Delta Financial Advisors

May 2008

Economic Comments

The Federal Reserve yet again pruned interest rates at its April-end meeting. Following the April 30th meeting, the Federal Reserve's rate setting committee lowered overnight interest rates by ¼ percentage point to 2.0 percent. With the most recent cut, the Fed has lowered overnight interest rates by 3¼ percentage points over the last 8 months.

While the most recent cuts have been largely due to recent financial market disruptions, internal disagreement within the Fed has been rising as two board members have expressed increasing concern with the Fed's short-term focus on current crises rather than taking a longer-term perspective in setting rates based upon more basic economic fundamentals. Moving forward, we anticipate this part of the rate setting committee to be increasingly vocal in raising their concerns.

While the Federal Reserve has placed heavy reliance on core inflation in setting overnight interest rates, we question whether this approach is somewhat ignoring the forest for the trees. The April reading on the CPI-U (the most common measure of broad based inflation) showed a hefty 4.0% increase over the prior year. While core inflation has recently been more restrained than the CPI, it expressly excludes the more volatile food and energy. The small challenge to this thought process is that these two cost inputs appear to be subject to broader based upward trends in pricing.

As a result, and despite the Fed's near term need to reduce interest rates to combat financial market disruptions, we believe that the Fed will be compelled to commence raising interest rates within the next several quarters so as to combat growing broad based inflationary pressures.

Despite the latest interest rate cut, the dollar has strengthened modestly by several percent against foreign currencies in recent weeks from its most recent lows. Helping facilitate the improvement has been a reduction in the country's trade balance (in this case imbalance) which has recently narrowed to a deficit of $58 billion, primarily as a result of lower imports.

To the surprise of many, the economy continued to grow in the 1st quarter, albeit at a very tepid rate. Initial estimates place the quarter's growth to have been at a 0.6% rate, the same level as the last quarter of 2007. A key driver in this performance remains the continued bleak level of new housing construction. Investment on new housing during the quarter declined by an enormous 26 percent while consumer spending turned more cautious, growing by only 1% - its lowest rate of expansion since the 2001 recession.

Another positive note was struck by labor productivity which rose a better than expected 2.2 percent in the first quarter. More critically, in a sign that wage pressures could be easing, unit labor costs rose at a rate of 2.2 percent – down from the 2.8 percent growth seen at year end 2007.

Tempering the enthusiasm is the continued plunge in construction as new home starts in March hit its lowest level in 19 years in the face of an 11.0% year over year decline. Looking forward, building permits (which anticipate future construction) also fell signaling continued problems for the troubled sector. Amidst the recent financial and economic uncertainty, many businesses are pulling back with durable goods orders falling by 0.3% during the first quarter.

Consistent with the decline in durable goods, consumer confidence also has suffered. Consumer sentiment fell again in April, for a third month in a row, and hit its lowest level in more than 25 years amidst inflation and housing worries. A major consumer concern remains oil prices which have firmly moved above $120/barrel.

We have been surprised by the resilience of the economy in the face of these elevated energy prices. As a result, we remain cautiously optimistic that the economy will avoid a major slowdown but rather, at worst, will be subject to a brief pause before resuming a more robust growth pattern.

Market Comments

What a difference a month can make. As March ended, Wall Street was reeling from the hammer blows of enormous losses in the financial sector coupled with the failure/sale of the major Wall Street player Bear Stearns. Four weeks later, the markets have largely shrugged off its recent fears and surged upwards by almost 5% for the month of April.

Leading the charge, amidst continued resurgence in oil prices, was the energy sector with an almost 11% gain. The only sector losing ground in April was the consumer staples sector as investors

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Performance as of 04/30/08				
	Close	***Month***	***YTD***	***1 Year***
DJIA	12820.13	+4.70%	-2.63%	+0.46%
S & P 500	1385.59	+4.87%	-5.04%	-4.67%
NASDAQ Comp.	2412.80	+5.87%	-9.01%	-4.43%
	Month end yld.	***Prior Yr. end yld.***	***12 mo. prior yld.***	
10 yr. U.S. Treasury	3.76%	4.03%	4.63%	

became less enamored of defensive names in the face of the month's broad based upswing.

As we look forward, corporate profits for the 2nd quarter are anticipated to decline by 5.5%. However, once the earnings (or in this case losses) from financial companies are removed, the S&P 500's earnings are actually anticipated to climb by almost 8 percent.

We are somewhat concerned that the market's mood has so quickly returned towards euphoria following its recent bout of fear. Typically, for a new bull market rally to commence, investors must achieve a sense of total defeat, give up on stocks being attractive investments and capitulate to the market gods.

Although the markets have rallied more than 10% from their most recent mid March lows, investors never truly surrendered their belief that the markets continue to inexorably rise. Demonstrating this issue is the CBOE Volatility Index, VIX, which measures investors' expectation for future market volatility. The VIX, which had briefly climbed above 30 in mid March as the Bear Stearns saga hit its climax, has declined more than 30% since then and now reads in the high teens. On purely historical levels, VIX readings above 40 have typically indicated market capitulations. As a result, many market strategists, including ourselves, are hard pressed to answer whether the recent downturn pressures on the market are truly over.

Analyst Corner

We have been holders of shares in Microsoft for awhile. The company has recently been in the news with its now failed attempt to acquire Yahoo! Inc. In an effort to increase its internet exposure, the Redmond, WA company failed in its attempt to convince Yahoo's management to sell the company.

The issue moving forward is what action will Microsoft take to remedy this perceived product deficiency. While we are strongly concerned that the company will take overly precipitous action, we believe that the company's current value already reflects an appropriate discount for these risks. While not suitable for all clients, the holdings of Microsoft should provide attractive, risk adjusted returns in coming years.

Planning Thoughts

While this tax code change will not go into effect for more than 18 months, we wanted to alert you to a major pending change in Individual Retirement Account rules. Currently, Roth IRAs may only be funded if a couple's combined income is under $159,000. Other IRA accounts may be converted into a Roth account if income is less than $100,000.

Starting in 2010 the income limitation for conversions is repealed. Individuals with high incomes will then be able to convert existing IRAs into Roth accounts. Moreover, by contributing funds first to a traditional IRA and then converting those funds into a Roth IRA, these individuals will also effectively be able to contribute to Roth IRAs directly.

Given the permanent tax exemption of Roth IRA accounts, we will certainly be having additional discussion of this attractive tax advantage as the eligibility date in 2010 comes nearer.

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