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Bottom Signs Abound, But There's Still Time

*April 21, 2008
Weekly Market Beat*

A week ago Friday, the market was bemoaning the disappointing earnings report from GE, fearing the worst in front of this past week's earnings reporting period. The stock market last week, however, again fooled the majority by rising over 4%. Google, IBM, and Intel all posted better than expected profits, and provided reassuring comments about the demand for their products, especially in international markets. The takeaway from these reports was that the corporate earnings picture was not as dire away from the financial sector.

Even the sharp declines in quarterly earnings versus a year ago posted by Wachovia, Citicorp, and Merrill Lynch were not as bad as expected, unleashing a wave of apparent short-covering that sent the financial sector ahead by 5.2% for the week. But the biggest gainers for the week were energy stocks, leaping by 7.7% on the heels of a 6.1% rise in oil prices, which closed at a record \$116.90 per barrel. Not far behind the energy sector was technology, which rallied 6.3%.

Away from corporate earnings, the economic news continued downbeat for the housing sector, as housing starts and permits for March fell to a 17 year low. This had little impact on the stock market, however, as investors are now accustomed (discounting?) to bad news on the housing front. The headline inflation news was as bad as expected for the Producer Price and Consumer Price Indexes, but when stripped of food and energy, their increases were lower than expected. That news and a surprisingly strong March report on industrial production contributed to a sharp stock market rally on Wednesday.

The rally in the stock market since the March 17 low has been accompanied by increasing media attention about a recession that we are either in already or are about to enter. Away from the obvious collapse in housing, declining auto sales, and financial service woes, exports are booming, the energy sector continues its rapid growth, and the farm economy is straining at capacity. The message of the market is surely reflecting that reality. The Dow Jones Transportation Average, whose major components ship industrial, energy and agricultural commodities, is ahead 12% this year. Most of this gain has been in the railroad stocks reflecting the booming global demand for alternative fuel sources, energy products and equipment, and food stuffs. As noted above, energy stocks themselves are market leaders

As we mentioned frequently in the past few months, we believe signs of a durable bottom in stocks are becoming more visible, but have not been strong or persistent enough to suggest that *the* stock market bottom is in place or is ready to begin a cyclical bull phase. The two-year Treasury note is now over 2%, in our view this is an important sign that risk-taking in the credit markets is returning. Investors are beginning to gravitate toward corporate and mortgage securities whose yield premiums are at decade's high levels. For many market watchers a shift in such risk preferences is a condition for a sustainable uptrend in stocks. Other noteworthy

signs include deep pessimism among individual investors, and a shrinking number of stocks making new lows. Then there is the Fed, President and Congress who have vowed to do whatever is required to avoid a recession (being an even-numbered fourth year and all). This includes a record drop in the Federal funds rate over a short period of time, debasing the dollar to help exports, raising money supply growth into the double-digits, all kinds of taxpayer and Wall Street bailouts, and tax rebates starting soon. Absent a revolt of foreign holders of dollars, this potpourri of “fixes” could be enough to prevent a two-quarter decline in economic activity, and therefore an outright recession.

The important question is despite some encouraging signs, will all this largesse together with contrarian sour sentiment and nascent signs of investor risk-taking be enough to launch a new upleg in stocks? We believe the answer is, not yet. Despite signs of more calm in the corporate and mortgage bond markets since the Bear Stearns panic, yields on inter-bank loans (LIBOR) relative to risk-free Treasury bills hit new highs last week, suggesting that confidence in the banking system is still low amid announcements of falling bank asset values and eroding capital. In addition, banking sector share prices relative to the S&P 500 are still near their multi-year lows. Until the meltdown in bank stocks has ended, inter-bank lending spreads begin to fall in earnest, and corporate earnings guidance from bellwether companies turns positive, we expect the stock market to struggle to sustain an upside breakout.

Those stocks and sectors furthest removed from the epicenter of banking system woes and the housing bust have performed relatively well such as energy, commodity and precious metals that have beneficiaries of a falling dollar and the emerging market infrastructure boom. The side effect of the food and fuel price riots in some parts of the developing world has been the continued sharp gains in the stock prices of commodity producers, which should continue long after peace returns as the supply of global dollar liquidity is rising a 15% annual rate, far in excess of the requirements to finance global economic growth. This excess appears to be finding its way into the commodity markets, as a hedge against further dollar erosion and future inflation.

From an asset allocation perspective, it is likely too early to have an above normal weighting in equities, and too late to be overly bearish. Though new lows in the stock market are possible in this base building phase, those circumstances should be used to become more exposed to stocks, not less. Selling weakness, given the destruction in share prices that has already taken place may not now be rewarding. As for bonds, Treasury bond yields appear to have amply discounted the odds of a recession, and are not likely to move meaningfully lower. Given the generous yield premiums on corporate, municipal, and mortgage-backed bonds, however, a gradual movement toward these securities for income-oriented investors may be warranted.



Thomas J. Steffanci, Ph.D.
President and Chief Investment Officer

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