

2008 Q1 Market Commentary

April 18, 2008

COMMENTARY

Economic data clearly weakened in the first quarter of 2008. As the quarter began, a recession seemed unlikely. The economy was adding jobs and GDP growth was strong in the third quarter. However, the likelihood of a recession increased throughout the quarter and the discussion moved from not if, but how long and deep the recession will be.

Gross domestic product (GDP) fell from 4.9% growth in the third quarter to 0.60% in the fourth quarter. The struggling housing market continued to drag down the US economy during the first quarter. Residential construction directly reduced US GDP growth by 1.3% in the fourth quarter. Indirectly, billions of dollars of sub prime mortgage debt write-offs created a liquidity crisis among financial institutions. Tighter credit standards led to lower consumer spending and corporate America reacted by reducing inventories and fixed investment spending, which subtracted 1.8% and 0.60% from GDP, respectively.

The overall economic weakness did not go unnoticed by the Federal Reserve. Despite elevated inflation, the Fed temporarily abandoned its dual mandate and focused on spurring economic growth rather than containing inflation. The Fed lowered the Fed Funds rate 2.0% during the first quarter. The Fed underestimated the impact of the credit crisis and was forced to aggressively cut the Fed Funds rate in an effort to revitalize economic growth. The Fed also enacted revolutionary measures to increase liquidity within the financial markets by reducing the quality of collateral it would lend against as well as extend the duration of such loans.

The federal government joined in the fight against slower growth as well. In an effort to boost consumer spending, the government approved an economic stimulus program that is expected to put \$168 billion in consumers' wallets this May. The unprecedented move comes as consumers face a slowing economy, rising unemployment, and significantly higher food and energy prices.

EQUITIES

US stock prices declined sharply in January and February before stabilizing in the quarter's final month. The S&P 500 index fell 6.0% in January, the worst performance since September 2002, as the credit crises worsened and liquidity in the banking system virtually disappeared. Not only did the economy slow to a crawl in January, but inflation continued to trend higher. The Fed responded by cutting the Federal Funds rate by a combined 1.25% with two rate cuts near the end of the month. Prior to the Fed's action on January 22nd, the S&P 500 Index was down nearly 11.0% in January. Economic data remained bleak in February as the economy shed jobs and the services sector plummeted at the fastest pace in more than 20 years. During March stocks spent a good portion of the month testing new lows. The Fed brokered "bailout" of Bear Stearns stress tested the market, but stock prices ended the month about where they started, indicating that a bottom might have been identified.

The benefits of diversification were hard to come by in the quarter. Unlike last quarter, when the Financials sector was the clear laggard, every sector of the S&P 500 index posted losses, with four of the ten posting double digit declines. The credit crisis and economy worsened during the quarter, putting earnings estimates for every sector in question. Small, mid, and large cap domestic stocks posted losses in a tight range of 9.5% to 10.0%.

Stock price swings were well above normal levels as the market reacted strongly to both positive and negative news. During the quarter, the S&P 500 index had a 1.0% or larger decline 18 times, with the largest daily decline

of 3.2% on February 5th. The S&P 500 index also jumped by more than 1.0% on 13 days during the quarter, with the largest daily increase of 4.2% on March 18th. Heightened stock volatility was driven by fears of a recession coupled with hopes that government assistance could help the economy avoid a major downturn.

International stocks posted an advantage over domestic stocks, but it was aided by currency appreciation and measured in relative losses rather than gains. Japanese stocks dropped 3.9% in the quarter, making it one of the best performing countries. Returns were helped by a 6.7% increase in the value of the Yen. Like the US, Financials is the largest sector in the European market. As the US credit crunch became a global credit crunch European Financials struggled with sizeable losses. The European Central Bank (ECB) kept interest rates steady as inflation trumped growth as their biggest concern. The ECB's unwillingness to increase liquidity into the market via rate cuts could potentially dampen future growth and this uncertainty was reflected in lower stock prices.

Emerging market stocks dropped during the quarter, but less than virtually every other major asset class. Emerging markets have provided faster economic growth than developed markets and their financial institutions have relatively modest exposure to sub prime securities. Resource rich countries in Latin American were the top performers as commodity prices continued to climb. After a meteoric rise in 2007, the Chinese market cooled off significantly in 2008. Chinese stocks dropped 13.1% as concerns about inflation and slowing exports to the US dampened investor sentiment and caused investors to sell stocks and lock in prior gains. Despite solid relative performance, emerging markets exhibited notable volatility during the quarter. The index lost 3.0% or more eight times and gained 3.0% or more on four occasions.

FIXED INCOME

Falling stock prices provided a boost for bonds as investors became more defensive and shifted assets toward safer securities. Despite the lowest Treasury yields in years, investors continued to pour money into the securities. According to Lipper, bond mutual funds attracted \$42.1 billion during the quarter while stock funds saw an outflow of \$13.3 billion.

The Federal Reserve maintained its campaign to boost a staggering economy and promote growth. The Fed reduced the overnight lending rate from 4.25% to 2.25% during the quarter. Fed officials admitted they underestimated the extent of the economic slowdown and acted aggressively to inject liquidity into the financial system. As a result, short term interest rates, which are more sensitive to the Fed Funds rate, dropped significantly during the quarter. Longer term rates, which are more impacted by inflation expectations, dropped, but not as much as shorter term rates. At quarter end, the 10-yr and 2-yr Treasury yields dropped 0.60% and 1.26%, respectively.

For the second consecutive quarter, credit quality remained the most important determinant of returns. The highest quality government-backed securities again had an outstanding quarter as investors flocked to safety. The LB Government Bond Index jumped 4.0%, surpassing last quarter's 3.7% gain. International government bonds posted even higher returns as US dollar weakness provided a helpful boost. The Citi non-US Bond Index posted a 10.9% return in the quarter. High yield bonds posted a loss, with the LB High Yield Index dropping 2.9%. Securities with any default risk were shunned and their prices fell as demand remained weak.

2008 MARKET OUTLOOK

The US economy has yet to show signs of a turnaround. The housing decline that started in 2006 remains a drag on the economy and falling home prices have yet to find a bottom. Financial institutions wrote off billions of dollars in losses related to sub prime and collateralized loans in the first three months of the year. Credit remains hard to find as evidenced by Bear Stearns sale to JP Morgan Chase for a fraction of its value only days earlier. Consumer confidence plummeted as the unemployment rate jumped, and oil and other commodity prices continued to push living expenses higher. Whether the US officially enters a recession is anyone's guess, but it is obvious that the slow down has spread well beyond the housing market and is negatively impacting virtually every aspect of the economy. Arguably, much of bad economic news has already been priced into the stock market. The S&P 500 dropped over 15.0% between October 9, 2007 and March 31, 2008. We believe that stock prices may be nearing a bottom and that aggressive action by the Fed and government may stabilize the weak economy in the second half of this year.

Growth expectations outside the US fell again during the quarter, but they remain relatively attractive. The International Monetary Fund (IMF) recently dropped its global growth estimate from 4.2% to 3.7%. The biggest adjustment was a reduction in the US from 1.5% to a modest 0.50% in 2008. Growth among the developed countries is projected to slow primarily due to the global credit crises. The emerging market countries are again projected to lead global growth. The IMF report has emerging market growth at 6.7%, well below the 7.9% in 2007, but still very good in relation to the rest of the world. Overall we believe the growth potential of international stocks remains favorable in comparison to domestic stocks. A concerted effort by global central banks to reduce borrowing costs would likely be the catalyst that international markets need to climb higher.

Investors continue to purchase treasury bonds in response to slowing economic growth and poor liquidity. Yields on government-backed bonds have fallen significantly over the last six months. Inflation remains elevated and it appears the Fed will have to take a break from its easing campaign fairly soon. Treasury bond yields will likely rise and credit spreads will tighten when the economic landscape improves, and we are therefore hesitant to embrace treasuries and are looking for opportunities to increase exposure to non-treasury bonds.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

AKT WEALTH ADVISORS, LP INVESTMENT COMMITTEE

Darin Richards
Doug Davison

Scott Barchus
Julie Robinson

Toby Daniels
Carl Pinkard

Charlie Zieky