

BONDS

Don't get caught in the bond / fixed income trap. It could be the late 1970's all over again for some disillusioned investors. After two severe bear markets within the last decade, the desire is overwhelming to abandon equities for the perceived safe haven of CD's, money funds and other traditional "safe haven" fixed income products. These investments, of course have a role to play in every portfolio, but they can be an investment death trap if inflation (especially hyper inflation) returns as we expect. Make sure you see the "forest for the trees" – like the late 70's, there are countless high quality equities, selling at bargain basement prices, sporting yields far higher than money funds, CD's, government bonds and tax free bonds. These solid "income equities" combined with short term notes and inflation protected bonds make the most sense right now.

Excess leverage at all levels – personal, corporate and government along with a "draconian" accounting valuation rule (mark to market) caused an unprecedented panic and credit crunch in the fixed income securities market. This mass of bad credit will take years to unwind, especially if we continue to prop it up with taxpayer "stimulus / bailout" money. But, dislocations always offer opportunity as investment dollars swing from one extreme to the other. Corporate bond yields are a perfect example – bond prices have been trashed to a point that presumes mass corporate bankruptcy. As a result, corporate yield spreads over U.S. treasury bonds are at unsustainably high levels. Tax free municipal bond yields are also trading at wide spreads to treasuries. Although these spreads (which equate to low bond prices) present a buying opportunity, it is wise to maintain relatively short maturities as protection against higher rates that are bound to come later.

The current deflation could easily morph into inflation as the money tsunami from excessive fiscal spending and a more than doubling of the money supply gains traction. Converging at the same time is the unfolding, enormous social indebtedness (Medicare and social security) to the retiring baby boom generation. A 1970's style inflation is likely to become the next big challenge. Interest rates will stay low for the foreseeable future, but if inflation kicks in, it means

rising interest rates. It is wise now to keep maturities short.

STOCKS

Stock prices always (ultimately) reflect earnings. The S&P 500 Index hit a high of 1,565 October 9, 2007. Average earnings per share that year were \$82.54 for a price to earnings ratio (PE) of 18.9. The average PE ratio for the index from 1960 through 2008 is 16.2 – not a whole lot lower. In other words, at the recent high, the stock market was not all that frothy - certainly not as over-priced as it was in late 1999, just before the "tech wreck" when the PE soared to 29.

So, what gives? Why has this market crashed so violently - an even bigger drop than the tech wreck in 2002? The major crash catalysts are the politically spawned binge in sub prime mortgages, vast over-construction (mostly new homes and condos), followed by a national collapse in home values (where most people maintain the bulk of their savings). Adding fuel to the fire was the irresponsibly excessive mortgage debt securitization by investment banks. These mortgage securities were assigned AAA ratings and sold worldwide, much on margin (borrowed money). These catalysts emerged largely because of bad government policies passed earlier, specifically, the Community Reinvestment Act and the Sarbanes Oxley Act (mark to market accounting rule).

Add exceedingly low interest rates to the equation (held down too long) and it was perfect chemistry for an implosion. Sadly, it will take time and patience to put all the little pieces back together. The free market (if left to its normal magic) is best suited to accomplish the task. As with all bear markets, there will be sharp upward spikes (rallies) offering opportunities to re-allocate and re-balance portfolios. Investors must now prepare for new dynamics, among them, the social costs of the changing demographics and inflation.

RECOVERY PLAN

Bad government policies and a lack of cogent free market ideas to stimulate the economy and fix the banking crisis have combined to make an already nasty bear market far worse. We frankly believed we had seen the low last November 20 when the S&P 500 Index hit 752, suggesting in our last letter that it would

be a U shaped recovery – slow and uneven, bouncing along the bottom as excessive leverage unwinds. But, the market death-drop of 48% from the high reached October, 2007 was just posturing for another level down, breaking through the 752 low to the recent, scary 676. Raw panic set in with projections of 500 or lower.

Several months ago, we would have scoffed at such a projection, but we must now admit - given the anti-capitalist, socialist rhetoric and legislation coming out of the new government, anything is possible. Without getting into detail, let's just say that nothing coming out of Washington these days is positive for stocks or bonds. Here is the sad litany: Higher individual, payroll and corporate income tax rates; re-imposition of estate taxes; massively increased government spending; newly created environmental taxes in the form of "cap and trade"; card check (abrogating union secret ballot voting); reduction in mortgage interest and charitable deductions; repeal of successful welfare reform; bailouts and possible nationalization of banks and insurance companies; private wage and salary controls; bailouts of the auto companies; over-expansion of the money supply; universal, government run health care and other egalitarian type programs. The market knows that this worn out "Great Society" type template does not work to improve the sick economy or increase prosperity. In fact, it does the opposite.

The big additional worry is trade protectionism - absolutely astounding that it would actually be considered given the fact that tariffs were a big cause of the Great Depression in the 1930's. Literally, investors can hardly catch their breath. None of these ultra left meanderings were forecasted – almost every smart political and investment commentator thought the new government of "hope" and "change" would be

centrist - they are now chagrined, admitting errors in judgment. Investor disgust is palpable - many have "thrown in the towel", selling equities at unprecedented levels. Therein lays the opportunity for courageous investors to retrieve at least some of their hard earned gains.

Despite all the negatives, there is "hope", but not from more taxpayer funded stimulus and bailouts or loose monetary policy. The real hope for reinvigorating the economy is global consumer demand and the productive capital investment of the private sector. Never underestimate the power of the free market. Look how rapidly it lowered the price of oil from \$147 per barrel down to less than \$40 bbl. That was entirely the built-in brilliance of the law of supply and demand. The same thing is happening with the price of other materials and products – everything including housing is becoming more affordable. So, the private sector is adjusting and will have a lot more to do with this recovery than anything government can do.

Now think of the billions of new consumers, producers and entrepreneurs throughout the globe with increasing wealth and new freedom geared up and ready to pursue a higher standard of living. They have the same needs and wants of everyone. These needs and wants are a constant – the one thing in the economy that does not change. These new consumers along with the immense cash on the sidelines will eventually overcome destructive government policy to assure eventual global economic recovery and of course, better securities markets. While it is unlikely the severe declines of this market mauling will be recovered in the next year or so, it is vital that investors stay the course with a disciplined asset allocation plan and high quality investments.

FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

| | 1 Year Ending <u>2/28/08</u> | 3 Years Ending <u>2/28/08</u> | 10 Years Ending <u>2/28/08</u> |
|---|------------------------------------|-------------------------------------|--------------------------------------|
| <i>This quarter's featured Investment Manager is:</i> Knott Capital Management (One of ECA's equity managers) | (34.2) % | (10.1) % | 4.5% |
| STOCK AND BOND MARKET INDICES: | | | |
| S & P 500 Stock Index | (43.3) % | (15.1) % | (3.4) % |
| Barclays Capital Aggregate Bond Index | 2.1% | 4.9 % | 5.6 % |
| Balanced Index | (20.6) % | (5.1) % | 1.1% |
| 90 Day U.S. T-Bills | 1.0 % | 3.2 % | 3.1% |
| Consumer Price Index | (0.3) % | 2.1% | 2.5% |

OUR SERVICES TO YOU

- Investment Management
- Asset Allocation Consulting and Performance Measurement
- Cost Tracking and Control
- Personal and Institutional Trust Services through Counsel Trust Company

- Investment Manager Search and Selection
- 401(k) / Employee Benefit Plans
- Manager Monitoring