

## **Market Update – May 15, 2008**

The global markets have settled down since “Bear Stearns Monday” back in March. Volatility, while still evident, is not as violent as it was during the first quarter of 2008. The Federal Reserve continues to act in stemming the credit and economic woes by reducing interest rates and injecting liquidity into the system. The credit markets have improved and capital is moving again, albeit much more cautiously. The housing slump is still an issue as prices continue to decline and foreclosures rise. There are certain areas of the country which are feeling the effects more than others – the Northeast seems to be the least impacted at this point.

So what has happened in the past several weeks? The Federal Reserve really changed the game when they bailed out Bear Stearns and opened their (our) balance sheet up to the remaining investment banks. The possible “run on the bank” scenario has been rendered impossible. So a return to the volatile fear trading of the January-March timeframe wouldn't seem reasonable given the Federal Reserve has become the ultimate “Sugar Daddy”

Although the Fed is providing liquidity, we suspect major banks will remain guarded in lending practices for a while longer, concentrating instead on rebuilding capital that has been seriously impaired by mortgage-related write downs and forced sales of securities that were weighing down balance sheets. While the Fed's liquidity infusions are helping, a much bigger contribution to balance sheet repair will flow from the spread between long and short-term yields that are being anchored by the 2% federal funds rate. In other words, banks can raise short-term funds through deposits and pocket the difference obtained on longer-term, higher-yielding assets, such as Treasury securities. This rebuilding of capital takes time and will not happen overnight.

Currently the US market is struggling to price a world where liquidity is improving, real economics are slowly deteriorating, and commodity prices are rising. Earnings reports for the 1<sup>st</sup> quarter were “better than expected” for many companies, but were still negative overall. If you take out financial companies the earnings would be positive for the quarter. However, expectations were lowered during the quarter before earnings were reported, so this has to be taken in context. It is important not to confuse “better than expected” with “very good.” Now if you ask us where the stock and credit markets will be in a year, we would probably say both will be in better shape as conditions improve. Looking to next summer, we'll probably be through this recession or near the end, housing will have bottomed, and there will be much more earnings clarity. However, in the near term, the markets are trying to assess the overall impact the recession will have on economic growth and corporate earnings. The up and downs of the market will likely continue until this uncertainty lessens. Gas prices seem to be the one wildcard and could further impact spending if prices continue to rise.

Eventually the Fed stimulus will begin to work through our economy and conditions will improve. In the near term we could see increased volatility. It is likely that a year from now, economic activity will increase resulting in stronger GDP growth in the US and in turn throughout the globe.

Have a great day and be sure to contact me if you have any questions. Thank you for your trust and I look forward to talking to you soon.

- Larry

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