

July 14, 2008

COMMENTARY

The US economy weakened sharply in the second quarter. The housing market continued to decline as inventories increased while prices fell. The homeowner vacancy rate hit an all time high during the quarter despite a 15% price decline over the last 12 months. Although home prices fell, prices of most other goods increased. Oil prices skyrocketed during the quarter, rising from about \$105 to \$140 per barrel. In addition, food and many other commodity prices also increased. The unemployment rate unexpectedly jumped from 5.0% to 5.5% between April and May as economic pressure led to layoffs and fewer employment opportunities. The 0.5% increase was the biggest jump in more than 20 years.

The Federal Reserve dropped the Fed Funds rate to 2.0% in April before leaving the rate unchanged in June. The Federal Reserve's efforts to reduce borrowing costs and increase spending have done little to help the struggling economy. Lending institutions are so cash strapped that they have been very reluctant to lend, even to high quality borrowers. Would-be borrowers faced ever increasing requirements and lenders demanded higher returns on their money. Rising commodity costs increased concerns about inflation and also acted to push interest rates higher.

Consumer confidence dipped to new lows during the quarter as home prices fell, unemployment and commodity prices climbed, and credit became increasingly scarce. Consumer spending accounts for about two-thirds of the US economy and the recent pullback in consumer spending is putting a damper on growth. First quarter GDP was finalized at 1.0% and despite help from stimulus distributions second quarter GDP is expected to be disappointing as well. The long term growth expectation of the US economy is about 3%.

EQUITIES

US stock prices declined sharply in June, after posting gains in April and May. The Fed's "bailout" of Bear Stearns in March provided support for stocks in April as many investors attempted to call a bottom among Financials. The S&P 500 returned 4.9% in April, driven primarily by a 6.5% gain in Financials. Stocks managed to hold onto gains in May despite Financials giving back much of April's return. The dam broke in June, and the S&P 500 index fell 8.4%, notching the index's third worst month this decade. The optimism that pushed stocks higher earlier in the quarter quickly faded as financial institutions continued to struggle with liquidity concerns. The Financials sector plummeted 18.3% in the quarter's final month. Higher commodity prices also pushed Consumer Discretionary and Industrial stocks lower.

In the first quarter virtually every sector and asset class declined sharply. Despite a dramatic sell-off in June, there were a few areas of the market that held up relatively well in the second quarter. Growth stocks were the clear winners, with large, mid, and small cap growth stocks all notching gains. The Information Technology and Healthcare sectors showed resilience and drove most of the gains among the growth indices. Significant losses in the Financials and Industrials sectors were the primary drivers of losses among the value indices. Mid and small cap stocks outperformed large cap stocks. Strong performance within the small and mid cap Energy sector by drillers and explorers far exceeded returns among large cap diversified oil services companies. Smaller cap financial services firms, many of which have minimal exposure to the housing market, also outperformed the larger cap financial firms that are more closely tied to mortgage lending.

International stocks performed similarly to domestic stocks. The MSCI EAFE declined 2.3% in the quarter after dropping 8.2% in June. Growth stocks posted a modest gain while value stocks dropped 4.6%. The European Central Bank (ECB) appeared poised to raise interest rates in July to combat inflation, which recently measured nearly twice the preferred level. The ECB's focus on slowing inflation is expected to curb growth in Europe and the MSCI Europe index dropped 4.2% in the quarter. With the exception of a 6.3% decline in the value of the Yen, currency values remained stable and didn't materially impact international returns. The strongest performance came from resource rich countries, including Canada, Australia, and Norway. Japan held up well in the quarter primarily due to modest exposure to the mortgage mess that plagued financial institutions globally.

Despite a loss of 10.0% in June, emerging market stocks held up relatively well and finished the quarter down less than 1.0%. Resource rich countries in Latin America and Eastern Europe were the top performers as commodity prices continued to climb. Brazil finished the quarter up 18.4% while Russia jumped a more modest 10.8%. India was one of the worst performers, falling 19.7%. Rising inflation and political unrest are testing the country's ability to manage growth. The central bank was forced to raise rates in June in an effort to suppress rapidly rising food and energy costs. Many emerging market countries are highly impacted by higher food and energy costs because they make up a much larger percentage of consumers' budgets than in more developed countries. On a positive side, many emerging market countries have substantially increased exports to resource rich countries in the Middle East and Eastern Europe to make up for slowing growth in the US and EU.

FIXED INCOME

Falling stock prices normally provided a boost for bonds, but that wasn't the case in the second quarter. Concerns about higher inflation countered a flight to safety, pushing yields higher and bond prices lower. Persistently high inflation caused the market to consider that the Fed was done easing and the probability of rate hikes entered the equation. The US Federal Funds rate of 2.0% was well below rates in other developed countries and there was a global bias toward raising rates. There was also some discussion surrounding the belief that lower rates were causing US dollar weakness and this was contributing to higher oil prices. Consequently, yields on 10-yr. and 2-yr. Treasury bonds increased by 0.54% and 1.01%, respectively. Shorter term rates are more sensitive to the Federal Funds rate than longer term rates and short term yields jumped sharply.

The Federal Reserve abandoned its campaign of supporting growth even at the cost of higher inflation. The Fed reduced the overnight lending rate from 2.25% to 2.00% in April, but kept the rate steady at its June meeting. The Fed's minutes included the following statement "The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased." The market anticipated stronger language regarding inflation and yields actually fell a little following the release on June 25th.

For the first time in several quarters, the highest quality government-backed securities were not the top performers. Until recently, investors had been buying government-backed bonds with little regard for return as yields hovered near all-time lows. Risk aversion drove money into governments while spread sectors (mortgages and credits) struggled. Elevated inflation pushed inflation-adjusted yields into negative territory and the threat of higher yields caused governments' prices to fall. The LB Government index dropped 1.9% in the quarter after posting gains of 4.0% and 3.7% in the two prior quarters. International government bonds struggled in the quarter as the US dollar strengthened and yields climbed. Global central banks concerned about rising inflation acted to push rates higher to slow down inflationary pressures. The Citi non-US Bond Index dropped 4.7% after jumping a whopping 10.9% last quarter. High yield

bonds posted a gain after struggling for several quarters. The yield on high yield bonds reached attractive levels and investors became net purchasers, pushing prices higher in response.

2008 MARKET OUTLOOK

Let's put in perspective what we already know. First, the housing market remains very weak and a turnaround in the near future is unlikely. Second, commodity prices, mainly oil, have reached elevated levels that are taxing businesses and consumers and causing higher inflation. Third, financial institutions continue to struggle with poor liquidity and remain hesitant to lend funds. Fourth, the job market appears to be weakening, as indicated by an increase in the unemployment rate from 5.0% to 5.5% during the quarter. As expected, consumer confidence is testing new lows.

The stock market is a forward looking indicator and its level is primarily driven by future expectations. Much if not all of the bad economic news should already be priced into the market. Stock prices will be driven, higher or lower, based on future news. However, the stock market tends to overshoot both bottoms and tops during extraordinary periods. The considerable fall in stock prices has finally reached a level where the market may be testing lows. However, the intense market pessimism will only change course once a catalyst is identified and at this point we do not see such a catalyst.

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

Very truly yours,

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