal and high-yield bonds remain attractive, though the outlook is a bit less clear going into the second half of the year. Future markets are anticipating the Fed will begin to raise interest rates later in the year, though continued softness in the economy may prevent such action before 2009.

The bond market looks more attractive overseas due to interest rate hikes implemented by other central banks, which are putting additional pressure on an already weakened dollar. Bond managers also see value in high-quality bonds and preferred stocks, which have a fixed income component.

## **DOMESTIC STOCK MARKET**

### **THE 2ND QUARTER**

A spring rally in stocks was quickly washed away by a very negative June, the worst June performance the stock market has seen since 1930. The first half of 2008 was the poorest opening six-month stretch for the market in almost four decades. The broad Russell 3000 Index fell 1.69% in the 2<sup>nd</sup> quarter, and is down 11.05% through the first six months of the year.

Given the surge in commodity prices, the best performing sectors in the stock market during the quarter were no surprise. Energy stocks gained 16.9%, utilities were up 7.1%, materials rose 3.9%, and technology stocks mustered a 2.3% gain. Financial stocks continued to struggle as investors recoiled from ongoing write offs and mounting losses, dropping 19% in the quarter. Industrial stocks declined 10.6% and consumer discretionary issues were off 8.1%

Small cap stocks regained favor after lagging the market in recent quarters. The small cap Russell 2000 Index managed a 0.58% gain in the quarter, while the large cap Russell 1000 Index declined 1.89%. Growth stocks rose 1.51%, while value stocks lost 5.17% due primarily to the weak financial sector.



## Performance Update

### Annualized Returns

Market Index	2 <sup>nd</sup> Qtr	1 Year	2 Years	3 Years	5 Years	YTD
DJ Ind Average	-6.93	-13.26	3.29	4.09	7.27	-13.27
S&P 500	-2.73	-13.19	2.31	4.37	7.55	-11.95
Russell 2000	0.58	-16.19	-1.22	3.79	10.29	-9.37
S&P Mid-Cap 400	5.43	-7.34	4.79	7.45	12.61	-3.90
<b>Russell 3000</b>	<b>-1.69</b>	<b>-12.69</b>	<b>2.39</b>	<b>4.73</b>	<b>8.37</b>	<b>-11.05</b>
MSCI EAFE	-3.50	-13.04	3.88	10.09	13.77	-12.70
NASDAQ Comp	0.61	-11.92	2.75	3.69	7.16	-13.55
Lehman High-Yield	1.76	-2.26	4.41	4.54	6.92	-1.31
Lehman Agg Bond	-1.02	7.12	6.62	4.09	3.85	1.13
Lehman Credit Index	-0.90	3.81	5.25	2.75	3.27	-0.48
Lehman Gov Bond	-1.91	9.68	7.60	4.60	3.78	2.06

*The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.*

### LOOKING AHEAD

The steep decline in stocks that began after markets peaked in October 2007 has made equities look more attractive from a valuation standpoint. While we anticipate corporate earnings forecasts to continue to fall, selected sectors, such as energy, materials, technology, and industrial are positioned to show profit growth rates of 5% to 15%. Overall, a growing list of stocks now trade at what appears to be a significantly discounted price.

Small cap stocks are positioned to continue the leadership role they assumed in the 2<sup>nd</sup> quarter, and we anticipate boosting our holdings in domestic small cap issues. Financial stocks have been the hardest hit sector, but we remain cautious about the prospects for further write-downs and the likelihood of increased regulation tempering any near-term recovery in this troubled industry.

### INTERNATIONAL MARKETS

#### THE 2ND QUARTER

There was little refuge to be found in foreign markets during the troubled second quarter. Foreign stocks declined 3.5%, slightly worse than the performance of domestic markets. Emerging markets are dealing with higher inflation, in the range of 7% or more. Rising oil and food prices are taking a toll overseas as well.

Returns varied widely across the globe. Argentina and Brazil gained 26.8% and 18.7% respectively. Oil exporters, Norway and Russia, also generated double-digit returns. By contrast, investors stepped back from India's red-hot economy as the market there lost 19.3% in the 2<sup>nd</sup> quarter.

### LOOKING AHEAD

Rising energy prices and inflation in other areas will likely slow global economic growth in the second half of 2008. Still, growth is likely to be faster than what is anticipated in the U.S. during the same period.

Central bankers across the globe are focusing attention on controlling inflation. We continue to see favorable prospects for the Asian Pacific and Latin American markets. Even if growth moderates, it should still outpace economic activity in developed markets and there is no sign yet of a risk of "hyperinflation" creating any near term problems.

### SUMMARY

The doubling of crude oil prices over the past year has clearly had a major impact on the global economy and the investment markets. The question is whether this spike in oil prices is based on fundamentals of growing global demand or represents a "bubble" similar to the technology and housing bubbles that grew and burst in recent years.

In the 1970's, two dramatic oil price hikes occurred portending forecasts of doom and gloom. Prices eased considerably after that and stayed relatively low until recent years. Will oil prices topple again? We think there are several encouraging signs, including:

- The potential for increased regulation of energy market speculators
- Reduced demand domestically and steps to limit demand growth in emerging markets
- More sensible vehicle purchases by U.S. drivers (say goodbye to SUV's)
- Halting of additions to the U.S. Strategic Petroleum reserve keeping more oil supply in the open market

**Should these events come to pass we expect to see oil prices returning to earth, easing inflation and boosting consumer spending. The timing of such a change is impossible to predict, but if it occurs it should create a more positive investment environment.**



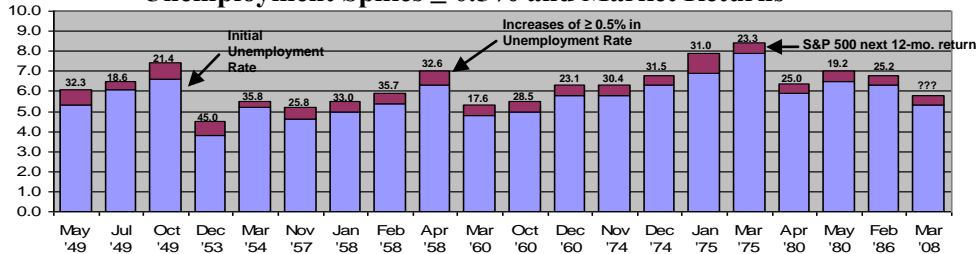
## Is Today a Good Time to Buy?

The first half of 2008 was not kind on the equity markets both domestically and abroad, but that does not guarantee that the negative trend will continue for the next few quarters. Bill Bergman of Morningstar states, "Getting bullish in an economic slowdown can make a lot of sense." History has shown us that the stock market tends to fall before a recession starts, remains weak during the early stages of the recession, and then rebounds before an economic recovery is commenced. Since the market is always forward looking and a recession is all but evident, those factors should not deter investors from looking for buying opportunities.

It is important to understand that the economy and the market do not always operate hand-in-hand. One shining example of this is the relationship between the University of Michigan Consumer Sentiment Index and the Stock Market. As the table below illustrates in recent decades, when consumer sentiment reaches extremely low levels the subsequent 12-month return of the S&P 500 Index has been markedly positive.

<u>Consumer Sentiment Bottom</u>	<u>S&amp;P 500 Return for Next 12 Months</u>
2/28/1975	22.2%
5/30/1980	18.1%
10/31/1990	29.1%
3/31/2003	32.8%
10/31/2005	14.2%
6/27/2008	???

### Unemployment Spikes $\geq 0.5\%$ and Market Returns

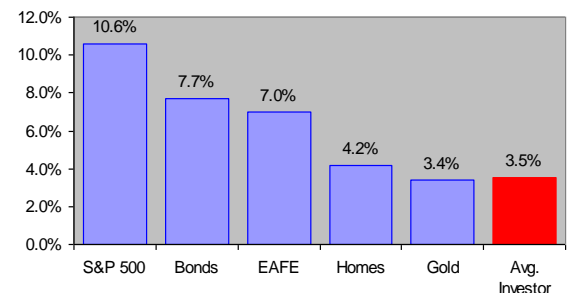


Another example is the recent spike in unemployment. Dating back to May of 1949 when the unemployment rate has increased by 0.5% or more, the ensuing 12-month return of the S&P 500 Index has been positive by at least 10%.

The twenty year period ranging from 1987-2007 resulted in a 10.6% annual return for the S&P 500 Index. Over that same period of time, the average investor only returned 3.5% annually because of untimely cash inflows and outflows to the market. History has shown that when the emotional investor is pulling out of the market there is a good chance that the market may actually be undervalued and thus presenting buying opportunities. History has shown that many investors act irrationally and impatiently during emotional times in the market. Greed trickles in when the market is going well and fear settles in when the market declines. A successful long-term investor must eliminate these two emotions when making their investment decisions. We began taking chips off the table at All Star Financial back in 2006, and with cash, bonds and alternative investments in our models ranging from 30% - 60%, we are patiently looking for buying opportunities in the equity markets.

### Last 20 Years

#### Market Returns vs Return for the Average Investor



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