# Delta Financial Advisors

***September 2008***

## *Economic Comments*

Having met on August 5th, the Federal Reserve's rate setting committee left overnight interest rates unchanged at 2%. The group continued to highlight its belief in moderating inflationary pressures along with its continued concerns about the ongoing housing contraction, elevated energy prices and tight credit markets. However, given continued soft economic data, the likelihood of a near term rate increase appears to be fairly unlikely.

With faltering growth in other developed economies, the likelihood of accelerating economic growth in the year's 2nd half is growing increasingly dim. Strong export growth coupled with weak import demand bolstered 2nd quarter's economic growth by almost 2½ percentage points. While having grown sharply over the last seven years, the United States' trade deficit (primarily as a result of increased exports) has narrowed by more than 15% from its summer of 2006 highs. In the absence of strong exports, the nation's economy would have barely treaded water with 2nd quarter growth of 0.5 percentage points.

The continuation of strong export markets grows less likely with the dollar having strengthened from its recent lows and large foreign markets, specifically the Euro zone and Japan, having slowed markedly over the last quarter. The one positive in this picture is that the U.S. economy is likely to recover sooner than Europe and/or Japan in that the United States' monetary policy with its already low overnight interest rates is already stimulative, albeit with associated inflationary risks.

The jobless rate jumped unexpectedly in August to nearly a five year high as unemployment surged to 6.1%. While the unemployment rate is still relatively modest on a historic basis, the recent jump was the result of both a falling number of jobs and an increase in people seeking employment. Nonfarm jobs declined by 84,000 with losses spread widely across industries with prior month payroll estimates revised downward to reflect greater job losses.

While reported consumer prices increased by 5.6% over the last year (the biggest jump in more than 17 years), the key component of accelerating inflation, average hourly wages, continues to show moderation with hourly wages showing a nominal increase of 3.4% and a real decline in actual purchasing power. Another damper on inflation expectations came with the unexpected surge in labor productivity coupled with a decline in labor costs. At a historically high 4.3% increase, the revised 2nd quarter productivity increase was nearly double initial estimates. Moreover, the resilient labor productivity reduces the risk of wage inflation – the area that often represents the biggest risk to accelerating inflation.

The core CPI has recently shown a far more modest increase of 0.3 percent, reaching a 2.5% rate of annual increase. The key question in assessing our inflationary future is how to define inflation. A parent with unhealthy children attending private schools is going to have a different appreciation of inflation than a healthy retired couple. From the Federal Reserve's perspective, historical inflation is mostly irrelevant as they are focused upon inflationary expectations and future expectations. In short, your perspective on inflation can be highly situational.

In a continuation of a tired old song, the housing markets' woes continue. Home prices have now declined by almost 8% over the last 12 months. Foreclosures of U.S. homes have risen by 55% as homeowners hit by weak housing sales, declining home prices, tighter lending criteria and a weak U.S. economy have few options with which to avoid foreclosure. In all but eight states, foreclosure rates have increased over year earlier levels. The small silver lining of this scenario is that the continued decline in housing prices is opening the market to more and more potential buyers who prudently stayed on the sidelines during the recent real estate euphoria.

We believe that the key to solving the U.S. economy's current funk will be a resolution of the continued housing contraction and its affiliated tight credit market. Unfortunately, it now appears likely that clarity on these issues will not appear until 2009 is well underway.

## *Market Comments*

With the end of August, all sectors of the S&P 500 were down for the year with the financial and telecom sectors showing the greatest declines. For the year, two stocks have declined for every 1 stock with gains within the S&P. As painful as the U.S. market losses have been, global markets have faired far worse with markets worldwide falling an average of 23%. The tiny Jordan and Morocco markets were among the few countries' financial

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| *Performance as of 08/31/08* | | | | |
|---|---|---|---|---|
| | ***Close*** | ***Month*** | ***YTD*** | ***1 Year*** |
| *DJIA* | 11,230.73 | +1.81% | -11.43% | -11.35% |
| *S & P 500* | 1282.83 | +1.45% | -11.39% | -11.13% |
| *NASDAQ Comp.* | 2367.52 | +1.80% | -10.72% | -8.81% |
| | ***Month end yld.*** | ***Prior Yr. end yld.*** | ***12 mo. prior yld.*** | |
| *10 yr. U.S. Treasury* | 3.81% | 4.03% | 4.54% | |

markets still showing gains for the year.

Additional insult to already skittish investor sentiment was inflicted by Fannie Mae and Freddie Mac in August as Wall Street came to believe that there was a high likelihood of the companies' stocks becoming worthless. With these two agencies having become the primary source of mortgage credit, it is now more important than ever (at least to Washington) to preserve the two mortgage providers.

The current credit crunch continues at full bore with the yields on high-yield bonds having moved to historically high levels. The yields on these speculative securities have expanded by almost 20 percent since the beginning of the summer to more than 8 percentage points above those of U.S. Treasury obligations. Similarly, over the last 3 months, the FDIC has increased by 30% the number of financially troubled banks that it is closely monitoring. However, the market for U.S. Treasury obligations has benefitted from the month's tumultuous stock market as the yield on ten-year notes declined by 0.17 percentage points to 3.81%.

The easing of commodity prices has somewhat eased investor's inflationary concerns. However, the recent decline comes as a mixed blessing as it appears to be an artifact of the economic slowdowns emerging in both Japan and Europe.

One challenge for earnings growth moving forward could be the reduced growth from foreign sales. Of those S&P 500 companies who break out their foreign sales, 46% of their revenues came from overseas in 2007. Between reduced growth rates in the major developed countries and a rebounding dollar, U.S. companies are likely to have additional headwinds going into their next earnings season.

While the near-term outlook remains far from rosy, we should keep the prospects for stocks in perspective. While market fundamentals have deteriorated, stock valuations (by some metrics) are historically low. Given the weak investor sentiment and historically low cash and bond yields, there is a high likelihood of stocks out-performing the other liquid investments available to investors over the next 12-18 months.

## *Analyst Corner*

We recently spent time favorably reviewing United Technologies (*NYSE:UTX*). A diversified industrial manufacturer, the company is best known for its Sikorsky helicopters, Otis elevators and Pratt & Whitney jet engines.

While clearly tied to the U.S. (and global) economic cycle, we believe that UTX has a very attractive product mix which yield substantial recurring revenue streams. Despite being conservatively capitalized with lesser amounts of debt, the company continues to produce attractive returns on shareholder's funds. Moreover, the company has consistently raised its dividend as a result of steadily improving cash flows. While not a "story" company, we believe that the company's longer term returns could be quite exciting.

## *Planning Thoughts*

Many of us do not keep very good financial records as other higher priority activities end up taking precedence. Unfortunately, this can cost money in the form of additional taxes. If you do not keep good financial records, all of your allowable income tax deductions and credits are probably not being utilized.

With a little bit of effort, you can set up a system to track tax related items that will save you from scrambling for this info at tax time, only to miss some money saving items in the rush to complete your tax return.

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