

June 30, 2008 Market Commentary and Outlook

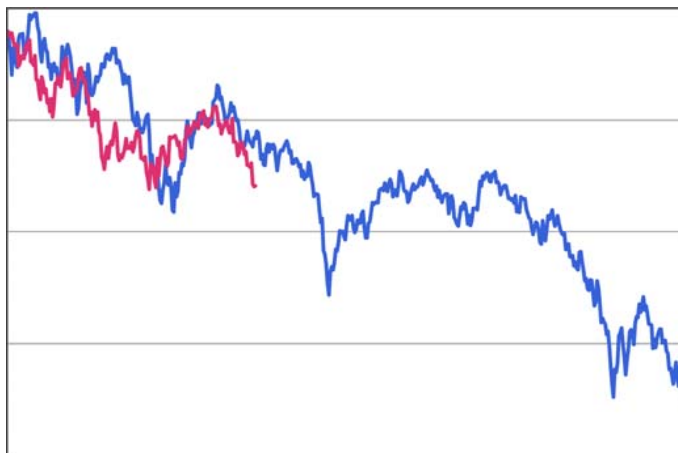
There's an old saying about those who forget history. I don't remember it, but it's good.

Stephen Colbert

George Santayana, the philosopher, poet, and literary and cultural critic, wrote, “*Those who cannot remember the past are condemned to repeat it.*” Given the performance of stock markets around the world over the past few months, investors would be well served to look back and see how bear markets tend to behave. (Last quarter, we wrote that the S&P 500's peak-to-trough performance at a negative 18.64% did not “qualify” as a bear market—down 20% being the requisite decline—but given that the close of the S&P 500 on July 7 results in a peak-to-trough calculation of a negative 19.99%, let's just round it up and we'll call it a “bear market.”)

The SEC (Securities and Exchange Commission) has its own take on history: “*Past performance is no guarantee of future results.*” Some disclaimer to that affect is required of any mutual fund when publishing performance results. Whereas such a disclaimer is certainly true, the SEC is not suggesting that we forget about historic results. Their concern is more about those market periods when performance has been positive: Do not believe great performance in the past is going to mean continued great performance in the future.

The chart here shows a dollar invested in the S&P 500 at its recent peak on October 9, 2007, and its subsequent valuations through to June 30, 2008 (the red line). Also plotted on the chart is a dollar invested in the S&P 500 on October 9, 2000—a little off the high of the bull market of the 90's—through to October 9, 2002, during which time the market fell 44.6% in value (the blue line). Curiously, October 9, 2002 was the very bottom of the 2000-2002 bear market, exactly 5 years to the day before the peak of the recent bull market.



Notice how the two periods in the market have trended similarly. After coming off a high, there is a sharp decline, a rally, and then a subsequent decline. Will the markets here in 2008 continue to decline as they did in 2001? *Does history give us any indication of where the markets might be headed?*

Before you jump to any conclusions from looking at the graph, remember there have been three recessions out of the last ten in which the S&P 500's performance—although double digits in decline—was better than the negative 20% needed to be properly characterized as a bear market. Solely looking at a trend line on a graph to determine the market's next move can be akin to reading tea leaves.

Although the long-term trend of a market's movement might be up or down, there are intervening periods during which the markets move in the opposite direction of its trend. For instance, during the 2000-2002 bear market, the market had advanced three times in excess of 20% as calculated from an intra-day low to a subsequent intra-day high, with many advances ranging from 5% to 10%. However, peak-to-trough during that period, the S&P 500 declined 49.15% on a closing basis. During the bull market of the 90's, there were many declines of 10% or greater while the S&P 500 continued on to new highs.

Market rallies in bear markets are the norm. We just saw one this year from March 11 through May 19 in which the S&P 500 advanced 12.04% (only to fizzle and drop to a low for the year). *Are these rallies tradable?* Certainly 10% to 20% advances are tradable, but keep in mind the characterization of the term “tradable.” Not only does one need to know when to buy, one also needs to know when to sell—two prescient decisions that need to be made consecutively! No easy feat. **Mutual fund investors should perhaps think of “tradable” bear market rallies as opportunities to sell into in order**

to become more defensive versus committing cash reserves for a short-term stock trade.

Ideally, the next rally that occurs is the start of a bull market (the markets having bottomed) and we all can see our portfolios once again steadily increase in value. *But how does one know if a market rally has started? What would have to occur for that to happen?*

So much of the recent negative sentiment (which in May killed the S&P 500's rally) has been attributable to rising oil prices. Consequently, the inevitable decline in the price of oil should help fuel a rally. *The decline is inevitable, you say?* Oil prices are impacted by demand, supply, currency valuations and speculation. Considering the economic weakness in the U.S. and most developed economies, it seems unlikely that oil prices have risen nearly three times over since early 2007 solely due to demand growth. If the global economy continues to soften, demand will lessen, supply will increase and the speculative fever should abate. Commodities typically do not perform well during recessions; reversals in the near vertical ascent in prices can be dramatic. Early in 2007, oil prices collapsed from \$80 a barrel to \$50. Barring some catastrophic event such as Israel bombing Iran, oil prices—and those of other commodities—should decline as the economic strain of those increasing prices creates a reduction in demand. Hopefully this will happen in the 3rd Quarter.

The recent run-up in the prices of food and gasoline, not to mention the unabated rise in healthcare costs, can adversely impact consumers. Consumer confidence in June dropped to the lowest levels in 16 years. The retrenchment of the consumer—currently responsible for 71.5% of the Gross Domestic Product in the U.S.—has yet to show up in a decline in corporate profits. (Seeing this in the 3rd Quarter will not be a big surprise.) A decline in oil could mean a decline in gasoline prices and some relief for the consumer. *Would this not be a good reason for the market to rally?*

It doesn't take much to get investors excited. 2008's rally of March through May was fueled by investors' positive response to the Fed's bail out of Bear Stearns. Despite the fact that the credit crisis was so extensive that one of Wall Street's biggest firms teetered on insolvency, investors were heartened to think the credit crisis could be easily contained by the "astute" maneuvers of the Federal Reserve. (As if the credit crisis was an event and not a process.)

All that is wrong in the world is not just the price of oil. The housing market is in terrible straights (the President of the San Francisco Fed

recently predicted that housing prices may continue to fall into 2009). There are still significant mortgage credit problems. A spreading housing recession can negatively impact the credit situation in other sectors. We do not think that all the bad news that exists concerning the need to further write down assets by financial institutions has been disclosed. Even if all the bad news is out there, financial institutions are frantically rebuilding their capital. Their lending policies are severe and much less credit is available. Things can still go badly for the economy and negatively impact the financial markets despite a decline in the price of oil.

Investors have, to date, been relatively complacent about the decline in the markets. We've all seen declines before and have lived to see the markets recover. What we haven't seen yet is panic and capitulation. Unfortunately, most investors do the absolutely wrong thing at the most inappropriate time. Amidst such panic, there is usually significant selling—a strong signal that we might be at the bottom of this bear market.

Investors who have appropriate asset allocations within their portfolios, of course, are better positioned for the inevitable bear *and* bull markets. Getting asset allocation right is critical to successful, long-term investing. Remember that a reallocation of your portfolio is best undertaken during a bull market, or a strong bear market rally.

Within our discretionary portfolios, we have cash reserves slated for equity purchases—reserves we had when the market peaked last October. The recent sell-off in the equity markets (which amounts to a 20% discount on the market from 8 months ago) has our attention. But we're investors, not speculators. The odds are high enough that we could see lower lows before this market consolidation is concluded. Absent some change in market fundamentals, we are reluctant at this time to increase our equity exposure from current levels which we consider to be prudent asset allocations.

Investment Committee
Northwest Capital Management, Inc.
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