Godsey & Gibb Associates
Investment Watch
March 31, 2008

Data Suggest U.S. Economy May Experience Recession, Policy Makers Respond With Extraordinary Liquidity Measures and Deleveraging Continues To Weigh on Growth

The ongoing credit market turmoil took center stage in the first quarter as a liquidity crisis increased financial market volatility and sent shares of leveraged investment banks, hedge funds and commercial lenders dramatically lower. Yields for U.S. Treasury securities fell to a multi-year low as investors sought safety and quality. The economic data in the U.S. continued to weaken and the Federal Reserve intervened with extraordinary liquidity measures to stabilize financial markets.

The economic data in the U.S. indicate that a contraction in growth has begun, most likely in December 2007, increasing the risk of a recession. While the official word on a recession versus a significant economic slowdown will not come until the National Bureau of Economic Analysis makes its ultimate determination after the fact, a broad range of economic measures declined in the first quarter. Moreover, in its statement on March 18, the Federal Reserve said, "The tightening of credit conditions and the deepening of the housing contraction are likely to weigh on economic growth over the next few quarters."

Multiple economic indicators are signaling a slowdown. The index of leading U.S. economic indicators, a broad measure of economic activity, fell in February for the fifth straight month. The Federal Reserve Bank of Philadelphia's Business Outlook Survey, a gauge of manufacturing activity, contracted in March for the fourth month in a row. Non-farm payrolls declined in February, marking the second straight month of overall job declines and the third straight month of private sector payroll declines. Durable goods orders for items meant to last more than three years also fell in February and the Conference Board's consumer confidence index for March slumped toward recession levels. Consensus economic estimates are for overall economic growth of below one percent in the first two quarters of 2008, with a modest but below trend recovery in the second half of the year.

Given the credit market and economic uncertainty, volatility in both the equity and fixed income markets increased and remains elevated. As of March 31, the S&P 500 Index experienced daily changes of one percent or more on 46 percent of the trading days this year, a multi-year high. Moreover, yields for U.S. Treasury Bills recently reached the lowest levels in over 50 years as investors sought safety with short-term Treasuries.

In light of the increased risks to growth and financial market stability, the Federal Reserve and other policy makers recently announced extraordinary measures to provide liquidity. The Fed's announcements included: a Term Auction Facility to lend up to $100 billion to member banks, up to $100 billion in 28-day term repurchase agreements as part of its open market operations, a Term Securities Lending Facility to offer up to $200 billion to primary dealers, a Primary Dealer Credit Facility to make secured loans of an undetermined amount to primary dealers against an expanded range of collateral, and $30 billion in financing indirectly to an investment bank via its discount window. In addition, the Fed cut its Fed Funds Policy Rate three times in the quarter (Jan. 22, Jan. 30 and March 18) for a total of 200 basis points of easing and its Discount Rate four times for a total of 225 basis points. Since the beginning of its easing cycle in August of 2007, the Fed has reduced the Fed Funds rate six times, moving the rate 3.00% lower, and cut its Discount Rate eight times, moving it down 3.75%.

In addition to the actions by the Federal Reserve, the Office of Federal Housing and Enterprise Oversight (OFHEO) announced a major initiative to increase liquidity in support of the U.S. mortgage market. OFHEO reduced the capital reserve requirements for both Fannie Mae and Freddie Mac from 30% to 20%. The initiative is expected to provide up to $200 billion of immediate liquidity to the mortgage-backed securities market.

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The Federal Housing Finance Board also announced plans to allow the nation's 12 Federal Home Loan Banks to buy more than $100 billion in mortgage-backed securities, creating even more liquidity for the mortgage-backed securities market.

With these recent announcements, policy makers have indicated a willingness to do most anything in their power to ensure financial stability and to promote growth. Although the latest measures do expose a significant level of the Federal Reserve's balance sheet to an increased level of credit risk, in our view the interventions mark an innovative and creative approach to provide stability to the financial markets in a challenging period.

Along with the previously announced monetary and fiscal stimulus, several factors may limit the duration of the economic slowdown. In analyzing the last two U.S. recessions, several developments were able to limit the length and overall impact. Deregulation of markets, improvements in inventory management and increased globalization appear to have helped limit the duration of the last two recessions (1990-1991 and 2001) to an average length of eight months. In the 1990 – 1991 recession, Gross Domestic Product (GDP) declined 1.2% from peak to trough. In 2001, real GDP fell 0.4%. While the housing slump has subtracted over a percent from annual growth in the current cycle, rising exports added nearly one percent and helped to counteract the negative impact from housing.

We will be monitoring the ongoing credit crisis for any signs of improvement, as credit creation is a leading indicator. A reduction in the available level of credit caused by deleveraging is forcing banks to become more cautious and tighten lending standards in order to improve their balance sheets.

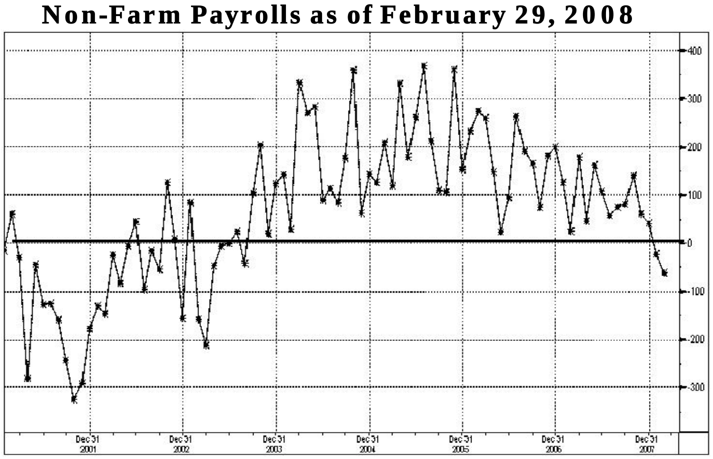
The unwillingness of banks to lend is impacting the financial markets and the economy. As banks called in loans and margin requirements from investors, commodity prices for gold and crude oil temporarily fell. Institutional investors that had bid commodity prices up were reportedly forced to sell assets to cover margin calls, sending the prices sharply lower. Economic activity based on lending is also declining, as the weakness that started in housing is spreading to Financials, Consumer Discretionary and other industry sectors.

However, the yield curve, which plots the yields of U.S. Treasury securities by maturity from three months to 30 years, has steepened. This may be a positive sign for the future earnings of Financials. An upward sloping yield curve allows financial institutions to borrow short-term money at low rates and lend it out longer term at higher rates.

Last year, declines in the Financial sector led to a four percent drop in earnings for companies that comprise the Standard & Poor's 500 Index. Financial sector earnings fell 37 percent, while non-Financial earnings rose over six percent, according to S&P. Although overall earnings are expected to decline again in the first and second quarters, S&P estimates increases in the second half of the year and an annual overall earnings gain of 12 percent.

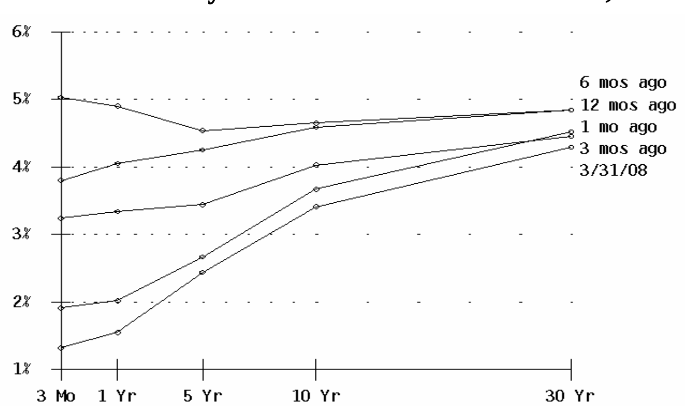
We remain overweight the Health Care and Consumer Staples industries, and maintain above average levels of cash. We are underweight the economically cyclical Financial and Consumer Discretionary sectors. Given the near-term risk to economic growth and earnings, we are maintaining our defensive portfolio positioning until indicators confirm additional economic stabilization and better prospects for the equity market.

Non-Farm Payrolls as of February 29, 2008



Source: Bloomberg

U.S. Treasury Yield Curves as of March 31, 2008



Source: Baseline

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