

# Hugh's Comments



Johnson  
Illington  
Advisors, LLC

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## **Outlook Update**

The basis of our approach to managing balanced portfolios is to identify important financial market trends and to reconcile those trends with the performance of important economic variables. If they are consistent; that is they both are performing in a way that historically has been associated with poor stock market and poor economic conditions, then we position portfolios defensively. We recommend that investors reduce their exposure to equities, raise their weighting of defensive stock market sectors (consumer staples, healthcare, utilities), and reduce their weighting of economically-sensitive sectors (basic materials, consumer cyclicals, industrials, technology). Additionally, we recommend that investors increase exposure to large capitalization stocks and reduce exposure to more volatile smaller capitalization stocks. These are important portfolio decisions.

Sometimes the message of the financial markets and economic variables is not “lopsided” or clearly bearish or bullish. Under those conditions, we generally weight portfolios somewhere between “bullish” and “bearish” depending upon conditions. This is the case now.

In mid-March, when the Federal Reserve assisted in the purchase of Bear Stearns by J.P. Morgan Chase, the financial markets made a somewhat decisive turn for the better. In a word, investors collectively have decided to take greater risk.

- The S&P 500 has risen 2.3%.
- Investors have migrated to more volatile “bull market sectors.” The technology sector has risen 9.2% and been the best performing sector of seven economically-sensitive sectors.
- Mid-capitalization and small capitalization stocks have outperformed large capitalization stocks.
- The yields of 2-year, 5-year, and 10-year U.S. Treasury notes have risen as investors have found less need to seek the safety of short-term U.S. Treasuries.

- The spreads between lower quality debt-market securities and U.S. Treasuries have declined suggesting that investors are willing to take greater risk.

Of particular note is that the spread between the yields of mortgage-backed debt market securities and U.S. Treasuries and the levels of interest rates on auction-rate securities have declined meaningfully since March 14th.

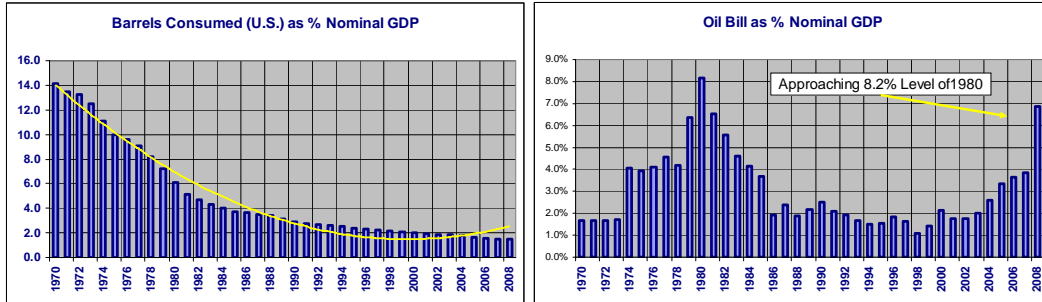
Financial market variables have improved as important monetary and economic variables have improved. Of particular note:

- The Federal Reserve has continued to lean toward less restraint. The real federal funds rate or federal funds rate adjusted for inflation has declined from 2.7% (April-07) to -1.8% (May 2008).
- Liquidity conditions have improved. Bank lending and money growth have been strong. Real M2 or the broad-based money supply adjusted for inflation has grown 3.3% in the last twelve months. The probability that strong real M2 growth will be followed by a contraction in real GDP in any of the following four quarters is statistically low (.8 in 10 or .8%).
- Leading indicators for the economy have begun to improve. The Conference Board's Index of Leading Economic Indicators has risen for two successive months after having declined for five successive months and being unchanged in March.

These financial market and economic variable signals are consistent and encouraging. Even so, it would be premature in our view to conclude the economy and earnings will improve "meaningfully" in the second half and investors should, hence, shift portfolios to a "bull market structure." Importantly, these financial market trends have deteriorated significantly in the most recent five weeks. This has coincided with ongoing upward pressure on oil and other commodity prices.

### **Comment on Oil**

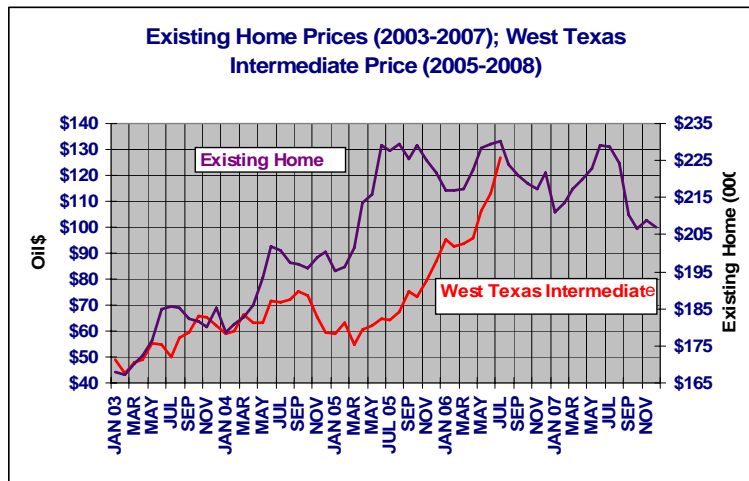
Although there are some signs that credit market conditions have improved, oil prices have risen to levels that most likely should have a drag on overall economic activity. More precisely, the number of barrels of oil consumed as a percent of nominal Gross Domestic Product (left chart) has declined steadily since 1980. However, the "oil bill" (barrels times price) (right chart) has risen to levels that are approaching levels reached in 1980.



Source: BP Annual Statistical Review (2007)

It is, given these simple observations, difficult to conclude that the “oil bill” or “oil tax” will not impede overall U.S. growth.

A meaningful argument could be made that the current rise is a bubble and, like previous financial bubbles or manias, will break. Indeed, if we simply superimpose the price of oil on a line representing housing prices, we notice similarities. As the London Daily Telegraph correctly states, “The price has this parabolic shape that is characteristic of bubbles.” We include a chart that superimposes a chart that shows the rise in oil prices on a chart that shows the rise in housing prices in 2004 and 2005.



Source: National Association of Realtors, Bloomberg News

While it is somewhat useful to recognize that the rise in oil prices is a bubble, it would be very useful to forecast when it will break.

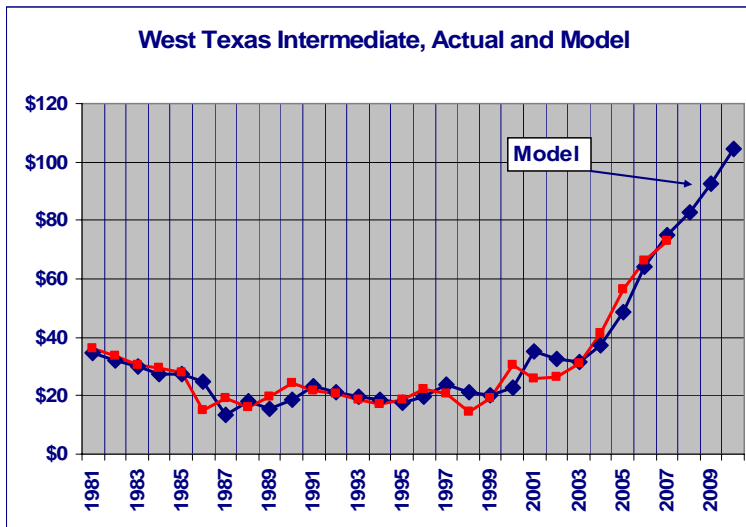
Unfortunately, based upon a review of the history of bubbles, it is difficult at best to forecast the end of a bubble. Suffice to offer two simple and important observations.

First, based upon data through 2006 from the BP Annual Review of World Energy (2007), which details consumption, production, and energy reserves, it is difficult statistically to rationalize a price of \$135 per barrel. Using current estimates for 2008 and 2009 nominal economic growth for the U.S. and for the world, we can estimate U.S. and total global consumption. Moreover, we can estimate total production for 2008 and 2009.

Based upon what we believe are statistically sound estimates for consumption and production, we can estimate prices.

The following table summarizes our forecast for consumption, production, and prices. We also include a chart that summarizes actual oil prices and our model for oil prices followed by a table that shows the regression output for the model. The statistical correlation between consumption and production on the one hand (i.e. supply and demand), and price on the other hand is significant.

Year	Global Consumption	U.S. Consumption	Production	Price
2005	83,080	20,802	81,250	\$56.59
2006	83,719	20,589	81,663	\$66.02
2007	85,160	20,788	82,910	\$73.01
2008	86,626	20,988	84,175	\$82.67
2009	88,743	21,433	86,800	\$92.82
2010	90,975	22,066	88,983	\$104.64
Thousands of barrels per day				
Source: BP Statistical Review, Johnson Illington Advisors, LLC				



Regression Output	
Sample size 30	Number of parameters 5
Mean 35.17	Standard deviation 24.45
R-square 0.9688	Adjusted R-square 0.9638
Durbin-Watson 2.036	Ljung-Box(18)=15.94 P=0.4036
Forecast error 4.652	BIC 5.639

Global consumption is growing 1.2% per year and global production is growing 1.1% per year. Under these conditions it is, of course, reasonable to expect that price will continue to rise as the chart shows. However, the rise in the price of oil from \$73 per barrel (average West Texas Intermediate, 2007) to \$135 is clearly unreasonable. In a word, the

price of oil does not reflect, in our view, underlying global supply and demand conditions.

We are inclined to agree with the comments of Michael W. Masters of masters Capital Management, LLC. Who, in recent testimony before the Committee on Homeland Security and Government Affairs of the U.S. Senate, stated:

Today, Index Speculators are pouring billions of dollars into commodities futures markets, speculating that commodity prices will increase....According to the CFTC and spot market participants, commodity futures prices are the benchmark for prices of actual physical commodities, so when Index Speculators drive futures prices higher, the effects are felt immediately in spot prices and the real economy. So there is a direct link between commodities futures prices and the prices your constituents are paying for essential goods.

Michel W. Masters  
Testimony  
Committee on Homeland Security  
and Government Affairs  
May 20, 2008.

Secondly, if indeed the rise in the price is “unreasonable” or is “a bubble”, when will the bubble end and the price decline to more reasonable levels?

The answer, again unfortunately, is that we do not know. Even so, it is perhaps of some value to point to some of the characteristics of “bubble tops.” Again, we turn to Professor Kindleberger and his remarkable survey of bubbles.

“*Causa remota* of the crisis is speculation and extended credit; *Causa proxima* is some incident that snaps the confidence of the system, makes people think of the dangers of failure, and leads them to move from commodities, stocks, real estate, bills of exchange, promissory notes, foreign exchange-whatever it may be-back into cash. In itself, *causa proxima* may be trivial: a bankruptcy, a suicide, a flight, a revelation, a refusal of credit to some borrower, some change of view that leads a significant actor to unload. Prices fall. Expectations are reversed. The movement picks up speed. To the extent that speculators are leveraged with borrowed money, the decline in prices leads to further calls on them for margin or cash, and to further liquidation. As prices fall further, bank loans turn sour, and one or more mercantile houses, banks, discount houses, or brokerages fail. The credit system itself appears shaky, and the race for liquidity is on.”

Charles P. Kindleberger  
Manias, Panics, and Crashes  
Page 120.

It is somewhat clear that Kindleberger’s description applies to events related to the housing bubble. It remains to be seen if the description will also apply to the rise in oil prices. Even so, recent shifts in public policy toward regulating speculation in commodity futures could qualify as an event that could motivate speculators or non-commercial investors in crude oil futures to rethink strategy.

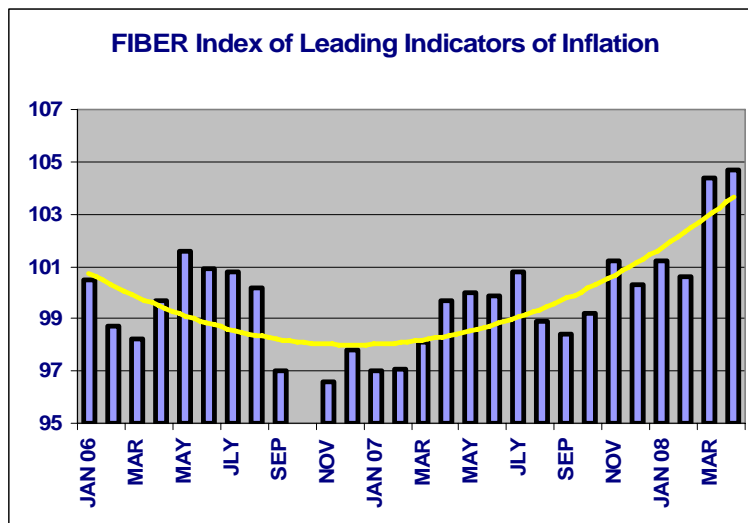
**Comment on Inflation**

The rise in the price of oil and other commodities is contributing to rising worries about inflation. Those worries have been expressed by many Governors of the Federal Reserve.

Some indicators of longer-term inflation expectations have risen in recent months, which is a significant concern for the Federal Reserve. We will need to monitor that situation closely.

Chairman Ben Bernanke  
 Harvard University  
 June 4 2008

The worries are summarized for us in the Index of Leading *Inflation* Indicators from the *Foundation for International Business and Economic Research*. The Index is currently 5% higher than one year ago.



The components of the index imply statistically that consumer inflation will remain above 3% through the third quarter of 2009. The following table shows the consensus forecast for consumer prices, and our forecast for consumer prices and consumer prices excluding food and energy prices.

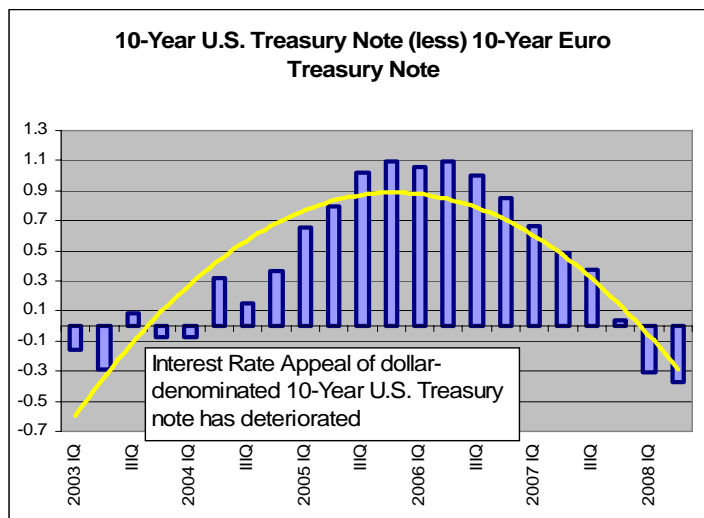
June 2008 Forecast			
Year/Qtr	Consensus	CPI	CPI (ex Food&Energy)
Q1 2008	4.2%	4.2%	2.4%
Q2(e)	3.9%	3.9%	2.4%
Q3(e)	4.1%	4.5%	2.5%
Q4(e)	3.5%	4.0%	2.4%
Q1 2009(e)	3.0%	3.5%	2.4%
Q2(e)	2.7%	3.6%	2.4%
Q3(e)	2.5%	3.4%	2.3%
Q4(e)	2.5%	2.8%	2.3%
2007	3.2%	3.2%	2.5%
2008	3.9%	4.1%	2.4%
2009	2.7%	3.3%	2.4%

Source: Blue Chip Economic Indicators, Johnson Illington

Based upon this analysis, it is reasonable to anticipate that, if economic conditions improve, the Federal Reserve will begin to “lean toward restraint” in Q2 2009 as is the current consensus expectation as measured by *Blue Chip Economic Indicators*.

### Comment on the Dollar

If the Federal Reserve “leans toward restraint” as is now anticipated and if, at long last, there is a convergence of U.S. and European monetary policy as is also expected, then it is reasonable to anticipate that (a) the deteriorating interest rate differential (U.S. ) will end or reverse and (b) the trade-weighted dollar may stabilize. We include a chart that summarizes the interest rate differential which has deteriorated since April 2006. As the reader can see, the “edge” of dollar-denominated over euro-denominated securities has been eroding since the second quarter of 2006.



This can be very important. If the interest rate difference or spread between dollar-denominated fixed income securities and euro-denominated fixed income securities stops declining, and the dollar stabilizes, then international capital flows to the U.S. financial

markets is likely to expand. This could make our forecast for equity prices (below) turn out to be wrong and low.

**Forecast Update: Quantifying The Message of the Financial Markets and Economic Variables.**

A reasonably sound case can be made that credit market conditions are improving. A reasonably sound case can be made that (a) inflation will be somewhat stronger than is currently forecast, (b) the Federal Reserve will “lean toward restraint” or begin to raise short-term interest rates in Q2 2009, (c) oil prices will at a minimum stabilize, (d) the U.S. trade-weighted dollar will stabilize, and (e) the U.S. economy will begin to recover...some...in the third quarter. Using these assumptions as a starting point, we can quantify the outcome for U.S. interest rates and stock prices.

The consensus forecast for the economy, consumer inflation, and the federal funds rate (Federal Reserve policy) is as follows.

June 2008 Forecast				
Quarter	Real GDP	Q/Q Annual Rate%	CPI Y/Y	Federal Funds Rate
2008 IQ	\$11,701.9	0.9%	4.2%	3.18%
IIQ	\$11,713.5	0.4%	3.9%	2.10%
IIIQ	\$11,756.7	1.5%	4.1%	2.00%
IVQ	\$11,791.7	1.2%	3.5%	1.90%
2009 IQ	\$11,846.8	1.9%	3.0%	2.00%
IIQ	\$11,919.1	2.5%	2.7%	2.20%
IIIQ	\$11,999.7	2.7%	2.5%	2.50%
IVQ	\$12,084.3	2.9%	2.5%	2.70%
2007 (average)	\$11,566.8	2.2%	2.9%	5.0%
2008 (average)	\$11,741.0	1.5%	3.9%	2.3%
2009 (average)	\$11,962.5	1.9%	2.7%	2.4%

Source: Blue Chip Economic Indicators, forecast for federal funds rate is June forecast

If the consensus forecast for the federal funds rate is correct, then short-term interest rates should play out as follows. We anticipate that short-term interest rates will be generally rising as the Federal Reserve leans toward restraint.

June 2008 Forecast				
Quarter	Federal Funds Rate	91-Day U.S. Treasury	2-Year U.S. Treasury	5-Year U.S. Treasury
2008-Q1	3.22%	2.04%	1.98%	2.70%
2008-Q2	2.13%	1.59%	2.26%	3.02%
2008-Q3	2.00%	2.00%	2.80%	3.60%
2008-Q4	1.90%	1.90%	2.70%	3.50%
2009-Q1	2.00%	2.00%	2.80%	3.60%
2009-Q2	2.20%	2.20%	3.10%	3.90%
2009-Q3	2.50%	2.50%	3.40%	4.20%
2009-Q4	2.70%	2.60%	3.50%	4.30%
2007 Average	5.0%	4.3%	4.3%	4.4%
2008 Average	2.3%	1.9%	2.4%	3.2%
2009 Average	2.4%	2.3%	3.2%	4.0%
Source: Johnson Illington Advisors, LLC				

If the consensus forecast for the federal funds rate is correct and our forecast for other short-term interest rates is correct, then longer-term interest rates should play out as follows. We anticipate that the yield on longer-term U.S. Treasuries should be generally rising

June 2008 Forecast			
Quarter	10-Year U.S. Treasury	Moody's Baa Corporate	Bond Buyer 20 Bond Index
2008-Q1	3.61%	6.8%	4.6%
2008-Q2	3.78%	7.0%	4.8%
2008-Q3	4.20%	6.4%	4.5%
2008-Q4	4.10%	6.3%	4.4%
2009-Q1	4.20%	6.4%	4.5%
2009-Q2	4.50%	6.7%	4.7%
2009-Q3	4.80%	7.0%	4.9%
2009-Q4	4.90%	7.1%	5.0%
2007 Average	4.6%	6.5%	4.3%
2008 Average	3.9%	6.6%	4.6%
2009 Average	4.6%	6.8%	4.8%
Source: Johnson Illington Advisors			

Under the interest rate conditions outlined:

- The yield curve as defined by the difference between the yield on 10-year U.S. Treasury notes and 91-day U.S. Treasury bills should increase/steepen modestly from the current level of 2.33 percentage points.
- Quality spreads as measured by the difference between the yield on a BAA-rated corporate bond and a 10-year U.S. Treasury note should decline modestly from its current level of 2.98 percentage points.
- The ratio of the yield on municipal bonds and U.S. Treasury notes should decline from its current level of 1.16 percentage points.

If the consensus forecast for the economy is correct and our forecast for longer-term interest rates is correct then S&P 500 operating earnings, the price/earnings ratio of the S&P 500, and the S&P 500 should play out as follows.

June 2008 Forecast			
Quarter	S&P 500 EPS (LTM)	P/E	S&P 500
2008-Q1	\$81.69	16.4	1343
2008-Q2	\$78.64	17.0	1333
2008-Q3	\$76.76	17.9	1377
2008-Q4	\$76.77	18.3	1403
2009-Q1	\$78.14	18.4	1441
2009-Q2	\$80.61	18.4	1485
2009-Q3	\$83.87	18.1	1518
2009-Q4	\$87.49	17.8	1553
2007 Average	\$90.08	16.2	1458
2008 Average	\$78.46	17.4	1365
2009 Average	\$82.53	18.2	1500
Source: Johnson Illington Advisors			

The table states that the S&P 500 (13) is 6.5% below the level it “should” average in the fourth quarter of this year and the S&P 500 “should” rise 10.7% in 2009. (Fun with numbers)

As stated previously, we warn investors against taking any quantified forecast for interest rates and stock prices too seriously. Such forecasts tend to be statistically compelling and, as such, seductive. They also have a tendency to be wide of the mark. As a recent study of Federal Reserve forecasts for the economy have concluded, “Historical forecast errors are large in economic terms, indicating that-if past performance is a good guide to forecast accuracy-uncertainty about the economic outlook is considerable.” The same can be concluded about the consensus forecast for the economy as summarized above. Hence, since our forecast for interest rates and stock prices is derived from that consensus, it should not be taken too seriously.

What is important is the primary trends in financial market prices and economic variables. Currently they are signaling that the economy and earnings may strengthen...some...in the second half. This is, to some extent, consistent with our statistical or quantified model for interest rates and stock prices. That is, of course, interesting and offers some reason to feel confident about continuing a modestly defensive approach to the financial markets.

### Strategy

Although the message of the financial markets and economic variables is modestly positive, it is not strong enough to require us to shift our portfolio strategy aggressively toward positive or bullish. Hence, the asset, sector, capitalization, and style recommendations we show in the following tables remain on balance defensive...or, at least, somewhat defensive. We have made some steps toward a more positive structure by raising exposure to small and mid-capitalization stocks in the equity component of portfolios.

## Asset Allocation

We continue to recommend that investors maintain a modest allocation to equities in a balanced portfolio. The percent of total allocation that should be allocated to equities depends on the investor's guidelines. We are currently recommending that investors maintain an allocation between the low end and mid point of guidelines. The following tables summarize the recommendation.

Investors should maintain an equity allocation between the levels summarized in the left and right tables.

Asset Allocation	Percent	Asset Allocation	Percent
Range Allowed	Recommended	Range Allowed	Recommended
Under Guidelines		Under Guidelines	
20-50	20.0%	20-50	35.0%
30-60	30.0%	30-60	45.0%
35-65	35.0%	35-65	50.0%
40-70	40.0%	40-70	55.0%
50-80	50.0%	50-80	65.0%
60-90	60.0%	60-90	75.0%
70-100	70.0%	70-100	85.0%
Source: Johnson Illington Advisors, LLC		Source: Johnson Illington Advisors, LLC	

## Sector Allocation

We are currently recommending that investors maintain an over-weight in some "bull market sectors" and an over-weight in some bear market sectors. More specifically:

Sector	Recommended Weight	Market Weight	Ratio
Basic Materials	4.6%	3.6%	1.27
Consumer Non-Cyclical	14.1%	11.1%	1.27
Energy	16.9%	13.3%	1.27
Industrial	15.5%	12.2%	1.27
Technology	20.0%	15.7%	1.27
Utilities	4.6%	3.6%	1.27
Consumer Cyclical	5.1%	8.6%	0.60
Finance	10.1%	16.8%	0.60
Healthcare	7.1%	11.9%	0.60
Telecommunications	2.0%	3.4%	0.60
Source: Johnson Illington Advisors, LLC			

## Capitalization and Style Allocation

We have increased our recommended weighting in mid and small capitalization issues and reduced our allocation to larger capitalization issues. More specifically:

Capitalization	Recommended Weight	Market Weight	
Large	79.2%	87.2%	0.91
Mid	13.9%	8.6%	1.61
Small	6.9%	4.2%	1.65
Source: Johnson Illington Advisors, LLC			

We continue to recommend that investors over-weight growth issues and underweight value issues.

Capitalization/Style	Recommended Weight	Market Weight	Ratio
Large-Value	27.7%	44.5%	0.62
Large-Growth	51.5%	44.5%	1.16
Mid-Value	4.9%	3.8%	1.29
Mid-Growth	9.0%	3.8%	2.40
Small-Value	2.4%	1.8%	1.39
Small-Growth	4.5%	1.8%	2.58
Source: Johnson Illington Advisors, LLC			

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