

Market Update

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Plumbing Still Clogged

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Two fears currently overhang the US economy: recession and inflation. The troubling prospects for a long-running recession and spiraling inflation suggest no quick solution to our financial woes. It started months ago, even years ago, when interest rates encouraged "lenders" to provide money to anyone who could fog a mirror. Irrational exuberance has unraveled into irrational exasperation wherein the financial markets are frozen; finding money is very difficult. The backdrop of frozen credit, akin to clogged plumbing, holds a key to future market recovery. At the moment, it appears this crisis is in slow motion; the credit pipeline is stubbornly plugged and flow is not easily restored. As the clog begins to move, so too will be better days for the stock market.

The Fed has lowered rates 2.25% to 3% (more likely to come on March 18) and the government is preparing to send Americans \$166 billion to stimulate the economy. There may even be "principal reduction" provided by banks to delinquent homeowners to alleviate an increasing problem wherein the mortgage amount owed is greater than the current market value of the home (an upside-down mortgage).

Our twin fears, recession and inflation, almost never happen at the same time. History reflects that this phenomenon is very rare. Usually as an economy slows, so does inflation with a lag. Hopefully a few more months with lower fuel demand and slowing international economic growth will combine to allow inflation to decline to acceptable levels. Slowing world economies should encourage foreign central bankers to lower interest rates (like the US), which would also stall the slide of the US dollar (sliding dollar is pushing commodity prices higher).

February was a better performing month than January, until Leap Day (2/29; it won't happen again for 4 years). The average domestic stock fund fell 2.5% in February, leaving it down 8.9% year-to-date. The Dow sank 3.0%, the S&P 500 slipped 3.5% and the NASDAQ dropped 5.0%. Foreign provided a positive return in February, beating domestic in general for the year-to-date.

	<u>February</u>	<u>YTD</u>
Foreign	+1.0%	-7.8%
Mid growth	-1.7%	-10.9%
Large growth	-2.2%	-11.0%
Mid value	-2.7%	-7.6%
Small value	-2.7%	-7.3%
S&P 500	-3.5%	-9.2%
Large value	-3.6%	-8.3%
Small growth	-3.8%	-13.4%

Bonds continued to offer a safe-haven alternative to stocks generating better returns again in February. Their better performance was weaker than in January. Some areas of the bond market remain difficult; they are the clog in the financial pipes. Investors do not want bonds that are hard to understand, illiquid, low-quality, or undue risk; those bonds are being severely punished and may not be easily traded. Unique bond structures are problematic clogs in the credit market pipelines.

We expect the clogged pipes will start to dislodge. There are many financial participants taking earlier action in this crisis than ever before in history. Yet this is a different, BIG problem. We expect stocks may soon start to inch upward as the pipes unclog. As that occurs, bonds will likely sell off (prices drop and yields will rise). Treasury bonds are expensive and offer low yields. Please keep in mind, the current problem will be worked on for many years while the economy and financial markets gradually recover. This crisis is a slow motion experience.

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Several themes we have implemented in client portfolios include:

- Broad diversification – own many different style funds with high quality focus
- Good quality bonds – high quality municipals are very attractive; high yield (not yet)
- Foreign may outperform domestic (could be cheaper); Emerging Markets are expensive and priced for perfection
- Large should perform (long-term) better than small; growth better than value

At the moment, investors are not forward looking. They see no end in sight to many economic woes (inflation: food and oil), declining home prices and decreased bank lending. They are asking, "What will it take for stocks to recover?" The prospect for economic growth (albeit slow) is being provided via government stimulus and low interest rates. These actions will start to unclog the financial plumbing. We expect inflation pressures will subside (commodities are priced at irrationally exuberant levels). Lower commodity prices, more available credit, and economic stimulus will cause investors to look forward again and the markets to find footing.

Hang in there; spring and sunshine are on their way. The markets should look more cheery as well.

Other interesting thoughts; or are they?

Serial Bubbles – The tech bubble peaked in 2000; money then flowed to housing (low interest rates) peaking in 2006; money now flowing into emerging markets and commodities (in particular), which seems priced at irrational exuberant heights. Warning: don't invest by following the herd or emotions.

Check our website nvestwealth.com regularly for weekly updates on the markets.



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