



Executive Summary: 2Q 2008 Client Newsletter

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After recuperating from a difficult 1Q, financial markets appeared to be on a recovering trend. But by mid-May, world-wide financial markets retreated again with substantial year-to-date declines in all equity indices; see Exhibit 9 on page 8 in our full Newsletter. The reasons for this weakening include: (1) heightened concerns about the health of the US economy; (2) a substantial rise in oil prices coupled with the potential impact on global economies and inflationary expectations; and (3) a renewed apprehension surrounding the well-being of the US and international banking systems, due to their exposure to the US mortgage markets. Concerns over the stability of Fannie Mae and Freddie Mac added to this anxiety.

US Economy

The US has been experiencing a gradual deceleration in its economic growth. The economy is soft and tangible issues do exist that affect the country; yet, this is a situation where perception is more pessimistic than reality. For instance, even if GDP dips into recessionary territory, it appears any potential economic downturn will not be as severe as is presently perceived by most consumers, businesses and investors. The real potential problem is that often negative perception can and does affect consumer and business behavior in such a way that the perception itself becomes a self-fulfilling prophecy. Since the health of the US economy is delicate, but not dire, why is the Consumer Sentiment Index currently so low? Pages 2-5 in our full Newsletter offers insight into this quagmire.

Oil

While no one can know where oil prices are heading, current prices already have had a significant impact on the global economy. Three major factors have contributed to the price rally: (1) fundamental supply and demand conditions; (2) a weak US dollar; and, (3) speculation by investors. However, there is much debate on the weight and importance of each of these factors. Substantial economic growth in developing countries has changed the supply/demand equation for oil in the world economy. In terms of commodity trading speculation, the real issue is not the trading done by traditional speculators, but the actions of a “new breed” of institutional financial investors. Assets allocated to commodity index trading strategies have risen dramatically over the last few years and must have had an impact on the price of oil. Whether significant or not, the impact is still not known. Page 5 in our full Newsletter contains further details on oil.

Inflation

Led by commodity prices, global inflation has been increasing in 2008. Even though headline US CPI statistics have been edging higher, increased commodity prices have not yet started to trickle into the rest of the economy. While the Federal Reserve has been extremely active in addressing issues affecting the stability of the financial system (implementing measures to re-establish confidence and stability in the financial markets),

some measures have been criticized as inflationary. Some critics have gone as far as saying that the country is facing the risk of an inflationary spiral similar to the one experienced during the late 1960's and 1970's. Although it is true that current skyrocketing commodity prices have caused some to reminisce about the inflationary outlook of the 1970's, in fact, the US economy today has little in common with that time period. In fact, the energy shocks of the 1970's occurred during a time period that was already experiencing inflationary pressures in other parts of the economy. Find additional information on inflation in page 6 of our full Newsletter.

Other World Economies

The Eurozone has experienced an economic deceleration as higher commodity prices and the appreciation of its currency have added to the effects of the global slowdown. Tighter monetary policy already has impacted GDP growth rates, and inflation is more likely to trickle into the real economy. The prospects for economic growth in emerging markets continue to be positive. However, emerging market inflation is becoming problematic and will need to be addressed, reinforcing the trend towards lower GDP growth. Further information about this topic is found in page 7 of our full Newsletter.

Equities

Stocks continued their decline as rising crude oil prices, massive write-downs by large Wall Street banks, fears of a slowing global economy and rising inflation drove equity investors to the sidelines. However, we believe uncertain markets create opportunities for patient investors. Where appropriate, we now see such opportunities in large US and international equities and in both value and growth companies. On a more selective basis, we might find opportunities in real estate and mid-caps. Performance of equities is further discussed in page 8 of our full Newsletter.

Fixed Income

During the first two months of the quarter, government bond yields rose, reversing the flight-to-quality seen earlier, and credit spreads narrowed as corporates and agency mortgage-backed securities rose. However, by quarter-end, inflation fears and stresses in the financial system (including the downgrade of two bond insurers) weighed on the fixed income markets. While these factors may persist, opportunities exist in the mortgage and corporate sectors and, on a more selective basis, in other areas of fixed income. Read more about fixed income performance on page 9 of our full Newsletter.

Conclusion

Human nature reinforces investor behavior that often results in buying high (when the market is exuberant) and selling low (when the market is depressed); this behavior can be harmful to investors. Where appropriate, and as opportunities present themselves, SOL continually rebalances the asset allocation in clients' portfolios -- by shifting among asset classes during good times and bad -- attempting to reverse this behavior. Although we can never know when the market will bottom, investment opportunities presently are ample in most asset classes for investors with a long-term horizon. Lastly, during difficult times it is worthwhile to emphasize that a broadly diversified portfolio, a disciplined approach and patience are the most important tools needed to withstand market volatility.