



## AMERICAN FINANCIAL ADVISORS, LLC

### Market Commentary 2<sup>nd</sup> Quarter 2008

Asset Class	Qtr	1 Year	3 Year	5 Year
US Stocks (S&P 500)	-2.7	-13.1	4.4	7.6
International Stocks in Developed Countries (MSCI EAFE)	-2.6	-10.6	12.8	16.7
Emerging Market Stocks (MSCI Emerging)	-0.9	4.6	27.1	29.8
Bonds (Lehman US Aggregate)	-1.0	7.1	4.1	3.9
Inflation Protected Bonds (Lehman US TIPS)	-0.3	15.1	5.6	6.0
Real Estate Investment Trusts	-4.9	-13.6	5.0	14.3
Commodities (DJ-AIG)	16.1	41.6	19.8	18.6
Inflation	2.5	5.0	4.0	3.6

The second quarter was the best of times for energy stocks (+17%) and the worst of times for financials (-19%). This duality reflected investors concerns about inflation, weakening corporate profits, faltering employment rates, continued weak real estate markets on which mortgage-backed securities depend. Overall stocks were down as were bonds.

So how do we think investors should react to all of this?

First, don't panic. Recessions happen. Some are worse than others. This one feels pretty bad, but it's ridiculous to even broach the idea of a depression as we've heard some commentators do. As we've mentioned in the first paragraph, it is a tale of two cities. There are winners. Exporters and domestic manufacturers are benefiting from a weak dollar (our products are cheaper) and from high energy prices (it's more expensive to transport goods from abroad). Higher commodity prices are helping farmers and energy producers.

Investors should maintain the proper perspective, which is a time horizon of at least five years. Through the second quarter stocks were still well ahead of bonds and inflation over the last five years. We have noticed that, since the beginning of 2000, they are barely positive and behind inflation. The fact is if stocks weren't risky, if they never underperformed, they wouldn't offer the expectation of higher returns.

This leads to the most important issue, which is one of diversification. In our minds, we divide the world along two axes, growth and inflation. Sometimes economic growth rate increases or decreases and sometimes inflation increases or decreases *relative to current expectations*.

Higher growth with higher inflation is good for commodities.  
Higher growth with lower inflation is good for stocks.

Lower growth with higher inflation is good for inflation-linked bonds.  
Lower growth with lower inflation is good for nominal (fixed rate) bonds.

I've greatly simplified to make the following point. It's so difficult to forecast how the future will deviate from current expectations, that it makes sense to cover the bases perhaps emphasizing the areas somewhat based on one's own expectations.

Currently, our expectations are that inflation will be a problem due to global growth. US growth will remain lackluster while the real estate situation settles. It took years for the real estate bubble to inflate and it will take a while to deflate just as it took a while for the tech bubble.

The market clearly has its share of fear and panic. It appears to us that many financial stocks are priced for the worst. The Financial sector (XLF) is down over 42% over the last twelve months. The market is already discounting a weak economy and real estate market.

This is not a stock market to avoid. When there's this much anxiety prices are usually reasonable or attractive. This isn't to say things can't get even worse and that prices can't go down further. They can. Rather we view this market as an opportunity. In contrast, we become anxious when everyone is euphoric and prices are high. When this market does recover, it may very well rise sharply and quickly which is why we counsel against getting out of the market completely.

We continue to think the global growth story is still intact, although emerging markets will not grow as fast as previously forecast. Long term, one should have an allocation to these markets. While commodities have had a good run, we still want some exposure because of our concerns about inflation.