



GRAY & COMPANY

# **CAPITAL MARKET REVIEW**

**Second Quarter 2008**

# CAPITAL MARKET REVIEW

## The Headlines: Inflation Not Recession (Yet)

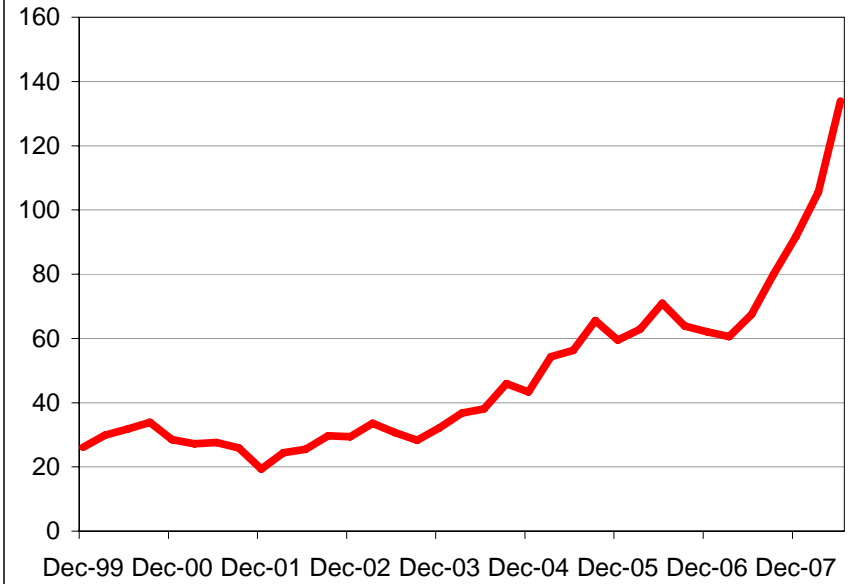
**The Rest of the Story:** The price of oil accelerated this quarter with global implications for inflation. Inflation rates have been rising around the globe due to higher commodity costs, particularly energy and food prices. The danger with high inflation is the self-perpetuating cycle of higher cost leading to higher wages, which further drives up costs. High inflation rates also erode the value of financial assets.

As the price of oil rises, some believe a "bubble" has been created by investors and/or speculators. The facts are 1) that the demand for oil has increased significantly in the past five years, and 2) the supply chain takes years to adapt to the increased demand. Unfortunately, we will not know if or when the "bubble" occurred until it bursts.

Technically, a recession has not occurred in the U.S.; however, many economists are predicting slower or negative economic growth in the coming quarters. Their argument is supported by the higher energy costs, low wage growth, the further deterioration of the housing market, additional fallout from the credit crisis, and waning consumer confidence.

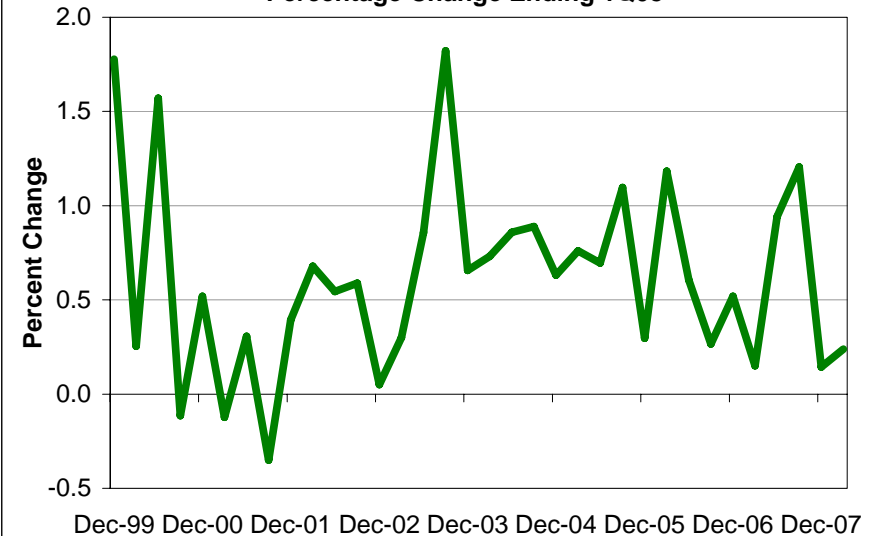
Central banks around the world have reversed their position on monetary policy, signaling that price stability supersedes economic growth. Yields trended higher as the fixed income markets anticipated the intervention of the central banks.

Price of West Texas Intermediate Crude (\$/Barrel)



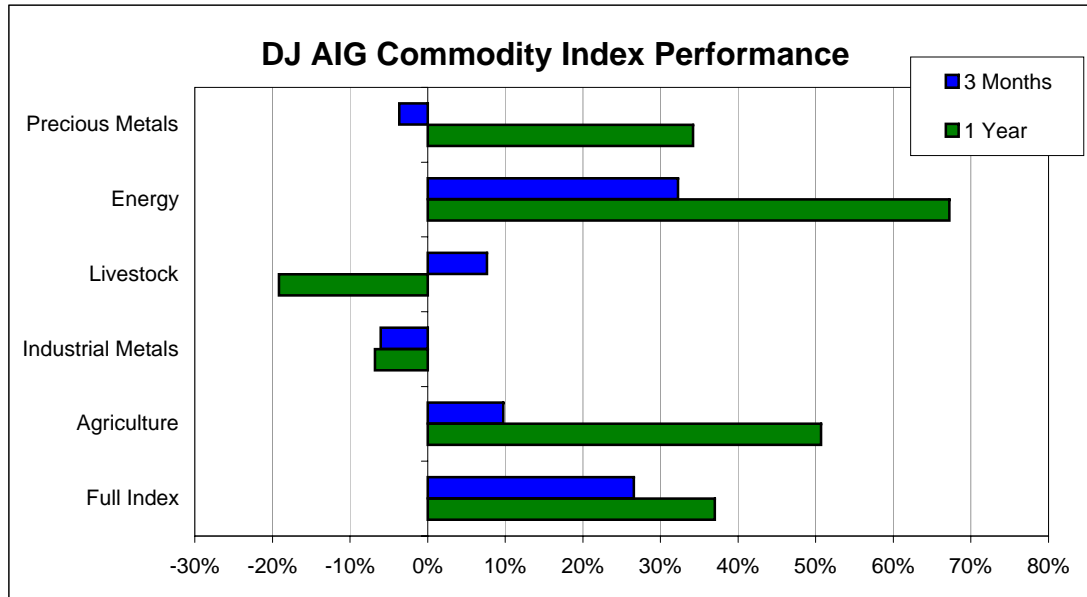
Source: Federal Reserve Bank of St. Louis

Real GDP - Seasonally Adjusted Annual Rate  
Percentage Change Ending 1Q08



Source: Federal Reserve Bank of St. Louis

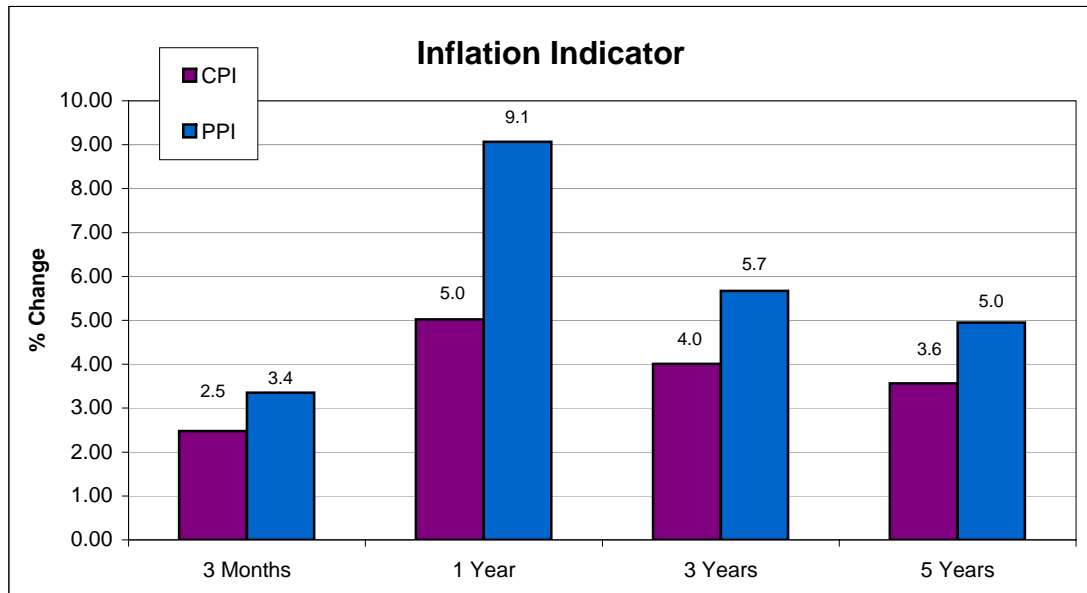
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**Oil is King:** Oil futures enjoyed its best quarterly performance since the first quarter of 1999, rising 38%. Other commodities shared in the euphoria - Corn up 28% and Soybeans rose 34%. However, weak demand due to the slowing global economy sent the prices lower for most precious and non-precious metals.

Businesses and governments have called for a more balanced approach to managing the supply and demand for energy. This includes debating the exploration and development of new oil fields, the search for alternative energy sources, and the role of investment managers in the commodities markets. Consumers have reacted by purchasing small, more fuel-efficient automobiles and reducing the number of miles traveled (U.S. vehicle miles dropped 4.3% in March compared to a year ago - the sharpest decline in the history of the measure).

The rising commodity prices have sent inflation rates upward. Production costs have escalated significantly in the past year (the PPI has increased 9.1% over this time). In the past six months, corporations have shifted a greater percentage of the higher production costs onto consumers. The relationship between commodity prices and inflation rates has strengthened; a trend that seems likely to persist for some time.



Source: Bureau of Labor Statistics

# CAPITAL MARKET REVIEW

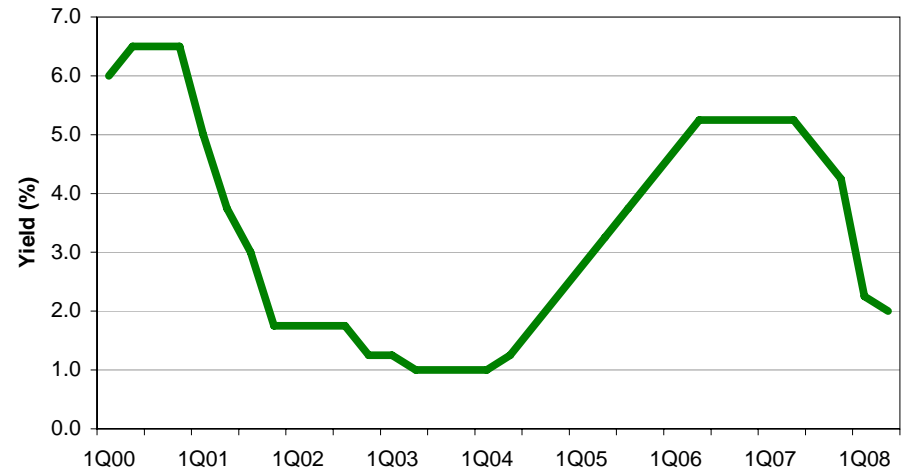
**Fed Battles Two-Headed Monster:** The Federal Reserve is attempting to spur the economy and control inflation. The economy is struggling to overcome the deterioration of the housing market and the crises in the credit markets. Inflation is rising under pressure from higher energy costs.

The Fed lowered the Federal Funds Rate just once this quarter, bringing the rate down to 2.0%. However, by the end of the quarter the Federal Reserve had shifted its focus to fighting inflation.

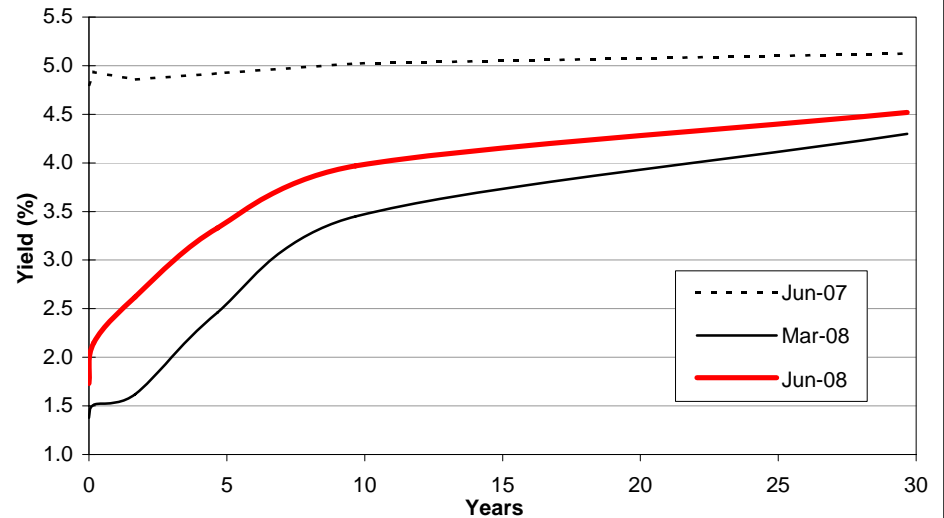
The impact of the Fed's stimulus package that started a year ago continues to help reduce the likelihood of a recession. That same stimulus package has helped to foster an inflationary environment.

The yield curve shifted upwards as the fixed income market priced in the higher expected inflation rates. The markets are anticipating rate hikes by the Fed before the year is over.

### Historical Fed Funds Rate



### Yield Curve



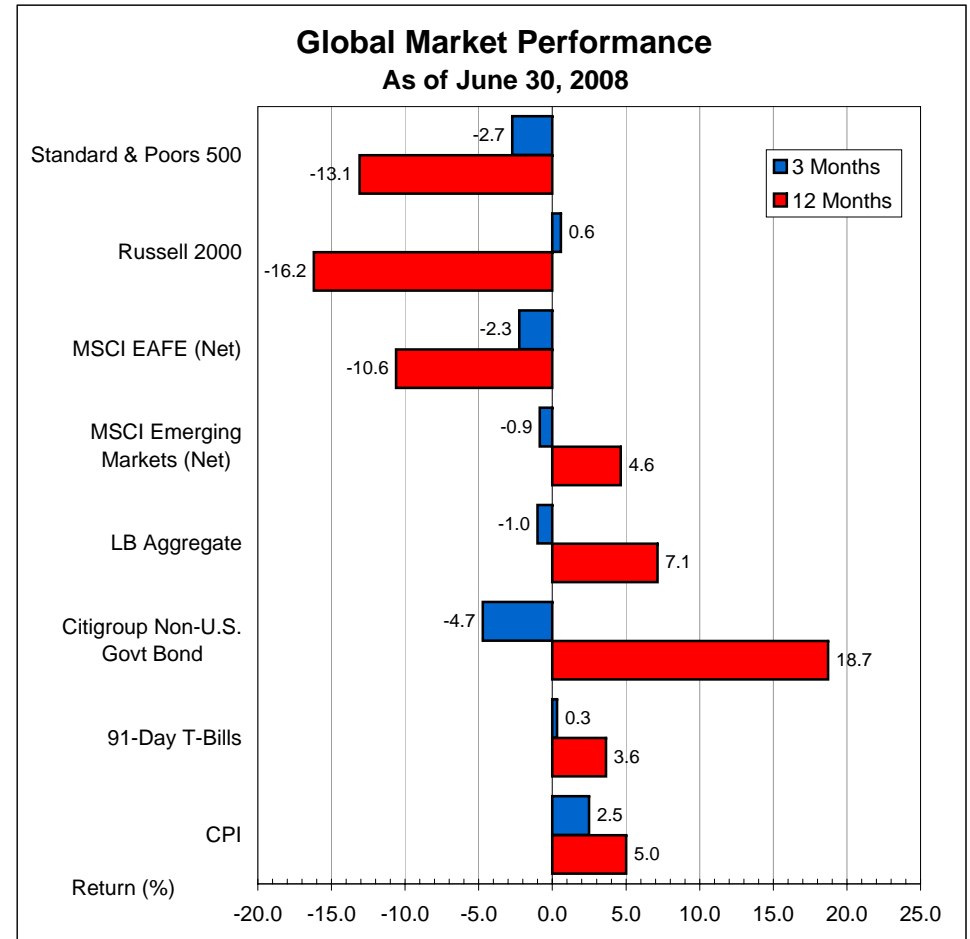
# CAPITAL MARKET REVIEW

**Global Inflation and Slowing Economy Exacts Toll:** The equity markets started the quarter with nice gains in April and May. However, the rising costs of commodities is fueling inflation around the globe and slowing economic growth. The markets reversed course in June and ended slightly negative for the quarter. The inflation concerns carried over into the fixed income markets with the yields on most investment grade bonds rising.

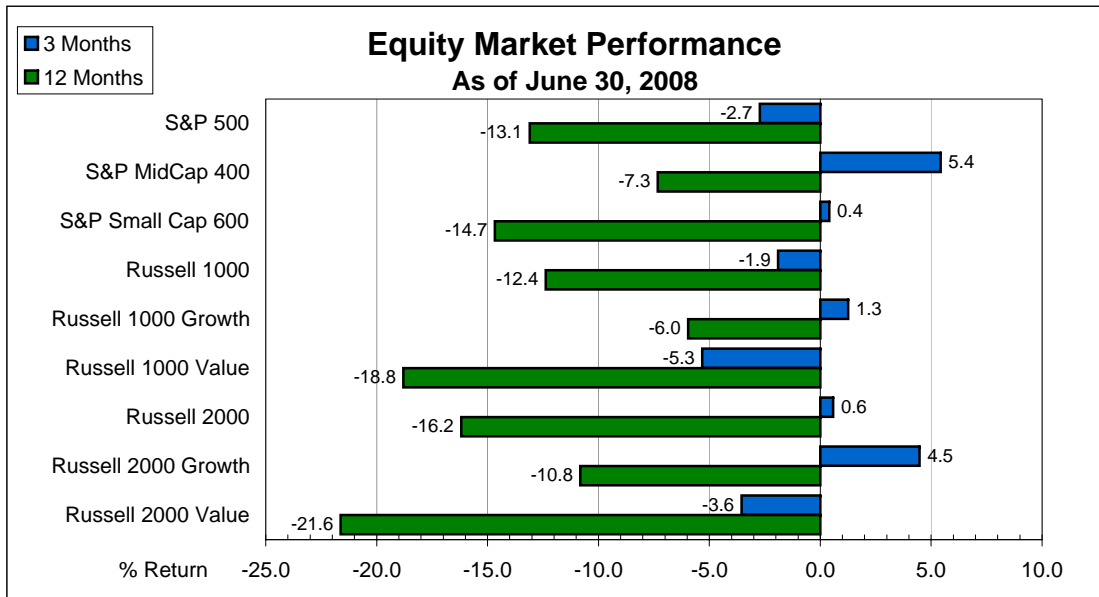
The world markets are strongly correlated as well, due to the global impact of higher commodity prices. Pockets of strength were limited to the nations that export those commodities.

Central banks have shifted their stance from economic growth to price stability. The markets are anticipating higher short-term rates across the developed regions.

The Euro showed the first signs of weakness this quarter, as the U.S. Dollar and Pound Sterling appreciated slightly this quarter.



# U.S. EQUITY MARKET

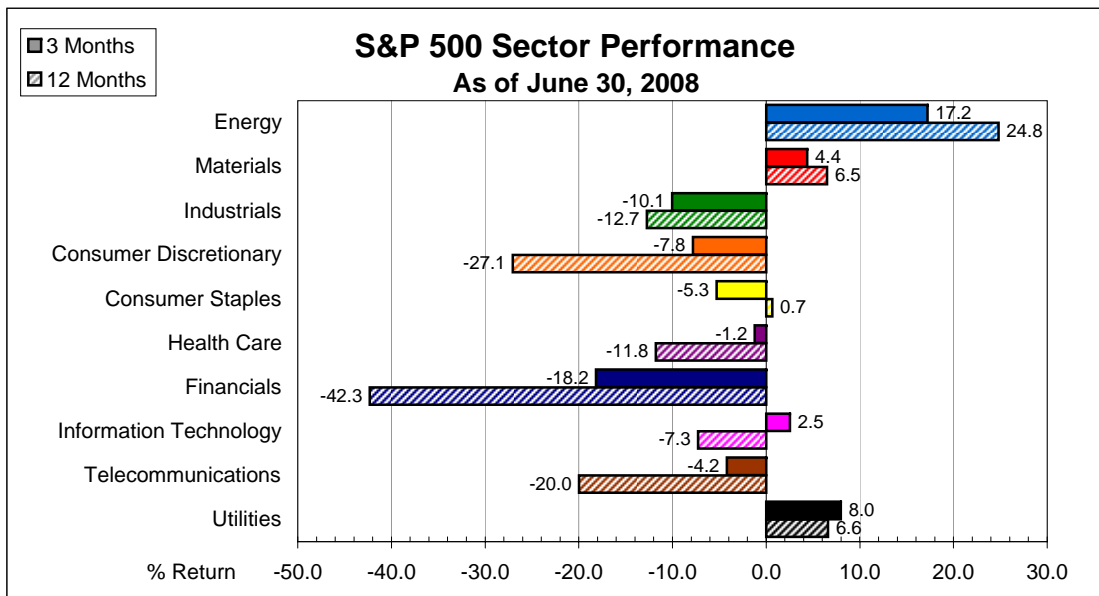


**The Wild World of Equities:** Stocks had a crazy quarter. The equity markets advanced in April and May with returns of nearly 10%. In June, however, higher oil prices and inflationary fears crushed the majority of stocks.

Mid Cap stocks were the best survivors and posted the strongest gains, up 5.4%. Large Caps dropped 2.7% this quarter and 13.1% over the past year; Small Caps were slightly positive for the quarter.

Growth outperformed value across all capitalization ranges this quarter, reversing value's triumph from last quarter. Surprisingly, growth stocks have held up the best in the declining market; the Russell 1000 Growth Index outperformed the Russell 1000 Value Index by 12.8% over the past twelve months.

Financials (Major Banks) and Industrials (Automotives) struggled again, with both sectors declining by over 10%. Energy, powered by the surge in oil prices, rose over 17% during the quarter. In the past year, Financials have fallen by over 42%.



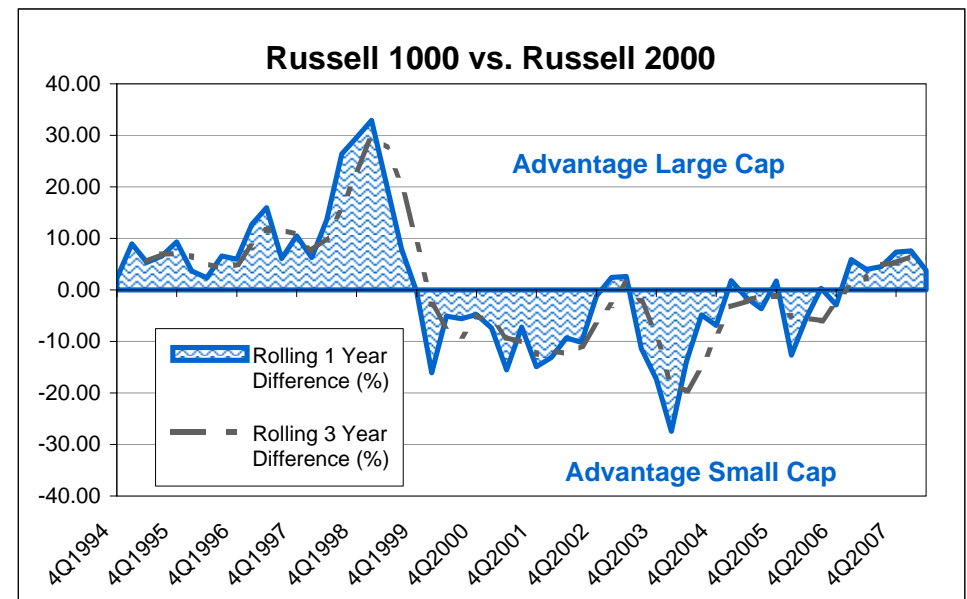
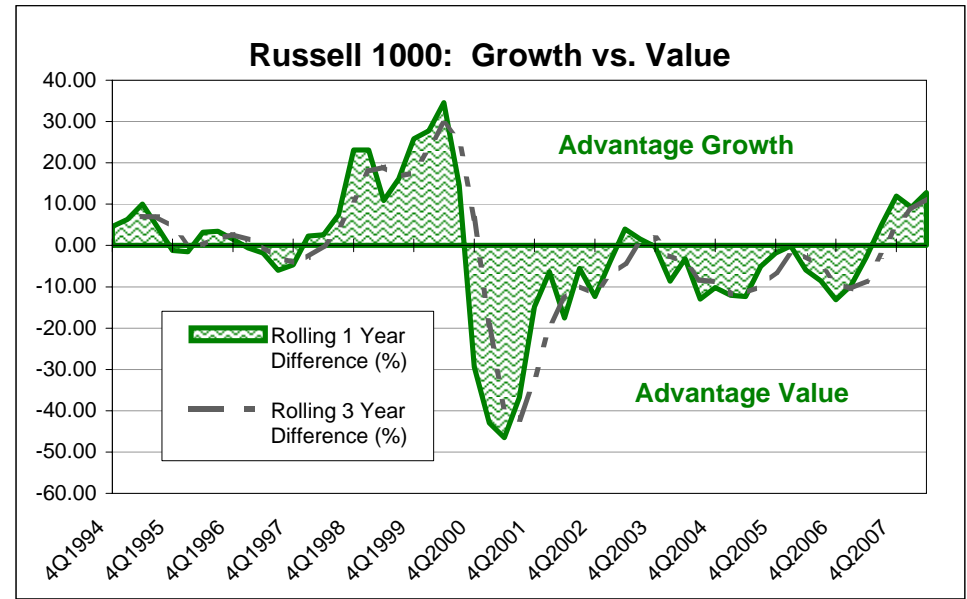
# U.S. EQUITY MARKET

**Growth Retakes the Lead:** Growth was able to withstand the market's decline in June and survived the quarter with a modest gain. Value took the brunt of the downturn; the value indexes have significant weightings to Financials (down 18.2%) which continue to struggle with the credit crisis and impairment of assets.

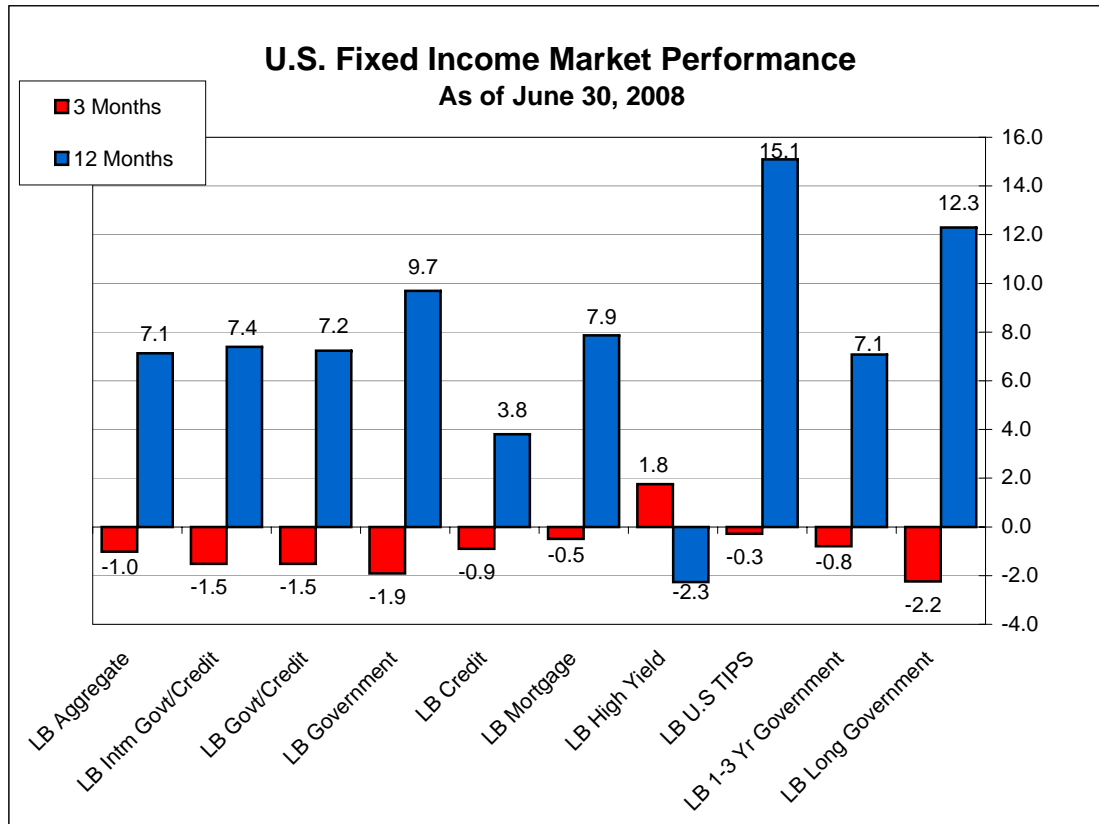
Interestingly, the style and capitalization shifts appear to be related. The long run in value was accompanied by out performance of small cap equities. The prior period favored large cap and growth stocks. These style and capitalization cycles are linked to the economic cycle. The different stages of the economic cycle produce favorable conditions for different sectors of the equity market.

The economic cycle appears to be waffling between the late-recovery stage (favoring Technology and Telecommunications) and the slowing/recessionary stage (favoring Health Care and Consumer Staples). As the economy recovers (early-recovery stage) the Industrials and Materials sectors will tend to out perform. Energy and Financials are being influenced by factors independent of the current economic cycle.

The volatility theme continued from the second half of last year. Volatility is measured as a percentage of days on which the S&P 500 Index rises or falls by more than 1%. This increase in volatility tends to favor active trading strategies.



# U.S. FIXED INCOME MARKET



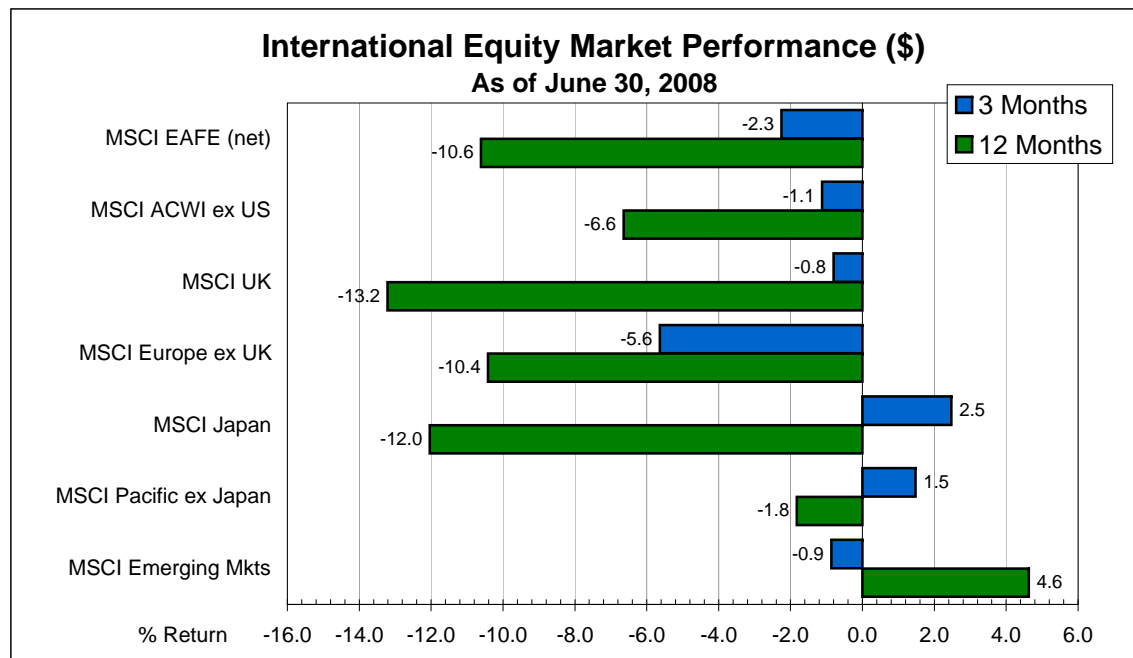
**Treasuries Fall to Inflation:** The fixed income market responded to the surge in inflation data. The yield curve shifted upward for the first time in twelve months; expectations are that the Federal Reserve will institute a tightening policy by the end of the year.

Government issues, the strongest performing sector coming into the quarter, suffered the most from rising rates (down 1.9%). Credit and Mortgages returned slightly better as spreads narrowed, down less than 1.0% for the quarter. High Yield bounced back after two negative quarters, providing the only positive return in the fixed income market.

With inflation being the primary market force, US TIPS (Treasury Inflation Protection Securities) performed the best of the investment grade issues. Over the past year, TIPS have returned 15.1%, benefiting from investors' flight to safety and inflation protection.

The fixed income market is facing several related problems: 1) the continued deterioration of the housing market - the underlying collateral for mortgage backed securities, 2) the impact of sub-prime exposure on many financial institutions and the associated damage, 3) the lack of liquidity within the market due to the fear of mis-pricing securities, 4) the lack of financing available to borrowers due to perceived counterparty risks, and 5) the slowing economy and the impact on individuals and corporations. Despite the efforts of the Federal Reserve, the fixed income market will continue struggling to operate normally until economic conditions improve and the housing market stabilizes.

# INTERNATIONAL EQUITY MARKET



## MSCI Country Indexes Three Months Ending June 30, 2008

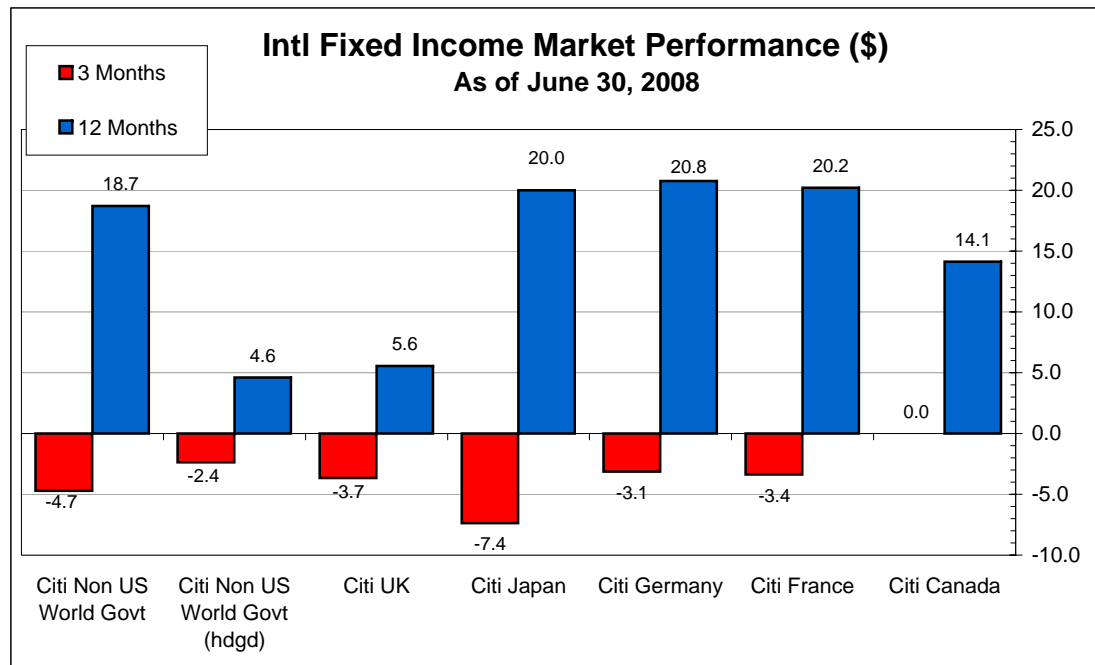
	Return		
	Return US\$ (%)	Local Currency (%)	Currency Effect (%)
France	-3.9	-3.4	-0.6
Germany	-2.4	-1.9	-0.6
Italy	-5.4	-4.8	-0.5
Spain	-8.5	-8.0	-0.5
Switzerland	-5.6	-2.8	-2.8
UK	-0.8	-0.9	0.1
<b>Europe Total</b>	<b>-4.2</b>	<b>-3.6</b>	<b>-0.6</b>
Australia	4.0	-1.1	5.1
Hong Kong	-3.9	-3.8	-0.2
Japan	2.5	9.1	-6.7
<b>Pacific Total</b>	<b>2.2</b>	<b>5.4</b>	<b>-3.2</b>
China	-3.5	-3.3	-0.2
India	-19.7	-13.9	-5.8
Brazil	18.4	7.7	10.7
Mexico	-4.5	-7.8	3.3
<b>Emerging Total</b>	<b>-0.9</b>	<b>-1.6</b>	<b>0.7</b>

**Two Out of Three Is Not Good Enough:** As in the U.S., the majority of international markets moved higher in April and May, only to give back all of their gains in June. Investors in companies/countries exporting commodities and natural resources survived the best (Brazil, Canada, Russia...) while finance and consumer oriented companies/countries (Switzerland, Spain, Italy...) felt the most pain. The international equity markets added rising inflation to the growing list of concerns, including the financial crises, the slowing global economy, and falling consumer confidence.

Europe faces the additional challenges of a strong currency and non-accommodating central bank; stocks declined across the continent with the more severe losses in countries having higher finance exposure. In the United Kingdom, the housing market further compounds problems for equities. However, the market was only down slightly. Japan fared the best of the developed countries, in local terms, as the market bounced back from the abysmal first quarter (down 18%).

The emerging markets provided a wide range of returns for U.S. investors, with Brazil up 18% and India down almost 20%. The winning countries shared strong natural resource-based economies. The common theme with the big losers was inflation, China and India reported inflation rates approaching 10%. In aggregate, emerging markets were slightly lower for the quarter (-0.9%) and positive (4.6%) for the past twelve months.

# INTERNATIONAL BOND MARKET



## Citigroup Country Bond Indexes Three Months Ending June 30, 2008

	Return	Return	Return
	US\$ (%)	Local Currency (%)	Currency Effect (%)
Austria	-3.6	-3.1	-0.6
Belgium	-3.6	-3.0	-0.6
Denmark	-3.6	-3.1	-0.6
France	-3.4	-2.8	-0.6
Germany	-3.1	-2.6	-0.6
Ireland	-4.4	-3.8	-0.6
Italy	-3.9	-3.4	-0.6
Netherlands	-3.4	-2.8	-0.6
Spain	-3.5	-2.9	-0.6
Sweden	-3.9	-2.5	-1.4
Switzerland	-4.3	-1.4	-2.9
UK	-3.7	-3.8	0.1
<b>Europe Total</b>	<b>-3.5</b>	<b>-2.9</b>	<b>-0.6</b>
Japan	-7.4	-1.3	-6.0
Australia	4.7	-0.4	5.1
Canada	0.0	-1.1	1.1

**Another Example of the Global Economy:** Inflationary pressures drove interest rates up around the globe. In Europe and the United Kingdom, credit spreads narrowed during April and May. However, continued signs of the slowing global economic growth sent spreads wider in June. The dollar strengthened against most major currencies, compounding the negative performance.

In Europe, inflation rose to 4.0% year over year in June, well above the ECB's 2% target. The ECB suggested monetary tightening may occur during the summer to control the inflationary pressure, and the bond markets quickly priced in several rate hikes. England continued to struggle with a slowing economy and the collapse of the housing market. The Bank of England lowered rates again by 25 basis points early in the quarter, but rising inflation (above the 3.0% limit) led investors to anticipate rate increases by the end of the year.

In Japan, the inflationary pressures were concentrated in energy and food costs. The Bank of Japan maintained their neutral stance, trying to balance between spurring a weak economy and controlling rising prices.

The emerging fixed income markets out performed the developed markets, generating flat returns for the quarter.

## SELECTED INDEX RETURNS - PERIODS ENDING June 30, 2008

	Quarter	One Year	Three Years	Five Years	Ten Years
<b>US EQUITIES</b>					
Dow Jones Industrial Average	(6.9) %	(13.3) %	5.9 %	7.2 %	4.5 %
Standard & Poors 500	(2.7)	(13.1)	4.4	7.6	2.9
Russell 3000	(1.7)	(12.7)	4.7	8.4	3.5
S&P MidCap 400	5.4	(7.3)	7.5	12.6	9.8
Russell Mid-Cap	2.7	(11.2)	6.8	13.1	8.1
S&P SmallCap 600	0.4	(14.7)	4.1	11.6	7.6
Russell 2000	0.6	(16.2)	3.8	10.3	5.5
Value Stocks - Russell 3000 Growth	1.5	(6.4)	5.9	7.6	1.1
Value Stocks - Russell 3000 Value	(5.2)	(19.0)	3.3	9.0	5.1
<b>US FIXED INCOME</b>					
LB Aggregate	(1.0)	7.1	4.1	3.9	5.7
LB Intm Govt/Credit	(1.5)	7.4	4.3	3.5	5.6
LB Govt/Credit	(1.5)	7.2	3.8	3.6	5.7
LB Government	(1.9)	9.7	4.6	3.8	5.7
LB Credit	(0.9)	3.8	2.8	3.3	5.6
LB Mortgage	(0.5)	7.9	4.8	4.5	5.8
LB High Yield	1.8	(2.3)	4.6	6.9	4.9
LB U.S TIPS	(0.3)	15.1	5.6	6.0	7.8
LB 1-3 Yr Government	(0.8) %	7.1 %	4.7 %	3.3 %	4.7 %
LB Long Government	(2.2)	12.3	3.7	4.7	6.7
<b>INTERNATIONAL (Measured in US Dollars)</b>					
MSCI EAFE (Net)	(2.3) %	(10.6) %	12.8 %	16.7 %	5.8 %
MSCI ACWI ex U.S. (Net)	(1.1)	(6.6)	15.7	18.9	n/a
MSCI Europe (Net)	(4.2)	(11.3)	13.6	17.1	5.6
MSCI Pacific (Net)	2.2	(9.0)	11.3	15.7	6.6
MSCI Emerging Markets (Net)	(0.9)	4.6	27.1	29.8	n/a
Citigroup Non-U.S. Govt Bond	(4.7)	18.7	6.7	7.1	6.7
<b>REAL ESTATE</b>					
NAREIT Index	(5.1) %	(16.6) %	2.5 %	12.1 %	9.5 %
NCREIF Property Index	0.6	9.2	15.0	14.7	12.2
<b>OTHER</b>					
91-Day T-Bills	0.3 %	3.6 %	4.3 %	3.2 %	3.6 %
Consumer Price Index (percent change)	2.5	5.0	4.0	3.6	3.0
Producer Price Index (percent change)	3.4	9.1	5.7	5.0	6.9

Note: Returns for periods longer than 12 months are annualized.