

Quarterly Market Review

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Financial Markets and Economic Analysis, First Quarter 2008

Perspective

It would be relatively easy, though well beyond the usual length of our commentary, to discuss the major events that have negatively impacted the markets during the first quarter. The U.S. equities markets had their worst overall quarter since 2002, the end of the last bear market. The larger questions are: "Where are we today?" and "Where are we going tomorrow?"

As of the end of the first quarter, the 1-year Treasury is yielding 1.6% and the year-over-year change in the CPI-U reading as of February was 4%. Many forecasts for 2008, when including food and energy, are for slightly lower inflation; but at levels that would indicate a negative real rate of return on the 1-year for 2008. Gold, after hitting a high of more than \$1,000 per ounce in February, backed down slightly before the end of the quarter, but still finished over \$900 per ounce. Oil also had a slight pullback in March, but ended the quarter at more than \$100 per barrel, a 75% increase from the year before. The trade weighted value of the U.S. dollar has fallen 9.6% over the last 12 months, continuing a trend that has lasted since early 2002. As of the end of the year, the latest point from which data is available, 5.8% of all mortgages in the U.S. were delinquent and a record 2% were in actual foreclosure. New single family home sales fell 1.8% in February, and were down nearly 30% over the preceding 12 months. New construction of housing fell 7.8% in February and was 36.5% below the level a year ago. Including the March numbers released last week, job growth in the first quarter was -232,000 and unemployment increased from 4.8% to 5.1%.

The litany of concerns relevant to market participants includes: falling interest rates, negative real returns, rising commodity prices, falling value of the dollar, rising foreclosure and delinquency rates, negative job growth and rising unemployment. Negativity abounds in the market today, as well it might with 10% losses during the quarter. On the other side of the equation, GDP growth over the remainder of 2008 is expected to be positive, however minimally. If the recently passed economic stimulus package has the same impact as the stimulus package in 2003, there will be a (temporary) spike in growth. So, the remainder of 2008 should see slow, but positive growth, under an overhang of negative market sentiment and a slew of economic problems. The fixed income markets will be difficult to use as the usual safe haven, with yields below 3%, and little price appreciation left. Corporate bonds face the dual spectre of a further widening of spreads and a weak economic environment. International fixed income may deserve a larger place in asset allocations, even with lower global yields, as the continued weakening of the dollar would increase returns. We would expect the equity markets, both domestically as well as internationally, to continue to be highly volatile through the remainder of the year, as the effects of the sub-prime crisis have not fully played out yet. For investors with long-term goals, and the fortitude to withstand near-term swings, current valuations are a tempting target. Overall, 2008 should be a very exciting year, which may give market participants a better understanding of the Chinese curse: "May you live in interesting times."

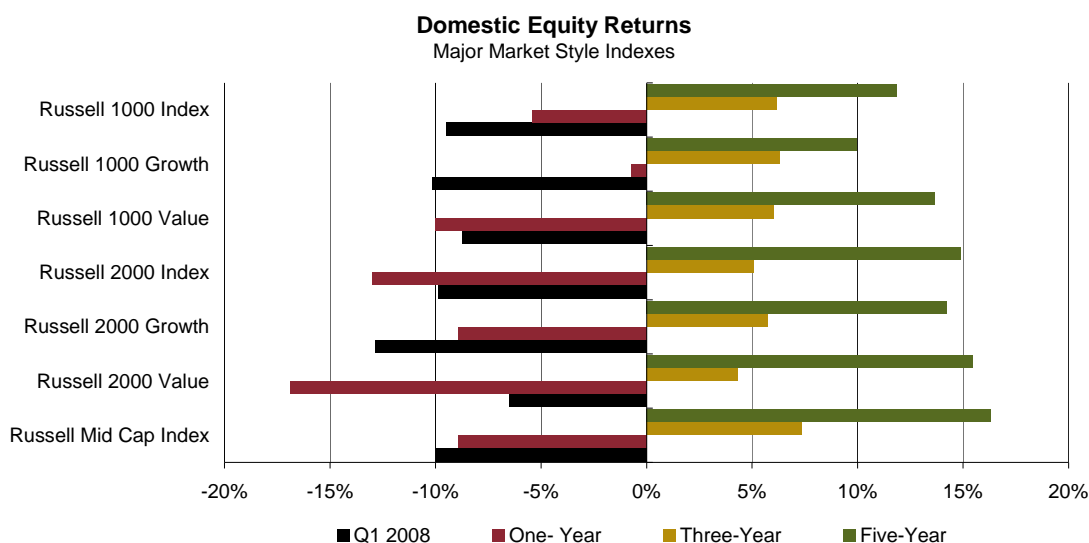
Domestic Equity Markets Overview

Similar to the fourth quarter, the domestic markets were negative across the board during the first quarter of 2008. This also pushed all of the Russell indexes into negative territory over the trailing one-year period. The Russell growth style indices, in favor for the first time in four years in 2007, quickly reversed that trend, at least for the first quarter, underperforming the value indices across the board. However, there was very little difference in returns by market cap for the Russell indexes. Energy appears to have been the swing sector among the Russell indices during the quarter. In the small cap

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space, Energy was the only positive sector, allowing the small caps to keep pace with large caps. In the large cap space, the negligible losses for the Russell 1000 Value compared to sharp losses in the 1000 Growth accounting for most of the 1.4% difference between those indices.

Delving deeper into the index returns, the two most depressed segments in the large cap index were the Financials sector (-13.2%) and the Technology sector (-14.6%), neither of which is surprising. Portfolio managers were given some room to add value during the first quarter, as the remaining sector returns ranged from -3.6% in the Consumer Staples sector to -11.2% in Utilities. The Russell 2000 Growth Index was the worst performer in the asset class for the quarter. This was primarily due to losses in the Technology sector (-19.9%) and Healthcare (-16.1%), which make up more than 45% of the Index. Surprisingly, the Russell 2000 Value Index was the best performing index, as the critical Financials sector was down just 4.6% for the quarter.



International Markets Summary

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The international markets were down sharply as well during the quarter, with the MSCI EAFE Index down 14.9% in local currency terms. The continued slide in the dollar mitigated some of those losses for U.S. investors, with just an 8.8% loss for that Index in dollar terms. There was little opportunity to add value through region selection during the first quarter, as most of the major regions had very similar returns. However, country selection left managers many more opportunities. Country index returns ranged from Denmark's 0.4% (the only positive country index) to Hong Kong at -18.8%. Outside of Denmark, Europe was "led" by Ireland (-1.0%) and Switzerland, (-1.8%) while Greece (-15.8%) and Portugal (-13.2%) brought up the rear. In somewhat of a reversal from recent periods, Japan outperformed most of the Pacific markets, down just 7.8% for the quarter.

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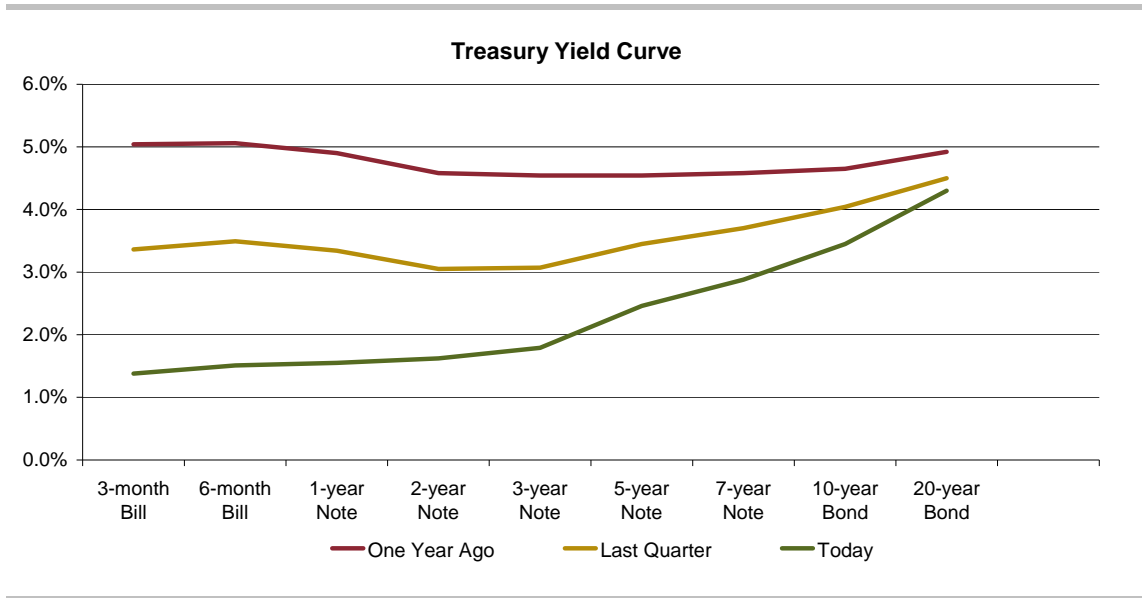
Many of the leading emerging markets saw sharp reversals in the first quarter. Last year's leader, Brazil, saw a relatively slight 5% decline, while China (-23.7%) and India (-27.0%) had significant losses. The emerging markets offered even more opportunities for portfolio managers to add value, as there were a handful of country indices with positive returns for U.S. investors. Latin America was led by Chile (+9.8%), Peru (+5.3%) and Mexico (+5.0%). Taiwan (+5.3%) and Thailand (+3.4%) were leaders in the Far East. On the other side, emerging Europe was negative across the board with Hungary (-13.7%) and Russia (-11.5%) near the bottom. In addition to the losses in China and India, the Philippines (-16.9%) and Korea (-12.7%) also saw significant losses.

Fixed Income Summary

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The Fed's interventions during the first quarter, two rate cuts and the opening of the discount window to investment banks, along with continued risk aversion from investors created a similar return pattern in the first quarter as was seen in the fourth quarter of last year. Treasury yields continued to drop with the short end of the curve dropping nearly 200 basis points and the intermediate portion of the curve dropping nearly 100. 5-year Treasuries yields fell to just 2.5% at the end of the quarter, and the Lehman Intermediate Treasury Index returned more than 4.5% over the first quarter. Spread product continued to trail the Treasury indexes, despite falling rates as risk averse investors continued a "flight to quality," and credit spreads widened substantially. The Lehman Intermediate Corporate Index returned just 0.8%, while the Lehman MBS Index, including Agency securities, was up 2.4%.

The municipal market was shocked at the end of February, with sharp losses to end that month. Hedge fund sellers are reportedly to blame, dumping massive supplies on the market. Hedge funds have been significant buyers of municipals over the past few years, and their absence from the market has been felt. The market recovered sharply in March, though only at the short and intermediate maturities was it enough to bring the indexes into positive territory for the quarter. The Lehman 1-10 Year Municipal Index returned 1.47% for the quarter, though the Lehman Municipal Index (covering all maturities) fell 0.6%. Higher credit quality portfolios should have sharply outperformed those of lesser quality, regardless of maturity, as the AAA and AA sectors of the market outperformed the BBB segment by more than 150 basis points. With the sharp fall in Treasuries over the course of the quarter, municipal bonds are trading at or near the same yields, for similar maturities. This could create some excess demand over the short-term.



Outlook

Investors were treated rudely in the first quarter, with broad and deep declines in the world equity markets. There was some good news in the fixed income markets, but only a little, and only for investors in the right areas. For the remainder of 2008, volatility is likely to remain high, which could be a difficult transition for many investors after a long period of very little to no volatility. Prima continues to believe that the credit crisis will continue to hang over the market for at least the second quarter, and possibly longer, given that policy makers will be constrained by the recessionary environment, rising prices, and shrinking value of the U.S. dollar. Investors should remain focused on their long-term goals, prudent asset allocation, and continue to monitor portfolio exposures. The recent volatility in the market provides investors with the chance to re-asses risk tolerances, an important factor in a portfolio construction process.

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