



# EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

## NEWSLETTER

April 2008

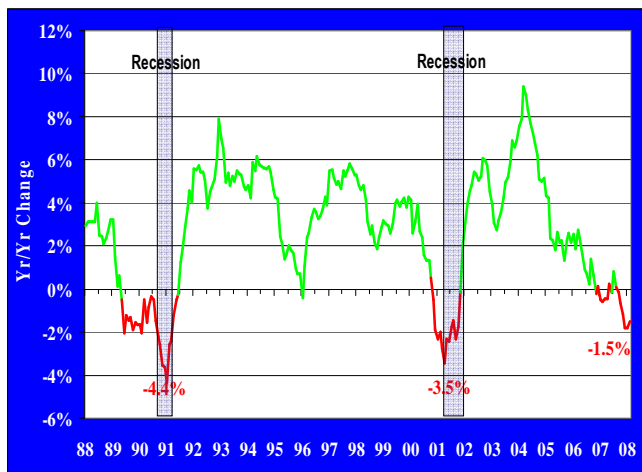
### A "BEAR" OF AN ECONOMY

*Impacting the consumer and corporate profits*

Whether or not the economy is in a recession will not be determined for many months. In the meantime, the consumer, the homeowner, the employee, and the business person already feel they are in the midst of one. Although, it is not yet at the depths of the prior two business downturns, the Index of Leading Economic Indicators is in negative territory just as it was before the 1991 and 2001 recessions (see Chart I). Additional signs of economic weakness are sluggish retail sales, lack of employment growth, a weak housing market, rising mortgage delinquencies, and a financial system struggling with excessive sub-prime loans packaged in the form of complex securities.

**CHART I**

Index of Leading Economic Indicators  
1988- 2008



At the same time, the weakening economy is accompanied by rising inflationary pressures. The escalation in crude oil prices directly impacts the consumer at the pump and indirectly through the rising cost of food, transportation, and plastics, which

use crude oil. The decline in the value of the dollar relative to foreign currencies adds to our inflation by raising the cost of imported goods. The dollar has fallen to its lowest level in decades, declining nearly 40% since its peak prior to September, 2001. In the last year alone, its value declined more than 12%.

These factors should be reflected in the economic numbers for the first half of the year. The economy, which gained only a marginal .6% in last year's fourth quarter, may have declined in the recently completed March quarter. Depending on the timing of the distribution of the Treasury's stimulus checks and how soon those funds are spent, the second quarter may show some improvement over the first. Some checks could come as early as May. Overall, however, soft business conditions could be prevalent for much of the first half of this year.

Corporate profits will undoubtedly be impacted. Margins are expected to contract as companies have difficulty passing their increased costs forward to the consumer. Net profit margins for the Standard & Poor's Index, which were as high as 9.3% in 2006, contracted to 8.5% last year and are likely to fall further in 2008. Profits could decline 8% - 12% during the first half of the year. By way of comparison, this is significantly less than the 31% and 20% declines experienced during the 1991 and 2001 recessions.

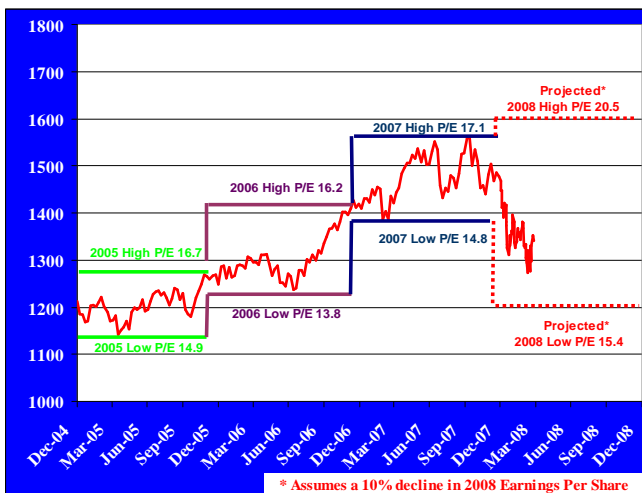
During the second half of the year, the economy is expected to strengthen. The stimulus checks should provide a temporary injection to consumer spending over the summer months. Going forward, the lagged effect from the Federal Reserve's interest rate cuts should have a more sustained impact. Profits should improve with a marginal year-over-year gain in the

third quarter followed by a double-digit percent gain in the fourth quarter against a drop in last year's closing quarter.

## INVESTMENT STRATEGY

The weakness in stocks could continue over the next several months as the economy conditions remain depressed, speculation on the upcoming Presidential election intensifies, and investors await a more visible resolution to the crisis in the financial markets. Recognizing these risks and weak earnings reports anticipated for the recently completed March quarter, the projected 2008 trading range for the Standard & Poor's Index has been reduced from 1,300 -1,700 to 1,200 – 1,600.

**CHART II**  
Value Range for the Standard & Poor's Index  
1988- 2008

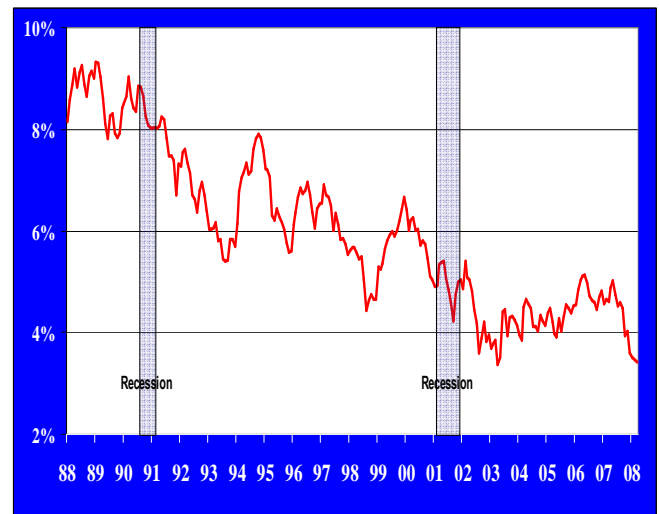


Yet, most of this “bear” market may be behind us. First, the aggressive application of fiscal and monetary policy should curb both the depth and duration of the economic downturn. Second, this market decline was preceded by a peak October price-earnings ratio of only 18, a modest valuation in contrast to 31 that preceded the 2000-02 “bear” market. Third, “bear” markets not preceded by excessive valuation, had an average decline of 18%. The recent market decline was also 18%.

While there is still considerable risk and uncertainty relative to the economy, the credit markets, and earnings, most of the bad news may already be reflected in existing stock prices. History has shown

that stock market troughs commonly form during periods of poor investor sentiment, low valuations, and after extensive declines. Therefore, the recent decline in stocks may already discount current economic conditions. Furthermore, low interest rates help support existing price-earnings ratios, thereby limiting additional downside risk.

**CHART III**  
Ten Year Treasury Yield  
1988- 2008



The outlook for the fixed-income markets is not as favorable. Interest rates are now near their 20-year lows and at levels that are unlikely to persist once the economy stabilizes. When the Federal Reserve's priorities shift to protecting the dollar and curbing inflation, interest rates are likely to rise causing bond prices to fall. Price declines in bonds could offset a good portion of the modest interest coupon. Therefore, the fixed-income portion of the portfolio should continue to be under-weighted.

The risk/return prospects appear more favorable at this time for stocks versus fixed-income securities. A gradual redeployment of cash reserves, which were accumulated toward the end of last year, into stocks would be appropriate. Such investments, however, should focus on companies with a solid financial condition, a strong leadership position in their respective industry, and an above-average dividend yield in the event the current economic downturn lasts longer than expected. Exposure to the financial sector in both the bond and stock portions of the portfolio should be limited until the problems in the credit markets subside.