Economic and Social Outlook: *April 2008*

If a short, shallow slowdown unfolds, as we expect, then the stock market has likely already bottomed and the next major move is up. This will be driven by investors increasing their equity exposure in anticipation of a recovery sometime in 2009.

Market Overview

In our market comments three months ago we said we were reducing equity exposure (where appropriate) in anticipation of a rough market ahead. Unfortunately, we were right. In the first quarter of 2008 the S&P 500 index fell 9.4%, the Dow Industrial Average lost 6.9% while the NASDAQ index lived up to its riskier reputation by shedding 14.1%. It was a bad quarter by any measure.

In fact, it was the worst quarter we've seen since the 3rd quarter of 2002. That, you may recall, was at the very bottom of the epic bear market that began in 2000. We think there's more than a passing similarity between today's market climate and what we saw back then.

Sentiment

As was true in 2002, headlines during the first quarter of 2008 read like something out of the Book of Revelation—falling home prices and spiraling foreclosures, plunging financial stocks and banks going bust, gas prices spiking with unemployment rising and recession fears spreading like wild fire.

Of course the media, particularly the financial media, is in the business of creating anxiety—it's how they capture eyeballs. But even taken with a grain of salt, the economic news in 2008 has been decidedly negative.

Not surprisingly recent reports show both consumers and small businesses losing confidence in the economy. And our fellow investors are as downbeat as they've been in years.

The Put/Call Ratio

One of the best measures of investor psychology is the so-called "equity put/call ratio." This ratio is derived by dividing the volume of equity put options traded in a given period by the volume of call options. We'll spare you the details, but suffice it to say investors in put options are buying ***downside protection*** while those buying call options are seeking ***upside participation***. The equity put/call ratio thus gives us a quite precise measure of how much fear is at work in the markets relative to greed. The higher the ratio, the more fear is priced into the market.

During March of this year the equity put/call ratio hit an all-time high--higher than was registered even at the bottom of the bear market in October of 2002. On this measure investors in March were more fearful than they were a year after 9/11, five months before the invasion of Iraq and at the very bottom of a bear market that had cut the S&P 500 in half. We are very encouraged by this.

As we've said countless times, extremes of sentiment, positive or negative, are excellent indicators of future market direction—***contrary*** indicators, that is. Bull markets always die of excess optimism while market declines always end in panic. The put/call ratio in March clearly gave a panic signal.

Volatility

When investors panic they sell indiscriminately in order to eliminate market exposure. This is the "get me out" moment. When this happens *en masse* the resulting wholesale selling drives prices sharply lower but also exhausts the supply of shares to unload.

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Major Market Performance through March 31, 2008

	1st Quarter 2008 % chg.
DJIA	-6.92
S&P 500 (large cap)	-9.44
S&P 1000 (small/mid cap)	-8.41
S&P 1500 (all cap)	-9.33
NASDAQ	-14.07
Lehman State G.O. Muni Bond	0.35
Lehman Gov/Credit Interm. Bond	3.00

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This exhaustion cedes market control to the forces of demand (buyers), who in turn drive prices higher. At the end of a market decline you often get an alternating series of such sell-offs and rallies as the market builds a "bottom," a floor, if you will, from which the next leg up in share prices can launch. The volatility experienced so far in 2008 looks a lot like this sort of pattern—one we also saw in late 2002.

Our View on the "R" Word

Investor psychology is, of course, only one part of the story. The ultimate drivers of stock prices are corporate earnings and these in turn depend on growth in the overall economy. That growth has been called into question as many, including former Fed Chief Alan Greenspan, believe the economy has already fallen into recession. While we're not fully convinced on this point, it's clear that economic growth has slowed to a crawl, if not halted, and will likely remain feeble for the rest of 2008.

That prospect, however, is already priced into stocks. The first quarter did that. For investors, the question now is whether we have a short and shallow slowdown (whether technically a recession or not) with a recovery in 2009 or something longer and deeper. While we can't dismiss the latter possibility, we think the former is far more likely. Our reasons for this conclusion are three.

First, the Federal Government is aggressively using the tools at its disposal to stimulate the economy: cutting interest rates, providing liquidity to the banking system, sending out tax rebates and possibly offering direct assistance to mortgage holders. When Congress, the US Treasury and the Federal Reserve get serious about the economy they generally get results.

Second, a careful reading of the economic data thus far is not yet signaling recession: unemployment is rising but at a far from recession-like pace; industrial production has actually perked up recently, not fallen as you'd expect in a recession; and corporate earnings outside the financial services sector are still growing at a decent pace. Given this mixed data, it's not a foregone conclusion that we'll have a recession at all. Against such a backdrop the aggressive steps already taken by the Feds seem even likelier to prevent a prolonged and severe recession.

Third, our old friend the yield curve has returned to a positive slope where interest rates at shorter maturities are lower than rates at longer maturities. We were mistaken a year ago when we discounted the yield curve's move to an "inverted" posture (short rates higher than long), which has been a very good indicator historically of an economic slowdown ahead.

The yield curve was right a year ago and we were wrong. We think it is right again now as its positive slope suggests a growing economy ahead.

What We're Doing

If a short, shallow slowdown unfolds, then the stock market has likely already bottomed and the next major move is up. This will be driven by investors increasing their equity exposure in anticipation of a recovery in 2009 (remember: stock prices look ahead six to twelve months). We are in this camp. We're keeping our powder dry, however, with equity exposure held at neutral levels pending further signals of a coming upturn in the economy.

Some of the early signs we've already seen are: stock prices stabilizing—the stock market itself is a good leading indicator of the economy's direction; improving performance of "early cycle" sectors like transportation stocks, which are some of the first beneficiaries of economic recovery; and the yield curve returning to a positive slope.

Our job is to stay focused on these sorts of leading indicators, rather than the current gloomy news, as we position client portfolios. Investors who make decisions based on the day's headlines are like a person driving his car by looking in the rearview mirror. Not recommended.

Farnum Brown

Social Advocacy: Darfur

We were pleased to withdraw shareholder resolutions at **Morgan Stanley** and **Merrill Lynch** that asked them to address their relationship to foreign oil companies whose business in Sudan provides revenue for the government's ongoing **genocide in Darfur**.

Morgan Stanley agreed to write to the oil companies to convey their clients' concerns about Sudan, to prepare a public position statement on the issue, and to empower a senior oversight committee to refuse deals based on human rights considerations.

Merrill Lynch agreed to review its own investment banking procedures to take human rights crises into account in its "due diligence" process, and will distribute to its research analysts any information we or other knowledgeable sources provide on companies operating in Sudan. Merrill will also prepare a public statement addressing its stance on human rights and genocide.

Shelley Alpern