



Financial Crisis Pressures Linger as the U.S. Economy Experiences Post-Housing Bubble Moderation and Risks to Inflation Increase with Food and Energy Prices

Financial sector write-downs and credit losses, declining home values and higher food and energy prices worked to restrain U.S. economic growth in the second quarter and negatively impact the labor market and consumer sentiment. During the second quarter, stock prices moved lower, bond yields rose and the surge in prices for commodities increased inflation expectations.

The ongoing financial crisis, which has led to almost \$400 billion in announced write-downs and credit losses worldwide to date, continued to weigh on the share prices of banks, brokerage firms and insurance companies in the second quarter. Future earnings in the Financial sector will likely also remain under pressure as revenues from securitization, corporate mergers and acquisitions and initial public offerings moderate to below historic levels. The announced losses have led to a reluctance of financial institutions to lend. As a result, tighter lending standards remain a threat to economic growth, as credit expansion is needed in an economy that relies on borrowing. The current phase of balance sheet repair and capital issuance will need to run its course to allow for the extension of credit for future economic expansion.

The recession in the housing market is also restricting economic growth. As evidenced by price declines, lower sales and construction levels and rising defaults and foreclosures, housing related data remain exceptionally weak. Between 1996 and 2005, house prices nationwide increased about 90 percent, but in 2006 the boom turned to bust and house prices have shown significant declines in many areas of the country. Recent data indicates that home prices are falling at an accelerating pace. The Standard & Poor's/Case Shiller Index for the first quarter of 2008 showed prices for existing homes nationwide declined 14.1% from a year ago, a rate higher than the 8.9% price decline in the fourth quarter of 2007.

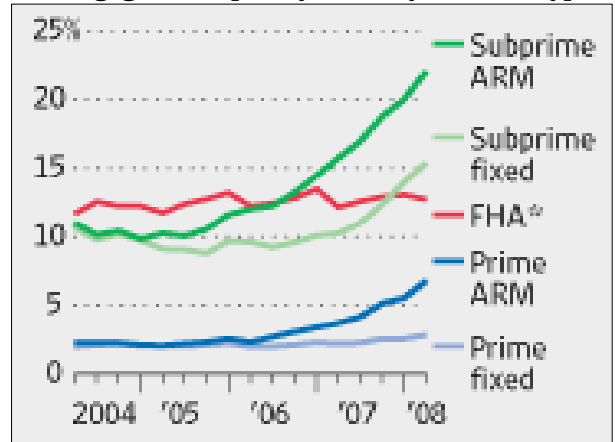
After peaking in 2005 at 6.35 million units annualized, sales of existing homes measured 4.89 million in April. Single-family home construction dropped to a 17-year year low of 692,000 annualized in April, according to the Commerce Department. The Mortgage Bankers Association reported that approximately 1.3 million homes were in foreclosure at the end of the first quarter. The number of loans that were at least 30 days past due climbed to 6.35%, the highest since 1979.

Write-downs and Credit Losses vs. Capital Raised

Region/Firm	Total Losses	Capital Raised
Worldwide	\$399.4 billion	\$322.2 billion
Citigroup Inc.	\$42.9 billion	\$44.1 billion
UBS AG	\$38.2 billion	\$29.4 billion
Merrill Lynch & Co.	\$37.1 billion	\$17.9 billion
HSBC Holdings Plc	\$19.5 billion	\$3.5 billion
Deutsche Bank AG	\$16.2 billion	\$13.3 billion
Royal Bank of Scotland	\$15.6 billion	\$24.5 billion
Bank of America Corp.	\$15.1 billion	\$20.7 billion
Morgan Stanley	\$14.4 billion	\$5.6 billion
Credit Suisse Group AG	\$9.8 billion	\$1.5 billion
Washington Mutual Inc.	\$9.3 billion	\$12.1 billion

Source: Bloomberg

Mortgage Delinquency Rates by Product Type



Source: The Mortgage Bankers Association and The Wall Street Journal

In an unwelcome surprise to the global economy, prices for food and energy are soaring. The synchronized global expansion from 2003 – 2007, including the unprecedented growth in emerging markets, as well as tight supplies, a weaker U.S. dollar and an increase in the volume of commodities contracts are all contributors. Crude oil, corn and natural gas rose 46%, 63% and 78% respectively, this year. The national average price for gasoline topped \$4 per gallon in June.

Global central banks are raising interest rates and reserve requirements for banks in an effort to contain inflation pressures. In June, Federal Reserve Chairman Ben Bernanke said policy-makers “will strongly resist an erosion of longer-term inflation expectations.” However, this environment is challenging for the Fed’s dual mandates of low inflation and full employment, especially as non-farm payrolls have declined each month for the first five months of 2008.

Manufacturers are passing higher raw materials costs to their customers. The yearly change in the producer price index measured 7.2% in May, near a historic high. While market-based inflation expectations remain moderate as measured by the 2.6% rate differential between 5-year U.S. Treasury notes and Inflation Indexed notes, the Reuters/University of Michigan survey of households in May registered 5-year inflation expectations of 3.4%. There are some signs of demand destruction and behavioral changes that along with slower economic growth could help to moderate the rise in commodity prices. Americans are driving less, SUV sales are down while compact/hybrid sales are up, and airlines are cutting flights in order to reduce fuel consumption.

Godsey & Gibb Associates remains cautious as the lingering pressures from the financial sector, the recession in housing and the rise in inflation expectations have led to reductions in the labor markets and weaker consumer spending, which is the primary driver of U.S. economic growth. The unemployment rate increased from 5.0% to 5.5% in May and the University of Michigan Consumer Sentiment Survey for June measured a 28-year low. While wage gains and rent inflation have both been modest, Treasury yields have increased as fears of inflation in the volatile food and energy sectors have risen. The Federal Reserve lowered its projections for growth in real GDP this year from a range of 1.3% - 2.0% in January to 0.3% - 1.2% in April. Consensus estimates for S&P 500 earnings growth for 2008 are currently 7.1%. Company profit margins may have peaked and the lagged effects of \$4 per gallon gasoline will likely slow economic growth into next year.

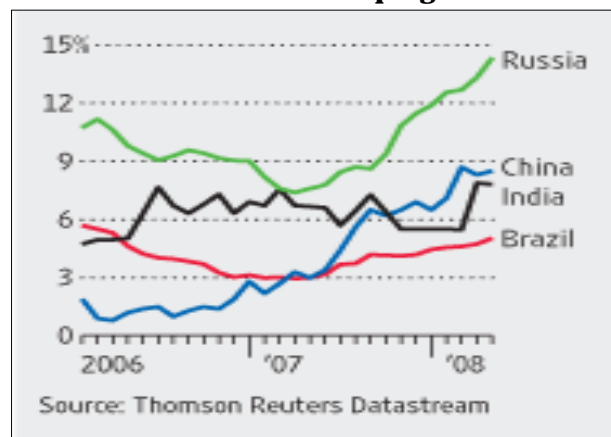
Given the heightened risks to near-term economic growth, our investment strategy remains defensive. We continue to position portfolios conservatively for capital preservation and consistent long-term growth. We maintain an overweight to U.S. large cap growth companies, with attractive valuations, leading market share positions and reasonable capital structures. We maintain an underweight exposure to the economically sensitive Financial and Consumer Discretionary sectors, an overweight position in the less economically cyclical Health Care and Consumer Staples industries and above average cash levels for capital preservation. In balanced and fixed-income portfolios, we maintain a conservative stance with an overweight position in short and intermediate term investment grade securities to minimize interest rate risk.

Corn Futures - Price of Front-Month Contract



Source: The Wall Street Journal

Inflation Rates In Developing Economies



Source: The Wall Street Journal

This report is intended solely for the clients of Godsey & Gibb Associates. The information and opinions herein are for general information use only. Godsey & Gibb Associates does not guarantee their accuracy or completeness, nor does Godsey & Gibb Associates assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sale of any security or as personalized investment advice.