THE CONROY REPORT

Outlook
As of July 1, 2008

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Summary

Economic Outlook

- The market and the Fed are now mostly focused on inflation as the driver of the economy. Inflation has been above its long-term average of 3% for the past five quarters. Higher interest rates are needed to curtail price appreciation.
- Markets will be in turmoil, range bound and volatile. We believe higher interest rates are necessary to stave off inflation despite the risk of curtailed consumer spending.

Investment Recommendations

- Today's steep yield curve reflects expectations for rising inflation. Move in to cash for now and/or allocate more heavily to short-term corporate bonds.
- We continue to believe that investors should look to hedge performance in stock markets, but we are concerned about the dramatic appreciation in commodity prices.

Economic Forecast

We have been arguing for some time that the U.S. economy will come to face inflation risk and this now appears to be the case. Inflation has been at or above its long term rate of 3% (see top chart on right) for the past five quarters. Despite wide credit spreads, we believe that underlying regulatory rates and Treasury bond yields are too low and need to be higher to avert further inflation pressures.

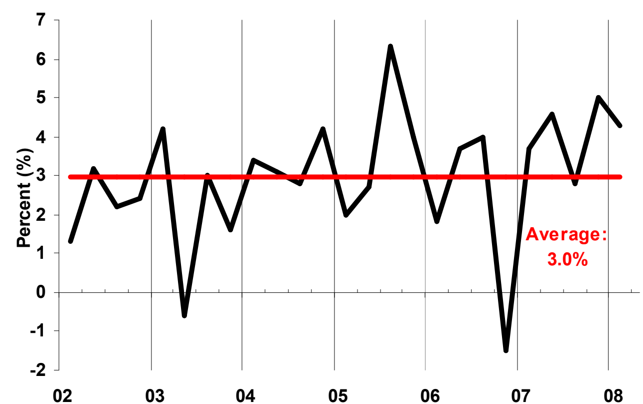
The Fed tweaks the federal funds rate, now at 2%, by lowering it to stimulate the economy or raising it to make it more costly to borrow money thereby inhibiting growth and rising prices. From 2004 to 2007, the Fed raised rates as housing prices skyrocketed. When housing prices finally peaked, a new problem emerged – higher rates contributed to losses in the mortgage lending business. Prices fell dramatically for complex asset-backed securities, many of which had shaky mortgage loans as collateral, and soon the subprime lending crisis emerged. The Fed watched this develop for over a year until it began to quickly reduce rates as it had underestimated the impact of the crisis.

While housing prices have fallen, there has been inflationary pressure elsewhere in the economy. Commodity prices, particularly oil and food, are still on the rise. Low interest rates have and will continue to exacerbate the situation. The Fed and the market are now grappling with the risk of a broader appreciation in prices with respect to both consumption and income or wages. The fact that longer-term interest rates are much higher than shorter term ones reflect expectations for rate hikes. This has been our view and remains our view: regulatory and market-driven interest rates will be higher in a year from now.

We forecast a 3.5% annualized GDP growth rate for the U.S. economy in 2008. The 0.9% annualized growth rate for the first quarter (see **green bars** on chart) suggests it will be otherwise. However, the year is not over. Inflation risk is high, rates are still low and the U.S. Dollar is weak. Also the market is less concerned with the fallout of the subprime lending crisis. Perhaps it is being perceived that banks are being more preemptive in dealing with associated balance sheet problems.

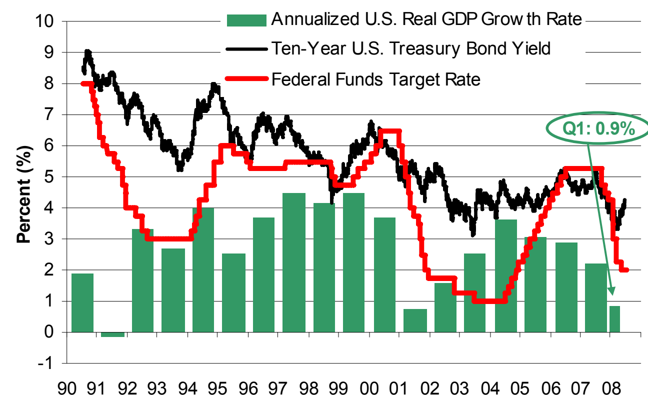
Looking forward, we believe the main risk to the economy may be a contraction in consumer spending. Unemployment has recently risen. Consumer net income is being strained with salaries unchanged in the face of inflation. Consumer balance sheets are also weaker: falling home prices, weaker equity markets and a low savings rate on the one hand; high debt loads and rising interest rates on the other. Markets will be in turmoil, range bound and volatile. We believe higher rates are necessary to stave off inflation despite the risk of curtailed consumer spending.

Inflation Remains High



Sources: U.S. Department of Commerce Bureau of Economic Analysis. Data series shows seasonally-adjusted quarterly changes in the Consumer Price Index on an annualized basis.

U.S. Economic Growth and Selected Interest Rates



Sources: Federal Reserve, U.S. Department of Commerce Bureau of Economic Analysis, Yahoo! Finance.

Introduction to Bond Investing

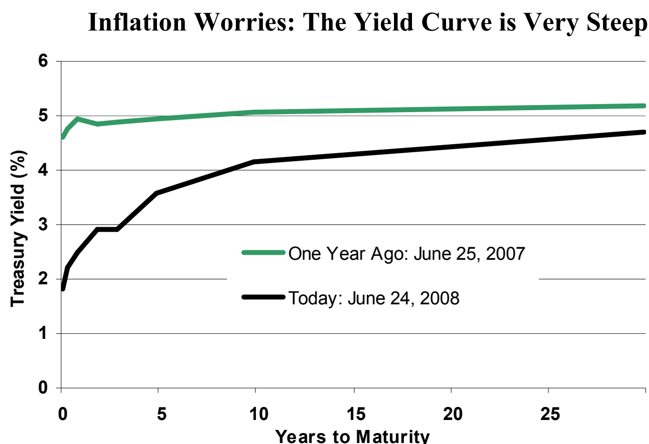
We encourage investors that have less familiarity with bond investing to contact us at ConroyServices@gmail.com regarding this topic. Following are some important facts about the bond market:

- Bond prices move in the opposite direction of interest rates.
- The rate of return on a bond is a result of price movement, like a stock, as well as income from periodic interest payments or "coupons".
- The minimum amount to invest is usually $1,000.
- Bond ratings are meant to reflect credit risk and are assigned by rating agencies, such as S&P, Fitch and Moody's.
- The same diligence should be taken when buying a bond issued by a company as buying a stock of that company.
- Investment-Grade bonds have the highest ratings, triple-B or higher, and are generally considered to be "safe". This means that the issuing entity is very likely to pay to investors all promised principal and interest and is, therefore, very unlikely to default.
- Corporate bonds can be rated as high as triple-A, but most are double-A, single-A and triple-B rated.
- Treasury, Municipal, and Mortgage bonds are usually rated triple-A.
- High yield bonds are, generally speaking, corporate bonds that are rated below triple-B. This market has higher default risk than the investment-grade market. They are sometimes called "Junk" bonds.

Government Bonds

A popular citation these days, in one form or another, is that today's steep yield curve reflects expectations for rising inflation. The shape of the Treasury yield curve is certainly a hot topic. As shown in the accompanying chart, the "yield curve" can be illustrated by plotting interest rates at various maturities. In the chart, we show the current yield curve (see **black line** on chart) and its shape a year ago (see **green line** on chart). It is immediately apparent how steep the yield curve is now relative to how flat it was a year ago.

Inflation Worries: The Yield Curve is Very Steep



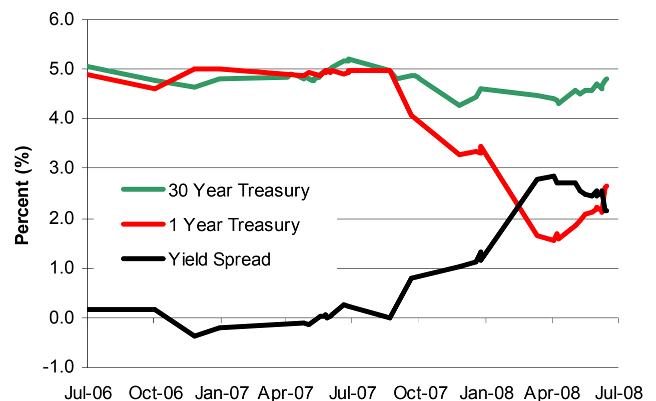
Sources: Yahoo! Finance, U.S. Department of Treasury.

Today's steep yield curve suggests that interest rates will rise and this can be attributed to expectations for rising inflation. This is a view which we continue to espouse. Bond yields should reflect any risk that might be encountered between now and the time the bond matures. Importantly, investors demand an offset to inflation and this is a major factor in a bond's yield. The value of a dollar today should rise as time elapses given the general appreciation in prices over time. Prices tend to rise by about 3% per year as reflected in the Consumer Price Index. Each point along the curve provides a lot of information, some of which is related to other points along the curve. All else being equal, the yield curve reflects the market's outlook for inflation and the greater the worry about inflation, the steeper the yield curve.

For over a year, we have been forecasting for higher Treasury bond yields and recommending that investors should allocate funds more heavily in the short end of the yield curve. Longer-term bond yields have stayed about the same for more than a year. In both charts we can see that the 30-year Treasury bond yield is still hovering around 5% (see **green lines** on charts). As discussed, we expect it will move higher. Our investment recommendations were and continue to be for a holding period of twelve months. Therefore, we believe that investors that locked in high short-term rates did well over the past year. As shown in the graph below, 1-Year Treasury Bond yields and 30-Year bond yields were both at 5% twelve months ago; there was no extra compensation for buying longer-term bonds.

Looking at the yield curve now, we recommend moving even further to the short end of the yield curve. We recommend cash, CDs and other money market instruments. Moreover, we believe that consumers should be increasing their savings rate.

Interest Rates Have been on the Rise this Past Quarter



Sources: Yahoo! Finance, U.S. Department of Treasury.

Investment-Grade and High Yield Corporate Bonds

We believe investors should buy selected investment-grade corporate bonds that mature within two years. These bonds offer yields that are very high relative to savings accounts and many other short-term investments. We believe that these yields overcompensate for the current risk in financial markets. We also believe that these bonds will perform well if market conditions change in-line with our expectations.

Of the many factors affecting bond markets today, two major ones are that interest rates are very low and credit risk is very high. Low interest rates have made it difficult to find attractive yields on short-term investments such as savings accounts and CDs. For example, the graph shows that the two-year U.S. Treasury Bond yield is now around 3.0% (see **red line** on chart). To put things in perspective, this investment yield would just offset the typical rate of inflation which is around 3% per year. At the same time, credit risk is very high. The subprime mortgage lending crisis and fears of an impending recession have given way to inflation risks. This heightened uncertainty has made lenders apprehensive and, therefore, corporations and other borrowers now have to pay a much higher interest rate on loans than usual (see **green line** on chart). We believe the high yields offered by short-date corporate bonds relative to Treasury yields (see **black line** on chart) and other money market instruments negate these problems effectively.

We believe that short-dated corporate bonds will remain in favor and perform well if market conditions change in-line with our expectations. If economic growth recovers in 2008, as we expect it will, then we believe interest rates will move higher and that credit risk will diminish. Bond prices move in the opposite direction of both interest rates and spread. This inverse relationship is magnified by the maturity date of the bonds. Also, the impact of interest rate movement is generally greater than that of credit spread changes. Therefore, we believe short-dated corporate bonds will perform well on a relative basis if markets change as we expect.

Technical Discussion

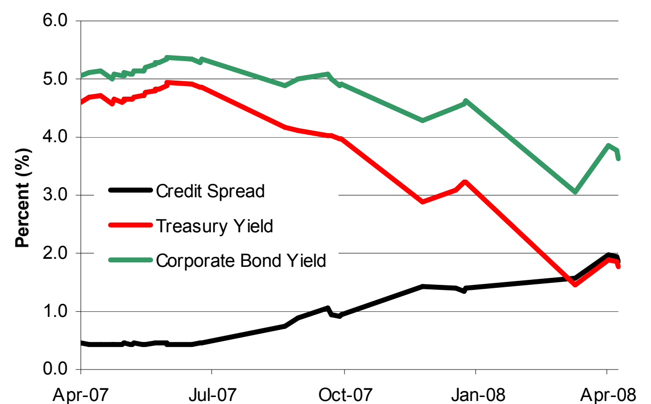
Corporate bonds that mature within two years now offer yields that are very high relative to many other short-term investments. For example, the graph shows that the yield on two-year, single-A rated U.S. Corporate bonds (see **green line** on chart) is now about 2% higher than the yield on two-year U.S. Treasury bonds. This credit spread is four times the amount that was available only one-year ago when the credit spread was below 0.5% (see **black line** on chart).

We also believe that short-dated corporate bonds overcompensate for current financial market risk. The 2% additional yield offered by the average two-year, single-A rated corporate bond means that the credit spread can widen by an additional 1% before the corporate bond would begin to underperform the comparable Treasury bond.[1] Such a widening would leave the credit spread around 3%. This is extremely high on a historical basis; it is a credit spread typically associated with 30-year, triple-B rated bonds or high yield bonds.

[1] A two-year bond price changes about 2% for every 1% change in yield.

Another way to show that corporate bond yields overcompensate for financial market risk is to see how the extra yield translates into protection against the possibility of the bond issuer defaulting. It can be shown that the 2% additional yield offered by the average two-year, single-A rated corporate bond means that the market has priced in a probability of default of 6.5%. It can further be shown that an additional 1% of credit spread widening translates into a default risk of 10%. Both of these "implied" default rates are extremely high relative to the actual historical default rate which is below 0.25% over two years. Therefore, this suggests that today's credit spreads offer gross overcompensation for the risk of default.

Corporate Bonds Now Offer A Lot of Extra Yield



Graph shows yield (in percent) of 2-year, single-A rated Corporate bonds and U.S. Treasury bonds as well as their difference in yield. Source: Yahoo! Finance.

Investment Recommendation

We recommend buying some of the investment-grade bonds as shown in the table below.

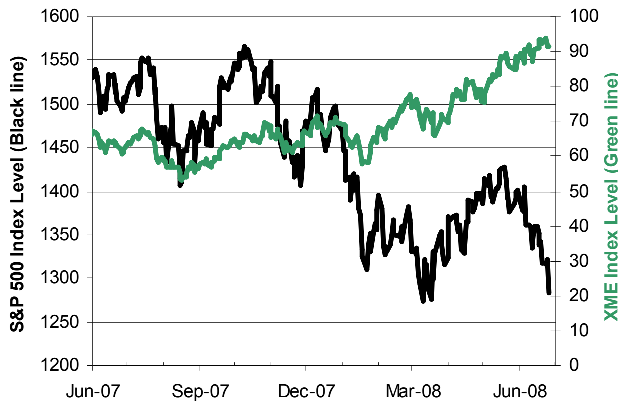
Issuer	Ratings	Coupon (%)	Maturity Date	Price	Yield (%)
CIT Group Inc	Baa1/ A-	4.250	Feb-10	88.25	12.68
Roadway Corp	Baa3/ BB	8.250	Dec-08	100.75	6.35
Washington Mutual Inc	Baa3/ BBB	4.000	Jan-09	96.95	9.98
Union Carbide Corp	Ba2/ BBB-	6.700	Apr-09	100.65	5.78
Liberty Ppty Ltd Partners	Baa2/ BBB	7.750	Apr-09	100.93	6.50
Sears Roebuck Accep Cor	Ba2/ BB	6.250	May-09	100.15	6.05
Sprint Cap Corp	Baa3/ BB	6.375	May-09	100.09	6.25
Great Lakes Chem Corp	Ba2/ BB	7.000	Jul-09	101.50	5.49
Liberty Media Corp	Ba2/ BB+	7.875	Jul-09	102.50	5.36
May Dept Stores Co	Baa3/ BBB-	4.800	Jul-09	99.50	5.30
Mandalay Resort Group	Ba2/ BB	6.500	Jul-09	100.50	6.01

Notes: Pricing as of June 27, 2008. The structure of each bond may differ in terms such as the frequency and type of coupon payments.

Stock Markets

Over the past year, we have made few recommendations in the stock market. One of these, however, was to invest in hedges against the market's overall performance by using such instruments as the S&P Metals and Mining Index (ticker XME).[1] This strategy performed very well since the recent sell-off in the overall market over the past six months. The chart below shows that the S&P 500 is virtually unchanged from three months ago and is 250 points lower than when it began to sell off in October of 2007. Meanwhile the XME index has traded up by about 50% higher over the past six months.

S&P 500 and S&P Metals and Mining Indices since June 1, 2007



Source: Yahoo! Finance.

[1]This recommendation was made in our report published on May 29, 2007.

We continue to believe that investors should look to hedge performance in stock markets, but we are concerned about the dramatic appreciation in commodity prices. The Energy and Industrial Materials sectors have even sold off over the past month – these had been the two best performing sectors over the past year, three years and five years (see Table below). Perhaps increasing bonds would make some sense, but we recommend cash strongly.

If we had to take on equity exposure at this stage, we believe the consumer products sector may offer some opportunities. We would tend to favor some companies that produce a lot of cash and have high brand name recognition. Food manufacturers with good brands come to mind. There is also the chance for some of these companies to be purchased in M&A activity which has been on the rise in this sector. We recommend avoiding banks and other financial institutions, airlines and auto manufacturers for the time being.

U.S. Stock Market Sector Returns

Sector Name	YTD	1Mo	3Mo	1Yr	3Yr	5Yr
Software	-6.4	**1.3**	6.1	3.4	11.4	13.5
Utilities	-0.9	**-0.3**	9.2	12.3	23.6	25.3
Healthcare	-5.2	**-0.5**	0.2	-1.7	7.8	10.6
Hardware	-4.3	**-1.8**	7.5	9.1	16.7	20.5
Business Services	-2.7	**-2.1**	6.3	2.7	18.0	18.5
Energy	10.9	**-2.3**	22.1	32.1	29.6	34.3
Consumer Services	-2.0	**-2.5**	-2.7	-6.0	5.3	10.1
Industrial Materials	5.3	**-4.4**	8.3	27.3	35.4	36.8
Consumer Goods	-6.9	**-4.7**	-4.6	2.0	16.7	16.4
Telecommunication	-14.3	**-7.4**	-2.5	2.3	22.8	23.3
Financial Services	-14.5	**-7.5**	-7.3	-13.9	9.9	13.1
Media	-9.9	**-8.3**	-4.2	-18.8	2.4	6.8

Note: Data as of June 27, 2008. Source: Morningstar.

Special Recognition given to Sanford Jenkins for his contributions to this edition of the Conroy Report.

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