Bellwether CONSULTING

Your Quarterly Update on the Financial Markets

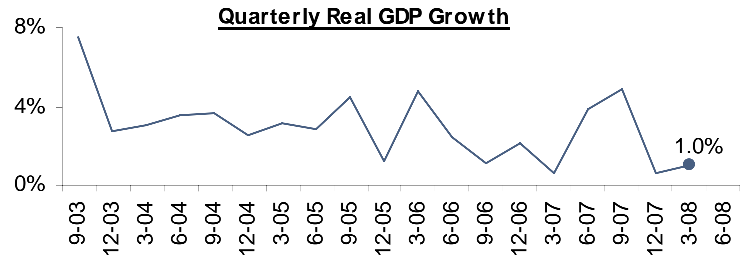
June 30, 2008

2nd Quarter

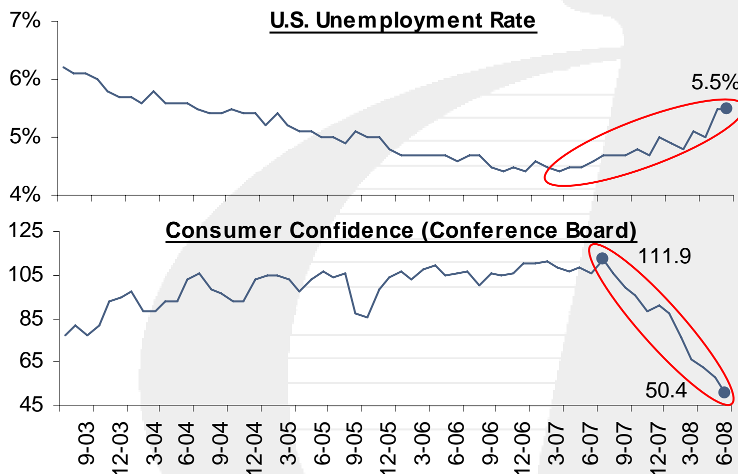
MARKET Recap

The Economy: *"That '70s Show"*

The pace of U.S. economic growth picked up slightly in the first quarter, rising at a 1.0% annual pace (compared to 0.6% in Q4). General themes remained the same; residential fixed investment decreased 24.6%, following a decrease of 25.2% in the prior quarter.

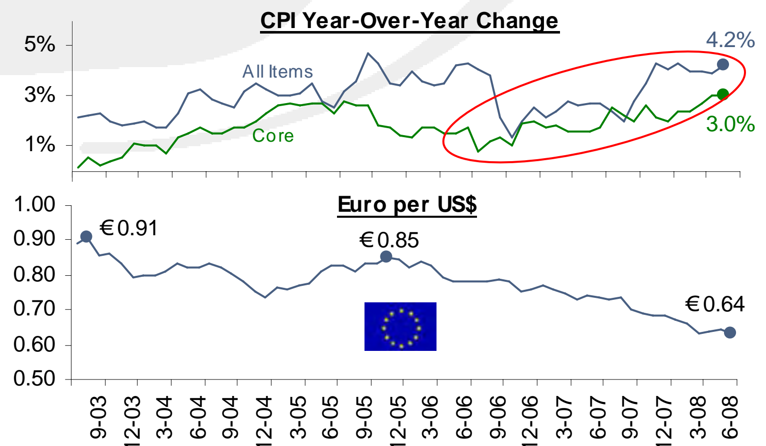


Unemployment edged up to 5.5% in May and stayed there in June, on layoffs in the financial services, construction, retailing, and automotive sectors. So far in 2008 the U.S. economy has shed 438,000 jobs, with 62,000 layoffs in June. Yet personal consumption expenditures have not yet fallen to the degree one might expect in a recessionary environment. To a certain extent, government assistance programs and voluntary severance packages tend to delay and mitigate the negative effects of job reductions. So far, the impact has primarily been felt in the area of big-ticket, deferrable purchases such as home improvements and automobiles. Falling auto sales in Q1 subtracted 0.48% from real GDP growth; in the second quarter auto sales plummeted, with GM reporting year-over-year sales down 18% in June. Toyota reported a 21% reduction. Although the popular press is quick to connect falling sales to rising gasoline prices, in fact the reductions spanned the spectrum of available car models including smaller, more efficient vehicles. Consumers are worried, and they are deferring major purchases when they can.



Is this bad news for manufacturers? So far, we think not. The Institute for Supply Management's manufacturing index rose to 50.2 in June, a mildly expansionary number. Overseas demand continues to drive results for manufacturers with access to foreign markets, due to weakness in the U.S. dollar. Increased exports help explain why first quarter growth numbers were better than expected – real exports increased 5.4%, continuing a significant trend.

The dollar rallied against the euro early in the quarter, then fell in June back to Q1 levels on expectations (later fulfilled) that the European Central Bank would raise rates. Inflation is a significant concern for both regions, but one which the ECB prioritizes to a greater degree than does the current Fed. The solution set to the stagflationary environment of the '70s included painful rate hikes to break the back of inflation. Leverage was not nearly as great then, and we would expect that economic activity is still much more sensitive to interest rates today than it was in the '70s. Consequently, we would expect rising rates to slow the economy more than it did then, and we see little hope of significant recovery this year. In short, we continue to believe this contraction will develop more gradually, and last longer, than most expect.



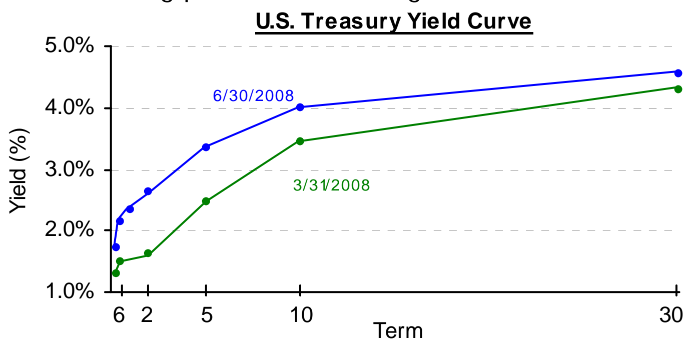
The U.S. Bond Market

Stock market weakness and economic uncertainty often bode well for lower-risk bonds (as demonstrated in Q1), but in the second quarter of 2008 bonds performed only a little better than stocks. Compared to the first quarter close, the second quarter of 2008 ended with the yield on the 3-month bill up 44 basis points to 1.73%. The yield on the 10-year treasury closed the quarter up 55 basis points to 3.98%, and the yield on the 30-year treasury ended up 23 basis points at 4.53%. With yields ending the quarter higher, prices on bonds, and returns on most of the bond indices, were down.

Bond Indices - 2Q08 Total Return	
Lehman Aggregate	-1.02%
Lehman Interm. Gov't	-1.84%
Lehman Long Gov't	-2.25%
Lehman Interm. Credit	-1.00%
Lehman Long Credit	-0.61%
Lehman High Yield	1.76%

In the second quarter investors remained wary of riskier assets. The insolvency of Bear Stearns, the deterioration of General Motors, and the continued problems faced by financial sector firms seemed to drive a market-wide realization that default risk is real. And with defaults typically increasing during recessions, the specter of an economic downturn compounded the concern. While AA spreads were off somewhat from the very high levels seen in Q1 (207 basis points), they were still more than twice that in 2006 (183 basis points vs. 77 basis points in Q1 2006). And the trend has been more dramatic in the high yield and MBS sectors.

The Federal Open Market Committee met twice, on April 29/30 and June 24/25. After the first session the federal funds rate was reduced 0.25% to 2.00%. The rate remained unchanged after the second meeting. Statements released after each meeting pointed to softening labor markets, financial markets under considerable stress, tight credit conditions, and the deepening housing contraction as factors weighing on economic growth. To achieve its goals of "sustainable economic growth and price stability," the Fed stated it would "continue to monitor economic and financial developments and will act as needed." Throughout the quarter there was much speculation as to whether the Fed would begin raising the federal funds rate as soon as August. Many Fed-watchers now think a move will come at year-end at the earliest.



Not surprisingly given the continued credit crisis, U.S. mortgage-backed securities issuance plunged in the second quarter and on a year-to-date basis. According to Thomson Reuters, a total of $48.6 billion from 83 issues was the lowest quarterly dollar volume since the second quarter 2000 when there was a total of $33.3 billion from 102 issues and lowest number of deals in a quarter since the first quarter of 1995 when 61 issues came to market. Mortgage defaults remain high (73,880 in April and 67,967 in May), according to Mortgage Insurance Companies of America (MICA), an industry group. Issuance of bonds backed by companies other than Fannie Mae and Freddie Mac has virtually ceased as investors refuse to buy securities backed by loans where payments are not guaranteed.

In contrast, overall high-grade bond issuance in 2008 has been close to 2007 levels. New issuance in the first half of 2008 totaled about $493 billion, just below the $500 billion in issuance for the same period last year, according to J.P. Morgan, with the biggest year-over-year growth coming from non-financial institutions. Industrial issuance was up 58% and issuance by utilities was up 150%. What is interesting is the pattern of issuance where three months (January, April and May) have had more than $100 billion in issuance each, offsetting lesser volumes during the more volatile months of February, March and June. Supply in June, totaled just $47 billion, down from $92 billion in June 2007, according to Bank of America research.

The U.S. Stock Market

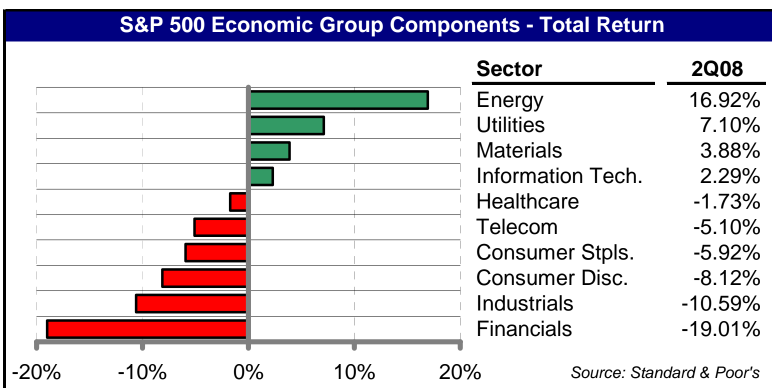
The U.S. stock market flirted with a dispiriting milestone at the close of the second quarter. It all but entered a bear market with the Dow Jones Industrial Average closing at 11,350, down 19.9% from its October 9, 2007 record high of 14,165. (A 20% fall off is generally considered to be an indication of the start of a bear market.) The last bear market, as measured by the S&P 500, ran from March 2000 to October 2002. Over the last century, the U.S. stock market has gone through three extended bear runs, 1901-21, 1929-48 and 1965-82, in periods of geopolitical or economic turmoil (i.e., wars, the Great Depression, stagflation).

Market volatility, climbing since the third quarter of 2007, moderated through the first half of the quarter, but was back again as the quarter closed. The Dow had 23 days of triple digit fluctuations – 7 up and 16 down (compared to totals of 36 days, 28 days and 24 days in 1Q 2008, 4Q 2007 and 3Q 2007, respectively) with 12 of the 16 drops occurring after

May 15th. By the end of June, U.S. stock prices as measured by the volatility index of the Chicago Board Options Exchange (VIX) showed fluctuations in line with the last three quarters.

Stock Indices - 2Q08 Total Return			
Largecap Stocks		**Midcap Stocks**	
S&P 500	-2.73%	S&P Midcap 400	5.43%
Russell 1000	-1.89%	Russell Midcap	2.67%
Growth	1.25%	Growth	4.65%
Value	-5.31%	Value	0.07%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	0.82%	S&P Smallcap 600	0.40%
DJ Wilshire 5000	-1.55%	Russell 2000	0.58%
		Growth	4.47%
		Value	-3.55%

The broad markets finished the quarter down, with the Dow Jones Wilshire 5000 returning -1.55%, the Russell 3000 returning -1.69%, and the MSCI Barra Broad Market Index returning -1.54%. Among the sectors, results were quite varied. With record-high gasoline prices, sliding home values, credit concerns, worries of recession, and business slumps remaining in the headlines, investors looked for more stability. And with investors seeking a haven from the slowing economy, growth stocks outperformed their value peers. This hunt for growth flowed through to the capitalization sectors where mid- and small-cap stocks bested their large-cap peers. The large-cap sector was dragged down by Financial sector stocks with the sub-sectors of Diversified Financial Services, Commercial Banks, and Thrifts and Mortgage Finance returning -25.43%, -27.39% and -29.24% respectively. Mid-cap performance benefited from Biotech in particular, which returned 44.83% for the quarter as a sub-sector. In general within the markets, the energy and commodity sectors, buoyed by record-high oil prices and increasing world demand, were the place to go for good returns while banks and other financial services and consumer goods, weighed down by the continued credit problems and recession fears, were the places to avoid. The consistent and dramatic out-performance by energy stocks has many reflecting back to the late 1990s tech bubble, wondering if the energy sector is over-priced relative to fundamentals with speculation driving oil prices too high or if this is the new reality. (See this quarter's Focus piece, "Oil! Shocking!", for discussion.)



Not surprisingly, fear factors driving the stock market influenced the IPO arena as well. The second quarter of 2008 was the worst for IPO issuance since 1995, with just 16 companies raising $5.2 billion, according to Dealogic. Compared to the second quarter last year, the number of IPOs fell 79% while dollar volume was off 73%. On a year-to-date basis, 57 companies pulled their IPO plans in the first six months of 2008, nearly double the number for the same period last year.

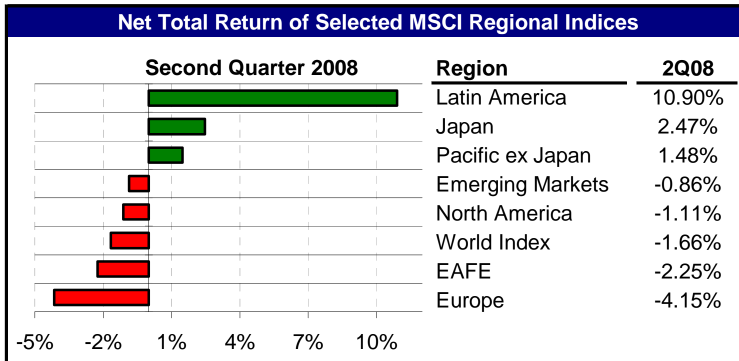
Growth estimates have been falling as well. According to Thomson Reuters, as of July 3, 2007 the blended earnings growth rate for the S&P 500 in second-quarter 2008, combining actual numbers for companies that have reported and estimates for companies yet to report, fell to -12.4% from -11.3%. The drop was attributed to downward estimate revisions in Financials which were partially offset by upward revisions to the Energy sector. On January 1, 2008, the estimated growth rate for the second quarter was 4.7%. By April 1, this estimate had fallen to -2.0%. As of June 23, Standard & Poor's Equity Research estimated a full-year operating earnings-per-share growth rate of 7.9% for the S&P 500.

Overseas Markets

Despite negative economic news global markets have shown a measure of resiliency. Although nearly all of the major sectors lost ground during the quarter, losses were not as large as one would have expected given all of the negative news. Developed markets continued to slump, although Asian emerging markets appeared to be the hardest hit during the quarter. Latin American emerging markets continue to perform well in the face of a global economic slowdown and pricey oil.

The ECB held Eurozone rates steady in both May and June as it showed some reluctance to stimulate an economy whose growth appears to be stalling as inflation continues to run well over target. Consumer inflation across the zone rose at a 3.6% annual rate in May as relatively robust first-quarter economic growth appears to be giving way to the second quarter's falling exports and inflationary pressures. Eurozone retail sales posted an unexpected 0.6% monthly decline in April where consensus expectations were for a 0.7% increase. May's survey of German financial analysts and institutional investors showed deterioration in economic sentiment due to inflation and a strong euro. Likewise, the IFO Index of business climate fell to 1.7% in June from 6.1% in May, signaling that business executives across a number of industries feel pessimistic about the coming 6 months. The MSCI Germany Index was down 2.41% for the quarter. In France, consumers are feeling the pinch from high fuel prices, going as far as staging demonstrations calling for relief. President Sarkozy has requested that the EMU's VAT tax on fuel be capped to help contain prices. Household confidence in France has reached an 18-year low at this point. The MSCI France Index was down 3.94% for the quarter.

Japanese core consumer prices accelerated at their fastest pace in a decade in March on higher food and transportation costs. The core consumer price index, which excludes volatile fresh-food prices, rose 1.2% from the year-earlier period, matching consensus expectations. According to economics minister Hiroko Ota "…the price rises are being led by upward pressure from higher raw material costs and not by strong demand, so it isn't a good pattern." Core consumer prices in Tokyo increased 0.7% in April year-over-year, after rising 0.6% in March. The Tokyo area inflation data acts as an indicator to the nationwide inflation figures. Even with the not so rosy news the sector managed to finish in the green.



Region	2Q08
Latin America	10.90%
Japan	2.47%
Pacific ex Japan	1.48%
Emerging Markets	-0.86%
North America	-1.11%
World Index	-1.66%
EAFE	-2.25%
Europe	-4.15%

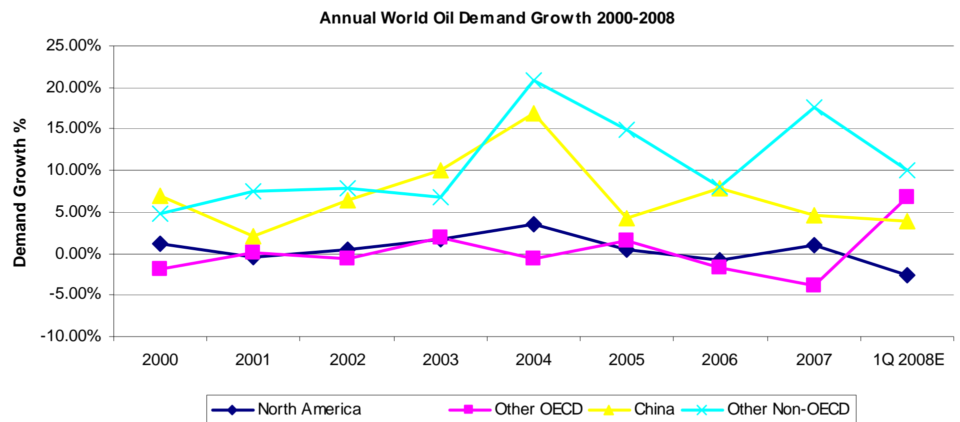
In China export growth was surprisingly strong in May, growing 28.1% from a year earlier, after gaining 21.9% in April. The strong growth may have eased concerns regarding an economic slowdown amid a strengthening yuan and slowing U.S. demand for Chinese goods. The yuan has gained about 18% since 2005, and China stepped up the pace of appreciation in recent months to attempt to control inflation. The yuan rose at an annualized rate of about 17% in the first three months of 2008. Early in June the Chinese central bank raised bank reserve requirements in an attempt to stave-off inflation. Banks were required to set aside 17% of deposits as reserves beginning in mid-June with the rate rising to 17.5% at the end of the month. Inflation in China was 8.5% in April, near an 11-year high as the country is flush with cash stemming from trade surplus and foreign investment and speculation. The MSCI China index was down 3.46% for the quarter.

Latin American emerging markets performance continued to defy both the economic news coming out of the sector. Good news in Brazil came early in the quarter from S&P which upgraded its rating to BB+, or investment grade, from BBB-. However, this news was short-lived as consumer prices surged in May due to higher food costs, putting pressure on the central bank to raise its benchmark interest rate again. Increasing costs pushed May's annual inflation rate to 5.58%, the highest rate since January 2006. This increase may force the central bank's hand, requiring a third increase in the benchmark rate since the beginning of the year. However, the MSCI Brazil index was up 18.37% for the quarter. In Argentina accelerating inflation, farm strikes and slowing investment have taken their toll on South America's second-largest economy. Analyst growth estimates have been reduced to 5.5% in 2008 from 7% and 2% in 2009 from 4% as the economy feels the effects of lower investment, inflation and waning consumption. Surprising, given the economic and socio-political issues from the sector, the MSCI Argentina index finished up a strong 35.36% for the quarter.

Focus On: *Oil! Shocking!*

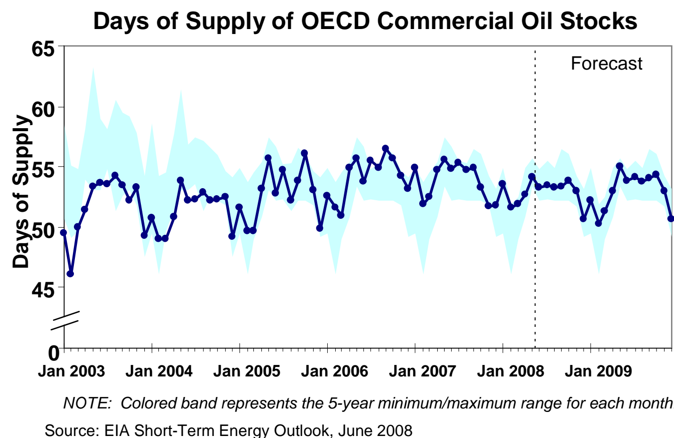
Unless you've been living on another planet, or you don't drive or consume any goods, you've recently felt the price of oil skyrocket to over $140 per barrel. The impact of rising oil prices ripples through the economy and affects everything from driving a car to buying that morning cup of coffee. Many possible explanations have been posited by the media, government officials and the man on the street as to the cause the oil price increases we've seen. Take your pick – supply and demand, the weak dollar, excessive speculation. Why are prices rising and what, if anything, can be done?

Increased speculation in all commodities, and especially oil, has been driven by a number of factors. One of the primary drivers, however, has been the falling value of the U.S. dollar. Oil is U.S. dollar denominated so as the value of the dollar falls, the price of oil increases in a very direct way. This increase attracts speculators into the market as investors use oil as a hedge against dollar weakness. Further exacerbating the situation is that oil producers are, in turn flush, with dollar denominated assets; to sell additional oil would have producers accumulating more low-returning assets.



Oil Fundamentals

Let's consider fundamentals first. Ultimately, supply of and demand for oil should determine the price. Historically, oil supplies have been able to expand in response to growing demand for the commodity. Sustained demand growth, especially from growing economies such as China over the last few years, has increasingly created capacity limits as global supply has responded slowly to rising prices. In the case of oil, demand has caught up with production capacity after long periods of surplus capacity. Capacity expansion has been limited by increased average costs of production in marginal fields constrained by technology, geology, environmental concerns, and politics. It is anticipated that structural supply limitations will remain in place for the foreseeable future. This imbalance should continue to drive long-run prices.



NOTE: Colored band represents the 5-year minimum/maximum range for each month.
Source: EIA Short-Term Energy Outlook, June 2008

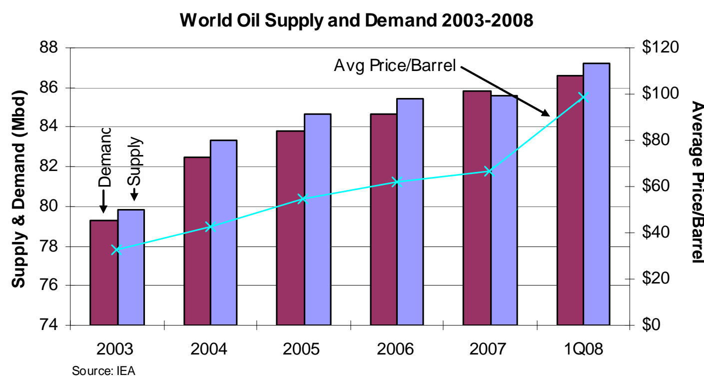
Over the last 5 years oil supply has barely kept pace with demand. In 2007, world demand actually outpaced supply, and according to the International Energy Association demand growth is expected to continue to closely match or outpace supply. As demand for oil has increased there has also been an increase in the average price per barrel of oil.

The old paradigm of economic weakness in the U.S. leading to lower oil prices appears to no longer hold. Increased demand from growing economies in Asia, Latin America and even Africa is more than offsetting slowing demand in the U.S. and explains a significant amount of the recent price run-up.

Speculation on Speculation

Speculators, investors that make bets on the direction of the price of a commodity today or in the future, enter the markets by buying or selling futures contracts - a contract set at a predetermined price for delivery of the commodity in the future. The futures markets create a place where producers (sellers of futures contracts) and buyers (generally users of the commodity) can negotiate market prices in the future, to take some of the risk out of daily market price fluctuation. Speculators serve a meaningful purpose in these markets - they risk capital in an attempt to earn a profit while making it easier for others to offset risk. The liquidity added by speculators further aids the process of price discovery, revealing the price impact of supply and demand changes to the market more quickly than a spot-only market would. While we may not be happy with the price on any given day, knowing the current price is valuable for all market participants.

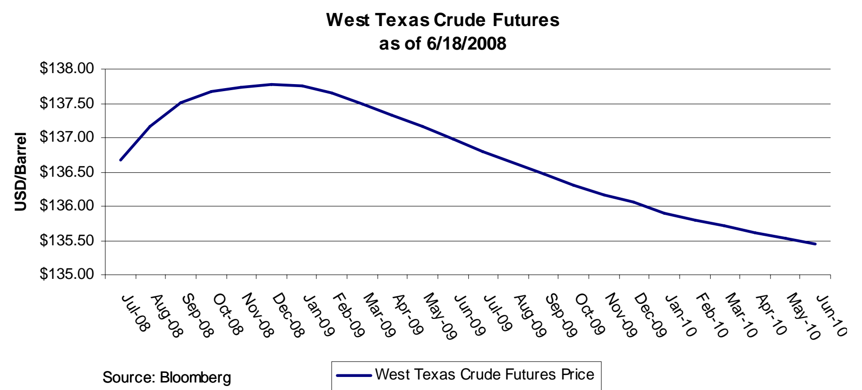
Clearly there has been an increase in the amount of speculation in the markets as measured by the 20-fold increase in investment in index funds tied to commodities, from $13 to $260 billion between 2003 and 2008. Anytime there is a significant price run-up in a particular commodity, speculators are drawn into the market. This has been true of oil. According to his testimony before the Committee on Homeland Security and Governmental Affairs on May 20, Michael Masters of Masters Capital Management said that "...according to the DOE annual Chinese demand for petroleum has increased over the last 5 years from 1.88 billion barrels to 2.8 billion barrels, an increase of 920 million barrels. Over the same five-year period, Index Speculators' demand for petroleum futures has increased by 848 million barrels." Said differently, the increase in demand from speculators is almost equal to the increase in demand from China. Demand from Index Speculators and other institutional investors has been mostly driven by demand for exposure to oil rather than actual demand for the physical product. Unless speculators can take delivery of crude oil and store it (i.e., hoarding the commodity), long-term prices should not be driven by speculation. Note that less than 9% of contracts resulting in an actual delivery.



Source: IEA

Until approximately the middle of 2007 market conditions gave both oil companies and speculators a financial incentive to stockpile oil, implying that futures prices were higher than spot prices – a situation known as contango. Around mid-2007 fundamental market movements made it more financially lucrative to sell the stockpiled oil. At this point, the oil futures curve moved into backwardation – where future prices dropped below spot prices. Despite common expectations of higher future oil prices, these technicals suggest that holders of physical oil should be selling their inventories; in fact, commercial oil stocks at Cushing, Oklahoma are running near the bottom of their 5-year range. Near the end of June West Texas Crude in the spot market was around $140 per barrel with the future price for the 2 year con-

tract at around $135.50 per barrel. By all appearances, the futures market continues to exhibit a backwardation structure – which should continue the trend of inventory liquidation.



According to Barclay's, index funds account for only 12% of the outstanding contracts on the NYMEX and have a value equivalent to only 2% of the world's annual oil consumption. In addition, speculators are neither adding physical demand for oil, nor removing supply by hoarding as we have seen decreasing oil inventories. This would tend to imply that speculators have not been a significant driver of oil prices.

Market Manipulation

At issue on the question of speculation is whether there has been any market manipulation that would cause an artificial increase in world oil prices. Of paramount concern is that speculators are coming into the market and taking only long positions, betting that prices will continue going up. Through the first week of June the net-long positions of speculators were around 100,000, the lowest in nearly a year. According to data from the Commodities Futures Trading Commission (CFTC) there appears to be an equal number of short sellers, speculators betting on falling prices, as there are long positions, allaying fears that there would be no counterparties to offset long positions. In addition, information from the CFTC indicates that through mid-June, the number of speculators in the energy market has been trending downward.

There seems to be a mindset among legislators that speculation is akin to manipulation. Speculation is merely another word for prediction. To use an apt analogy, the amount of money that you bet that a "6" will come up at the craps table has no effect on the actual outcome of the roll of the dice. Many legislators in the U.S. are calling for increased regulation of the CFTC including increased margin requirements for speculators and barring index and hedge-fund investors that have no interest in taking delivery of the commodity from the market. It is not clear that either a margin increase or barring a class of speculators would significantly impact prices either in the short- or long-term. It is certain, however, that regulating "fat cat" speculators during an election year is much more politically feasible than acting to either expand supply of, or curb demand for, crude oil itself.

Conclusions

Clearly at the present time there are a number of issues that are driving the price of oil. Fundamentals seem to explain a significant portion of the price increases as demand growth outside the U.S. is increasing without a commensurate increase in supply and no evidence of significant increases in production coming online. In addition, inventories appear to be at the lower end of recent historical ranges. Increased speculation may also be playing a part in the short-run rise of prices, but the evidence here is not nearly as clear cut as the fundamental argument. As far as additional regulations go, we are opposed to increased regulation in the commodities markets as there also appears to be no evidence that speculators have been manipulating prices. Any additional regulation would be counterproductive for a number of reasons. It would certainly have an impact on price discovery in the market and it would force speculators to move their trading outside of the U.S. to markets in Europe and Asia where it cannot be monitored as effectively. The one thing that we are confident of is that oil prices in the long-term appear to be headed higher.

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