

## SECOND QUARTER 2008 IN REVIEW

Since our first quarter report to clients, much has changed in our fundamental outlook.

What concerns us is the degree of risk associated with current economic issues, and the time it will take to work through this period of transition from bad times to better times. Therefore, as we approached the end of the quarter, we began reducing portfolio risk by taking three actions:

- ◆ Reducing the equity weighting.
- ◆ Exiting what we think are the most vulnerable areas of the equity market based on our evaluation of the fundamentals and the levels of stock prices.
- ◆ Purchasing Treasury Inflation Protected bonds (TIPS), where appropriate, to offset potentially damaging inflation risk.

## INVESTMENT OUTLOOK

Factors that have raised the level of uncertainty have been thoroughly reported on by the media. The main two factors affecting our near-term view of the world are:

- 1) The rapidly increasing negative effect of oil and food commodity costs. The most recent spike in energy prices – which have more than doubled over the last year and are up over 40% in the last three months alone – is the worst since 1999, when oil recovered from the Asian economic crisis. But back then the price was in the range of \$20 per barrel.

Regardless of whether or not we are in a commodity “bubble,” the effect of higher energy and commodity costs on consumers is real and immediate, unlike the Internet bubble of the late 1990s. With this recent price spike from already high levels, energy costs in the U.S. have very quickly risen to the point where they represent almost the same incomes they did in the late 1970s. Back then, oil prices topped out at \$40 per barrel, having risen from about \$2 per barrel over the previous five years. While we believe this

impediment to consumer spending will dissipate in time, there is no immediate resolution to the problem.

- 2) The continued fragility of the banking and real estate sectors. The condition of our financial system is delicate and the industry must shrink to regain its health. This will not help the housing market at all. There are signs that, at a minimum, the rate of decline in the housing market is lessening, which is encouraging. The seeds of recovery appear to be taking hold. Yet, coupled with the continuation of rising energy and commodities prices, recovery in the housing market will likely take longer this time than it has in previous declines.

Not all is gloom and doom, however. Worldwide economic growth continues to be positive at present, led especially by Asia, South America, Russia and Eastern Europe. Many of our multinational companies are quite profitable, bolstered by their international business and their diversified sources of income. The high level of pessimism in the U.S. for both the economy and future investment returns suggests that the capital markets have already discounted a good bit of the current negative environment.

Stock market valuations are not high, though certainly they do not appear to be at bargain lows. Personal incomes and jobs are holding their own so far. We may be experiencing a beginning of stabilizing of the residential real estate market. We may also be finally taking actions to improve our dangerous energy situation, something we started talking about mid-1970s but have done nothing about over the past 30 years.

Focusing on the longer term, the challenge is to get through this period of difficulty and be in a position to take advantage of a better environment when that time comes. We continue to project the likelihood of better returns for stocks than other investment assets over the next three years, which is why we are maintaining a substantial through reduced weighting in equities.



## CONCLUSIONS

The effect of falling housing prices and the retrenchment of the financial sector has hit the U.S. economy hard, but has not overwhelmed it. The housing market will eventually recover as there is a natural rate of demand for housing. Housing affordability is rising also (as housing prices fall, they become more affordable).

There is no clear solution to the energy and commodity price run-up, other than perhaps a material, sustained reduction in demand, which would more than likely come about due to a recession. This is definitely not positive from an investment standpoint. The possibility also exists that prices of energy and commodities might decline near-term as they correct from such a large run-up over the last many months. As it stands now,

economic growth may be constrained by energy and commodity supplies/prices.

The combined effect of our fragile financial system with the dramatic rise in the cost of commodities is such that we took action in client portfolios. We reduced risk by selling equities, especially those exposed most weakening U.S. consumer spending trends.

Looking further out, we believe that the commodity supply/demand imbalance will be redressed in ways that will allow for positive economic growth. Our recent actions have placed the portfolios in a better position to take advantage of these future investment opportunities when they come.

## 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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