

WOW! Is the worst behind us?

Wow....The first quarter of 2008 has been a roller coaster ride. Here are some highlights from the first quarter:

- The S&P 500 had its largest down day in 5 years and it's largest up day in over 10 years.
- The Federal Reserve cut interest rates 3 times, two of which were .75% instead of the standard .25%. The Federal funds rate went from 4.75% to 2.5% in two months.
- The dollar's 7 year slide continued; gold traded for over \$1,000 for the first time ever; and oil cost more than a \$100 a barrel.
- Housing prices continued falling in most parts of the country, the steepest decline in median home prices ever recorded by the National Association of Realtors.
- Carlyle Capital, a \$21 billion dollar hedge fund, declared bankruptcy. This occurred when banks and investors would no longer loan money against its highly leveraged portfolio of government bonds, thus causing investors to lose most if not all of their investment.
- Bear Stearns, the 5th largest investment bank in the country, agreed to a bail out by JP Morgan and the Federal Government to avoid bankruptcy. Bear Stearns stock began the quarter at \$88 per share but agreed to a \$10 a share buy out.

All of this is a result of the liquidity crisis we wrote about in the winter 2008 newsletter entitled; Debt Crisis or Liquidity Crisis.

The Federal Reserve has done many things to alleviate the liquidity crisis with the idea of getting the market and economy functioning properly again. They lowered interest rates making it cheaper to borrow money. They have also injected more cash into the system by increasing money supply. In a bold move, they offered to temporarily trade banks \$200 billion in treasury bonds for illiquid mortgage backed bonds. This helped in two ways. It permitted banks to show more capital on their books thus allowing them to lend more. Secondly, it gives banks more time to work out of their more illiquid bond holdings, stopping a fire sale like happened to Carlyle Capital. This also helped to stabilize the bond market.

Throughout this tumultuous period, Marshall & Sullivan has adhered to its disciplines and maintained a long term focus to investing. During the fourth quarter of 2007 and first quarter of 2008 we sold all of our financial stocks

along with any other company that looked like it would be unable to grow its earnings during the current economic slow down. We left the sales proceeds in the money market for most of the quarter.

As the quarter has come to an end we are starting to think that the markets have seen their lows for the year. We believe the worst in market action is behind us and that the market will be higher at year end than it is today. We make this bold prediction for the following three reasons.

Here are the things we know: the subprime mortgage market is a mess; commodity prices are high, the housing market is in a slump; consumer confidence is waning; the dollar is falling and the economy is slowing. Because these are known issues they are already factored into the market. Second, the Federal Reserve has proven that they will do everything they can to add liquidity to the market and make the current economic slow down as short as possible. Third, the market is cheap. The last time the S&P 500 traded lower than it is today on a price to earnings basis was 1991. Not only are companies trading at a low price compared to their earnings but earnings are projected to grow at a double digit pace for non financial companies.

This is not to say that the markets will go straight up from this point. The market will continue to be volatile throughout the spring and summer. When good news is released it will run up and when bad news is announced it will drop. As long as no large unknown issue comes to light, it appears that the lows reached in January and again in March should be the lows for the year.

With this in mind, we are starting to take advantage of the down turn to do some bargain hunting. We are planning on spending the cash over time with a good portion of it invested by year end. We will do this by sticking to our strict disciplines; buying only companies that are fairly valued compared to their price to earnings ratio and projected earnings growth rate.

For our balanced and fixed income clients, we are reinvesting maturing bonds in government agencies and/or municipal bonds depending on the account's tax status. We are staying short so the bonds mature as interest rates rise in the future. As always we are staying away from riskier corporate bonds.

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