SilverOak
WEALTH MANAGEMENT LLC

Second Quarter 2008 Market Summary

Initial Steps Toward Market Normalization

Former British Prime Minister Harold Wilson once said, “I am an optimist but an optimist who carries a raincoat.” This quote reflects a perspective on how the current market environment can be viewed. Economic clarity remains elusive and uncertainty persists. However, the second quarter saw the first tentative and essential signs of market stabilization as the re-pricing of risk reverted to more traditional asset valuation methodologies. This first step can be attributed to the Fed’s unprecedented policy initiatives implemented during the second half of March. These policy responses were designed to enhance liquidity and influence interest rate spreads (particularly interbank spreads i.e., the rate at which banks lend to each other) thus easing market disruptions that caused markets to seize during the first quarter. On June 3rd, Chairman Bernanke commenting at the International Monetary conference in Barcelona stated, “that financial markets had improved of late, but conditions remain strained and some key funding and securitization markets have shown only tentative signs of recovery.” He went on to suggest, “Highly rated corporations retain good access to credit, but credit conditions generally remain restrictive in areas related to residential or commercial real estate.” The good news is that we appear to have made a transition from irrational deleveraging (forced selling by leveraged entities) to rational or orderly deleveraging.

Economy Continues Under Pressure

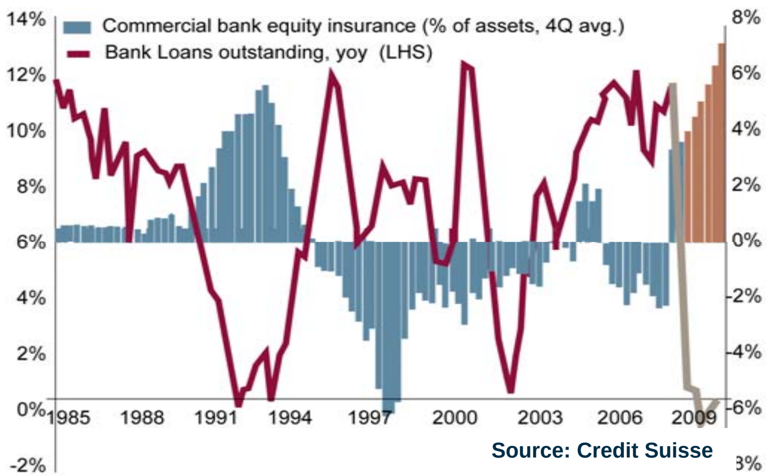
The signs of a tentative return to stability in the financial markets were not as visible in the broad based economic data during the second quarter as it continued to suggest a prolonged period of slow growth rather than a deep recession. The Fed cut the funds rate an additional ¼% to 2.0% on April 30th and signaled the likelihood of an extended pause.

Concurrently the discount rate was reduced ¼% to 2-1/4%. The Fed has aggressively cut the funds rate 3-1/4 % since August 2007. Non-farm payrolls declined 149,000 for the period March through May, while unemployment rose from 5.0% to 5.5% in May. Housing prices continued to decline and the imbalances between demand and supply continued to rise. Mortgage rates rose approximately ½% in the last month. Declining home prices and rising mortgage rates impede a quick resolution of the housing crisis. It should be noted that there is a bifurcation in nationwide housing price declines based on a number of factors including zip code and percentage participation in earlier price increases. The stabilization of housing prices is critical to long-term economic growth and to the continued improvement in risk pricing. Asset price stabilization is ultimately linked with house price affordability.

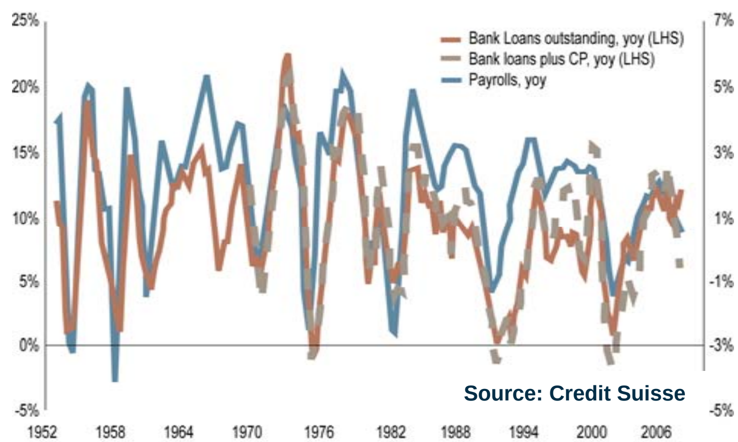
The level of consumer spending surprised a few analysts during the quarter even as consumer confidence declined to recession levels not seen since 1992. The May tax rebates were assumed to be the rationale for the consumer spending/confidence paradox. The remaining rebates were delivered by the end of June and overall indications are that aggregate payments will be 15% lower than anticipated, potentially muting the benefits to the economy. Overall economic growth (GDP) is expected to come in around 1.0% - 1.5% for the second quarter.

A fundamental necessity of economic expansion is the availability of credit. Banking institutions continued to re-build their balance sheets during the quarter. The importance of this is seen in the charts below that clearly illustrate the economic ramifications associated with the banking recapitalization process. The rebuilding of bank balance sheets is a positive; however, the process slows down the availability of credit.

When Banks Recapitalize They Don't Lend...



When Banks Don't Lend the Economy Slows



Once again, the data to watch is housing prices. If housing prices decline more than what is currently anticipated, mortgage portfolios will be negatively impacted. This would raise the potential for additional write-downs by the banking industry and other financial institutions. Chairman Bernanke, referring to the Fed's liquidity initiatives in his June 3rd speech stated they "should help to promote an orderly resolution of current market dislocations." His words confirm the need for further resolution.

The Fed, Inflation and Interest Rates

The Fed and the economy continued to face multi-dimensional risks as the second quarter concluded. Financial system risk, while reduced by aggressive Fed actions, still lingers. Housing deflation and its broad impact on both consumers and the banking industry is worrisome and that, along with continuing fundamental economic risks, will help to insure that Chairman Bernanke keeps his day job. Essential to the Fed's success is identifying and focusing on the "probleme du jour." In early June, the issues of credit and housing were temporarily put aside and focus was directed towards inflation. The driving force in this shift in emphasis has been the growth in headline inflation and concern that longer-term inflationary expectations might accelerate. Headline inflation, which includes food and energy, continued to outpace the rise in core inflation. The rationale for having different measures of inflation is that core inflation is less volatile and thus more accurately measures inflationary trends. Core inflation remains slightly elevated above the Fed's "comfort zone" of 1% to 2%. The energy shock gained momentum during the quarter as the price of a barrel of oil increased from $105.62 on March 28th to over $140.00 on June 26th. Recently the Fed, supported by economic data that suggested a deep recession was not imminent, increased its anti-inflationary expectations rhetoric. In response, financial markets drove interest rates higher. The yield curve flattened with the 2-year treasury rising from 2.51% on June 2nd to 3.05% on June 13th. The 10-year treasury moved from 3.98% to 4.27% during the same period. The market, anticipating a Fed tightening, has priced in a rate increase this summer. Are we witnessing an appropriate response from market participants or an overreaction? We answer this question with a series of other questions and let the reader come to his/her own conclusions.

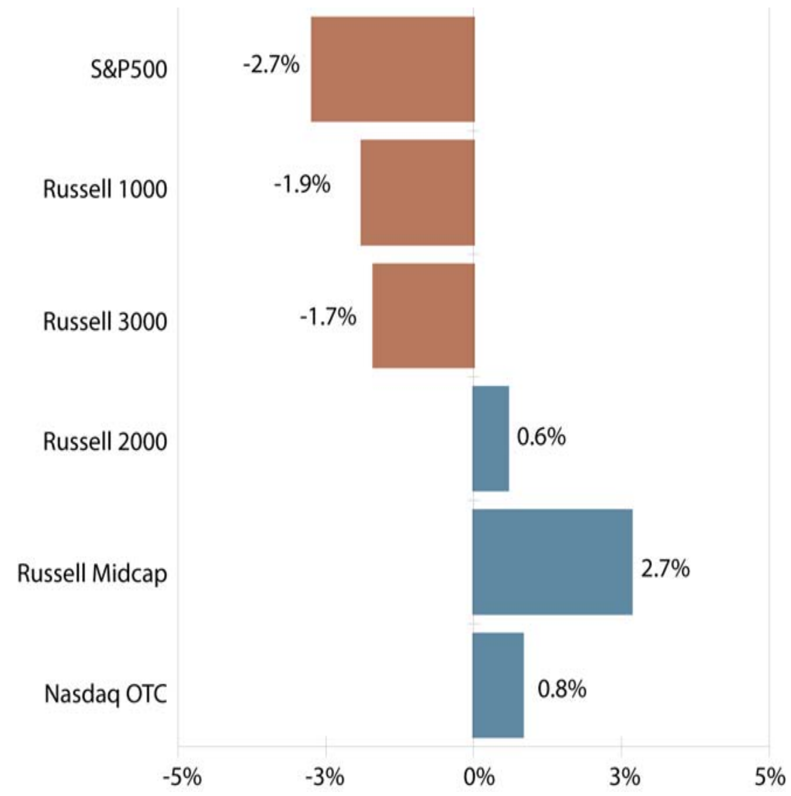
- Will a declining economic environment eventually offset commodity inflation?
- Is it prudent for the Fed to tighten as unemployment increases?
- Does it make sense to raise rates while housing prices continue to decline?
- Is it reasonable to tighten when the financial system remains tenuous?

On Wednesday June 25th, the FOMC (Federal Open Market Committee) decided to leave the Fed Funds rate at 2.0%. The aggressive policy actions taken by the Fed over the last ten months have officially ended and we have transitioned into the "pause" stage. One analyst suggested that Bernanke and company are playing "Whac-A-Mole" in attempting to effectively influence independent but overlapping problems facing the economy. As stated earlier, we now know that the current focus is inflation and inflationary expectations. The official comment stated that the downside risks to growth "appear to have been diminished somewhat" while the "upside risks to inflation and inflation expectations have increased." The Fed's own forecast expects inflation to moderate in the second half of this year and into 2009. Their weapon of choice at this time is strong anti-inflationary rhetoric. Once again, the markets are data dependent.

Equities – "Sound and Fury Signifying Nothing"

The equity market had a difficult first quarter with the S&P closing out March down in the double digits. Despite a larger than expected decline in non-farm payrolls for March, the S&P rallied impressively and ended the first week of the new quarter up 4.20%. The good feelings were short lived as General Electric posted disappointing earnings causing the market to give back -2.74%, or more than half of the previous week's gains. The view that increased volatility was an integral part of the investment landscape was reinforced the following week as the S&P moved aggressively higher, finishing the week up 4.31%. The Fed cut the funds rate an additional ¼% on April 30th, and in response, the market rallied 1.15%. The cumulative effect of the volatility experienced in April was a recovery of 60% of the decline experienced in the first quarter. During the first week of May the S&P dropped 1.81% mostly in reaction to rising commodity prices and specifically to a $9 increase in the cost of a barrel of oil. The dance of volatility continued as the S&P rallied 2.67% the following week. A review of the Fed minutes from the April 30 meeting indicated an increasing concern regarding inflationary expectations. This insight, combined with weaker than expected economic fundamentals and oil at $135 a barrel, drove the S&P down 3.47% during the third week of May. Market returns continued to be schizophrenic the last week of May with the release of surprisingly strong economic data. The S&P rose 1.78% for the week on solid durable goods orders, positive April new home sales and core inflation numbers that met analyst expectations. The rollercoaster ride continued into the first week of June when the S&P lost 2.83%, principally as a result of a spike in the unemployment numbers from 5.0% to 5.5% and the loss of 49,000 additional jobs. The weekly volatility took a breather during the second week in June as the S&P went virtually unchanged for the period. The calm of the previous week was altered as weak economic data combined with negative company headlines took the S&P down 3.10% during the next to last week of the quarter. The S&P, while continuing to decline, sharply pared the losses incurred during the first quarter falling 2.7% in the current period.

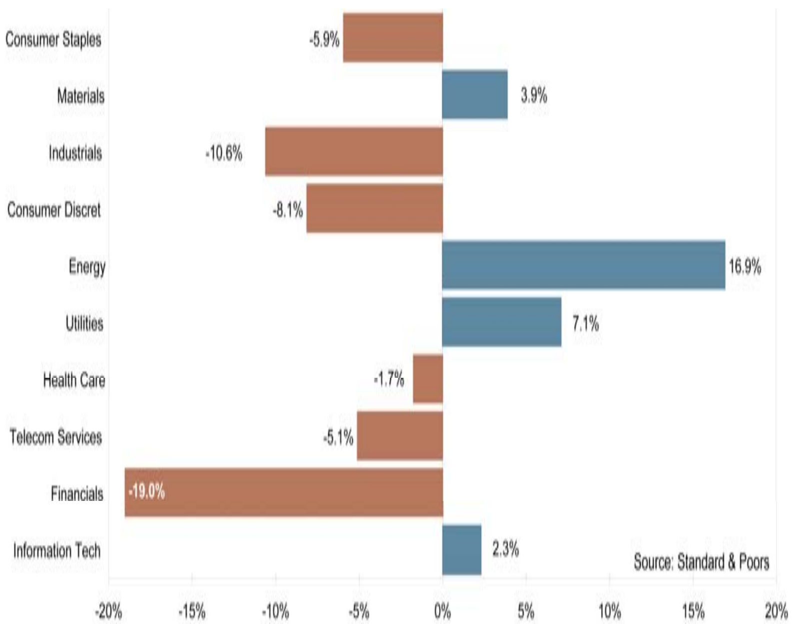
Broad Market Index Returns – Second Quarter 2008



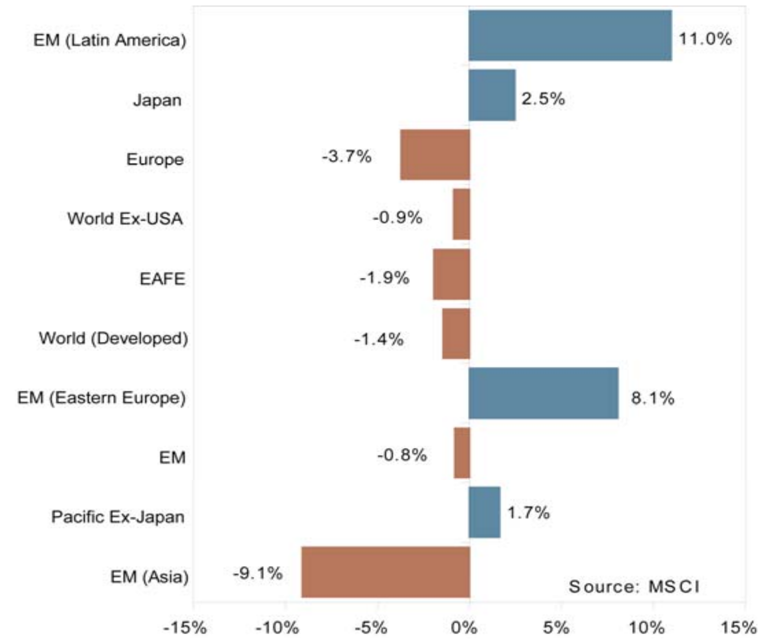
As illustrated in the chart below, the quarter's best performing sectors were energy, utilities, materials and information technology. Healthcare and telecom services were down again in the second quarter but pared their losses. For the most part, consumer discretionary, consumer staples, industrials and financials repeated their poor performance registered in the first quarter.

The performance of international equities during the second quarter was good depending on one's viewpoint. Japan, Eastern Europe, Latin America and the Pacific Basin all had positive returns reversing first quarter negative performance. The MSCI EAFE index, Europe and EM (Asia) continued to have negative returns albeit smaller than their first quarter losses. On a sector basis, energy, materials, industrials, technology and utilities outperformed.

U.S. Equity Market Returns by Major Sector
(Securities in S&P 500, Second Quarter 2008)



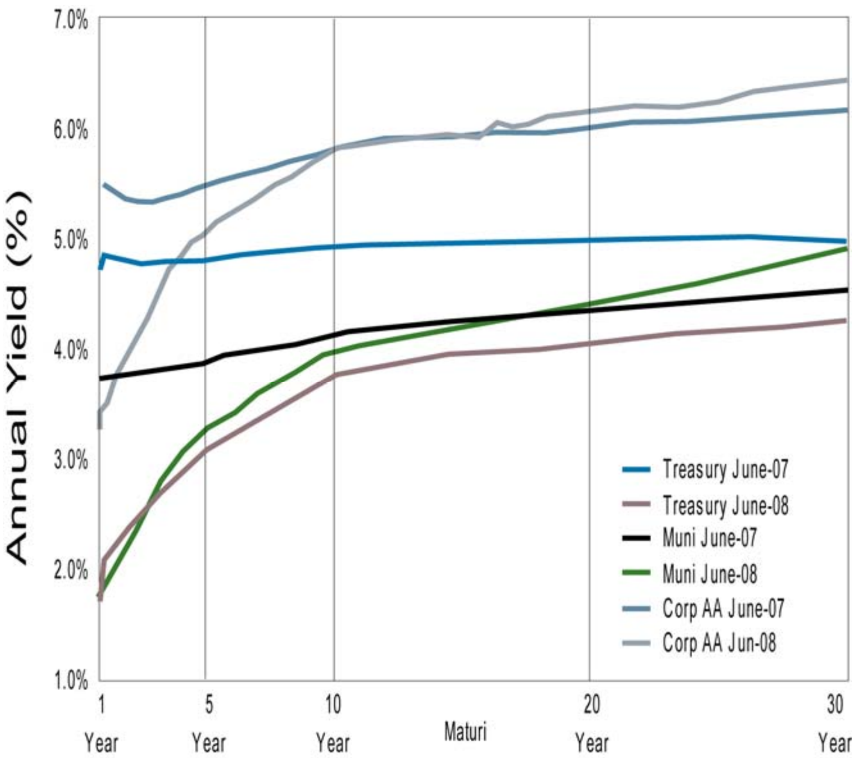
Non-U.S. Equity Market Returns By Country
US Dollars - Second Quarter 2008



Interest Rate Securities – Adjusting to the New Realities

The “flight to quality” strategy that benefited treasury securities in the first quarter began to unwind during mid-April. The 10-year treasury rose from 3.44% on March 28^{th} to 3.86% on May 2^{nd}. Treasuries remained relatively stable until the middle of June when the market, concerned that the Fed was shifting toward a tightening bias, took the 2-year and 10-year treasuries up 5/8% and 3/8% respectively. The yield curve has flattened as the 2-year treasury and the 30-year treasury have risen 1.0% and ¼% , respectively, since April 1^{st}. Corporate bond new issuance set records in the second quarter as corporations employed a “preemptive” strategy designed to borrow prior to any potential rise in rates. Issuance in the banking and finance sector was attributable to the re-building of their balance sheets. The volume of corporate supply has caused new issues to come to market at a rate approximately ¼% to ½% less (higher yield) than secondary paper. Corporate spreads tightened (offered less yield) post the Bear Stearns collapse and the aggressive actions taken by the Fed in March. As the quarter ended, corporates began to widen out again (offer more yield) relative to treasuries. As expected, the mortgage sector had limited new issuance but did mirror the spread tightening cycle of corporates (tightened early in the quarter and widened some as the quarter ended). The municipal market is clearly attempting to adjust to new realities in the market. The subprime crisis, which initially led to the demise of the auction rate preferred market, has caused the entire concept of insured municipals to be re-evaluated. With the downgrading of various monoline insurers, investors and professional traders are reverting to the old fashioned, but fundamentally solid methodology of analyzing municipal credit worthiness. They are asking – what is the intrinsic value or underlying strength of the issuer? The municipal market, while going through a major re-structuring, offers value and will emerge substantially stronger.

U.S. Treasury, Muni and Corporate 30-Year Yield Curves



PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.