

For the first two months of the quarter, markets responded positively to the Fed's actions to add liquidity and stability to financial markets, and to the rescue of Bear Stearns. In late May, credit fears and concerns about the economy returned and markets retreated. The price of oil continued to rise and ended the quarter at \$140 per barrel. Other commodities, in particular corn, also hit record highs as Midwest flooding lead to concerns about poor crop harvests. The rise in oil and basic commodities elicited inflation concerns. The Fed, which aggressively cut interest rates late in 2007 and early 2008, did not raise or lower rates during the quarter, in part due to inflation fears. Despite so many obstacles, the economy still showed promise.

### Godfather Part III Market

Just when the markets appeared to have weathered one of the largest financial storms in recent history, volatility returned and pulled the market back to its recent lows. June's stock market performance for the Dow Jones Industrial Average and the S&P 500 was the worst since the Great Depression. During the quarter, the Dow was hurt by losses from GM (40%) and AIG (39%). The catalysts for the downturn were the same that have plagued the market for the past year: housing, the price of oil and the credit crisis. Markets responded positively when the price of oil dropped and negatively when prices increased. With oil increasing 33% during the quarter the down days outnumbered the up days. In June, renewed fears of the credit crisis lead equities down.

Peter McKay, "Stocks End Quarter Just Above 'Bear', but Challenges Remain for Rest of Year", Wall Street Journal, July 1, 2008.

Alexandra Twin, "Stocks: Mixed Day, Brutal June", CNNMoney.com, June 30, 2008.

International stocks were the worst performing major index in the quarter and, over the past year, had almost identical performance to the S&P 500. Small cap stocks were the only bright spot in the quarter. The major equity indexes are down for the one-year period. The following table shows the returns for four major indices:

Index	1st Qtr	1 Year	5 Year	10 Year
S&P 500	-2.7%	-13.1%	7.6%	2.9%
S&P 600	.4%	-14.7%	11.6%	7.6%
MSCI EAFE	-3.5%	-13.0%	13.9%	3.7%
Lehman Brothers Agg.	-1.0%	7.1%	3.9%	5.7%

Source: Wall Street Journal, July 3, 2008

The S&P 500 is a commonly used measure of common stock total return performance.

The MSCI EAFE is a commonly used measure of common stock total return performance of international markets.

The S&P 600 is a commonly used measure of small capitalization stocks.

The Lehman Brothers Aggregate Bond Index is a commonly used measure of bond market total return performance.

All referenced indices are unmanaged and not available for direct investment.

**Past performance is not a guarantee of future results.**

Inflation concerns caused Treasury bond yields to increase. At one point in June, the yield on ten-year Treasury bonds hit 4.30%, up nearly a full percentage point from the start of the quarter, before retreating to 3.98% at quarter end. This increase in yield was due in large part to the rise in commodity prices that caused inflation fears, which negatively impact bonds. Typically, when the economy slows, bond yields drop. Despite the slowing economy the rise in commodity and oil prices caused bond yields to increase. The total return for the Lehman Aggregate Bond Index dropped 1% for the quarter. One encouraging trend for most of the quarter was the narrowing spread between Treasury bonds and junk bonds as investors looked to riskier bonds for higher yields.

Liz Rappaport, "In the Credit Markets, Relief Rally Gives Way to Renewed Fear", Wall Street Journal, July 1, 2008.

### '55 Chevy

The quarter was not kind to General Motors. The high price of gas and a slowing economy lead to a decrease in car sales. More troubling for GM were analysts' reports discussing their financial troubles: one analyst even speculated about a GM bankruptcy filing. GM's stock declined to its lowest point since 1955. GM is rushing to shift its production mix away from trucks and SUVs, focusing on cars that run on alternative fuels.

John D. Stoll and Serena Ng, "GM Shares Plunge to 53-Year Low", Wall Street Journal, June 27, 2008.

### Housing—The Gorilla in the Room

Oil prices may grab headlines, but the dominant force in the economy is housing. Congress is debating how to help homeowners, and housing will become an election year issue. Home prices have been steadily decreasing, and the widely followed Case-Shiller Index now shows that housing is back to 2004 levels. The level of sales is well below levels seen one year ago. The chart on the right from the Wall Street Journal shows that home prices are back to the 2004 levels:

#### Stat of the Week

**BACK TO 2004 PRICES:** Average home prices are now back to the level of four years ago, and down 19% from the June 2006 peak, according to the S&P/Case-Shiller 10-city composite.



Source: Wall Street Journal Online, Stat of the Week, June 29, 2008, <http://online.wsj.com/article/SB121469557432013683.html>

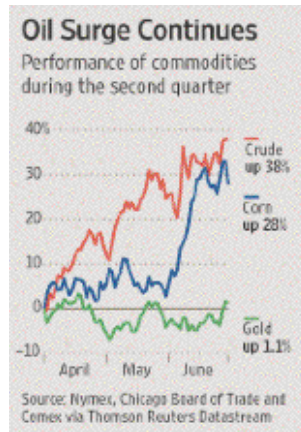
The gloom about housing has been pervasive, impacting the economy and consumer confidence. Recent housing data shows small signs of improvement. Sales of existing homes increased in May, as lower prices are spurring buyers. The May Case-Shiller Index showed an increase in prices for eight of the twenty markets tracked. This is up from only two markets in April and none in March. While the overall picture is glum, there are signs of hope in the housing market.

Kelly Evans and Anton Troianovski, "Consumer Confidence Plummetts", Wall Street Journal, June 25, 2008.

Floyd Norris, "Housing Prices Rally?", New York Times, June 24, 2008  
Standardandpoors.com

### Commodity's Continued Climb

Commodities continued to surge in the second quarter. Oil was the most prominent, increasing from \$102 a barrel to \$140 a barrel. The price for an unleaded gallon of gas jumped from \$3.30 to \$4.10, a 24% increase. The high price of gas caused Americans to drive less, with total miles traveled dropping 4.3%, the largest decline since 1942. However, global demand for oil is expected to increase in 2008. Food commodities, in particular corn and soy beans, increased due in part to concerns over poor weather in the Midwest. Corn passed the \$8.00 per bushel for the first time in its history. During the quarter, corn increased 28% and soybeans increased 34%. The chart to the right from the Wall Street Journal shows the increase in a few commodities:



Source: Wall Street Journal, July 1, 2008

Some commodities did not increase in this quarter. Industrial metals declined. Zinc, which is used for galvanizing steel for the automobile and construction industries, declined 30%, as recession fear caused demand to drop.

Carolyn Cui, "Commodities Prices Jump, and Upward Trend Likely to Continue", Wall Street Journal, July 1, 2008.

AAA's Daily Fuel Gage Report

### Fifteen Minutes of Fame

Erin Callan, Lehman Brothers' former Chief Financial Officer and the highest ranking woman on Wall Street, went from hero to scapegoat in less than a quarter. In March, her straight talk to analysts and the media was credited with helping Lehman avoid the fate of Bear Stearns. In May she was profiled in the Wall Street Journal. In June, after Lehman missed its earnings and re-started rumors of its financial problems, she was demoted and reassigned. It was a head-spinning turn of events for the would-be media darling.

Susanne Craig, "Lehman's Straight Shooter", Wall Street Journal, May 17, 2008.

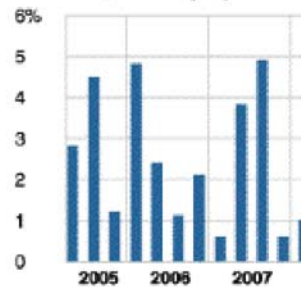
Susanne Craig, "Lehman Shuffles 2 Key Jobs in Bid to Restore Confidence", Wall Street Journal, June 13, 2008

### Economic Outlook

From housing to commodities to poor performing stock markets, economic news has been troublesome this year. Despite expectations of a recession, the economy grew at a rate of 1% in the first quarter. When viewed in light of the first quarter's credit problems, the positive result looks even better. Nonetheless, the forces that lead to the slow growth are still at play in the market. Commodity prices are still increasing and the housing market is still slumping. The Fed kept short-term interest rates steady at 2% at its June meeting, as it tries to balance the need for economic growth while controlling inflation, a near impossible task in today's environment.

### REAL GDP

Change from previous quarter at annual rate, seasonally adjusted



Source: Department of Commerce

The most recent Wall Street Journal survey of fifty-two economists (May 2008) predicts the economy to grow through the rest of the year. This is an improvement from previous surveys. The growth is expected to be below levels seen in 2005 through 2007, but still positive. The chart on the left shows recent GDP figures:

Source: Wall Street Journal Online, Economic Chartbook, July, 1, 2008, [http://online.wsj.com/mdc/public/page/2\\_3024-ecocharts.html](http://online.wsj.com/mdc/public/page/2_3024-ecocharts.html)

The stimulus checks mailed to millions of people are expected to help the economy in the second quarter, but most economists expect that the checks will have been spent by the third quarter. The economy has strong headwinds and it will be a tribute to its resiliency if it can produce the positive returns economists expect.

Wall Street Journal's Monthly Economic Forecasting Survey for May 2008. Kelly Evans and Anton Troianovski, "Consumer Confidence Plummet", Wall Street Journal, June 25, 2008.

### Conclusion

The most encouraging part of the first half of the year is that it is over. Equities performed poorly and interest rates increased. Gas hit one all-time high after another and other food commodities also hit all-time highs. The credit crisis that seemed to abate in April and May proved it was still alive in June. Housing, which has been slumping for the better part of three years, is still in trouble, but showed slight signs of improvement in May. Hopefully this is the start of a positive trend. As the third quarter progresses, the pending presidential election will take center stage and the economic proposals of the two candidates will be scrutinized. Despite bad economic news, the economy managed to continue growing.

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