

Market Update

The economic data over the past month confirms that the US economy continues to grind lower; however, there is evidence that most of the bad news and the likelihood of a recession are priced into the market and that the market may now be looking across the valley and anticipating a recovery later this year. The stock market typically rallies before recession troughs, and we may be seeing an anticipatory rally beginning.

Economic News

As expected the Fed lowered the fed funds and discount rate by 25 basis points, to 2% and 2.25%, respectively. We believe the Fed is now on pause and will not make further rate cuts unless economic conditions deteriorate more than expected, believing that the 3.25% in rate cuts since September 2007, along with other measures taken to stimulate the economy, will eventually have their intended effects. The end to interest rate cuts could have some positive effects as it could help bring an end to the dollar's decline and help stabilize, and even reduce, the cost of oil. The falling dollar has contributed to the run up in oil prices since oil is priced in dollars, and more dollars are required to purchase a barrel of oil when the dollar declines.

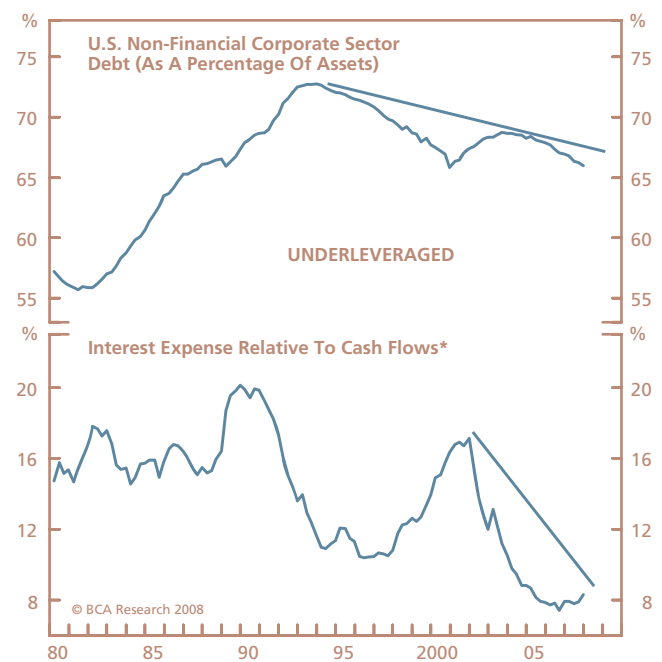
The 1st quarter GDP numbers, which were released on April 30th, confirm that the economy continues to struggle. Real GDP growth was 0.6% for the quarter and while this is actually better than the consensus expectation of 0.2%, the upside surprise was due to an increase in business inventories. This marks the second quarter in a row in which real GDP growth has been only 0.6%. Growth should pick up in the second quarter due to the effects of the governments tax rebate stimulus program. The distribution of tax rebate payments as part of the stimulus program started on April 28th and by the end of May the distribution of over \$100 billion in funds will largely be completed, providing spending stimulus that should help stabilize the economy.

For the economy to fully stabilize and start to rebound, housing prices need to bottom. There is no evidence that is happening yet as home prices declined another

2.7% in February, as reported in the S&P/Case-Shiller report released on April 29th. Housing prices are not expected to stabilize until sometime in 2009, potentially causing a drag on the economy through 2008.

One reason to believe the current slowdown may be relatively mild, despite the havoc wreaked by the housing bubble and subprime meltdown, is the health of the non-Financial corporate sectors. Chart 1 illustrates this point, showing that non-financials are relatively underleveraged and their healthy profit margins are resulting in very low interest expense as a percentage of cash flow.

CHART 1: HEALTHY CORPORATE SECTOR



* Earnings before interest, taxes and depreciation.

In addition to healthy balance sheets, earnings of the S&P non-Financial sectors are also growing, albeit at a slower pace, with growth of 10.7% for the 1st quarter after excluding Financials (see Chart 2).

Businesses have also kept hiring in check and inventories low, which should allow corporations to weather the downturn without making the drastic cuts in headcount and production typical of most recessions.

CHART 2: NON-FINANCIAL EARNINGS GROWING

Sector Contribution to Aggregate S&P Earnings Growth - Q1 2008	
Excluding - Financials	10.7%
S&P 500	-12.6%
Excluding -Discretionary	-12.7%
Excluding -Materials	-13.1%
Excluding -Utilities	-13.3%
Excluding -Telecom	-13.6%
Excluding -Industrials	-14.2%
Excluding -Staples	-14.9%
Excluding -Tech	-15.4%
Excluding -Health Care	-15.9%
Excluding -Energy	-19.0%

Source: Strategas

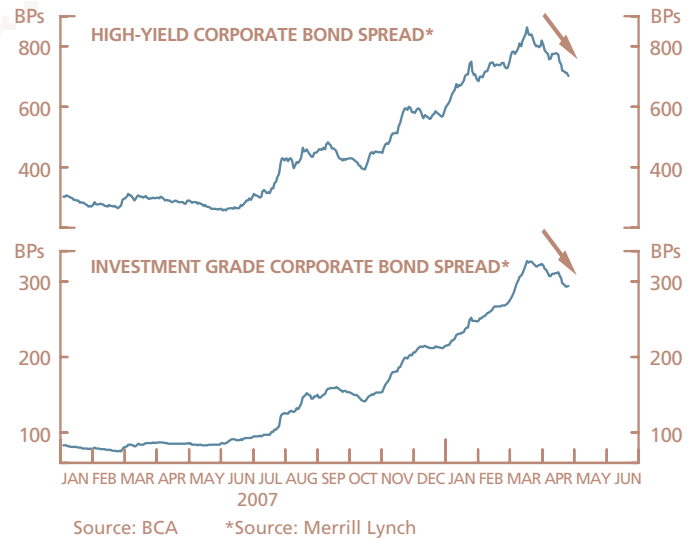
Market Performance and Outlook

Equity market lows were reached in March with the S&P 500 closing at 1273 on March 10th, one week before the Fed bailed out Bear Stearns. It is interesting to note that the S&P index has increased nearly 9% through April 30th since its lows in March. It is possible that the bailout of Bear Stearns could have been a turning point in the market. The Fed's actions signaled that it will do just about anything to keep the subprime mess under control. The market may see light at the end of the tunnel, even though there will be more bad news in the weeks and months ahead as the economy works through the housing-created slowdown.

Evidence that investors are starting to take more risk can also be seen in the recent narrowing of credit spreads, which reached their peaks about the same time the stock market bottomed in March (see Chart 3).

Since that time, spreads have narrowed considerably, indicating that investors are becoming more comfortable returning to risky assets.

CHART 3: RISK TAKING RETURNING TO MARKET



Source: BCA *Source: Merrill Lynch

It is certainly possible that the recent market rally may not be sustained as several risks remain that could create a deeper slowdown than expected. These include:

- The continuing downward spiral in housing prices. As prices continue to decline, foreclosures increase and add additional risk to the subprime mess.
- Consumer spending. The loss of wealth due to declines in home values and investment portfolios could cause consumers to slow their spending to a point that we experience a more severe recession than many are predicting. Consumer spending makes up 70% of GDP, so a significant slowdown here could have a more pronounced impact on the economy. Government stimulus checks and plans to aid struggling homeowners should mitigate this risk.
- Conditions in the credit markets which are keeping banks from lending to each other and to consumers. The Fed's aggressive actions to provide liquidity should eventually work to get the credit markets functioning normally.
- The increasing costs of oil, food and other commodities are putting pressure on the consumer and could lead to uncomfortably high inflation.

We will continue to monitor these developments and communicate our thoughts in ongoing commentary.

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