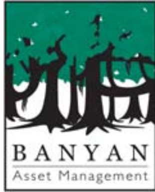

"The Growling Bear"
Market Commentary – March 2008

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According to a revised estimate released on February 28, Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., grew 0.6% in the fourth quarter. This preliminary reading is the same as the advance reading released in January. The Federal Reserve recently lowered its 2008 GDP forecast from 1.8%-2.5% in October to 1.3%-2.0%. Fed Chairman Ben Bernanke told the House Financial Services Committee that "the economic situation has become distinctly less favorable". He added that the Fed "will act in a timely manner as needed to support growth and to provide adequate insurance against downside risks". Bernanke maintains that the U.S. can still avoid a recession (traditionally defined as two consecutive quarters of contracting GDP).

As the Federal Reserve tries to stimulate economic growth, futures markets see the Fed in interest rate cutting mode through the end of this summer. The intent of lower interest rates is to boost U.S. economic growth. The Fed has slashed its benchmark Fed Funds rate from 5.25% in September 2007 to its current level of 3.0%. This is the fastest easing since 1984. Futures markets expect the Fed to lower the Fed Funds rate by another 25 basis points to 2.75% when the Federal Open Market Committee meets on March 18. Moreover, futures estimate a 34% probability that the March cut could be 50 basis points, resulting in a Fed Funds rate of 2.5%. Looking ahead, the Fed Funds rate is expected to be as low as 1.77% by September 2008.

If inflation continues, however, the Fed could be limited in its ability to lower interest rates further. Since low interest rates can help fuel inflation, the Fed needs to be careful to not trade the problem of slow economic growth for runaway prices. Producer prices in January spiked 7.4% year over year, the largest increase in more than 26 years, due to commodity prices. Core producer prices, which factor out the volatile food and energy sectors, rose 2.3% versus last year. When the Fed revised its GDP forecast, it also raised its expectations for core inflation from 1.7%-1.9% to 2.0%-2.2%. Still, the Fed believes that commodity prices, and thus inflation, will moderate going forward with slower economic growth.

While commodity prices indicate inflation, the housing industry is in a deflationary spiral. Median new home prices plunged 15.1% in January versus a year earlier. New home inventory sits at 9.9 months, the highest since October 1981. The weak housing market and general economy have taken their toll on consumer confidence. The Conference Board's Consumer Confidence index fell to 75, the lowest since early 2003. Moreover, the expectations portion of the index, measuring 57.9, is the lowest since January 1991. A shaky consumer is a major concern, since consumer spending accounts for 70% of U.S. GDP.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. According to *Barron's*, reported earnings on the S&P 500 one week ago were $78.60, yielding a price-to-earnings (P/E) ratio of 17.2. This week, reported earnings have fallen to $71.71, resulting in a higher P/E ratio of 18.6. This illustrates how volatile earnings have been this quarter. Even more telling, earnings are getting weaker. This does not bode well for stock prices, which are driven by earnings growth.

The major market indexes are having difficulty forming a higher high, indicating that the bear market is still growling. While resistance on the S&P 500 around 1400 has proven to be formidable, support has held firm near 1300. With undervalued stocks popping up on our radar in recent weeks, we incrementally added several new stocks to some of our portfolios. Should the stock market rally a bit from here, we would look to sell some covered calls to generate income. If the January bottom fails and the market pushes even lower, we would incrementally add new positions as stocks consolidate at lower prices. Our expectation is that the stock market will form a bottom before the news headlines turn favorable. After all, stocks like to climb a "wall of worry".