



2nd Quarter 2008 Market Outlook/Strategy

Bloomberg's June Survey of Economists estimates a 50% probability of a recession, down from 66% in April. Despite the market's more optimistic outlook, Pugh Capital is more convinced than ever that a recession is virtually inevitable. The U.S. economy is poised on the edge of a cliff. We believe that further weakness in any of a number of areas will tip the economy over the edge into recession.

In past strategy pieces we focused on the evolving weakness in the housing sector. As we analyze the data it appears clear that home prices will continue to decline over the next year. To date, much of the price action in the housing market has been driven by consumers and builders. As of the first quarter, roughly 2.5% of loans were in foreclosure, up from the long term average of about 1%. Over the next 1-2 years, financial institutions will sell foreclosed properties which should cause another leg down in prices. Lehman Brothers estimates that foreclosed properties will sell for about 20% below the prices of non-foreclosed properties. The other major drag comes from banks cutting back significantly on residential lending, which is a key ingredient to a healthy housing market. This next phase of the housing crisis may be even more painful.

July 1st marks the beginning of a new fiscal year for most local governments. In states and counties which rely heavily on real estate taxes as a source of revenue, budget cuts will be necessary once the decline in real estate prices is reflected. Since payroll represents the single largest budget item it is likely that public sector layoffs will start to take place. This impact, combined with continued weakness in financials, construction, retail and manufacturing should keep nonfarm payroll growth in negative territory for the rest of the year. Year to date the economy has lost 324,000 jobs. The current trend would translate to a loss of about 700,000 jobs for the year. We expect job growth will be weaker than the current trend.

Consumers are being buffeted by a number of concerns. Gas prices are at record highs, savings rates are low, housing prices continue falling, banks are tightening credit availability, unemployment is increasing and the stock market is weak. It should be no surprise that consumer confidence is near record lows. Fiscal stimulus through tax rebates has temporarily boosted retail sales. However, the environment is sufficiently negative that we feel strongly that the increase in spending will be reversed.

Market risk is increasing. The stock market is selling off, volatility is increasing and corporate earnings outlooks are becoming more negative. We expect the bias of the market to be toward wider spreads over the next quarter. While we don't expect the Corporate Index spread to get as wide as it did during the Bear Stearns crisis, we expect that some individual names may trade wider. Earnings for financial institutions are expected to be disappointing and it is becoming increasingly difficult for them to raise capital. We have therefore reduced corporate exposure. We are more neutral on other spread sectors. While higher commodity pricings are fueling inflationary fears, we believe it is unlikely that these increases will lead to a wage price spiral. If rates move higher as a result of inflationary concerns, it presents a buying opportunity in bonds.