

## REVIEW OF THE FIRST QUARTER 2008

Unlike the last half of 2007, where some areas of the capital markets remained relatively immune to the dislocation in the real estate and fixed income markets, investments of most types have been materially marked-down in price since year end.

Broad stock market indexes around the world declined 10% or more in the first quarter. Fixed income of all but the very highest quality bonds also suffered significant losses, as did real estate and infrastructure securities. This extensive degree of weakness is not unprecedented, but to have so much compressed into a single quarter is unusual.

Broadly speaking, negative returns were driven primarily by concerns about:

- The size and scope of the housing and credit related problems. Not only have banks and other financial companies had to write-down more bad loans than expected, but credit problems have spread into other areas of the economy, such as car and credit card loans.
- Real estate and credit market troubles impacting the overall economy. According to Intrade, a “prediction market” in which the public can actively wager on outcomes of various economic, political and other events, the likelihood of a recession has risen from less than 50% at the beginning of the year to slightly more than 70% at the end of the quarter.
- Domestic economic growth. As this slows, the effects could spread outside the US. During the extended global growth cycle of the past several years, China and India have accounted for approximately half of the total. A slowdown in these two rapidly growing economies would have a material effect on the overall rate of global growth.
- Inflation as an issue. The rate of global inflation has remained elevated over the past year. With the February CPI report showing an annualized inflation rate of 4.1%, recent reported data have provided no solace to investors. However, inflationary pressures are expected to subside in the months ahead as the deflationary effects of lower real estate values and credit congestion continue to persist.
- Future national tax policy resulting in harsher treatment of investment capital. Speaking strictly from a financial point of view regarding after-tax returns on investor capital, the tax cut package of 2003 was favorable to investment of savings by lowering rates on capital gains and dividends. Based on policy speeches by several presidential front-runners and senior Congressional members, it appears increasingly likely that current tax rates would rise as early as next year and perhaps could even surpass pre-2003 levels.

## INVESTMENT OUTLOOK

As is always the case, there are a number of economic, political and psychological factors to consider in the investment process. Identifying which are the most important and deriving the right conclusions largely determine the degree of investment success.

We believe the following factors will have the largest effects on the capital markets over the coming months and quarters.

1) The US economy

Uncertainty exists as to whether measures taken by our government and the private sector will be sufficient to rekindle economic activity. The list of actions taken thus far includes:

- The Congress and Administration's emergency stimulus bill designed to give cash rebates to middle-income households;
- The Federal Reserve's reduction of the Fed Funds rate by 300 basis points this quarter, from 5.25% in January to 2.25% presently;
- The Fed's expansion of the list of securities that banking and brokerage institutions can use as collateral for borrowing;
- The Fed allowing non-bank institutions to access their credit window to borrow for up to 90 days;
- The government's easing of capital ratio requirements for Fannie Mae and Freddie Mac, freeing up approximately \$200 billion for mortgage lending;
- Raising the "Jumbo" mortgage amount from \$417,000 to a \$700,000 to \$900,000 range, allowing more expensive homes to be purchased with cheaper government-backed mortgages;
- The Administration's willingness to consider additional forms of housing relief; and
- Restructuring actions by many companies in the housing and banking industries to return to more solid and sustainable footing.

However, these combined actions will require time to stanch the downturn and eventually reverse our current negative economic course to a positive one.

2) Foreign operations of US companies

Companies comprising the S&P 500 Index derive approximately half of their earnings from outside the US and other domestic companies' foreign earnings are significant. Therefore, the sustainability of economic growth outside the US will no doubt influence the amount of money companies earn in 2008 and beyond.

Foreign business operations remain solid. For example, General Electric's CEO, Jeffrey Immelt, recently said that the strength of overseas operations was sufficient to allow the company to generate 10% overall earnings growth in 2008, despite the fact that domestic operations were not doing particularly well. However, we note that if a significant slowdown occurs in the US, the rest of the world will most assuredly feel the effects.

3) Relative valuation of stocks to bonds

Compared to previous recessions and bear markets, stocks are inexpensive relative to bonds and suggest higher returns for stocks, even assuming a 25% decline in corporate earnings:

**1981:**

- US Treasury bond interest rate yield was 15.0%.
- S&P 500 expected earnings yield was 14.0%.

**1990/1991:**

- US Treasury bond interest rate yield was 8.0%.
- S&P 500 expected earnings yield was 5.25%.

**2000:**

- US Treasury bond interest rate yield was 6.0%.
- S&P 500 expected earnings yield was 3.7%.

**Early 2008:**

- US Treasury bond interest rate yield is 3.8%.
- S&P 500 expected earnings yield is 5.25% (assuming 25% earnings decline).

The obvious caveat is possibly that bond yields are simply too low at present (because they have benefited from a speculative “flight to quality”) and, therefore, bond yields are headed higher, which would reduce the attractiveness of stocks on this measure. Nevertheless, even with higher bond yields, stocks remain attractive.

**4) Investor emotion and sentiment**

Emotions are presently ruling stock prices as investor time horizons contract. No one is willing to look very far into the future when fear prevails. Yet, that is what creates opportunity for long term investors. Short term stock market bottoms are usually made when marginal sellers stop selling as emotions subside and value is recognized and acted upon. Only then do buyers come back in sufficient numbers to turn the market upward on a long term basis.

Indicator of sentiment today:

- The latest consumer confidence reading is at the lowest level since 1974.
- Only 14.9% of the respondents indicate that they expect their incomes to be higher six months hence, the lowest percentage since the question was first asked back in 1967.

## CONCLUSIONS

Our investment process continuously seeks opportunities where the odds for satisfactory returns are in our favor and in avoiding situations with unfavorable odds. To briefly review our process, we:

- Analyze previous periods of financial history for insight into future possible investment outcomes for today’s markets.
- Assess relative valuation levels of investment opportunities among different asset classes.
- Identify the public consensus on the investment picture and where our view differs.
- Consider the perspective from “the other side of the trade” – why is someone buying/selling, and thus driving the price up/down?
- Examine the risks of our investment strategy being wrong and the consequences to our portfolios.

Having formally worked through this process once again, we continue to believe that patiently weathering this highly emotional period is consistent with generating favorable long-term returns for our clients. We will continue our best efforts to shift the portfolios out of areas where we see limited return potential and into areas where we see new opportunities. During this difficult time, we remain vigilant in our analysis and will continue to communicate our thinking.

# CAPITAL MARKET RETURNS

## Periods Ending March 31, 2008

|   | Current<br>Quarter | Year<br>to<br>Date | Past<br>Year |
|---|--------------------|--------------------|--------------|
| <b><u>ASSET CLASSES</u></b>                 |                    |                    |              |
| Treasury Bills-30 day                       | 0.6%               | 0.6%               | 3.9%         |
| Long-Term US Government Bonds               | 3.6%               | 3.6%               | 12.9%        |
| US Treasury Inflation Protection Securities | 5.4%               | 5.4%               | 14.8%        |
| Infrastructure Securities                   | -7.3%              | -7.3%              | -7.5%        |
| Real Estate Investment Trusts               | -0.4%              | -0.4%              | -19.8%       |
| Foreign Real Estate Securities              | -6.9%              | -6.9%              | -18.3%       |
| Commodity Securities                        | 9.9%               | 9.9%               | 38.6%        |
| S&P 500                                     | -9.4%              | -9.4%              | -5.1%        |
| Russell 2000 Small Cap                      | -9.9%              | -9.9%              | -13.0%       |
| MSCI Europe & Far East                      | -8.8%              | -8.8%              | -2.3%        |
| MSCI Emerging Market                        | -10.9%             | -10.9%             | 21.7%        |
| <b><u>CONSUMER PRICE INDEX (CPI)*</u></b>   | 1.0%               | 1.0%               | 3.3%         |

\*Estimated

## ABOUT CHATHAM

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### INVESTMENT SERVICES

- Separately Managed Accounts
- Pooled Trusts (for tax-exempt retirement funds and IRAs): Small Cap Trust, Balanced Trust, and Equity Opportunity Group Trust
- Pooled Partnerships (for taxable accounts): Small Cap Partnership, Balanced Partnership and Equity Opportunity Partnership
- Asset Allocation Consulting for Retirement Plans

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