



2nd Quarter 2008 Commentaries

Domestic Equities

Domestic Equities had their worst start since 2001 during the first quarter of 2008. The Dow Jones Industrial Average fell 7% with the Nasdaq Composite declining double the Dow at 14%. Then came the second quarter where the early days of April saw the best quarter start for the Dow since 1938. On April 1, the popular average gained 392.3 points, or 3.2% to 12,655.2. The rally was short-lived when a number of closely watched companies including Alcoa and General Electric reported disappointing earnings. By mid-April, they were back down to late March levels.

As the quarter progressed and companies continued to report, it was clear that overall first-quarter earnings were on track to post a 15% decline according to Thompson Reuters. Excluding financials, earnings were coming in relatively healthy and slightly above expectations. Investors took heart and stocks moved higher until mid-May. From there, stocks seesawed with prices trending lower late into the quarter.

For the full year, analysts have been expecting earnings to be up 10%. This translates into a slight loss in the second quarter and very solid earnings in the third quarter and a fourth quarter. In fact, to meet expectations earnings would have to be the most profitable in history. Early in April, the consensus forecast for full-year 2008 earnings had been for roughly \$93 a share for the Standard & Poor's 500, a level we viewed as too rich.

During the quarter, a steady increase in energy prices and the rate of inflation (worldwide), weighed on stocks prices. It was becoming clear late in the quarter that most analysts were overly optimistic for corporate earnings as estimates began to be trimmed.

During the first quarter, we experienced a decline in equities that was credit-led. The second and current downward leg, appears earnings driven. While credit issues remain and will likely continue to play out over several quarters, credit is no longer the driving factor. Domestic stocks are currently squarely in the crosshairs of high energy prices and declining expectations.

We expect stock prices to remain volatile and to continue to trade lower into the third quarter. The problems for domestic stocks are numerous including earnings volatility (at an all-time high), continued deleveraging in the financial sector (especially in Europe where banks are more highly leverage), European Central Bank (ECB) intransigence (the probability of ECB rate increases), and high commodity prices. We expect stocks to bottom late in the quarter.

Given the current fundamentals, our year-end S&P 500 target is 1350. Critical to this forecast, GDP growth has to be slow enough to stop commodity prices from rising yet fast enough to justify earnings estimates. These two objectives are now increasingly looking incompatible tipping risk to the downside.

Overall, we have a neutral weighting on domestic equities. Of the individual sub-sectors of domestic equities, we currently favor small caps longer-term for investors with a moderate risk tolerance.

A number of events could change our outlook for equities including if oil prices fall towards \$80, the ECB shifts its focus from targeting inflation to targeting growth, the S&P falls to 1200, and if the housing market shows signs of recovery.

Developed World Countries

It had been the expectation of the European Commission for any euro-zone slowdown to be modest. The Commission forecast 1.8% growth in 2008 down from earlier projection of 2.2%. Inflation was forecast just over the preferred range of below 2%. Our expectation had been for the ECB to cut interest rates as early as June but not later than September. However, Euro-zone inflation hit a 16-year high across the 15-nations zone in May. Inflation rose 0.6% for the month, an annualized rate of 3.7%. Rising food, energy, transport and housing costs were the culprits. With inflation moving above the preferred range, the expectation is now for the ECB to raise rates, possibly as early as July.

ECB monetary policy has fueled a tug-of-war between the U.S. dollar and the euro. The euro strengthened after European Central Bank President Jean-Claude Trichet said inflationary pressures in the euro area will last longer than previously expected with risks to price stability increasing amid strong food and oil prices. A strong euro tends to boost the prices of crude and other raw materials traded globally in dollar terms.

Worldwide, the Japanese economy has been slowing. Recent reports estimate growth at 1.5%, down from 2%. Interest rates remain low with the official bank rate at 0.5%. According to Bank of Japan's quarterly survey the confidence index for large manufacturers fell to 11 in March from 19 in December, the weakest reading since December 2003. The survey sighted a weak US economy, the erosion of yen-based revenues due to a strong US dollar and higher commodity prices as reasons for the weakness.

Australia is poised to keep prospering. The Australian economy recorded another very strong year in 2007. Real GDP expanded by about 4 per cent. Growth in domestic final demand was even stronger, at over 5½ per cent. Faced with a combination of very strong demand growth in what was already a rather fully employed economy, inflation has been moving higher. Looking at Australia's domestic conditions, most indicators of actual economic performance for the early part of 2008 have remained quite strong. We do think, however, that demand growth in Australia is now in the process of moderating. The likely extent and persistence of this slowing in demand is quite uncertain, as these things usually are. The current rate of inflation is clearly uncomfortably high and has recently surged at fastest rate in almost 17 years (4.25%). Reserve Bank of Australia's comfort range is 2% to 3%.

Overall, most developed world economies have shown signs of weakening. All have shown signs of increasing rates of inflation. Based upon expected returns and estimated risk levels, we are presently under-weighted within this sector.

Emerging Market Countries

Developing economies are most at risk to rising inflation. A year ago, in a group of 24 large developing nations tracked by Bank of America about three quarters were meeting or staying below their inflation targets primarily due to rising commodity prices. Today none of them are. Inflation has returned to 2002 levels. In China and India, inflation is running at an 8% rate. Double-digit inflation has already arrived or is expected to arrive, in Russia, Turkey, South Africa, India, Indonesia and the Philippines. Tightening monetary policy is becoming a consideration for the growth rate in many emerging market countries. Since April, Russian rates increased 25 bp, Brazil 50 bp, South Africa 50bp. With slowing growth and higher inflation levels facing many emerging markets, we are underweighted in the sector. Present allocations are the lowest in five years.

A positive standout is Brazil. Despite the current U.S. slowdown, Brazil is still expanding, largely due to the country being rich in oil, iron ore, alumina and copper. According to the IMM, Brazil's economy is projected to grow at a 4.8% rate. Recently, Brazil's national petroleum agency discovered what could be the third-largest oil field of all time. Several companies likely to benefit from the new field include Petrobras the main field operator, and Repsol an international integrated oil and gas company. Brazil, like many countries, is experiencing higher inflation. However, Brazil's central bank has taken early action to tame inflation by boosting its key interest rate. In addition, Brazilian equities are relatively cheap. According to the Morgan Stanley Capital International index, Brazilian equities are

trading at a 15X PE for the prior 12 months. By comparison, China's equities are trading at a 27x PE. The biggest risk to investing in Brazil is the possibility that the central bank could significantly increase interest rates, thereby slowing the economy. Brazil is currently our favorite emerging market country for investment.

Simply because of the sheer size of China, one cannot ignore the opportunity. China's economy is slowing but is still expanding at a rapid rate. For the 1Q of 2008 China's GDP expanded 10.6% from a year earlier down from an 11.9% growth rate in 2007. Inflation remains high at an 8.3% rate in March. China has been a favorite for investors for a number of years. This year, Chinese shares have lost about 50% in six months, a result of artificially high valuations. China's State Council sees inflation as the chief economic problem. China's Central Bank has increased for the third time the amount of funds banks must keep in reserve in an effort to tame the economy. In addition, China until recently had been taxing each stock purchase or sale at a rate of 0.3% of the principal. This tax was originally charged to stem speculation. The rate has recently been lowered to 0.1% in an effort to curtail the steep decline in stock prices. We are presently neutral on China.

South Africa has been a favorite for investors. Now inflation expectations are bleak exacerbated by the rand's 18% drop against the US dollar. During April consumer prices were reported to have risen at a 10% annual rate. South Africa's central bank inflation target is between 3% and 6%. To temper inflation, the central bank recently raised interest rates by half a percentage point to 12%. Normal inflation rates are not expected to return for at least two years. We are presently underweighted in South African securities.

Commodities

In early 1970s, Club of Rome warned of a collision between global population growth and finite supplies. The world's population is projected at eight billion people by 2025 up from 6.7 billion today. It is expected there will be seven billion inhabitants in 2012. The rate of growth is escalating. The first 1 billion was reached in 1800, two billion was reached 130 years later, and six billion was surpassed in 1999. On average people are more prosperous and are consuming more resources.

Some resources in demand have no substitutes (land and fresh water) and global warming limits usefulness of some resources, such as coal. Crude oil just over \$100 a barrel at the beginning of the quarter has risen almost daily to near \$140. In the short-term, oil prices may ease as prices never continue to climb without pausing. However, in the long-term prices are likely to continue to rise. The oil industry has not found significant new sources of supply and consumers have yet to significantly cut back. In the past US, Europe and Japan have proven adept at adjusting to resource constraints. History is littered with societies believed to have suffered from Malthusian (from Thomas Malthus and English economist who died in 1834) Crises: the Mayans of Central America, the Anasazi of the US Southwest, and the people of Easter Island. Malthus wondered if society was "condemned to a perpetual oscillation between happiness and misery." To survive, we may need to rethink – producing and consuming ever more. Technology can help. However, consumers will eventually have to change behavior.

Commodities comprise a number of sub-sectors including agriculture, energy, and metals. Each of these sub-sectors can be divided into further sectors. For instance, the metal sector includes precious metals and base metals. Agricultural products include grains, coffee, citrus, lumber, meat products, etc.

From an investment perspective, the most important decision is how much of the portfolio is allocated to the primary sector (commodities) based upon expected returns and risk. This importance can be seen by the performance of the broad groups as reflected by the PowerShares DB Commodity Index Tracking Fund up approximately 30% for the quarter. Individual sub-sectors performed uniquely depending upon specific fundamentals. For example, the United States Oil Fund (USO) added 38%. The iPath AIG Natural Gas ETN added 45%. Gold as measured by the iShares COMEX Gold Trust gained 38%. The PowerShares DB Base Metals ETF added only 6.3% and PowerShares DB Agricultural EFT rose 11.1%.

A number of individual stories are playing out. US farmers planted significantly less corn this year and more soybeans because of a higher profit potential. Ethanol production however, is expected to make up more than 30% of this year's corn crop versus 14% in 2006. Couple lower than average stocks of corn (lower than they have been in decades), demand from ethanol, strong demand from China and India, and the latest mid-west floods which have unexpectedly ruined significant corn plantings and you get a recipe for higher prices. Corn now \$7.60 a bushel is up from \$4.00 one year ago and expected to surpass \$8.00.

The commodity boom is in large part the result of the U.S. Federal Reserves weak dollar policy. The dollar has fallen 25% since 2003 and nearly 8% against the euro so far this year. A number of commodities such as crude oil and gold are priced in dollars. As the dollar weakens against other major currencies, the result is rising prices (inflation). Significant strength in the dollar is unlikely until its fundamentals improve. Factors contributing to a weak dollar include large U.S. trade deficits, a slowing economy, a below average savings rate, and low interest rates. In the near term, these factors are not likely to change significantly. Therefore, there is little expectation for meaningful price declines in dollar denominated commodities.

All readers, especially our U.S. readers are aware of rising energy prices. With crude oil trading over \$130 a barrel and natural gas at \$13.141 per BTU there is a huge transfer of wealth from consumers to producers. In the short-run, one could argue that prices are over extended and due for a correction. However, the geopolitical situation remains tense, it is the beginning of the Atlantic hurricane season and demand from emerging markets such as China and India is expected to increase. All of these factors could keep upward pressure on prices. Longer-term we need to develop alternative energy sources and develop additional supplies of fossil fuels. Congress needs to ease its opposition to new exploration and allow responsible development of domestic resources. Until these steps are taken, only significant changes in personal consumption habits, we lower energy prices.

A major consideration when trying to estimate the course and rate of inflation is consumer-sentiment. If many people believe inflation will be high for a long time, such expectations are more likely to become embedded. According to Reuters/University of Michigan consumer-sentiment survey, Americans now expect prices to rise by a median of 3.4% a year during the next five to 10 years. Should this number continue to rise it would be of concern. The last time consumer-sentiment expected high inflation (between 1979 to 1987) Paul Volcker, the current Federal Reserve Bank Chairman pushed interest rates past 15% before inflation was vanquished.

Based upon all of these factors most off our portfolios are 33% to 40% allocated to commodities with precious metals and energy over weighted with lesser positions in agricultural products.

US Economy

U.S. Federal Reserve Chairman Ben Bernanke opened a new chapter in U.S. exchange rate policy in his speech on the U.S. economic outlook in early June. Bernanke noted "We are attentive to the implications of changes in the value of the dollar (U.S.) for inflation and inflation expectations and will continue to formulate policy to guard against risks to both parts of their dual mandate, including the risk of an erosion in longer-term inflation expectations."

Bernanke's comments are probably the strongest Fed statement on the USD since early 1995. In March of that year, Chairman Greenspan told a House committee that, "The weakness of the dollar against other major currencies is both unwelcome and troublesome. Dollar weakness, while very likely overdone is unwelcome because it adds to potential inflation pressures in our economy."

Our interpretation of the Bernanke comments is that the Fed will tend to re-enforce the recent 1.53 to 1.60 range in EURO/USD, increasing reluctance of market participants to stay short USD on approaches to 1.60 but providing no real offset to the USD's fundamental vulnerabilities. We also note that just as inflation pressures have apparently contributed to an increased sense of Fed alarm with respect to the weaker dollar, these same dynamics may well be contributing to a greater reluctance on the part of the ECB to allow EUR downside.

Most analysts have been predicting that the U.S. economy would slip into a recession. So far we have dodged the bullet. However, downside pressures still exist. The International Monetary Fund ('IMF') predicts the U.S. will slip into a 'mild recession' and sees a 25% chance that world economic growth could fall below 3% this year and next – "equivalent to a global recession." The IMF sees turmoil sparked in the U.S. subprime market as the largest shock since the Great Depression. Worldwide risk remains to the downside even though emerging economies are expected to continue robust growth through 2009.

We view the Fed's focus on the dollar to be not only correct by necessary. While a further slide in the dollar could bring down the current account deficit, additional weakness could diminish the appeal of US assets and encourage a reallocation. According to the IMF, even a gradual diversification away from dollar assets could trigger a sharp dollar depreciation further driving dollar driven commodity prices and inflation higher.

We continue to see conditions as quite difficult. We expect economic growth to bottom later this year and expect only moderate next year. A concerning fact is that a deeper-than-expected pullback in house prices could hit lenders and financial markets and further dampen economic activity.

Inflation news has been mixed and we expect prices will level out. However, longer-term expectations appear to have edged up but they have not yet become unmoored. Key to the rate of inflation will be the direction of the U.S. dollar.

We expect the Fed to hold its interest rate target at 2% through much of this year (at least until September). However, stronger language regarding the shift of risk from growth to inflation is probable. We view the Fed as unlikely to lower rates further and probably won't contemplate higher rates until there is more stabilization in home prices.

A trend to watch (happening without any political intervention) is that U.S. factories are bringing jobs closer to home due to soaring transportation costs and a rising standard of living in emerging market countries, especially China.

Real Estate

We continue to underweight the real estate sector. REITs which had staged a modest rally in 1Q driven by apartment buildings and self-storage space sold off during 2Q with prices back down to December 2007 levels.

Real estate prices remain under pressure with few bright spots, one of which has been farm land. According to the U.S. Department of Agriculture, the price of an acre of U.S. cropland rose 13% in 2007 to \$2,700 up from \$1,340 in 1998. Another 15% increase is expected this year. However, recent price increases may not be sustainable and a bubble in farm land could be developing. According to University of Illinois, farm land prices in Illinois are now 46% higher than capitalized values (the potential of that land from agriculture). Also of note, Iowa's superintendent of banking is concerned that reverse mortgages and agricultural lending may have a significant impact upon the future of the banking industry. Farm debt at the end of 2008 is forecast at \$228 billion, up \$8 billion from 2007, to set a record for a fourth consecutive year. Farm mortgage debit has increased 30% over five year to \$120.8 billion.

Both residential and commercial properties are still expected to sink further. According to the Federal National Mortgage Association, severe weakness in housing market is expected to continue through 2008 with increased delinquencies, defaults, and foreclosures. FNM expects prices an average to fall by 7-9% this year. FNM and sister company Freddie Mac buy more than 75% of all home loans originated in the U.S. and repackage them into bonds they guarantee.

In some markets, prices have been considerably weaker. According to Case-Shiller, Las Vegas, Miami and Phoenix have been the weakest with prices in Las Vegas and Miami down 26% and Phoenix down 25%. The strongest markets have been Charlotte and Dallas.

The decline in real estate prices has not been just a U.S. event. For instance, in the United Kingdom house prices posted their biggest monthly decline on record in May.

Miscellaneous

In what has been a difficult financial quarter, some things always catch your attention. Here's a few that caught ours;

- Cuba lifted its curb on cell phone use,
- The Olympic torch arrived in Beijing,
- The Court found Marilyn Monroe to be a New Yorker,
- Frontier Airlines, ATA Airlines, and Aloha Airgroup all filed for bankruptcy,
- The French parliament adopted a bill against inciting extreme thinness,
- Charles Ray Fuller, 21, tried to cash a check for \$360 billion in Texas,
- U.S. Supreme Court upheld Kentucky's use of lethal injections for executions,
- Geriatric doctors' average income is lower than interns with no specialized training,
- The world will need to invest \$45 trillion in energy in coming decades to build some 1,,400 nuclear power plants and expand wind power to half greenhouse emissions by 2050 and,
- Viagra turned 10.

Stark Financial Advisers

As a registered investment adviser, Stark Financial Advisers understands the importance of achieving positive returns over a long-term investment horizon. We also understand the relationship between risk and return. The optimum portfolio for any investor is a portfolio that has the highest potential return consistent with the risk tolerance and investment horizon of the owner.

Each asset class has unique characteristics. Over an extended period of time, it becomes possible to track returns and standard deviation (risk). Asset classes are unique and, while all are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

The return and other projections for each asset class are hypothetical estimates and are for illustrative purposes only. There is no guarantee such return projections may actually be realized. The asset classes listed are not subject to fees or transaction costs.

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