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

NEWSLETTER

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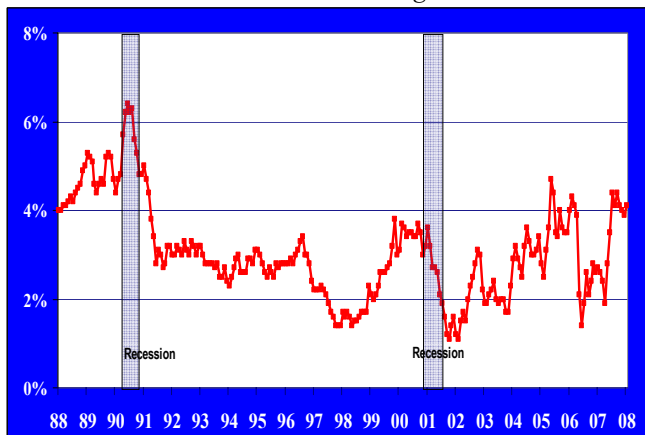
REBATE CHECKS MAY NOT BE ENOUGH

Government prescribed “stimulant” or “anti-depressant”?

To stem the recent deterioration in the economy, the U.S. Government issued stimulus checks of \$300 to as much as \$1,200 to most households.

This was part of a fiscal package passed this Spring to give households approximately \$110 billion to help cope with record energy costs, rising grocery bills, and the current housing crisis. The stimulus package also provides \$50 billion in accelerated depreciation benefits to encourage business investment.

CHART I
Consumer Price Index
Year/Year % Change



In a similar fashion, the Federal government issued rebate checks in 2001 and 2003. They were effective in accelerating consumer spending and they led to stronger economic growth. The recently distributed funds should also accelerate in economic activity. This time, however, the effect is likely to be muted and may not be as durable as in 2001 and 2003. First, the depreciation in the dollar, just since the beginning of the year, will cost the American consumer more than \$100 billion this year in the form of more expensive imports. Second, the rise in the cost of gasoline amounts to another \$130 billion.

Third, the inflation in corn (aggravated by flood damaged crops), soybeans, beef, chicken, and pork increased food costs about \$65 billion in the last twelve months. Thus, the stimulus checks don't even offset half of our escalating costs and may be better described as only a mild “anti-depressant.”

Compounding these inflationary pressures are several additional economic “headwinds”.

- ◆ **Housing** - The cyclically-sensitive residential housing sector continues to be plagued by a combination of excess inventory, rising mortgage rates, and a deepening credit crisis.
- ◆ **Consumer Spending** - Consumer's ability to spend will continue to be constrained by meager savings over the last year, the rising cost of living, and weakening employment prospects.
- ◆ **Fiscal Policy** - The government's fiscal stimulus has already had its greatest impact, and further benefits from that program will be diminishing.
- ◆ **Monetary Policy** - Due to the weak American dollar and rising inflationary pressures, the Federal Reserve is no longer in a position to offer the monetary stimulus that it made available over the last year.

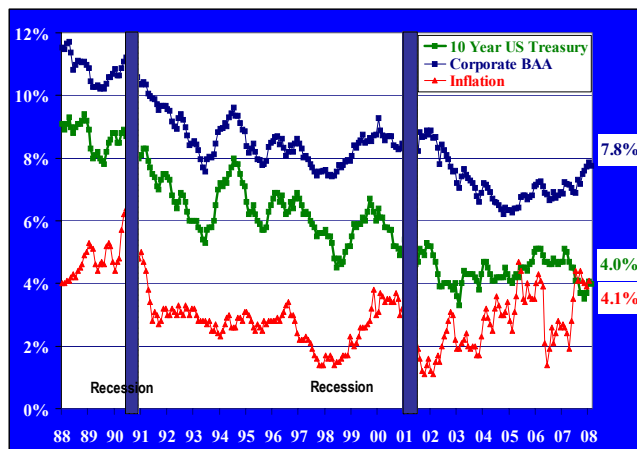
As a result, the economic risks may not abate during the second half of the year as underlying economic weakness becomes less disguised or distorted by earlier monetary and fiscal stimulants that have already “run their course.” Nonetheless, an improved foreign trade balance (a benefit from the weaker dollar) should cushion the deceleration process. This may help the economy dodge the technical definition of a recession, even though the prolonged economic malaise may feel like one.

INVESTMENT STRATEGY

After a series of eight interest rate cuts over the last ten months, the Federal Reserve decided not to have another at its June meeting, signaling a shift in monetary policy from assisting the economy to fighting inflation. Inflation is not only a problem in this country, but also overseas, particularly in the emerging markets. In many of these countries, including our own, short-term interest rates have not kept pace with rising inflation rates. This is likely to influence the Federal Reserve and central bankers around the globe to raise interest rates sooner than they would otherwise prefer.

In anticipation of a tightening monetary policy, the ten-year U.S. Treasury yield advanced nearly 60 basis points from 3.4% to 4.0% in three months, causing the price of the ten-year Treasury to drop 4.5%. While investor yields are now much improved from three months ago, government bonds still yield less than inflation, thereby denying investors a positive inflation-adjusted return (See Chart II). In this respect, government bonds could be subject to additional price weakness over the balance of this year and into 2009. Corporate bond yields, however, are more attractive. Therefore, any activity in the fixed-income portion of the portfolio should focus on the corporate sector and the better quality within that sector.

CHART II
Bond Yields vs. Inflation
1988-2008



Stock prices recovered during April and the first half of May, but then succumbed to a sharp retreat with the Dow Average falling below its March low and the Standard & Poor's Index very close to it. For the last three months, the Dow's price decline was 7.4% and Standard & Poor's Index was 3.2%. June's price decline for the Dow was its worst since 1930. While write-downs in the financial

sector make earnings estimates quite elusive, profit projections for the market as a whole are coming down and beginning to adjust to the weak economic environment. Mid-year earnings reports and corporate forecasts for the balance of the year could exert additional downward pressure on stocks.

Table I compares our projected 2008 value range for the Standard & Poor's Index against actual valuations for the last two recessions, recognizing the inverse relationship between interest rates (ten-year U.S. Treasury bond) and price-earnings ratios. The 2008 projected value range of 1,200 – 1,600 remains unchanged and allows for as much as a 10% decline in corporate earnings from 2007 levels, well below the current consensus forecast.

In addition, the low end of the value range is based on a modest price-earnings ratio of 15.5. By way of comparison, the 1990-91 recession had a similar valuation but that was against an interest rate environment in which government bonds were yielding twice as much as today. More recently, the 2001 recession had a trough valuation with the price-earnings ratio at 17.0.

TABLE I
Recessionary Valuation Analysis
S&P 500 Index

	1990-1991	2001-2002*	2008 Projected
Interest Rate - 10 Year Treasury	8.2%	4.8%	4.2%
Peak Price-Earnings Ratio	19.4	26.1	20.6
Trough Price-Earnings Ratio	15.5	17.0	15.5
EMFA Estimated Trough Earnings**			\$77.58
			Value Range High Value Range Low
			1600 1200
Standard & Poor's Price	06/30/08	1280	
			Projected Upside Projected Downside
			25.0% -6.2%

*Recession occurred in 2001, stock market troughed in 2002

** 10% decline from 2007 reported earnings

Based on the above, the low end of the 2008 value range appears conservative and discounts much of the economic risks that lay ahead. While near-term investor caution should be maintained, the projections at the bottom of Table I show a significant imbalance between the downside risk and the upside return potential. The current market environment will eventually lead to attractive investment opportunities.