WINTHROP
Capital Management

Economic & Capital Market Summary

Second Quarter, 2008

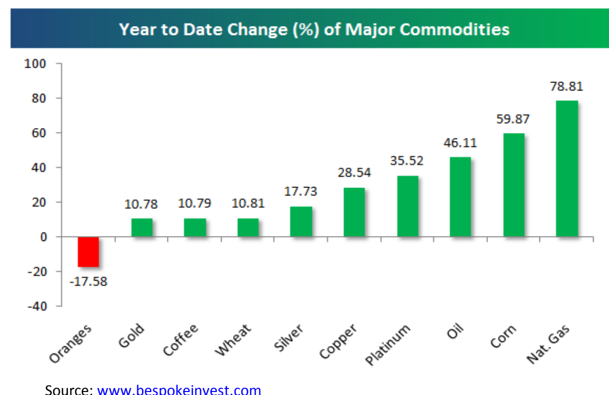
The Economy

There is no doubt that we are experiencing a severe slowing in economic growth and a rapid acceleration in the rate of inflation…

Growth in the U.S. economy continued to slow during the second quarter of 2008 and it now faces challenges from two fronts: a rise in the pace of global inflation and the continued deterioration of the U.S. financial system. During the second quarter, GDP grew by an estimated 0.7%, following a 1.0% growth rate for the first quarter. At the same time, oil spiked over $140 a barrel, the Dow Jones Industrial Average declined to 11,350 and the yield on the ten year U.S. Treasury climbed to 4.20%.

Whether our current economic state is ultimately defined as a "recession" or not, time will tell; however, it sure feels like one. As much as we would like to believe that what we are experiencing is a typical business cycle slowdown, it is clear that this economy is digesting excesses which existed in the markets for several years. Those excesses include an over built housing sector and liberal access to credit that resulted in a consumer spending spree which supported economic growth from 2002 to 2007.

The U.S. consumer has one more problem to add to their list of issues. In addition to falling home prices, tighter credit, surging energy prices and rising unemployment, the recent spike in inflation is reminiscent of the mid 1970s. A survey of Chief Financial Officers released by Duke University last month showed that nearly half of the CFOs surveyed intend to pass through higher commodity and energy costs to their customers. The result of inflation is higher prices that consumers pay for goods and services.



Source: www.bespokeinvest.com

The severity of any economic downturn is magnified when the financial system is broken. The U.S. financial system is in its worst shape since 1991 when major money center banks were reeling from Latin American loans, bad commercial real estate investments, rising defaults and deteriorating capital levels. So far banks have been forced to raise over $300 billion of new capital in order to maintain minimum capital requirements. And, they're not finished. Estimates range from $30 to $60 billion more in capital to support additional write offs of bad loans this year. So far this year, the FDIC has taken over six banks.

The recent downgrades of MBIA and AMBAC (the municipal bond insurance companies) from AAA to A will exacerbate the problems in our capital markets. In our recent article The Municipal Bond Insurers - What Just Happened!? We discuss the implications these recent downgrades will have, including the need to increase capital for financial institutions which invest in insured bonds. The hard issue we are facing is that the troubles in our financial sector are negatively impacting opportunities for economic growth.

During the second quarter the equity markets, measured by the S&P 500, declined -3.2% and the bond market, measured by the LBA, declined –1.02% as yields on U.S. Treasury securities increased across the maturity spectrum. It was clearly not a good quarter for financial assets.

Monetary Policy & The Fed

…and the Federal Reserve is caught between a rock and hard place.

Right now the Fed is buying time. They have clearly signaled that there is no need for further reduction in short term interest rates. The Federal Reserve, under Chairman Bernanke's leadership, is still trying to navigate between the trouble in our capital markets, growing inflation and the slowing economy. We believe the Fed has to this point made great progress in establishing investor confidence in the U.S. financial system through back-stop lending. However, we're not out of the woods yet. The almost insatiable needs for more capital by the major banks combined with the recent downgrades of the bond insurers from their vaunted AAA rating will have consequences throughout our financial system. The number one rule for a Federal Reserve chairman is to provide liquidity in times of financial crisis and to stimulate economic growth. Our financial system still needs liquidity in order to lubricate the cogs of the capital markets, provide lending, and allow for capital formation which results in continued growth. With consumer confidence plummeting to the lowest levels since 1992, in spite of the tax rebate checks sent last month, economic growth would benefit from more liquidity. That is "the rock".

However, at the same time that we need liquidity in the financial system, inflation is rising. The second rule, if you are a Federal Reserve chairman, is reduce liquidity at the first sign of accelerating inflation. Here is "the hard place". The price of oil is up 40% this year. The impact on gasoline, jet fuel, the travel industry, food prices, and the level of SG&A of most companies is significantly impacted. The flooding in the Midwest has reduced 8% of corn planted which impacts food prices as well as ethanol. Core inflation (which excludes price increases for food and energy) is increasing at the rate of 2.4% which is up from 2.0% last year. However, if inflation were calculated in the same manner it was back in 1979 (which would include energy and food), it is estimated that inflation today is increasing at a rate in excess of 10%. Unfortunately, for those of us who were around in the 1970's, it sure feels like it did back then.

Investment Strategy for the Third Quarter, 2008

The equity market has been a tale of two markets: the financials and the rest of the market. The dramatic repricing of risk in the equity market has left us with a desire to keep some powder dry. Until there is better transparency to earnings, we're not keen on the financials. We still like the energy and defense sectors and, as value investors, the pharmaceutical sector is looking interesting at its current depressed valuations.

With yields approaching 9.0% to 10%, we believe there is opportunity in certain bank and insurance preferred stocks. Banks have the challenge of shoring up capital and have, in the process, issued more equity which is dilutive to current common and preferred shareholders. Insurance companies do not have the same degree of magnitude of the problems that the banks have but have been swept in the downdraft with the rest of the market.

In the fixed income market, bank, finance and insurance companies on the short end of the yield curve offer excellent risk/reward at current spreads. While we're early on our allocation to high yield, we think there is good relative value in the higher quality end of the high yield market. High yield returned 1.76% measured by the Lehman High Yield Index for the second quarter. That said, as Steve points out in the Equity Market Summary, we are not as constructive on the auto companies.

Gregory J. Hahn, CFA
President & CIO

Stephen P. Carr, CFA
Portfolio Manager

This report is published solely for informational purposes and is not to be construed as specific tax, legal, or investment advice. Nor is this document intended as a solicitation or an offer to buy or sell securities or related financial instruments. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. The comments are based on current market conditions. Different market conditions and assumptions could have materially different results. Neither Winthrop Capital Management nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report.
©2009 Winthrop Capital Management