Robshaw & Julian Associates, Inc.

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Investment Matters

For the quarter ended March 31, 2008

Looking For a Bottom in Stocks

From its peak price of 1565 last October 9th to its recent low of 1273, the S&P 500 Index fell 18.6%, enough in some circles to qualify as a bear market. The key question at this point is, where is the bottom?

At bear market bottoms, the difference between the yield on investment grade corporate bonds and the yield on safer government bonds, normally about 1.5%, becomes unusually large. This "yield spread" gets bigger because corporate bond buyers demand a higher return for taking on the increased risk of lending to businesses when the economy is weak. At the exact low point of the last bear market in October, 2002 the yield spread reached a peak of 3.2%. More typically the yield spread has peaked at around 2.5%. The current reading is 2.7%.

THE HIGH CORPORATE YIELD SREAD IS TYPICAL OF A BOTTOMING STOCK MARKET

Stock market bottoms are also marked by low and falling real short term interest rates. The "real" rate is the current interest rate minus inflation. This represents the true cost of credit for borrowers. Using a Fed Funds rate of 2.25% and a core inflation rate of 2.40%, real short term rates are below zero. Most observers expect them to drop still further when the Federal Reserve meets in April.

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Bear markets usually drive stocks to attractive valuations. One simple measure of this is the Rule of 20 which consists of the price earnings ratio of the S&P 500 plus inflation. When these two add up to much more than 20 the market is rich. Much below 20 and the market is cheap. Depending on exactly how you measure earnings and inflation the recent low price of the S&P 500 produces a number between 16 and 19. Valuation is attractive.

Other indicators like investor sentiment (excessively pessimistic) also indicate that this is a good time to buy stocks.

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Are Stock Buybacks Good or Bad?

The financial press is full of stories of companies which are buying their own stock in the public markets. Despite the positive spin of these stories, stock buybacks are not uniformly good for investors.

First, buybacks may not actually reduce shares outstanding. This can happen if announced buybacks are not fully implemented or if repurchased shares are added the Employee Stock Option Plan.

Second, although using corporate cash to reduce shares outstanding automatically raises Earnings per share and Return on Equity while decreasing the Price Earnings Ratio, the market is not so easily fooled by what is essentially an accounting maneuver. A share buyback also reduces company Assets and Book Value per share. In a sense, a buyback shrinks the company.

Third, management may be repurchasing stock only to pump up the stock price in the short term, not to increase long term shareholder value. Unless a stock is selling below its long term intrinsic value, a buyback hurts the long term

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Buybacks: continued

investor. As Warren Buffet has said, “Buying dollar bills for $1.10 is not good business for those who stick around."

Companies issue stock to finance future growth. Having discovered a proprietary way to earn high returns, they seek more money to expand those returns. They use the money to purchase assets which they make more productive and hence, more valuable. Those which are successful are rewarded with higher stock prices. Companies with great opportunities are not likely to repurchase shares.

If a company does not see profitable opportunities for expansion, and its stock is truly undervalued, a stock repurchase makes excellent sense. If the stock is fairly valued the maneuver will be neutral. If the stock is overvalued, long term investors will be

Economic Perspective

The words “recession” and “depression” are increasingly being used to describe our current economic condition. Before too many of your tax dollars are appropriated to solve this problem, you may want to put the situation into perspective.

Gross Domestic Product, the total market value of all goods and services produced, is the standard measure of economic health. Real GDP growth, that is GDP growth minus inflation, is the statistic most often cited. The average rate of real GDP growth since World War II has been 3.2%. In 2007, with nominal growth of 5.1% and 2.6% inflation, real GDP advanced 2.5%.

A recession is a significant decline in real GDP which lasts for six months or longer. Since WW II the U.S. has experienced 10 recessions with an average duration of 10 months each.

The longest post-war recessions (1973-75 and 1981-82) lasted 16 months each. The last recession in 2001 lasted only eight months.

It is impossible to know for sure if we are now in a recession. Real GDP grew at an annualized rate of only 6 tenths of 1% in the last quarter of 2007 and data from the recent quarter has not been tabulated. Unemployment is at 5.1%, up from 4.5% one year ago but far below the typical recession level of 7%. New unemployment claims are also higher but not alarmingly so. Other indicators also point to slow growth but not to a recession, and surely not a deep or long lasting one. Rising food and energy costs are constraining consumer spending, but not enough to drive the entire economy into recession.

The economic effect of the mortgage crisis is difficult to estimate. As in every financial crisis (they used to be called as “panics”), a spiraling decline which ends in double digit unemployment is too easily imagined. More likely markets will self-correct as they have so many times in the past. The 1990-91 recession, caused by a near collapse of our banking system, was followed by a strong recovery. Bank stocks led the way up.

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As of January 31st, the government reports that vehicle miles driven in the U.S. has dropped 1.7% from last year and oil demand is down 2.2%.

The Bottom Line: 3/31/2008

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1323	-9.4%
Small company stocks *(S&P Small Cap Index)*	365	-7.5%
Short term interest rates *(3 Month T-Bill Yield)*	1.3%	From 4.9%
Long term interest rates *(10 Year T-Bond Yield)*	3.4%	From 4.6%
Inflation *(Consumer Price Index)*	212.6	+4.1%
Energy *(West Texas Intermediate Crude Oil)*	$101.60bbl.	+54%
The economy *(Inflation adjusted GDP)*	14.1 trillion	2.5%

QUOTABLE

“Throughout all my years of investing I've found that the big money was never made in the buying or the selling. The big money was made in the waiting.”

Jesse Livermore

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