



STRATEGIC FINANCIAL
MANAGEMENT GROUP



Investment Strategies & Insights

1st Quarter 2008

Hope Springs Eternal

This is the time of year when thoughts turn to new beginnings. We see signs of the re-emergence of flowers and plants as Spring bursts on to the scene and Winter fades away, as a new season begins. Over the past months the financial markets have gone through a turbulent time as the combination of a slowing economy and problems in the credit markets shook investor confidence resulting in a shift to a Bear market in stocks. After reaching lows in the middle of March that were almost -19% off of the October '07 highs, stocks have rallied +7.5% off of the bottom. This recent rally has now sparked the debate of whether the worst is over... has the Bull market returned... do stocks have new life again? In the minds of many hope does in fact spring eternal, but hope alone does not provide a firm foundation for prudent investing.

Investor attitudes are of great importance and their perception often dictate the reality of what happens in the financial markets. The natural tendency towards optimism has actually been confirmed by a recent study by researchers at New York University where they have identified brain clusters that are responsible for this trait. One of the researchers stated, "Although extreme optimism can lead people to underestimate risks and put themselves in harm's way, a moderate level of hopefulness has been linked to physical and mental health."

So there lies our task...to maintain a moderate level of optimism while avoiding extremes that cloud our judgment and exposes us to excessive risks. In order to strike the proper balance, we believe that we need to make a realistic assessment of the economy and the financial markets rather than just sing that the sun will come out tomorrow despite the lack of hard evidence to support the increasing upbeat forecasts.

Which Do You Want First...The Good News Or The Bad?

In making evaluations of financial conditions, it is always a good idea to make sure that you are looking at things in the proper context. Regardless of how much of an optimist you are, it is difficult to find a lot of good news over the last nine months. Initial concerns over a slowing economy increased as the residential real estate bubble began to burst. Concerns grew into fears as the problems in sub-prime mortgages surfaced, exposing the tremendous risks that had been created in the credit markets by the brokers, the banks, and the hedge funds. Fears led to panic as the losses in the financial sector rose to over \$500 billion and Bear Stearns faced collapse until the Federal Reserve backed a play by J. P. Morgan Chase to avert the crisis.

The shocks to the financial markets were not related to the economy, but were self-inflicted and the result of problems with the system itself. As such, correcting the problem becomes much more difficult since normal monetary stimulus does little to address the real underlying problem. It will take time for the excesses of the credit markets to unwind and we believe that the losses will continue to mount, further impacting the earnings of financial companies negatively.

Even though we think that there will be few positive economic surprises in the next 3 to 6 months, we still do not see a deep recession being highly probable. The reason is that corporate America is in much better shape than previous recessions due to low debt levels, low inventories, and not much excess capacity. This recession is led by declines in consumer spending, driven by the falling housing market and the increased difficulty in obtaining credit. An economic recovery can begin when the credit markets stabilize, housing prices bottom out, and the consumer begins to feel encouraged that the employment outlook is safe. The good news is that the stock market normally leads the economic upturn when investors feel confident that the sun will actually come out tomorrow and realistic optimism is warranted.

"Hope, as a wise man once said, has never been a viable investment strategy."

Rob Arnott

SUMMARY:

The hope that stock prices have bottomed must be tempered with the issues still confronting the financial markets.

Credit markets must return to solid footing and the Fed is attempting to restore confidence with aggressive actions.

Economic downturn...or recession... should be short due to the strong financial condition of U.S. corporations.

Consumers will lead economic recovery as housing market stabilizes and the employment outlook is safe.

Aggressive stimulus by the government to get money into the hands of consumers with rebates should help.

Stock prices typically lead the economic recovery by six months in anticipation of future growth.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- Inflation continues to be a concern with record oil prices and the attempts of the Federal Reserve to “reflate” the economy.
- The Consumer Price Index (CPI) rose 4.3% year-over-year, due primarily to rising food, commodity, and energy prices
- More concerning is inflation at the producer level which grew to 6.3% year-over-year.
- The inflation battle will be between companies wanting to pass through higher prices while the economy is weakening.
- The Fed will remain willing to lower rates to attempt to avoid a deep recession and worry about inflation later.

Economic Output and Direction

- All of the economic indicators remain negative and are not showing signs of improvement yet.
- The head of the National Bureau of Economic Research, the arbiter of U.S. recessions, stated that he believed that we have been sliding into a recession since December or January.
- The Fed Chairman, Ben Bernanke, has also suggested recession for the first time, but both believe that there should be a bounce in the second half of the year.
- If that occurs, this economic slowdown would be relatively short and mild.

Business and Consumer Indicators

- Weakness persists in both the service and manufacturing sectors with a substantial decline in new orders.
- Even though personal income rose last month, spending was flat indicating that the consumer is beginning to tighten the purse strings.
- This attitude is reflected in continued declines in consumer confidence, possibly related to recent weakening in the employment data.
- The greatest impact on consumer attitudes, other than their job situation, is how the slumping real estate market is affecting the value of their homes.
- New and existing home sales continue to decline, along with prices, indicating that we have yet to reach bottom.

Inside The Markets

The Stock Markets

- The Bear market continued in the 1st quarter as every attempted rally eventually failed with stock prices reaching a low in the first week of March.
- The current bounce appears to lack conviction, and trading volume, and will have to overcome weak economic news.
- In addition, earnings for the troubled financial sector will be released in the middle of April and bad news could put the market under pressure again.
- Even though the downside risk is not great at this point, stocks could remain in a narrow trading range for a while.
- International markets have corrected as well, but long-term global growth in the emerging economies is still intact.

The Bond Markets

- The price of Treasuries continued to rise as investors looked for safety as uncertainty in the credit markets rose.
- As a result, the spread between interest rates on U.S. government and lower quality bonds widened, increasing the cost of borrowing for corporations.
- Shorter-term yields have dropped as the Fed has continued cutting the Fed funds rate, and this trend should continue for the near future.
- Even though the U.S. dollar has rallied a bit lately, it remains very weak relative to other currencies.
- As a result, the European Central Bank is under increasing pressure to cut interest rates to curtail the rise in the Euro, as well as stimulate a slowing European economy.

Commodities / Alternatives

- Commodities suffered a -9% correction in March but have rebounded strongly to continue the long-term uptrend.
- Rising prices have not only been in oil, but grains and materials as well.
- Volatility should be expected as these markets get overbought, but the trend remains in place.
- The same is true for other long-term trend strategies, like water and alternative energy, as global demographics and demand should force prices upward from current levels.



One of the dominant themes in books written on investing is that to be successful you have to take emotions out of the equation. Many will offer models for making investment decisions that have worked in the past and encourage reliance on the data, not your feelings. There is definitely truth in this sentiment since the biggest mistakes made by investors are usually those driven by greed or fear. But to believe that you can remove emotion from investing is naïve at best. When the markets soar it is easy to feel euphoric...as well as brilliant, but when the losses begin to mount, fear and anxiety begins to grip you. We believe that you have to acknowledge that feelings are real, but you have to strike a balance where perceptions do not become your reality when the facts indicate otherwise.

When the economy and the financial markets go through difficult times, it is very easy to identify the impact of emotions in the increased volatility in the prices of the stock indexes. In fact, through the end of March we have experienced the highest volatility, daily moves up or down of 1% or greater, since 1938. There are many reasons for these swings, but it is evident that the hope that the worst is over is doing battle with the fear that there is more to come.

So how do we go about evaluating the massive amount of information that is dispensed every day concerning the financial markets? We first rely upon trusted sources that provide consistent and reasoned research. Then we attempt to determine the areas of most concern and what signals and indicators we should be monitoring in order to see the probable outcome of the issue. Lastly, we try to put the weight of the evidence, both economic and financial, into the context of an expected timeframe until resolution.

As a result of this process, we believe that the economy will continue to struggle for the first half of the year at a minimum. The indicators that will be important in determining economic direction are employment data, personal income, consumer spending, and residential real estate sales and prices. Improvements in these areas are key to a rebound in the economy and signs of any strengthening would be an early alert.

The continued problems in the credit markets will have to be resolved for the financial markets to be able to focus on the economy and the fundamental issues of earnings and the prospects for growth. Even though we were at the precipice of a crisis with the potential bankruptcy of Bear Stearns, the good news is the bold move of the Federal Reserve demonstrated that they will be the lender of last resort. Interest rates have been slashed and liquidity has been pumped into the financial system. Regulatory moves to free up capital in the mortgage market have been initiated.

All of these unprecedented stimulative efforts should soon have an impact on both the U.S. and global economy.

In addition, the government is taking action to spur consumer spending by simply sending \$600 to everyone that qualifies. In order to stabilize the residential real estate market, both the Congress and the White House are proposing various forms of relief to homeowners facing foreclosure. We believe the net effect of all of these approaches to shore up the financial markets and stimulate the economy will soften this economic downturn.

It has been said that 'people always hope for the best, even in the face of adversity'. We believe this has to be balanced with the knowledge that the 'excesses of hope and expectations improperly indulged must end in disappointment'. Our strategies will be guided by the reality of what the markets reveal and at this time, we believe that a defensive posture is appropriate for the near future.

Best regards,

Craig Greenway

Investment Strategies & Insights
is written by the scribes at Strategic Financial
Management Group.

For more information, contact:

Craig M. Greenway, CFP®
Strategic Financial Management Group
5310 Harvest Hill, Suite 226, LB 105
Dallas, TX 75230

972-960-6460 (Telephone)
972-960-6455 (Fax)

cmgreenway@sfgadvisors.com
www.sfgadvisors.com

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