

A Midyear Update

In our assessment of the market at the end of February, we said that much of the bad news had already been reflected in stocks. At that time several of our Equity Market Factors were giving positive readings. However, we cautioned that the sustainability of any rally would depend on the extent to which earnings estimates held up. And indeed after a significant rally off its March lows in which the S&P 500 recovered over 10%, the equity market began to lose steam in mid-May. The May selloff was followed by one of the worst Junes in market history.

Obviously, the dramatic rise in oil and other commodity prices was part of the concern, as inflation fears ticked up. However, there has been a dramatic falloff in earnings estimates as well, with the expected year-over-year 2008 consensus earnings growth rate for the S&P 500 Index falling from 15% at the beginning of the year to 6% currently. As shown in Table 1, declines in expectations have been broad-based and not limited to just finance and housing related areas. In fact, the only two sectors with rising earnings growth rates this year are Energy and Materials, not surprisingly the best performing sectors in the second quarter. With this dramatic falloff in earnings expectations, it is not hard to see why the rally ended.

Table 1
S&P 500 Estimated 2008 Growth Rates by Sector

Sector	as of 1/2/08	as of 6/30/08
Cons Discretion	24%	0%
Cons Staples	11%	1%
Energy	12%	34%
Financials	18%	-20%
Health Care	11%	7%
Industrials	12%	7%
Info Tech	18%	13%
Materials	10%	13%
Telecom	12%	-1%
Utilities	8%	5%
Universe Avg (\$WGT)	15%	6%

Valuation still favors growth.

Within this volatile market, the Russell 1000 Value Index underperformed its Growth counterpart significantly in the first six months of this year, down 13.6% versus down 9.1% for the Growth. As shown in Table 2, relative performance is consistent with the estimate revisions taking place in the two indices year to date.

Table 2
Russell 1000 Style Indices

	Est. 2008 Growth Rates			Relative Valuations 6/30/08		
	as of 1/2/08	as of 6/25/08*	as of 6/30/08*	P/E on '08 EPS	Est. Long Term Growth	P/E to Long Term Growth
Growth	16%	10%	16%	17.7	16	1.1
Value	14%	2%	-2%	12.2	9	1.4

*Before Russell Rebalancing
*After Russell Rebalancing

The expected 2008 growth rate for the Russell Growth fell from 16% at the beginning of the year to 10% currently, before the June 30th Russell rebalancing. In contrast, the Value Index growth rate fell from 14% to 2% over this same time period. The growth rate differential between the two indices is even greater after the rebalancing.

Growth stocks had a tremendous run last year, dramatically outperforming Value stocks for the first time in seven years. In our November letter last year, we pointed out that Growth stocks still looked attractive on a P/E to expected 2007 growth basis. Based on the ratios of current P/E multiples to expected long term growth rates for the newly rebalanced Indices, Growth stocks continue to offer better investment opportunities.

Energy and Materials: Last Men Standing?

After a miserable June in the equity markets and a poor start to the third quarter, investors are feeling the pain. The Dow reached official bear market status in the first week of July, and energy stocks, which had been on fire, sold off. The current weakness in energy stocks may be giving us a clue that the recent spike up in energy prices is unsustainable. Monetary authorities abroad are raising interest rates to combat rapidly rising inflation. The eventual slowdown in global growth perpetuated by rising rates may be what it takes to get energy prices down. In addition, the fact that bond yields have fallen recently even as oil prices have made new highs suggests that investors are becoming more worried about energy's effect on economic growth rather than inflation.

There's light at the end of the tunnel.

On the positive side, Sentiment has become extremely bearish again, with the difference between bulls and bears below the negative levels seen in March and the most pessimistic since 1994. Monetary factors are at least neutral, with credit conditions still tight and the Fed not likely to lower rates further. Finally, although we believe fundamentals may remain poor for awhile, our Valuation model continues to show stocks to be attractive on a longer term basis and the equity market should start to improve ahead of the eventual economic recovery.

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