



# Park Piedmont Advisors LLC

Registered Investment Advisor

VICTOR LEVINSON

NICK LEVINSON, CFP®

## MARCH 2008 COMMENTS

### MARCH 2008 MARKET ACTIVITY (ending Monday, March 31)

Despite significant price moves during the month, and noteworthy events (e.g., various Federal Reserve actions, including a  $\frac{3}{4}\%$  drop in interest rates and its involvement in the takeover of Bear Stearns), the monthly results for each of the major US stock market indexes showed only fractional changes: The S&P 500 fell approximately  $\frac{1}{2}$  of 1%, the Dow Jones Industrials were essentially unchanged, and the NASDAQ Composite increased approximately  $\frac{1}{2}$  of 1%. International stock market indexes, both Developed and Emerging Markets, declined, with Emerging Markets falling more after being up last month. Highest quality US Treasury bond prices were modestly higher.

Discussion of all of these price changes appears throughout this month's Comments. (See page 2 for monthly and YTD figures). In our February Comments we wrote: "If the history of stock price recoveries is to repeat, the current problems need to be overcome. The likelihood of recovery, and its timing, depends in part on the general recuperative powers of the very large US economy, and in part on whether both business and government policies are able to work positively to solve the problems. There are no assurances or certainties here, only the knowledge that prior periods with significant problems experienced stock price recoveries." This remains our core view on the current situation, and why we advise our clients to stay with their current portfolio allocations.

This month we will discuss a few economic ideas very much in the news these days: inflation and recession, and the Federal Reserve's actions directed at these issues.

### IMPORTANT UPDATES:

1. We have a new person working with Lynette in our NY office. Her name is Archana Shenoy. Elisabeth Reed, who was working with Lynette, had a baby at the end of February.
2. From now on, Victor's only phone number is 917-741-5450. The 212-588-0015 number is gone. Also, any fax to Victor should be sent to NY office fax at 212-391-2312.

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

**COMMENTS: INDEX RESULTS for period ending MARCH 2008**

	<u>YEAR</u>	<u>YEARS</u>	<u>YEARS</u>	<u>YEAR</u>	<u>YEAR</u>	<u>YTD</u>	<u>MAR</u>
<u>STOCKS</u>	<u>1999</u>	<u>2000-02</u>	<u>2003-05</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2008</u>
Vanguard Total Stock Market Index Fund (1)	23.8%	(37.2%)	53.1%	15.5%	5.5%	(9.5)%	(0.5)%
Standard & Poor's (S&P) 500 Index (2)	19.6%	(40.1%)	41.9%	13.6%	3.5%	(9.9)%	(0.5)%
Vanguard S&P 500 Growth Index Fund (1)	28.8%	(48.4%)	41.8%	9.0%	12.6%	(10.0)%	(0.8)%
Vanguard S&P 500 Value Index Fund (1)	12.6%	(26.2)%	63.2%	22.1%	0.1%	(9.0)%	(0.3)%
Dow Jones Industrial Average Index (2)	25.2%	(27.5%)	28.5%	16.3%	6.4%	(7.6)%	(0.1)%
NASDAQ Composite Index (2)	85.6%	(67.2%)	65.2%	9.5%	9.8%	(14.1)%	0.3%
Vanguard Midcap US Index Fund (1)	25.0%	(18.3%)	83.9%	13.6%	6.0%	(10.5)%	(1.9)%
Vanguard Smallcap US Index Fund (1)	19.6%	(24.2%)	87.5%	15.6%	1.2%	(9.2)%	(0.5)%
Vanguard International Index Fund (EAFE) (1)	25.3%	(45.9%)	95.9%	26.6%	15.5%	(8.9)%	(0.7)%
Vanguard Emerging Markets Index Fund (1)	61.6%	(29.5%)	162.7%	29.4%	39.0%	(10.5)%	(3.6)%
Vanguard Real Estate Investment Trust Fund (1)	(0.4%)	47.5%	98.6%	35.1%	(16.5)%	2.1%	6.2%
<b><u>BONDS</u></b>							
Vanguard Total Bond Market Index (1)	(0.8%)	30.4%	11.1%	4.2%	6.9%	2.2%	0.3%
Vanguard Intermediate Tax- Exempt Index Fund (1)	(2.9%)	23.7%	10.3%	4.4%	3.4%	0.0%	2.5%
Vanguard Short-term Bond Index (1)	2.1%	25.8%	6.5%	4.1%	7.2%	3.0%	0.0%
Vanguard Short Tax- Exempt Index Fund (1)	2.6%	13.8%	4.5%	3.2%	4.2%	1.4%	0.7%
Vanguard High-Yield Bond Fund (1); starting 2002	NA	1.7%	30.7%	8.2%	2.0%	(2.4)%	(0.2)%
Vanguard Inflation-Protected Bond Fund (1); starting 2001	NA	25.5%	20.0%	0.4%	11.6%	5.3%	0.1%

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
<b>S&amp;P 500</b>	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
<b>NASDAQ</b>	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
<b>BONDS</b>	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
<b>S&amp;P 500</b>	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
<b>NASDAQ</b>	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
<b>BONDS</b>	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
<b>S&amp;P 500</b>	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)			
<b>NASDAQ</b>	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)			
<b>BONDS</b>	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)	2.9	3.2			
		<u>2008</u>					<u>2009</u>					<u>2010</u>			
<b>S&amp;P 500</b>	(9.9)														
<b>NASDAQ</b>	(14.1)														
<b>BONDS</b>	2.2														

## MARCH 2008 COMMENTS

**STOCK** index prices for US stocks were virtually unchanged in March, which meant there was no recovery from the YTD declines of January and February. International and Emerging market indexes declined. The only positive result was in REITs, which was the worst performer in 2007, following years of outperformance (see details in chart on page 2).

The broad-based US indexes of Total Stock Market, S&P 500, Dow Jones Industrials, and NASDAQ Composite have declined YTD in a range of -7.6% to -14.1%. Emerging Markets are down -10.5% and Developed Country international down -8.9% YTD.

**BOND** returns (price change plus interest) for the higher credit quality part of the bond market were modestly positive for the month. Municipal bonds recovered from their unusual price declines of February. Treasury Inflation Protected bonds, last year's big winner, continued its outperformance, but their real yields (i.e., after inflation) have been pushed to extremely low levels. Lower credit quality junk bonds continued negative YTD, but the monthly change was fractional. The benchmark 10-year US Treasury yield closed at 3.43%, compared to 3.53% in February and January's 3.64%.

**ECONOMIC NEWS** impacting this month's price movements included negative employment growth, a noticeable slowing in consumer spending, a decline in manufacturing activity, and declining consumer confidence. Inflation rates held steady, while the Fed lowered interest rates by a highly significant  $\frac{3}{4}$  of 1% in an effort to improve economic activity and facilitate the functioning of the credit markets. The discussion of inflation and recession and the Federal Reserve, which begins on page 5, contains additional discussion of current economic news.

From a longer-term standpoint, the five month stock market retreat from October 2007 highs, as part of the housing and credit problems adversely affecting the economy, seems to signal the end of the 2003-07 recovery from the severe bear market of 2000-02. What this means for the direction of future stock prices is of course unknown. Reviewing the period from the 2000 highs to March 2008, the Dow Industrials are 5% higher, the S&P 500 13% lower, and the NASDAQ still a stunning 55% lower. Thus, the annualized returns for all three indexes since 2000 are far below their long-term average annualized returns. The mutual fund company Vanguard notes that from 1926 through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of plus 10.4%.

However, going back further to the bull market that began in 1995, all three major indexes have similar average annual returns, all positive, ranging from 8.3% to 9.2%. (These returns are, however, below the 10.4% average annual return for stocks dating back to 1926.) As they converge, "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), seems apparent. But Vanguard's observation is also meaningful, since annual returns during the bull market were far higher than the long-term averages, and the returns from 2000- Q1 2008 have been far lower.

**The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far) a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.**

	<u>S&amp;P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002 Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2007	1,468	(4)%	13,265	+13%	2,652	(47)%
March 31, 2008	1,323	(13)%	12,263	+5%	2,279	(55)%

**Context: Prior Five-Year Gains in Bull Market of 1995 - 1999**

	<u>S&amp;P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
MARCH 2008	1,323	12,263	2,279
Gain	864	8,429	1,527
Avg. Ann. % Gain: '95-3/08; 13.25 yrs	8.3%	9.2 %	8.7 %

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

## INVESTMENT CONCEPTS: Inflation, Recession, and the Federal Reserve

The chart below, which we introduced with our November Comments, has been updated to reflect the extreme volatility (mostly negative) of the months since the summer of 2007.

	S&P 500	Change from YE06	Dow Jones Industrials	Change from YE06	NASDAQ	Change from YE06
YE 2006	1,418	-	12,463	-	2,415	-
7/19/07 High	1,553	9.5%	14,000	12.3%	2,720	12.6%
8/16/07 Low *	1,370	-3.4%	12,456	-0.1%	2,387	-1.2%
10/9/07 High	1,565	10.4%	14,165	13.7%	2,859	18.4%
12/31/07 Close	1,468	3.5%	13,265	6.4%	2,652	9.8%
1/22-23/08 Low *	1,270	-10.4%	11,635	-6.6%	2,202	-8.8%
3/17/08 Low*	1,257	-11.3%	11,756	-5.7%	2,155	-10.8%
3/31/08 Close	1,323	-6.7%	12,263	-1.6%	2,279	-5.6%

\* Note - Lows from 8/16/07, 1/22-23/08 and 3/17/08 are not closing prices, but daily ("intra-day") lows

Some key observations from the chart:

- 1) From the 10/9/07 highs to the January and March intra-day lows, the S&P 500 was down 19.6%, the Dow Industrials down 17.9%, and the NASDAQ Composite down 24.6%. Those are major declines in a matter of months.
- 2) Each period of decline has witnessed some degree of recovery from the lows. While the extent of the recovery has ranged from modest to substantial, these recoveries, occurring in very short time frames, illustrate the dangers of exiting the stock market after a period of declines, on the assumption the declines will continue.
- 3) There is no way to determine at what point the lows for this market cycle will have been reached, until long after the cycle has been completed.

We will now turn to a discussion of Inflation and Recession, how these economic ideas relate to the current problems in the markets, and how the Federal Reserve is attempting to address these problems. First, some basic definitions:

Inflation refers to the idea of prices increasing generally over time, which in turn means that the same amount of money will buy less over time. The opposite of inflation is deflation, which would refer to the idea of prices decreasing generally over time.

Recession refers to the idea that general economic growth has slowed to the point where there are two successive calendar quarters of declining economic growth. Slow economic growth, particularly declining growth, would be characterized by a decline in employment, as well as in such other areas of economic activity as consumer spending and manufacturing.

There was a time when economists thought that inflation and recession should not occur at the same time, since an economic slowdown (recession) should not allow for rising prices (inflation). But experience during the 1970s proved that rising prices and slow economic growth could in fact exist at the same time.

To highlight why both inflation and recession are problems today, we are going to quote from the most recent Federal Reserve statement that accompanied its decision to lower interest rates by another  $\frac{3}{4}$  of 1%, to a rate of 2.25%, compared to last summer's rate of 5.25%. (Parenthetical comments are ours).

“Recent information indicates that the outlook for economic activity has weakened further. Growth in consumer spending has slowed and labor markets have softened. Financial markets remain under considerable stress, and the tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters.” (These factors all relate to the possibility of economic growth slowing to the point of recession).

The Fed statement continues: “Inflation has been elevated, and some indicators of inflation expectations have risen. The committee expects inflation to moderate in coming quarters, reflecting a projected leveling-out of energy and other commodity prices and an easing of pressures on resource utilization. (Note how a slowing economy would likely have the effects listed as reasons the Fed sees inflation moderating going forward). Still, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully.”

The Fed concludes by taking both economic growth and inflation into account, as follows: “Today's policy action, combined with those taken earlier, including measures to foster market liquidity, should help to promote moderate growth over time and to mitigate the risks to economic activity (i.e., try to avoid recession and restore economic growth). However, downside risks to growth remain. The committee will act in a timely manner as needed to promote sustainable economic growth and price stability.” (The last reference is to the Fed's efforts to control inflation, i.e., to provide price stability).

In the current difficult financial environment, the Fed is clearly favoring the restoration of economic growth, even at the expense of some rising level of inflation, based on its actions both to sharply reduce interest rates and to add liquidity to the financial system.

To continue the general discussion of inflation, consider that if an item that cost one US dollar last year costs \$1.05 this year, that would represent 5% inflation, assuming the item is the same (i.e., with no changes in its quality. The most familiar measure of inflation is the Consumer Price Index (CPI), which tells us how many US dollars it takes today to purchase a fixed basket of good and services that is representative of what consumers buy). It is probably fair to say that no one wants to see a high rate of inflation, where prices of goods and services outstrip the dollars that people have to pay for these goods and services. If the government prints more money to help people pay for these higher priced goods and services, then we are all in real trouble, because printing money simply leads to a spiral of higher prices requiring more money to pay for those higher prices.

Economic policymakers, such as the Federal Reserve in the US, can employ various policies to either encourage or discourage inflation in the economy. The Fed has the power to add or subtract money from the economy, and to impact interest rates, which are essentially the cost of money. As an example of the various forces at work, as oil prices rise, the cost of gasoline rises. All other things being equal, this would add to inflation. But the higher cost of gasoline could cause consumers to reduce their spending on other items, say a vacation, because they only have a finite amount of dollars to spend (and they need the gas, but not the vacation). In this case, the net impact could be some combination of falling prices (hotel rates go down to attract the vacationer) and/or an economic slowdown (if the vacation is not taken at all). If enough people are unable to pay for the variety of goods and services they were buying previously and have to cut back on their purchases, this leads to an economic slowdown, which can become a recession (defined as two consecutive calendar quarters of negative economic growth).

The negative connotations of inflation are clear. But the current economic environment demonstrates the complexity of even this idea, because it is falling home prices that started the problems in the financial and credit markets, and falling home prices are not at all inflationary. Indeed, even as the Federal Reserve tries to keep inflation under control, it is very much trying, AT THE SAME TIME, to have housing prices stabilize, and then resume their upward trend (one could also say "re-inflate"). Similarly, after stock prices decline, investors are most interested in seeing stock prices resume their increases (one could again say re-inflate). So how do we know which price rises are good, and which are not?

One answer to that question is a function of the rate of price increase. For example, an increase of 3% or 5% a year in housing and stock prices may be considered reasonable and sustainable, while increases of 10% or more become unsustainable, because economic growth (in the case of stock prices), or income growth (in the case of income to support higher housing prices), cannot be maintained at those rates for very long. When the prices of stocks or housing continue to rise beyond sustainable levels, a "bubble" is said to occur, and the piercing of the price bubble spreads serious economic damage (witness the history of the stock market declines of 2000-02, and the housing market declines of current times).

Another answer relates to the items whose prices are rising. The rise in prices of assets such as housing or stocks, which we think of as having value over extended periods of time and are capable of providing additional income, is usually looked upon favorably (again, absent the pricing bubbles referred to above). By contrast, the rise in the price of items we consume immediately, such as gasoline or food, or that need to be replaced with some frequency (autos and clothing), are typically looked upon unfavorably.

Suffice it to say that controlling the inflation we do not want, while encouraging the rise in prices we do want, is a very, very, complex matter, which, in the current economic environment, has placed the Federal Reserve in a very difficult position. Further complicating the Fed's current actions is its desire to maintain general economic growth at a reasonable rate. The decline in housing prices has made it clear that many of the mortgage loans made during the period of rising housing prices should not have been made. The investment losses on these mortgages and other credit-related securities has made many major financial institutions reluctant to extend further credit. (Many of these losses came from certain investors taking on highly leveraged positions that required the continuation of rising asset prices to work out favorably, but this is another subject for another day). This tightening of credit, which basically cuts off some consumers and businesses from needed sources of money, in turn feeds the prospect of an economic slowdown/recession. We are therefore seeing the Federal Reserve taking many steps to keep the financial system functioning properly (its involvement with Bear Stearns is an example of this, which is another subject for another day).

Our bottom line view at Park Piedmont is that the Federal Reserve knows what it is doing, much more so than the media and the politicians who keep up ongoing criticism of the Fed for either doing too much or too little. We believe it takes time for the Fed's actions to work themselves through the economy, and that some degree of patience is needed to allow the Fed's actions to achieve their desired results.



**Victor Levinson**



**Nicholas Levinson**