

Both domestic and foreign stocks were down sharply in the first quarter, with losses on broad indexes in the 9% to 10% range. Large-cap stocks, as measured by the S&P 500 Index, were down 9.4% for the first three months of the year, with growth modestly underperforming value. Mid- and small-cap stocks were down by roughly equivalent levels of around 10% and growth's underperformance of value was more significant as market-cap dropped. International stocks also had a rough quarter with the MSCI EAFE Index off by 9.5%. REITs managed a decent quarter, with a gain of 2.2%, while high-quality bonds gained more than 2% and high-yield bonds dropped 3% as investors in fixed income fled to quality.

The current investment environment is one that we suspect will continue to be one of the most challenging that we have faced in recent memory. It is probable that we are already in a recession or on the verge of entering one. It's clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs don't help, but are not the primary concern. The problems facing the economy are clear:

- **Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is still a ways to go. With a massive backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take a year or longer to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to dysfunctional credit markets.
- **Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. Sizable losses on subprime loans have lowered the capital base of many financial institutions. Highly leveraged entities are experiencing losses which forces them to sell assets (deleverage), which triggers more losses, and so on. The situation is exacerbated by a financial system that has, over a period of years, become intertwined in a spaghetti-like fashion through the spread of complex financial products (CDOs, CLOs, CDSs, and the like). This complexity makes it difficult to understand what assets may be at risk and how large those risks may be. This uncertainty has led financial institutions to retrench, which in turn makes credit more expensive and less available, even as the Fed tries to ease credit. Many financial institutions are now in a self-preservation mode, protecting their own

balance sheets and hoarding liquidity to protect against losses. This causes problems for even some credit-worthy borrowers who are finding it difficult to obtain loans to refinance their maturing debt. The ability to borrow money at a reasonable cost to support consumer spending and conduct normal business is critical to a stable economy.

- **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see a clear weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and Europe's is slowing. It is possible that a large portion of the developed world will continue to weaken. The emerging markets are in better shape, but we don't expect them to be fully immune from economic weakness in the developed world.

As always, there are positives as well. The biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented action of the Federal Reserve. Though the Fed's moves have not yet been as effective as they would like, they have made it clear that they will do what it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors. Export strength over the last six quarters has almost offset the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years.

We should not ignore the potential inflationary impact of recent actions by the Federal Reserve and policy makers as we conclude the first quarter of 2008. The amount of stimulus that has been provided by the Federal Reserve in dealing with recent market turmoil has increased the potential for higher inflation down the road. Evidence of inflation may be delayed due to the current weak economy but the increased supply of dollars will ultimately pressure prices. Further weakening of the dollar will

also increase inflationary pressures as the cost of imported goods increases.

At this time we believe that the most likely outcome for the economy is that the Fed's efforts, which go well beyond simply lowering rates, will be successful and that the U.S. will avoid a serious recession. The stock market appears to have discounted this mild recession scenario and most experts are forecasting improved earnings growth in the second half of the year. The bond market appears to expect a worse slowdown than the stock market at this point. Yields on the two-year Treasury note were recently less than 1.5% and most Treasury yields are at multi-year lows. Conversely, yields on more risky fixed income instruments were sharply higher. Many tax-exempt bonds were yielding more than comparable maturity Treasuries and junk bonds were yielding double digits.

The underperformance of municipal bonds relative to Treasuries is a result of several factors. Some of the problems in the municipal market were initially triggered by credit problems with firms (e.g. Ambac and MBIA, etc.) that have traditionally insured tax-exempt bonds, which historically have an extremely low default rate. In recent years these monoline firms began insuring structured debt, such as CDOs, that turned out to be much riskier than expected. Rising defaults from structured debt put the insurer's AAA credit ratings at risk. This in turn put the ratings of the underlying bonds which they insure at risk. Consequently, most insured bonds now trade as if the insurance did not exist. It has always been the policy at T. Leavell & Associates to rely upon the underlying rating and credit of the issuer rather than the insured rating when evaluating a municipal bond.

As we write this, market volatility continues. We can't know what the near-term will bring for financial markets but at times like these when economic uncertainty is high, our discipline and consistency of process keeps us grounded and gives us confidence in our ability to make sound long term decisions.

Best Regards,

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