



FARR, MILLER & WASHINGTON, LLC

INVESTMENT COUNSEL

Market Outlook

April 18, 2008

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Economic Backdrop

What Drove the Market Higher From 2003-2007?

- 1) **Oversold from the 2000-2002 market correction**
- 2) **Strong rally in commodity-related stocks due to 5%+ global economic growth**
- 3) **Lower risk premiums on all investment classes, which was a function of global liquidity**
- 4) **Huge increase in private equity activity, which is a function of low interest rates**
- 5) **Earnings growth resulting from margin expansion**

Low Interest Rates Were the Key!!!

Economic Backdrop

Where Are We Now?

Key Market Metrics:

S&P 500 Trailing P/E Multiple: 15.6x

S&P 500 P/E on 2008 EPS: 14.2x

Est. Earnings Growth for S&P 500 (2008/2007): 9.9%

Fed Funds Rate: 2.25%

Yield on 10-Year Treasury Bond: 3.57%

Economic Backdrop

Higher Home Prices Benefited the Economy in Numerous Ways...

**“Wealth
Effect”**

+

**Cash-Out
Refinancings**

+

**Home
Appreciation
Replaced
Retirement
Savings**

+

**Job Creation
in
Construction,
Finance, and
Other**

=

\$

Robust Consumer Spending

\$

Economic Backdrop

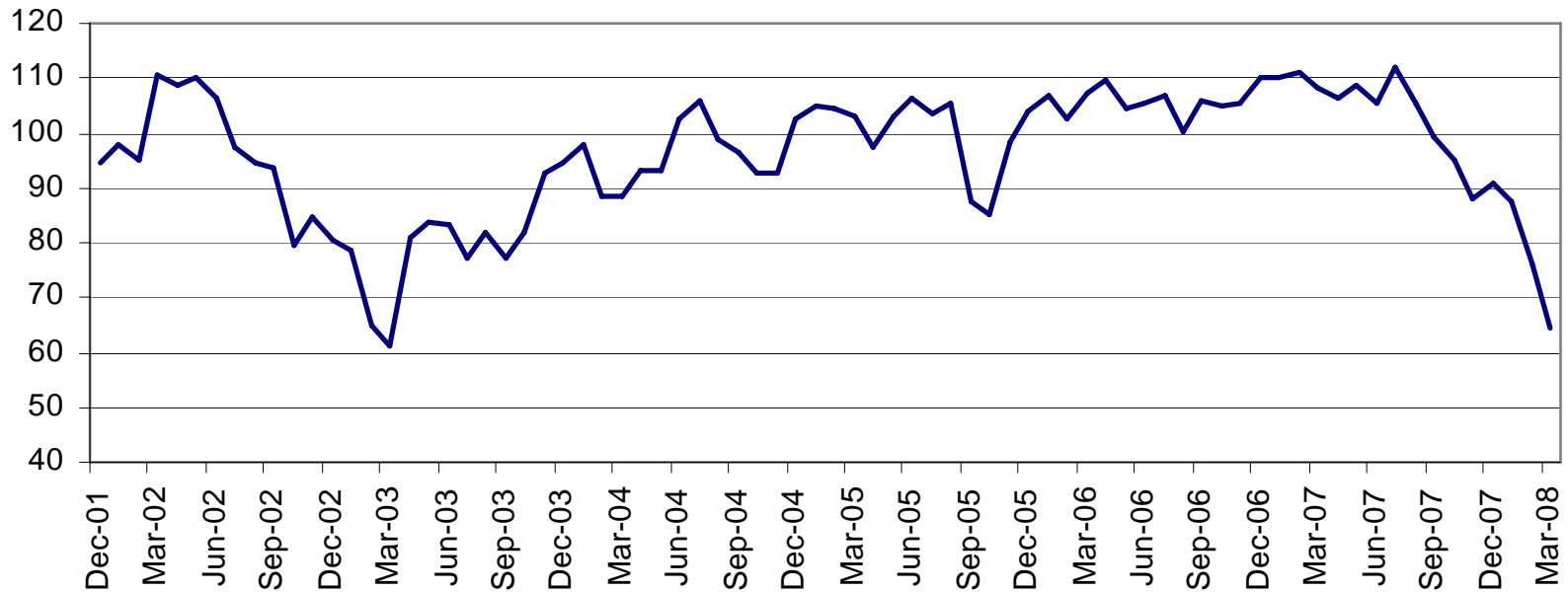
But the Bursting of the Housing Bubble Has Left Us with A Severe Hangover:

- 1) Continued Housing Price Declines
- 2) Diminished Access to All Types of Consumer Credit
- 3) Rising Unemployment in Response to Lower Consumer Demand
- 4) Federal Government Intervention Opportunities Limited

Economic Backdrop

Partially in Response to the Drop in Home Prices, Consumer Confidence Has Been Falling and Now Stands at Multi-Year Lows

Consumer Confidence

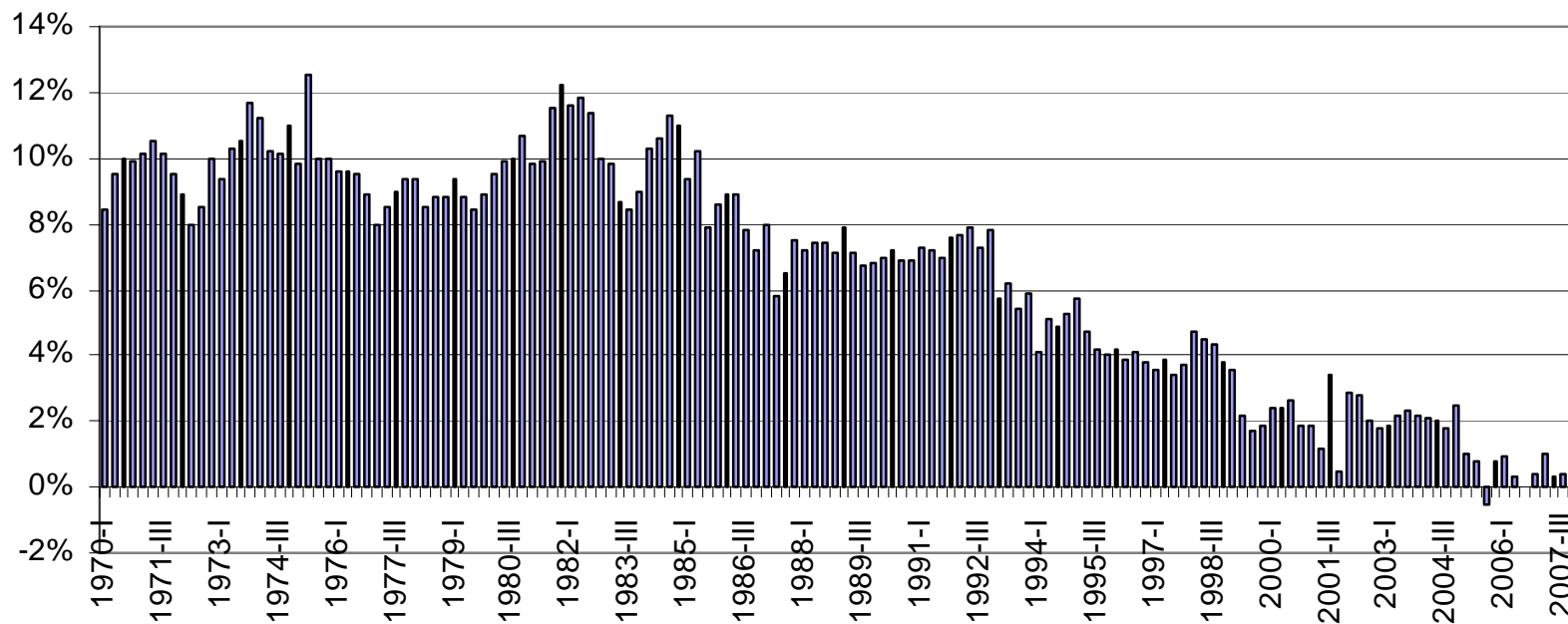


Source: Bloomberg

Economic Backdrop

In the Absence of Home Price Appreciation, the Consumer Must Start Saving Again

Personal Savings as a Percentage of Disposable Personal Income



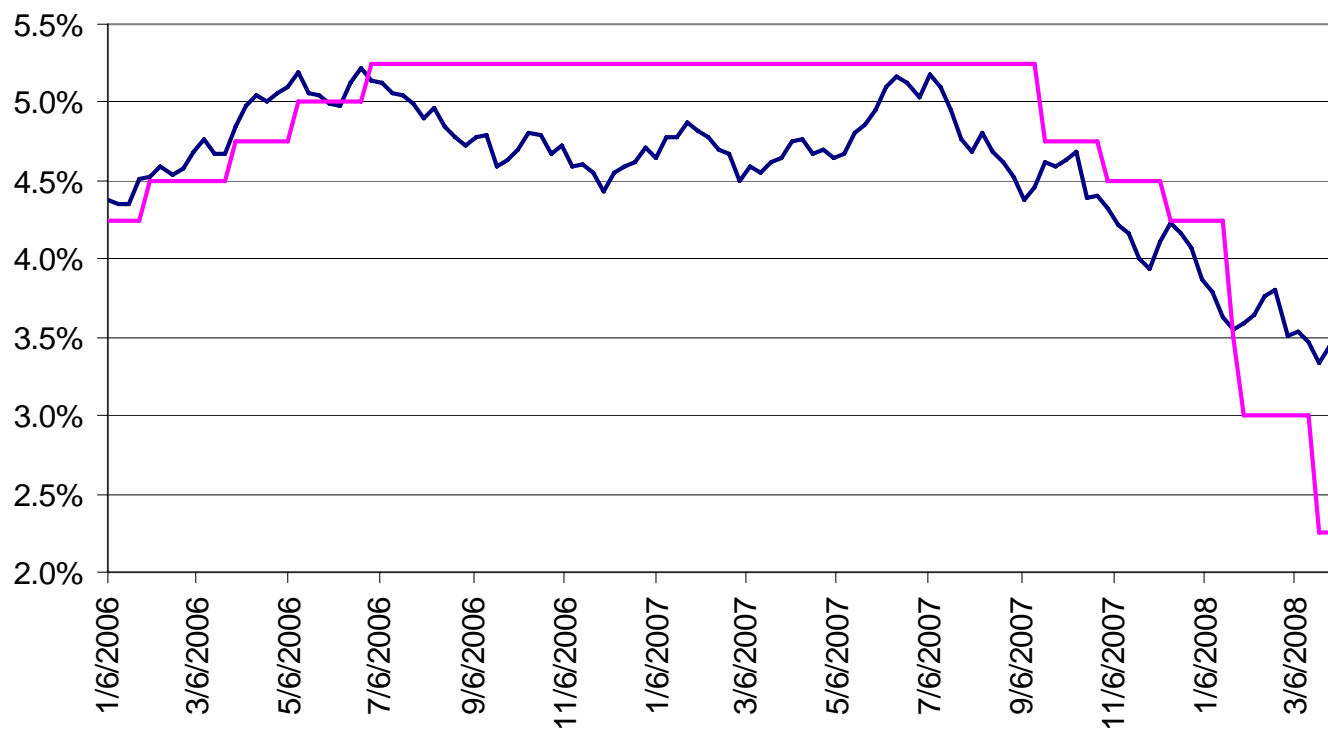
Source: Bureau of Economic Analysis.



Economic Backdrop

In Anticipation of Weaker Growth, the Fed Has Been Easing and 10-Year Treasury Yields Have Followed

Yield on 10-Year Treasury and Fed Funds Target Rate



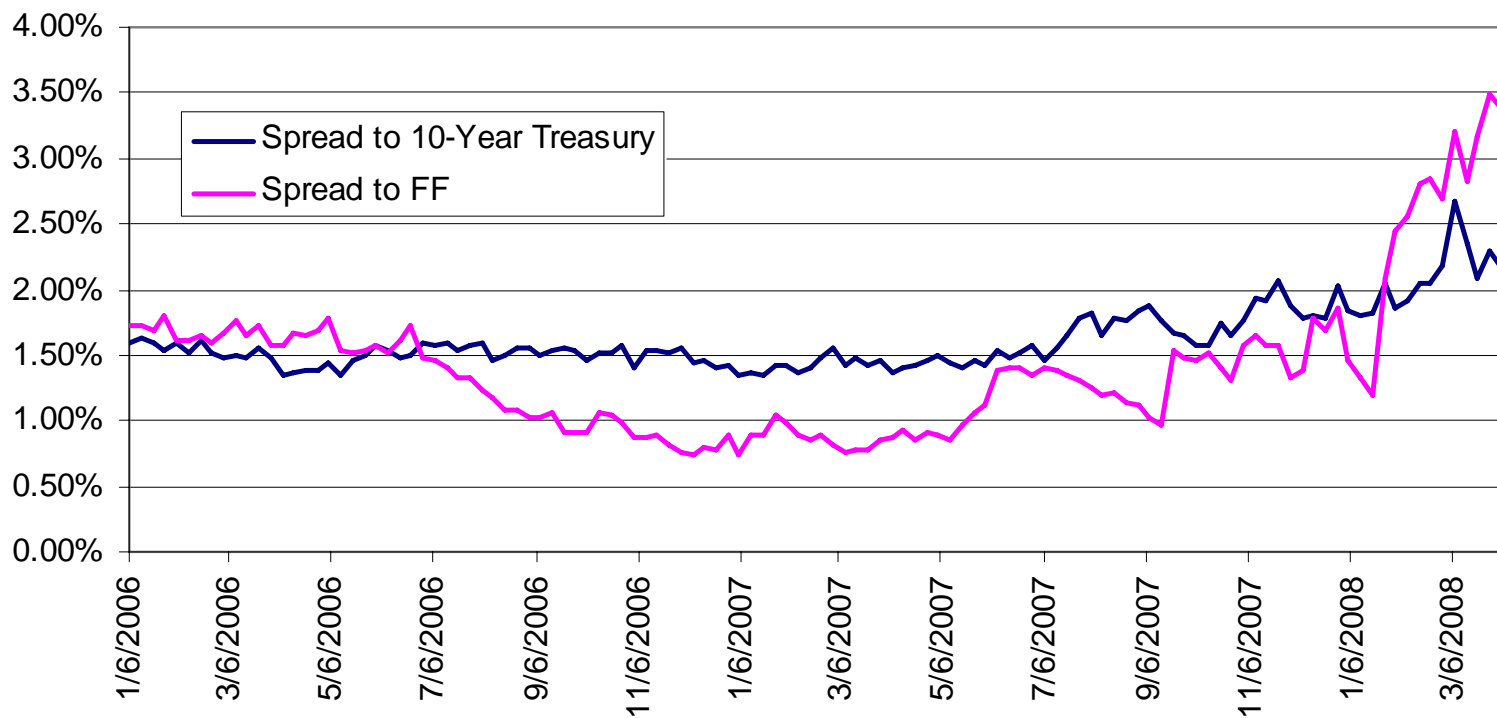
Source: Bloomberg



Economic Backdrop

...But Mortgage Rates Are Not Coming Down as Fast, Reflecting Banks' Reluctance to Lend

30-Year Mortgage Spreads



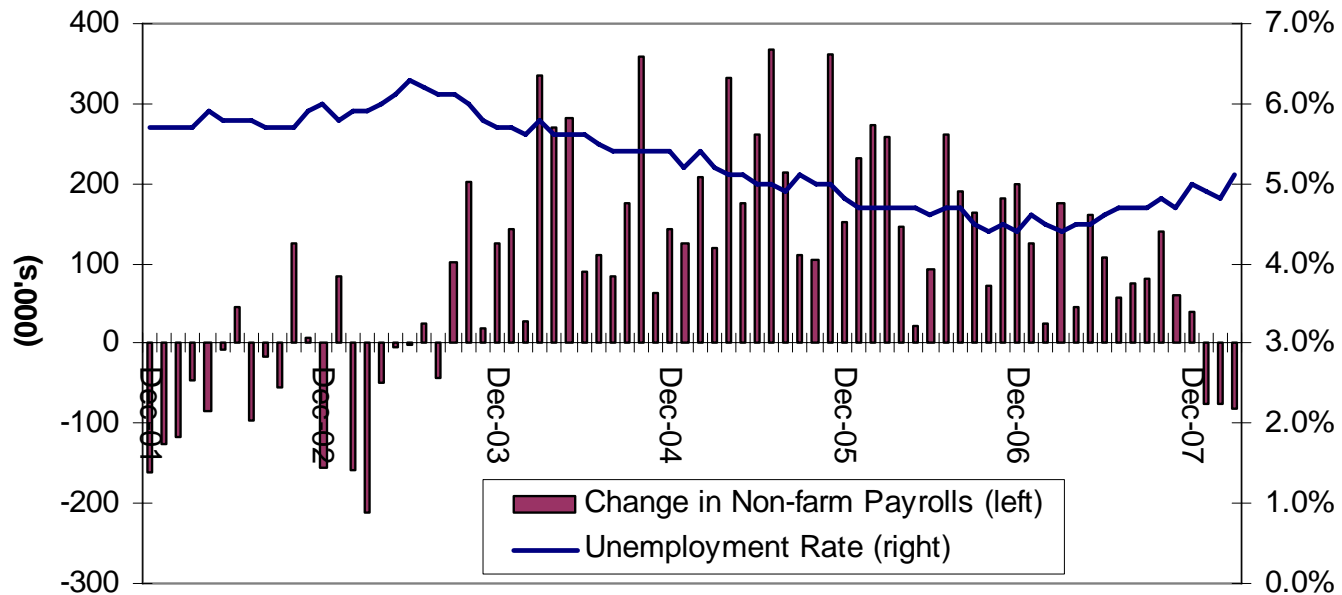
Source: Bloomberg



Economic Backdrop

Also Partially as a Result of Housing, the Economy's Ability to Generate New Jobs is Diminishing

Change in Non-Farm Payrolls and Unemployment Rate



Summary – Concerns for the Economy

Risks/Uncertainties

1. **Credit Crunch Not Over**
2. **Consumer Confidence & Spending Weakening**
3. **Housing Price Deflation Continues**
4. **Tightening of Bank Lending Standards**
5. **Falling Dollar → Higher Inflation**
6. **High Energy and Other Commodity Prices**
7. **Low Savings Rate**
8. **The “Twin” Deficits, Baby Boomer Retirements, and Entitlement Spending Requirements**

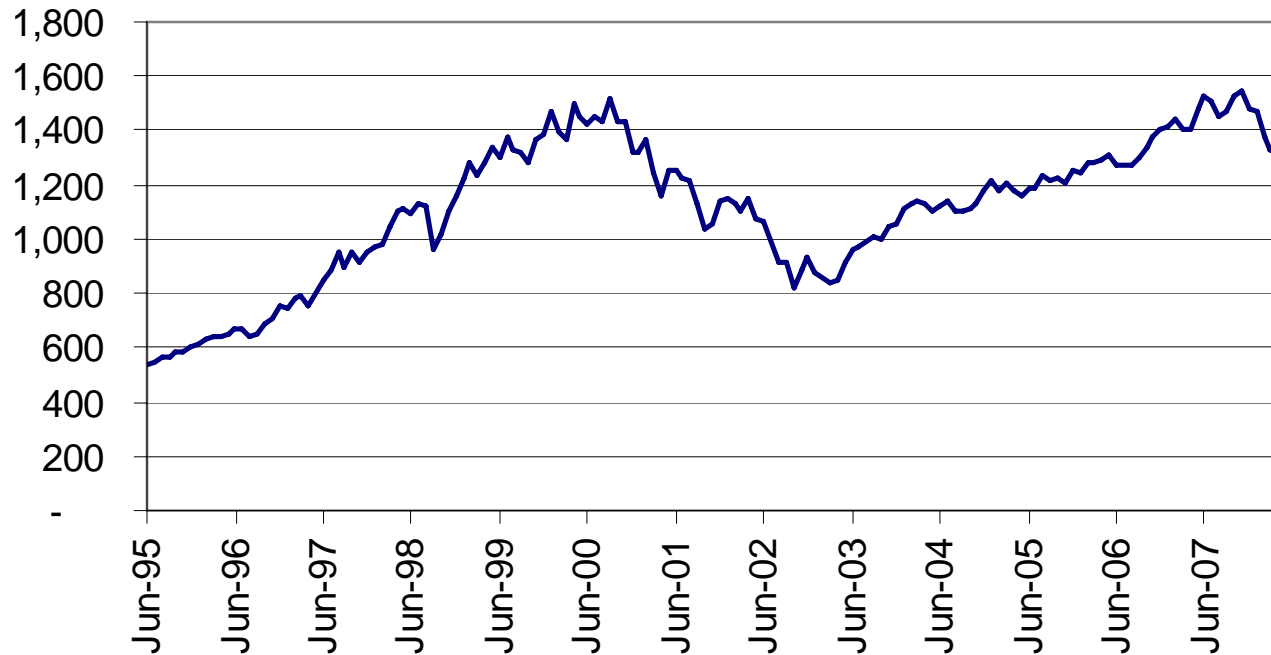
Risks Outweigh the Positives!!!



Stock Market Outlook

Despite the Recent Sell-off, We've Come a Long Way from the Lows of 2002

S&P 500

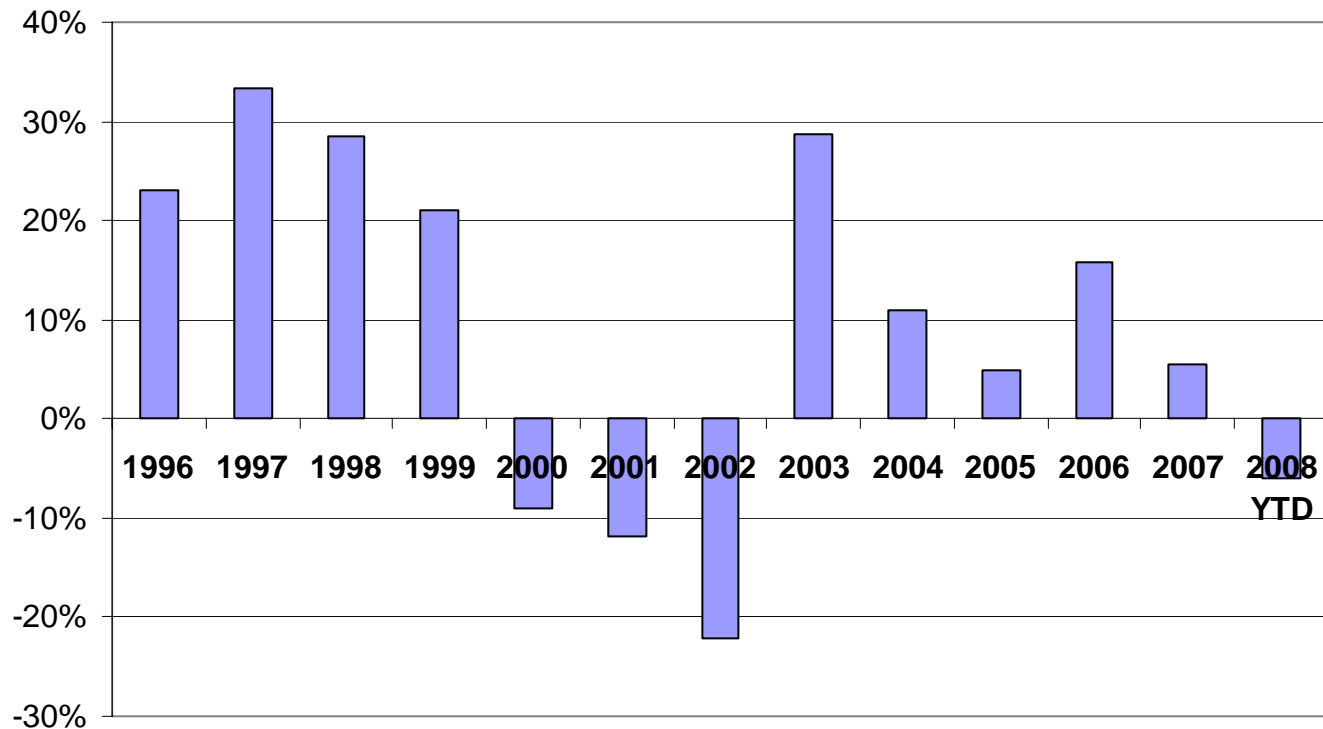


Source: Bloomberg



Stock Market Outlook

Returns on the S&P 500 Index, Including Dividends

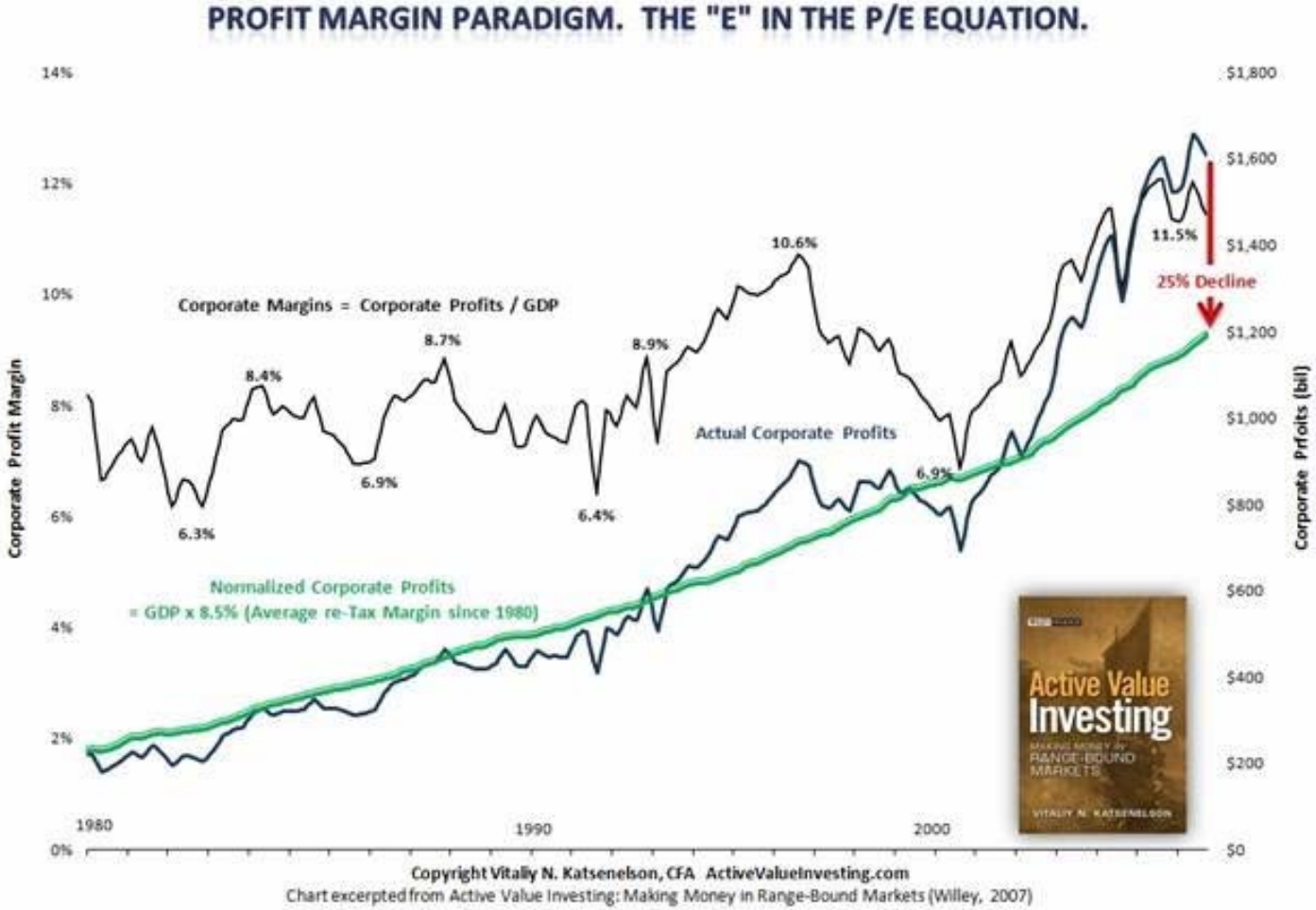


Volatility Rules! Nevertheless, investors in the S&P 500 have realized an average annualized total return of over 8.5% since the end of 1995.



Stock Market Outlook

Our Best Argument for Caution Going Forward....



Source: *Active Value Investing: Making Money in Range-Bound Markets*, by Vitaliy Katsenelson.



Stock Market Outlook

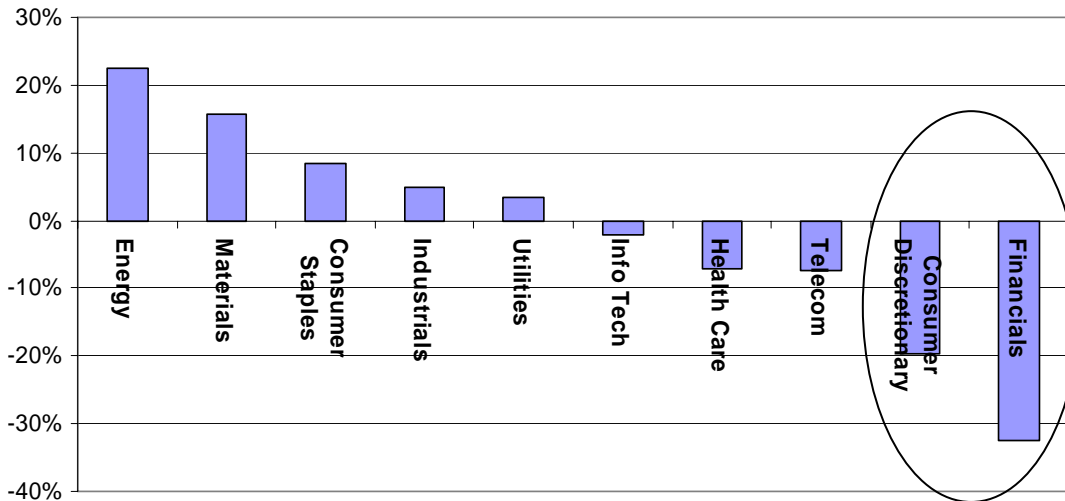
What Does a Recession Mean for Stocks?

- **Definition of recession: Two successive quarters of decline in real gross domestic product (only a guide)**
- **Since 1945, there have been 11 recessions, occurring every 5.5 years on average**
- **The longest stretch between recessions was the 128 months between the 1990 and 2001 recessions**
- **On average, recessions have lasted a little over 10 months with the longest recession lasting 16 months**
- **The average peak-to-trough decline in the S&P 500 was 26%**
- **The drop in US markets contributed to an average 23% decline of the MSCI-EAFE (a benchmark of large, global companies in developed nations)**
- **So far, the S&P 500 and the MSCI-EAFE are each down about 15% their highs in October 2007**

Stock Market Outlook

Could the Stock Market Be Wrong About the Consumer?

Performance of S&P 500 Industry Sectors
December 31, 2006 - March 31, 2008



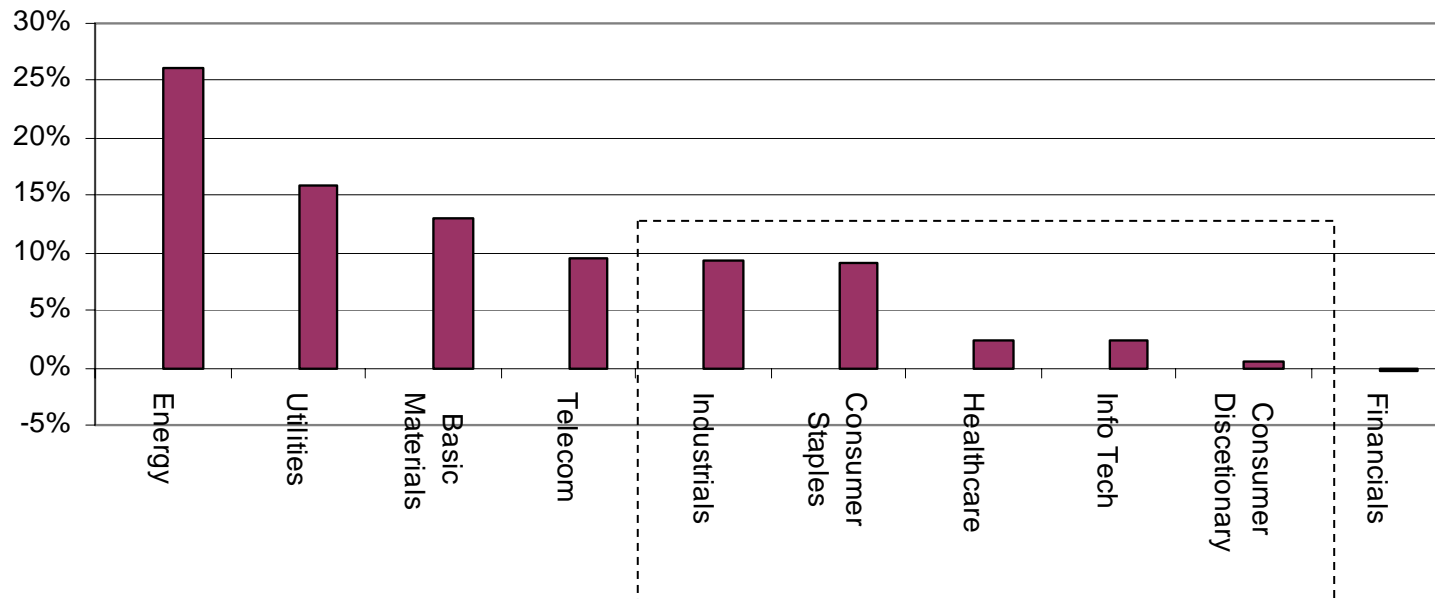
- Much of the economic data that is reported by government entities is dated
- Financial markets give us a more “real time” picture of the economy and where it is heading
- The stock and bond markets are telling us the consumer is in trouble and a recession is likely

Source: Bloomberg

Stock Market Outlook

In Recent Years, Much of the Gains Have been Highly Dependent on Surging Commodity Prices and Lower Interest Rates

**S&P 500 Industry Sector Annualized Total Returns
January, 2004 - March, 2008**



Going forward, we favor the sectors that have underperformed and are not dependent on commodity prices and/or low interest rates.



Where We've Been

In This Environment, We Favor Large-Cap, US Multi-national Companies with...

- **Outstanding Track Records**
- **Highly Visible Earnings**
- **High Exposure to International and Emerging Markets**
- **Seasoned Management Teams**
- **No Dependence on Commodity Price Increases or Falling Interest Rates**

Surprisingly, These Types of Quality Companies Have Been Underperforming the Market for Years!!!

...So Buy Low and Sell High

“The excitement and enthusiasm surrounding commodities, and the belief that they will continue to rise, is not surprising. People want to buy today what they should have bought 5 or 6 years ago; call it the 5 year psychological cycle. Today people want commodities, emerging market, non U.S. assets, and small and mid-cap stocks. Those were all cheap 5 years ago and had you bought them then you would be sitting on enormous gains. But 5 or 6 years ago, everyone wanted tech and internet and telecom stocks, and venture capital and U.S. mega caps. The time to buy them was in 1994 or 1995, when they were cheap...In general, you can get a good sense of what to buy now by looking to see what the worst performing assets or groups were over the past five or six years. That is long term for most people, and long enough to convince them that the malaise is permanent and to have migrated their money elsewhere, such as to whatever has done best in the past 5 or 6 years.”

- Bill Miller, Manager of Legg Mason Value Trust