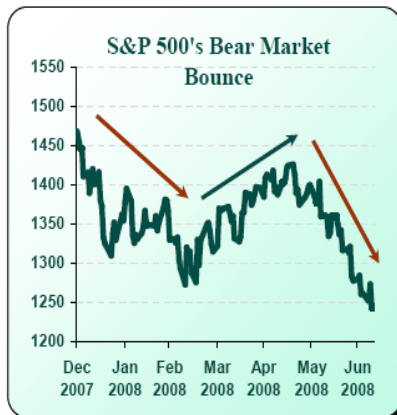


*By Jeffrey G. Johnson*

## Is The Worst Over?

The stock market pushed higher to start the second quarter on hopes the Federal and Congressional stimulus programs would trigger a speedy economic recovery. But the bounce proved typical of bear market cycles and quickly reversed as skyrocketing commodity prices, relating especially to food and energy, weighed heavily on consumer sentiment and retail sales. By the end of the second quarter the Dow Jones Industrial Average, S&P 500 Index, and NASDAQ all finished near their lowest levels of the year, down 13.4%, 11.9%, and 13.2%, respectively.



As the global economy muddles through one of the worst credit crises in nearly a generation, the heightened uncertainty of sub-prime loans, major financial firm write-offs, and geopolitical events left no place to hide at home or abroad. Despite the positive effects from a weakening dollar, international markets prolonged their reign as the worst performers of the year with losses ranging from negative 20% to 25%. (China is now down over 50% from its highs just ten months ago.)

While the natural resources and energy sectors benefited from the inflationary high oil prices, the debt-laden economy exacted its toll on the finance sector. Typically, during a market correction, large capitalization, value oriented companies would offer the greatest degree of safety compared to other equity style groups. However, because most large banking related stocks are categorized as "large cap value," the style was the worst performer during the first six months, off -13.1%. (Small cap value, down -8.5%, and mid cap growth, off -8.9%, fared the best.) Expectations of rising inflation even robbed the fixed income markets of a usual "flight to quality" (investors yearning for safety chase bond prices higher causing falling yields) as bond yields uncharacteristically rose and performance suffered, increasing the likelihood of stagflation. (Please refer to this quarter's newsletter for a full discussion on stagflation.)

With oil prices surging past US \$140 a barrel, the Federal Reserve faces an extremely difficult dilemma between perceived steep inflation and a slow growth economy. Mortgage defaults and falling home prices remain at the top of the Fed's crisis list. Over the past year, \$540 billion in "rate-reset" mortgages have flowed into the "risk of foreclosure" pool (180 days past their reset date); furthermore this high-risk pool is scheduled to double (between points 'A' and 'B' on the chart) to greater than \$1 trillion over the next six months.

If the Fed were to raise interest rates to fight inflation, strengthen the dollar and lower oil prices, they would knowingly hurt the already fragile banking system, force even higher loan reset rates, further contribute to falling home prices and risk sending the economy into a deep recession. Given these challenges, there is little relief in sight.

