

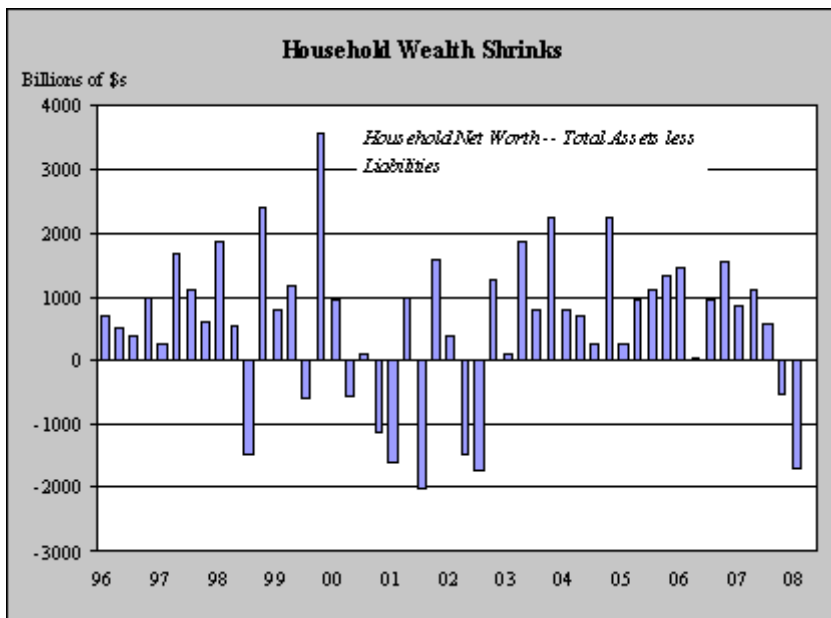
Market Update – June 17, 2008

In the last update we mentioned the US markets were struggling to price a world where liquidity was improving but real economics were deteriorating. Fast forward one month and the market is continuing its struggle as per barrel oil prices are at record levels, gasoline prices are over \$4 per gallon, and food prices continue to increase on an almost weekly basis. We are currently living in a world where there is inflation in things we need (food, gas, healthcare) and deflation in things we want (computers, electronics, autos, housing). The surge in food and gas prices is taking an ever larger toll on household spending negating efforts to maintain living standards. Each \$1 rise in gasoline prices translates into a roughly \$120 billion hit to discretionary spending. While households are spending less on energy compared to the 70's, the part of spending devoted to energy consumption has doubled over the past year.

Given the above mentioned headwinds facing the consumer, it was surprising to see that retail sales increased by 1% in May and the numbers for the previous two months were revised higher. Many economists had predicted a negative retail sales reading for the month adding some evidence to the argument the economy has drifted into a recession. Since consumer spending accounts for roughly 2/3 of total economic activity, it is likely we will see a decent GDP report for the second quarter based on these reported numbers. According to calculations by the Commerce Department, the retail sales gains in April and May indicate real consumer spending could reach 1% in the second quarter, enough to keep GDP in positive territory. So the question is – what is fueling consumer spending?

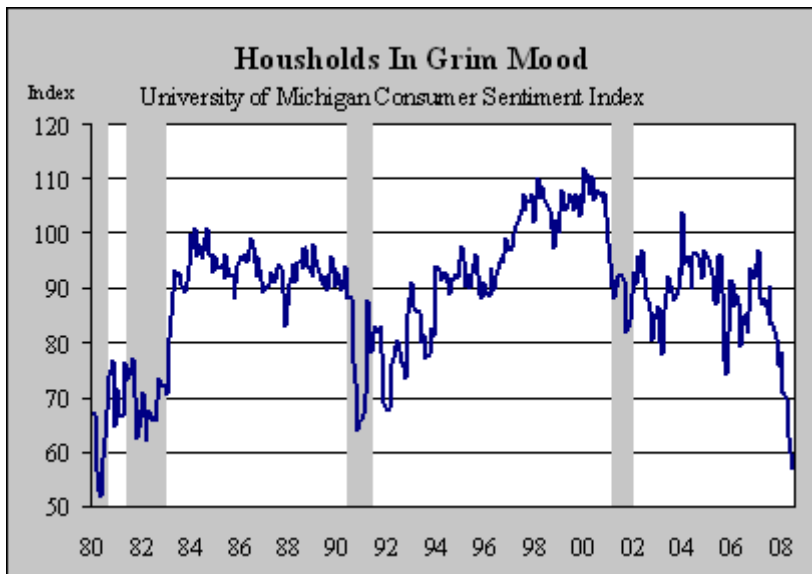
The answer – rebate checks. Roughly \$55 billion was mailed out in May which had an impact on the retail sales figure for the latest month. Spending in June and July should receive another boost as another \$50 billion or so expected to reach consumers by the end of this month. Not only are the rebate checks working their magic in the second quarter, there will likely be some spillover in the third quarter as well. Some economists believe this retail sales lift is an aberration and we will begin to see negative numbers moving forward after the stimulus wears off; while others claim the consumer is more resilient and will continue to spend, even with high energy prices.

The major influence that will weigh on consumer spending is the ongoing housing deflation that is showing no signs of letting up. Yes, the plunge in home sales may become less severe in coming months, thanks to improving affordability. But with the inventory of unsold homes still at a burdensome 10 months supply (5 months is average) and surging foreclosures at roughly 50% over last year is adding to the burgeoning list of homes for sale, the downside pressure on housing prices will persist for some time. That portends continuing erosion in household net worth, which has now shriveled by an estimated \$2.2 trillion over the last two quarters. Estimates vary as to the impact such wealth erosion has on spending, but the latest studies indicate that about 5 cents of every dollar of evaporating net worth is pulled out of the spending stream. That would translate into a spending retrenchment of roughly \$100 billion, offsetting the boost imparted by the rebate checks.



As we head into summer, it's hard to see the Federal Reserve changing its stance and begin raising interest rates any time soon, despite the growing expectations on Wall Street that such a move is just around the corner. The Fed futures market is pricing in a rate hike as early as the August 5 policy meeting, which would mark one of the fastest turns in Fed policy ever. To be sure, monetary officials are doing nothing to discourage such speculation. Fed chairman Bernanke has sounded increasingly hawkish in recent public appearances. Bernanke as well as the other hawkish-sounding Fed officials are responding to the persistent increase in oil and other commodity prices as well as to the slide in the dollar, which has also contributed to the surge in headline inflation. From where we stand, neither the credit markets nor the economy is strong enough to handle interest rate increases and the main purpose of the Fed statements is to appease the inflation hawks and to keep inflation expectations in check.

While consumers may be spending more than expected, they are hardly in an upbeat mood. According to the latest Reuters/University of Michigan sentiment survey, household spirits have sunk to the lowest level since May 1980. We guess consumers may be spending their rebate checks, but clearly are not happy doing it. They are worried about future employment prospects, soaring gasoline bills, upcoming winter heating bills, and the contracting housing market. Of course, these spirit-dampening influences have been battering confidence for the better part of a year without producing a tangible decrease in spending. You have to wonder if the cumulative effects of the various headwinds against the consumer will eventually have a meaningful impact on spending. So far it hasn't and we will have to wait a few months (after the checks have been spent) to find out. However, it's unlikely that the Fed will take the chance of adding to household woes by hiking interest rates this year.



In the near term uncertainty remains for both economic growth prospects as well as the potential increase in the rate of inflation, which is negative for equities and bonds alike. We should continue to see modestly high levels of volatility during the summer months as below average trading volume tends to accentuate up or down moves in the markets. We wouldn't be surprised to see the US markets trade both higher and lower during the next few months; yet not gain any ground versus today's levels as both bulls and bears battle over the prospects for the economy, energy prices, and the consumer. Surprisingly, the major US markets are currently near the same level today as they were at the end of March.

As we head toward the midpoint of the calendar year, we do have reason for cautious optimism. Despite the credit crisis, debt issues, housing depression, higher energy prices, an election, and various geopolitical risks, the markets are only down single digits for the year. That doesn't suggest negative events or unusual circumstances have disappeared; it may suggest markets have factored for the worst case and are beginning to look beyond the current negatives.

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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