

April Showers Not Strained

Market Summary

April 2008

came a merciful respite from the punishment the markets absorbed through the first three months of the year. In short, it wasn't that April was so beautiful, but that the prior months were so decidedly unlovely.

First of all, the "R" word—*recession*—was excised from the official vocabulary in April, at least for the moment, as revised data showed the GDP eked out a 0.6% gain in the first quarter, exactly matching its performance during the fourth quarter of 2007. Recession, by any name, remains a serious concern, and the word itself no doubt will reappear as the political year wears on, but for now we officially are in a "slump," a "slowdown," a whatever you please, but not a contraction.

However, we note that the positive GDP number came at a cost, as it was attributable to a rise in inventories—meaning simply that producers didn't slam on their brakes as quickly as consumers did, so goods piled up in warehouses. This is a bit like eating one's seed corn, as the surpluses will weigh against new orders when recovery comes.

Food Fights

Anyone who drives a car or pushes a grocery cart can tell you that the economy, though perhaps not going backward, has been going slow enough to pass for backward, especially in relation to the prices of energy and food.

April ended with the contract for next-month delivery of corn at just over \$6.01 a bushel on the Chicago Board of Trade. The nearby contract for corn sold for about \$3.24 at the end of July (see chart). The World Bank reports food prices have climbed 83% in the past three years. Rice has

The quality of mercy, said Shakespeare, is not strained, but falleth like the gentle rain. If so, it is very apt that with the gentle rains of April

spiked 141% during the first four months of this year, and wheat spurted 25% in one day on commodity exchanges. These numbers strongly suggest that speculators have entered the picture, but fundamental market forces also are very much at work. Consumption has risen substantially in China and India, where people literally are fattening up on export profits; and in America and Europe, where cars now consume vast quantities of grain, especially corn, under government mandate for biofuel programs.

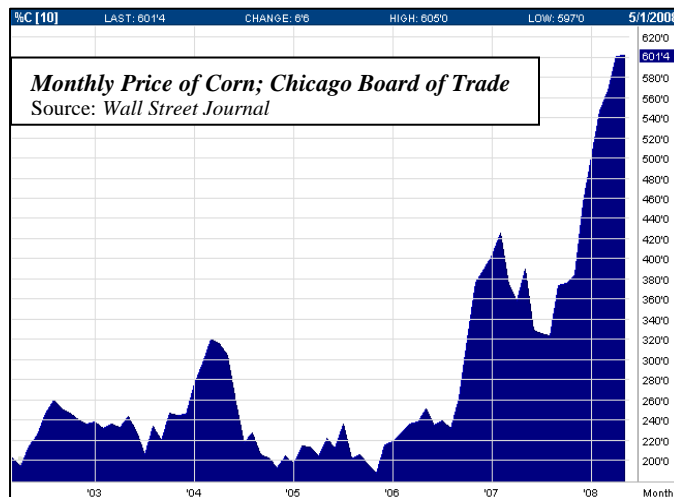
Food riots have broken out in several poverty-stricken countries. In Haiti, the prime minister resigned as a result of rioting over the price of staples such as rice and beans; in Egypt, the army was ordered to begin baking bread in the wake of violent protests. World Bank President Robert Zoellick warned recently that 33 countries are at risk of major civil strife over surging food prices.

Oil, of course, has its own scary tale to tell: Prices are up 96% in the past year; up 800% in the past decade. Nymex crude for June delivery hit

\$119.93 in intra-day trading in April—a record already handily surpassed.

These data, ugly as they are, have been background concerns recently—at least in the U.S.—for the same reason a bad toothache might be a background issue for a man being chased by a ravenous tiger. The

big worry in the financial world has been the crisis precipitated by the sudden souring of billions of dollars in debt instruments built from "subprime" (i.e., junk) mortgages. The investment banks that cobble these debt instruments together were caught with enormous inventories of virtually worthless mortgages, and desperately began to rummage the financial system for cash to shore up their balance sheets. The consequent liquidity drain caused a credit shortage, which in turn seriously aggravated the economic slump that already was in place.



Fed Aggressive

The Federal Reserve, continuing its vigorous opposition to the cash drought, cut its benchmark interest rate a quarter-point in April. Fed Funds are now at 2.0%, their lowest point since late 2004. In announcing the cut—the seventh in as many months—the Federal Open Markets Committee suggested it now would be inclined to let rates lie. Several Fed governors have expressed concern about low interest rates feeding inflation.

The Commerce Department reported in April that the “core” inflation rate that the Fed watches most closely showed a 2.1% year-over-year gain in March. That’s a modicum above the 1.0%-to-2.0% range the Fed regards as safe, and, considering that food and energy are excluded from this datum, not a wildly encouraging number.

Employment Data Slightly Improved

The April employment report showed a loss of 20,000 non-farm jobs, about a quarter of the number lost both in March and February. That was taken as good news by the markets, as was a decline of 6,500 in the weekly average of new unemployment claims (to 363,750), and a drop of 0.1% in the unemployment rate (to 5.0%). None of these numbers is considered especially good, but all very recently have been significantly worse.

Equities Good

Every major stock index gained in April, with solid returns across all categories. Domestic large-caps were led by the Russell 1000 Growth Index, which turned in a 5.2% gain. The Russell 1000 Index gained 5.1% and the Russell Value Index 4.9 percent. The Dow Jones Industrial Average was up 4.7%; the S&P 500 4.9 percent.

Domestic mid-cap stocks did slightly better, while also favoring growth. The Russell Midcap Index gained 6.76%; the Russell Midcap Growth Index rose 7.3%; Midcap Value 6.1%

Smaller was not better in all categories, however, as domestic small-cap stocks brought up the rear. Growth again was favored as the Russell 2000 Growth Index gained 5.1%, vs. 3.2% for the 2000 Value benchmark. The overall Russell 2000 Index moved up 4.2 percent. The NASDAQ, while strictly speaking not a small-cap index, led the category with a 6.1% gain.

International stocks did quite nicely in dollar-denominated terms, with the MSCI Emerging Markets Free and Pacific Rim Ex-Japan indices gaining 8.1%, and the EAFE Index 5.4 percent.

Commodities Are the Things

The Goldman Sachs Commodities Index gained 8.0% in April, raising its year-to-date gain to 18.7% and its year-over-year gain to a gaudy 50.1%—the highest of any index.

Real Estate indices also registered impressive advances in April, as the Dow Jones Wilshire REIT Index led the category with a 6.2% advance. The NAREIT Index moved up 6.1 percent.

All absolute return indices from Hedge Fund Research showed positive returns, led by a 3.1% gain in the Equity Hedge Index. Merger Arbitrage gained 1.7%; Event Driven 1.1%; Convertible Arbitrage 0.8%; Distressed Securities 0.2 percent.

Bonds Reach for Yield

The Citigroup High Yield Index logged a 4.6% gain, best among all bond benchmarks. The Lehman Government Bond Index, by contrast, fell 1.4%, and the Aggregate Bond Index dropped 0.2%. This means yield spreads between junk and government bonds are shrinking. The Lehman High-Yield option-adjusted spread was trimmed by 128 basis points in April, a significant move. The Lehman Broad Muni Bond Index gained 1.2%, and now has a 0.5% gain for the year.

The Citigroup World Government Bond Index lost 3.2%; the Non U.S. Citigroup World Government Bond Index lost 3.6% in its unhedged variant, whereas the hedged version fell 1.0 percent. That’s the first month this year that the hedged version out-did its un-hedged cousin, suggesting April was not a bad time to be linked to the dollar—welcome news for those of us linked to the dollar by paycheck.



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