JVL Associates, LLC

NEWSLETTER

JUNE 2008

Are we there yet?

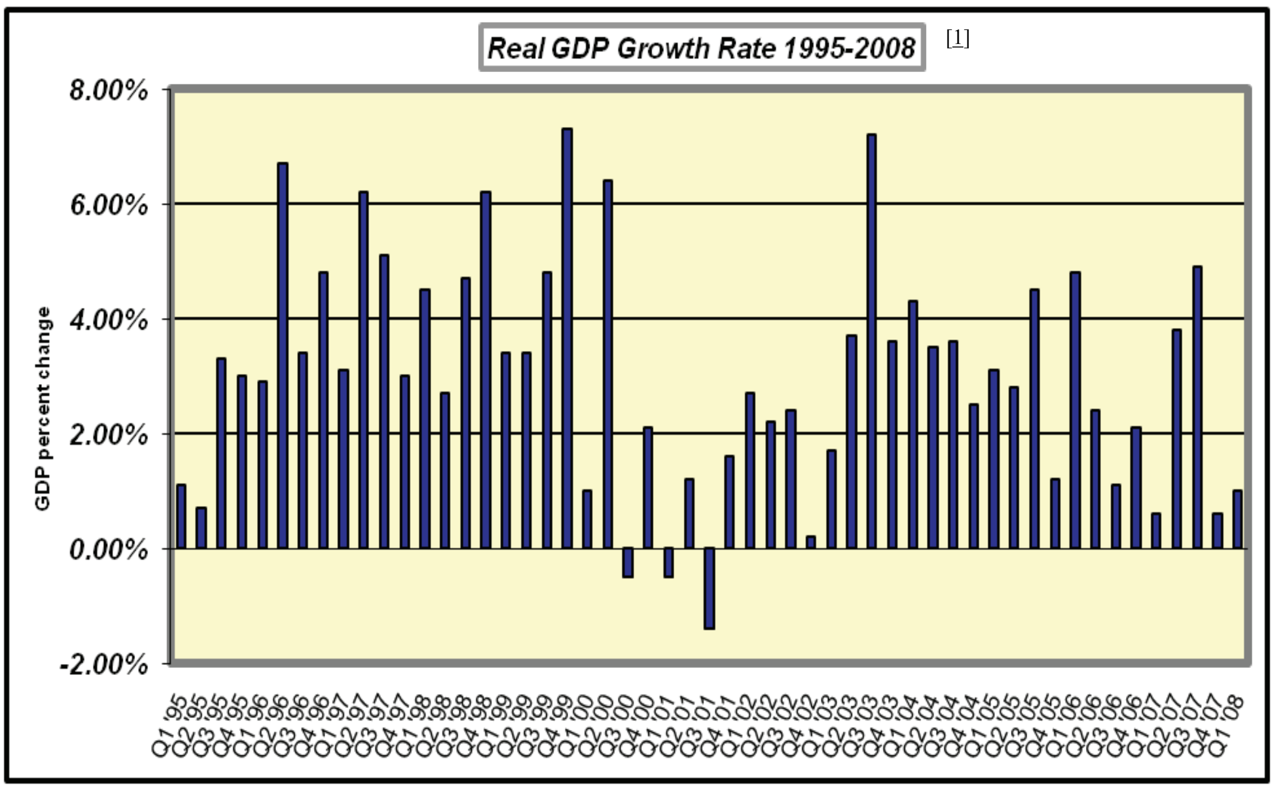
Every parent who has taken their children for a long car ride knows what these words imply …when will this trip end!? When we plan our trips we can look at a map and determine how many miles we have already driven, how many miles we have left and can compute an answer of "over half way" or "almost there".

Unfortunately, the financial markets don't provide a road map telling us how far the trip is and thus, we cannot compute how much farther we have to go. Therefore, it is not easy to provide a definitive answer to the question "are we there yet"?

We can, however, measure where we are today by looking at some key indicators of the economy.

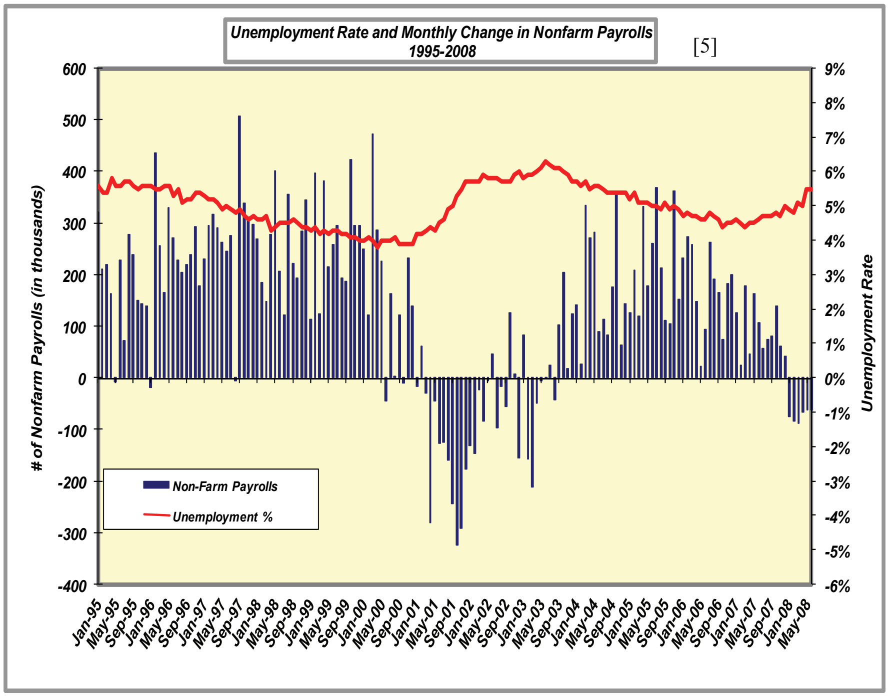
Economic Growth:

The U.S. economy has slowed considerably over the last nine months. Growth in the U.S. economy is measured by the Gross Domestic Product (GDP), which measures the value of all goods and services produced in the U.S. The GDP grew by only .6% during the fourth quarter of 2007, grew by 1.0% during the first quarter of 2008 and is expected to grow by less than 2% for the second quarter of 2008. Most economists project continued slow growth for the balance of the year and into 2009. While a recession, as measured in the technical sense (two consecutive quarters of negative growth), may be averted the economy is definitely feeling a slow down.



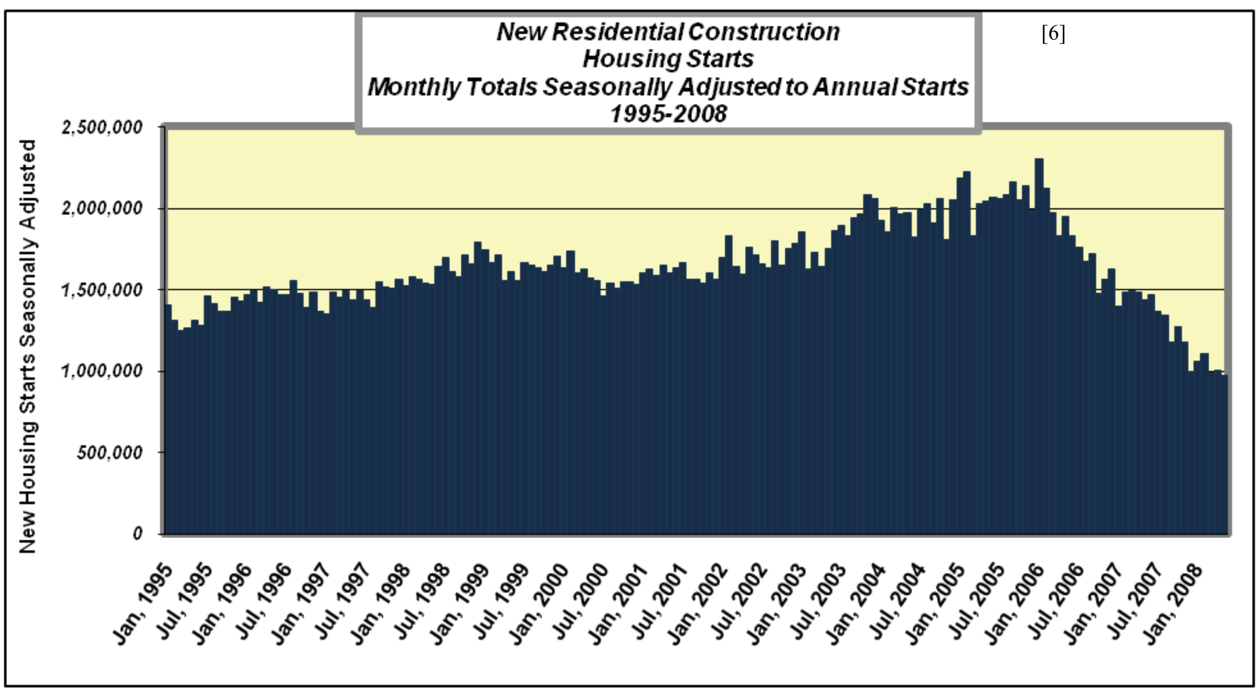
Employment:

Non-farm payrolls in the U.S. economy decreased in each of the first six months of 2008, totaling an estimated 438,000 jobs. The stated unemployment rate has moved back above 5% for the first time since September, 2005. "Goods producing" payrolls have decreased from 34% of payrolls in 1978 to 19% in 2008 while service sector payrolls have increased from 41% of payrolls in 1978 to 58% in 2008[2]. General Motors has decreased its hourly employees from 113,000 in 2006 to 55,000 in 2008 after providing early buy-out offers to over 53,000 employees over the past two years [3]. All of these factors combined point to a reduced earning capacity for many working class families in the near term. Partially offsetting these facts, is that businesses were cautious in hiring during the recovery over the last seven years keeping employment rather lean in comparison to prior recoveries. Thus, the need to cut excess employees may be less than in prior economic downturns[4].



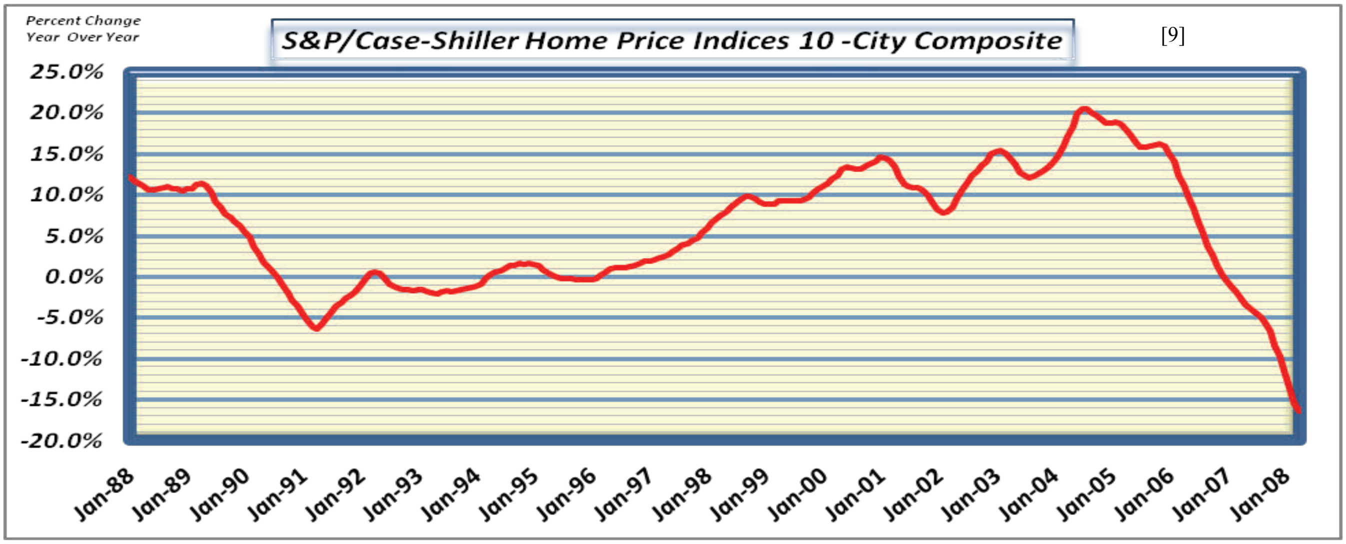
Housing:

New residential housing starts have continued to drop, falling below an annualized rate of one million new homes per year for the first time since 1991.

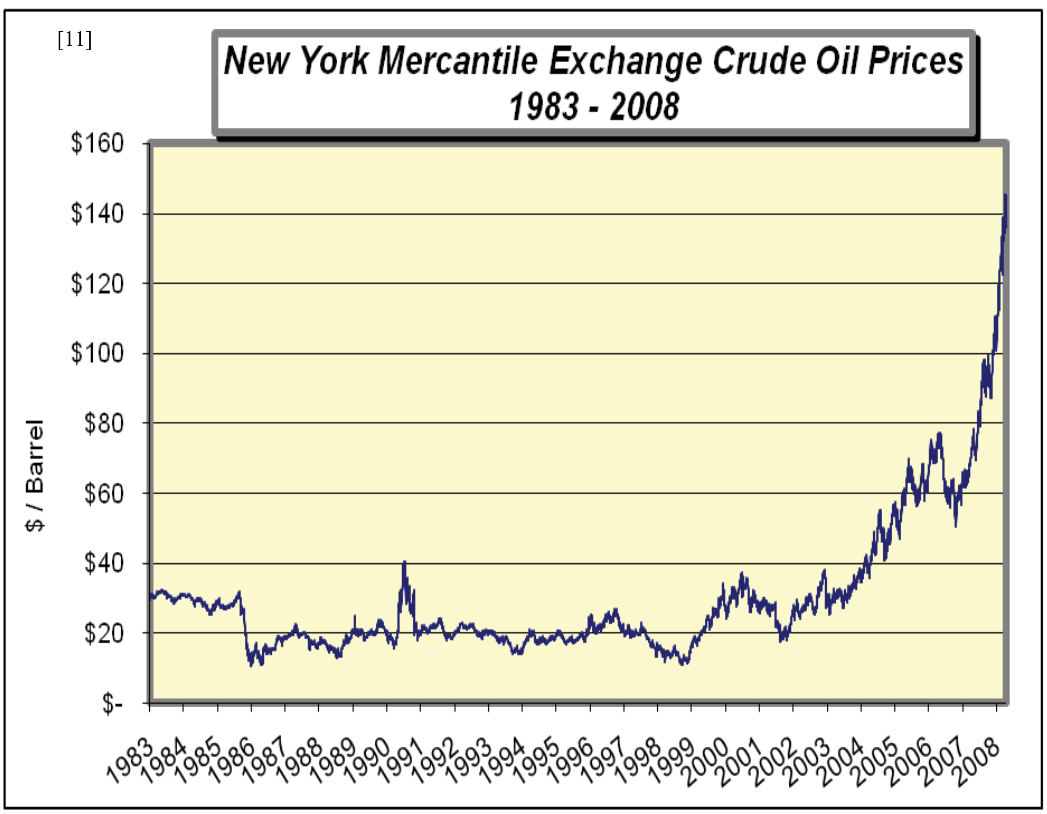


Housing (continued):

From the beginning of 1998 to August of 2006 home values increased each month between 5% and 20% on a year over year basis. These values were fueled by pent up demand and easy credit. Beginning in January, 2007 home values, as measured by the S&P / Case Shiller Home Price Index, have declined steadily. Values were down over 16% in April, 2008 on a year over year basis. This has resulted in home owners having less equity in their homes to draw against. Draws against home equity amounted to over $600 billion per year in 2004 – 2006 and have fallen to an annualized rate of $200 billion in 2008[7]. In addition, the inventory of homes for sale is equal to ten months of supply, almost double the average for the decade[8]. It may take another 18 – 24 months for house values to stabilize and the inventory of unsold homes to return to historical norms.



Energy:



The price of a barrel of oil rose to all time highs during the year. There are many debates over the cause, finite supply, increasing demand, geopolitical events and speculators in the commodities markets. One thing is certain; the demand for oil will increase as the emerging countries continue to develop. The average person in the U.S. (population 300 million) uses 25 barrels of oil per year, the average person in Japan (population 128 million) uses 15 barrels of oil per year while the average person in China (population 1.3 trillion) and India (population 1.1 trillion) uses less than 2 barrels of oil per year[10]. As the emerging countries develop they will compete with the developed countries for the finite supply of oil. It may not be long before we look back and wish for $4 per gallon gasoline prices again.

Credit "Crisis":

The current credit "crisis" in the financial markets is a result of a multitude of factors. The easy credit of the past five years resulted in many adjustable rate mortgages that offered a "teaser" rate for a given period of time and then "reset" to a higher interest rate, often at a rate the household cannot afford. Also, many mortgages required little, if any, down payment resulting in 100% financing on a home that is decreasing in value thus causing many households to owe more than the house is worth in today's market. Falling household incomes combined with rising food and energy costs have squeezed household budgets. This has impaired household's ability to service their monthly mortgage payments.

The Mortgage Bankers Association estimates that 6.3% of home mortgages are in default and another 2.5% are currently in the foreclosure process[12]. Some estimates are that as many as 2.5 million homes will enter the foreclosure process this year[13].

Financial institutions bundle mortgages together and sell them in the open markets to investors who receive monthly payments of both interest and principal. This has been a common source of fixed income instruments in the open markets for some time. However, as the mortgages began to experience trouble a "crisis" occurred when "no one" wanted to own these instruments. This caused a back-up in the mortgage industry as the bundled loans were not able to be sold. It also caused the value of the existing loans in the market to drop rapidly as "no one" wanted to own them and the market for these instruments dried up quickly. This resulted in massive write downs by the financial institutions that held the mortgages as current accounting rules require assets to be "marked to market". Because there was no market the instruments were subject to deep discounts for financial reporting purposes. This in turn decreased operating profits (causing massive operating losses) as well as affected mandatory capital requirements. Many financial institutions were forced to raise new capital thus diluting existing shareholders.

The Federal Reserve and the U.S. Treasury felt led to "step-in" by opening its coffers to allow financial institutions to temporarily exchange the nonmarketable obligations for U.S. Treasuries. This provided the liquidity to keep the markets moving. In addition, they orchestrated the sale of Bear Stearns to JP Morgan thus avoiding the potential bankruptcy of one of America's oldest financial institutions. They subsequently have provided backing and liquidity to both Fannie Mae and Freddie Mac the two large quasi private / government sponsored mortgage companies who were facing liquidity issues of their own.

As of June 30, 2008 financial institutions around the world have written down / off over $400 billion in debt related instruments[14]. Some analysts believe that this is over half of the potential total while others believe the write downs could exceed over $1.6 trillion before the "crisis" is over[15]. No one knows for sure if homeowners will continue to fight through their household financial problems and pay their mortgages or finally just walk away and "mail in the keys".

One positive result of this "crisis" is a return to prudent lending practices as many mortgage lenders have ceased operations and most financial institutions have tightened credit policies. This may cause a temporary drop in financing but it allows the market to work through the existing problems without more problems being created. Thus, the markets need to work through the proverbial "pig in the python".

Another potential silver lining is that the write downs relating to financial accounting rules which require the mortgage related instruments to be "marked to market" may in fact be written back up after the market works through the current liquidity issues. These write downs were for financial reporting purposes and may potentially be greatly in excess of their ultimate collectability. How much and when, if ever, these assets will be written back up is not known at this time.

We can also look at the current state of the financial markets.

U.S. Equity Markets:

The S & P 500 index reached its all time high on October 9, 2007 at 1,565. On July 15, 2008 it stood at 1,215, a decrease of 22.3% and thus officially qualifying as a bear market (defined as a decrease of 20% or more). Since 1942 there have been eleven bear markets prior to the current one and they have averaged 393 days from start to finish, the longest being 630 days (1973 – 1974) and the shortest being 101 days (1987). The average decrease in value has been -30.57% ranging from -48.2% (1973 – 1974) to – 20.57% (1948 – 1949)[16].

Conversely, bull markets (defined as an increase of 20% or more) have occurred twelve times since 1942 and have averaged 1,625 days from start to finish, the longest being 4,494 days (1987 – 2000) and the shortest being 105 days (2001 – 2002). The average increase in value has been +149.53% ranging from +582.15% (1987 – 2000) to 21.4% (2001 – 2002). The last bull market ran from October, 2002 to July, 2007, for 1,744 days and an increase of 99.94%[16].

U.S. Equity Markets (continued):

In the nine bear markets since 1956 the index advanced an average of +16.5% in the twelve months after the bear market ended. Seven of the nine times it advanced by double digits while twice it decreased in the subsequent twelve months[17].

U.S. Equity Valuations:

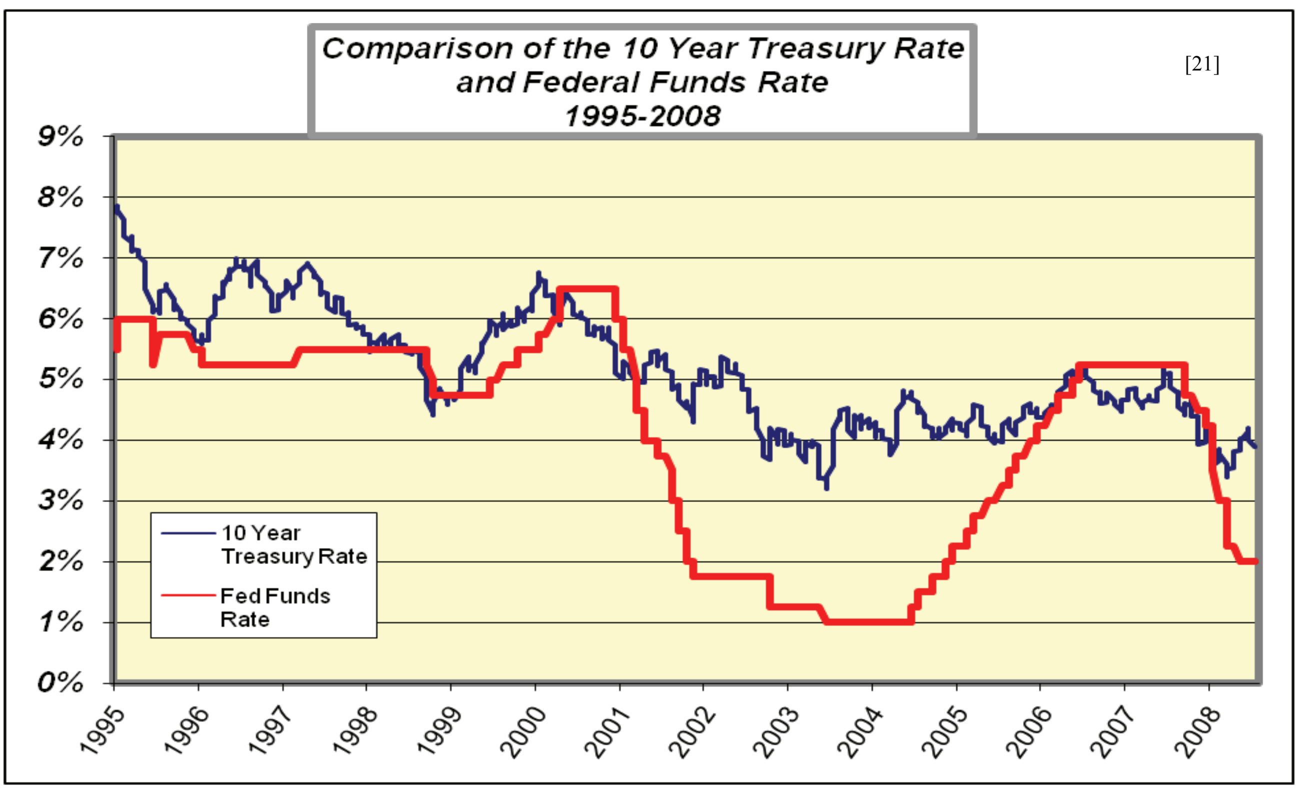
Stocks are valued based on their PE (price to earnings) ratio. Based on reported earnings as of June 30, 2008 large cap stocks were trading at a PE ratio of 17.8 compared to an average of 18.9 since 1979. Mid cap stocks were trading at a PE ratio of 19.6 compared to an average of 19.1 since 1979 and small cap stocks were trading at a PE ratio of 24.9 compared to an average of 22.8 since 1979[18].

Based on trailing twelve months, operating earnings growth for eight of the ten sectors in the S&P 500 were positive while two (financials and consumer discretionary) were negative[19]. Earnings are estimated to increase over 15% on a year over year basis during the next twelve months[20].

U.S. Fixed Income Markets:

The credit "crisis" has played havoc with the fixed income markets. As the "crisis" developed there was a flight to the safety of U.S. Treasury obligations. This caused an increase in the demand for U.S. Treasuries which drove down yields. At the same time the exodus from other fixed income instruments caused a decrease in the values of existing instruments already in the market. At the end of June, 2008 the ten year U.S. Treasury note was yielding less than 4%, down over 1% from a year earlier.

The Federal Reserve has continued to keep short term interest rates low in spite of rising inflation and the falling value of the dollar.



Foreign Equity Markets:

After a string of five consecutive calendar years of positive double digit returns the foreign stock markets recorded declines during the first half of 2008. Through June 30, 2008, both developed countries, as measured by the MSCI EAFA index and developing (emerging) countries, as measured by the MSCI EMID index were down double digits.

From a valuation standpoint, developed countries were trading at a PE ratio of 12.1, compared to an historical average of 19.7 while emerging countries were trading at a PE ratio of 14.0 compared to an historical average of 16.5[22].

In looking at world economies it is still apparent that the growth is in emerging countries. As these countries industrialize their economies will continue to grow at a much faster pace than their developed counterparts.

So what does all this mean to our investment philosophy and your investments?

As a financial advisory firm our role is to plan – not to predict. We cannot definitively answer the question "are we there yet?" But we can plan for all events including the events of today. We can develop an asset allocation and diversification strategy that is designed to capture reward while we minimize risk. We can monitor the economic factors that affect each asset class and make adjustments as the need arises. We can research and study individual holdings within each asset class to determine if the holdings make the most sense in the current environment. We can buy on opportunities and sell when the market has given us our perceived full value. And most importantly, we can offer perspective by analyzing historical events from the market and compare them to the events of today.

Craig Callahan, president of ICON funds, was recently quoted by MarketWatch as saying "the market doesn't issue invitations. It just takes off and goes…people wait for some event or some news and never get it, and that's what fools them and leaves them behind[23]." I couldn't have said it better. Trying to time the market by exiting asset classes after they have gone down and entering them when they have already come back up is not a strategy – it is a reaction.

I know that down markets cause emotional responses. I also know that this is your money, your future. My role is to listen and provide clear, concise and honest objective direction. If you have questions or concerns please know that I would love to talk in more detail. Please feel free to reach me at 616-261-2800.

By: Jerry VanderLugt CPA CFP®

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