Miracle Mile ADVISORS

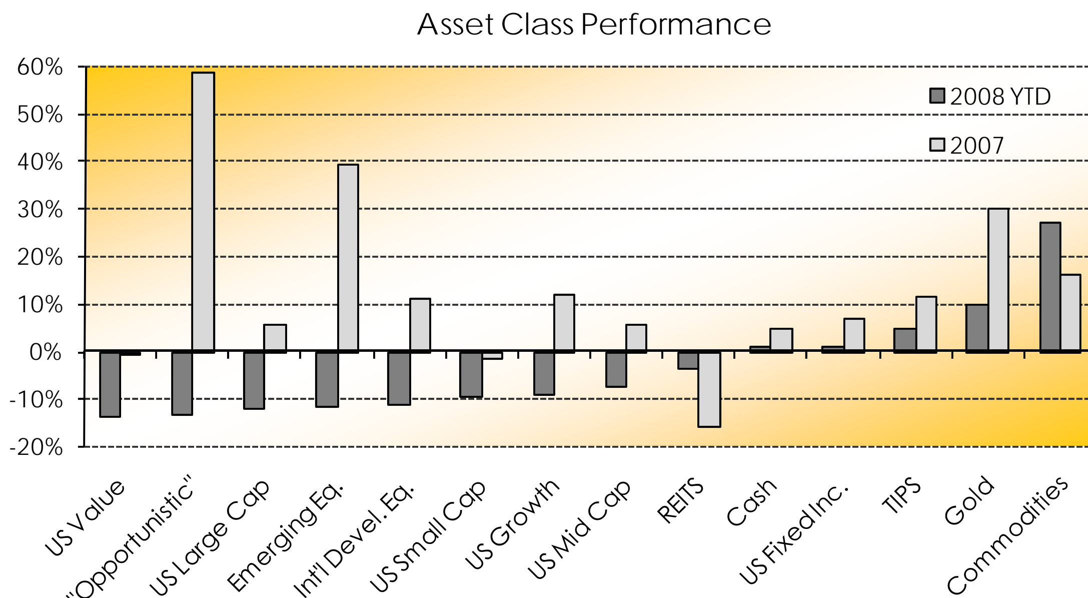
Providing Global Opportunities for the Risk-Aware Investor

The Halftime Report: 2008

We are half way through 2008, and it has not been an easy year. An already bruised and battered team of investors faced a formidable roster of opponents, forcing them to play defense for most of the last 6 months. The subprime mortgage crisis caused an unprecedented number of homeowners to default, leading to huge write downs for banks due to failed mortgage portfolios and worthless debt instruments. This caused the financial system to turn off the credit spigot, eliminating institutional investors' access to leverage and putting a severe credit crunch on consumers. With the U.S. economy already facing a sharp slowdown in growth and record-high gasoline and food prices, Americans have been squeezed by decreasing real estate values and declining wealth from their investments.

The Box Score

There were few places to hide in the first half of 2008: Global equity markets declined a majority of the first 6 months; high-quality fixed income benchmarks posted anemic returns; inflation more-than eroded interest earned sitting in cash; and while commodity markets were red hot, signs that some of the price run-up was due to speculation made risk-aware investors cautious to invest. The chart below shows returns year-to-date for major global asset classes.



Source: S&P, Russell, MSCI Barra, NAREIT, Lehman Brothers, Dow Jones-AIG

As we discussed in our 2008 Outlook, "*The Year Ahead: 2008*," published in January it is impossible to predict the curve balls that will be thrown at the onset of the year. But that did not stop us from forming some educated opinions about what we believed were the most important issues facing the markets in 2008. Let's take a look at what we said in January ("**January Pre-Game Analysis**"), how things have played out so far this year ("**First Half Wrap-Up**"), and where we stand today ("**Second Half Outlook**").

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Schedule of Opponents: 2008

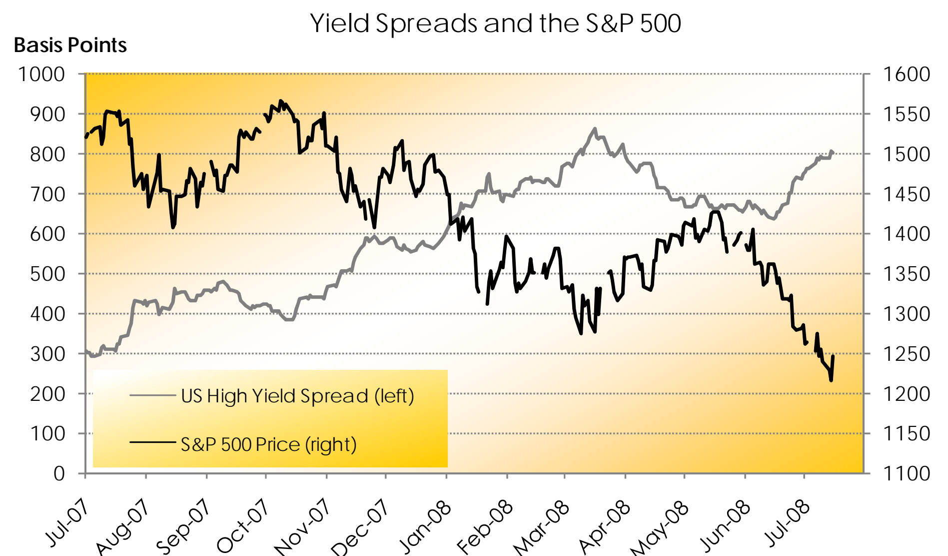
Subprime Mortgage Crisis

January Pre-Game Analysis (*from* "*The Year Ahead: 2008*"):

- It's not over. Although the most over-inflated housing markets took a hard and fast hit, the rest of the country still has a good deal of unwinding to do. The aftershocks of the crisis have widespread implications for homeowners who have either lost their homes or are still trying to sell in a dismal market. The subprime crisis has also shaken some of the biggest financial institutions in the world to their core; generating multi-billion dollar losses and leadership changes at the highest levels of management. For diversification, rely on investments in markets not unduly exposed to the continued unfolding of the subprime debt crisis and/or housing slump, i.e. not the U.S. and the U.K.

First Half Wrap-Up:

- What was called the "Subprime Mortgage Crisis" in January can now more generally be dubbed the "Credit Crisis". Despite the Federal Reserve lowering target interest rates by 325 basis points in under a year, banks are still unwilling to lend. In reality, access to liquidity is not the problem. The central bank turned on the monetary spigot to full blast, but lenders are clogging up the pipes. Banks are experiencing a crisis of confidence amongst their peers, with spreads on interbank loans rising as solvency questions remain. A depression-style run on a bank, as we saw with IndyMac, is symptomatic of the vulnerability of these institutions.
- As we discussed in our February 7, 2008 research piece "*Credit's Cheap, But It Ain't Easy*," credit spreads are a good directional barometer for the markets. We thought equities could have legs when we saw spreads narrow through the spring. When spreads leveled off in mid-May, the market again turned south. In early June, a series of hawkish comments from Fed officials which cited diminished downside risks to growth, caused investors to surmise that policymakers were going into inflation-fighting mode. When the Fed saw that the markets were pricing in an imminent rate hike, they back-pedaled in their rhetoric and spreads again widened.



Source: Merrill Lynch, Option Adjusted Spread, Yahoo! Finance

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Second Half Outlook:

- Despite continuing inflation pressures, it seems that Federal Reserve policy will remain on hold for the foreseeable future. The markets will continue to struggle for an anchor as bank failures, inflation worries, and a weakening consumer compete for attention.
- After years of build up, there is a major deleveraging going on in capital markets. Until there is some clarity on how deep the bank losses will go, we do not expect access to credit to return in any meaningful way. We expect the Financial sector to remain under pressure, with more collateral fallout possible from the Fannie Mae/Freddie Mac debacle. We are moving our cash holdings from short-term paper backed mostly by banks, to short-term Treasuries. This will provide not only a higher yield, but protection from concerns that certain money market accounts could go bust.

Inflation

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- Inflation is on the rise, and American consumers are feeling the pain. As we discussed in our November publication, "*What's the Story with Inflation?*" these price increases are hitting consumers in their every day purchases of milk, gasoline and other basic necessities. Developing countries are driving world demand growth for oil, making it possible that elevated oil prices are here to stay for the foreseeable future. The Federal Reserve continues to lower interest rates to ease the credit crunch, putting inflation concerns on the backburner. Gold, other commodities and Treasury Inflation Protected Securities (TIPS) serve as a defensive position against rising prices.

First Half Wrap-Up:

- MMA hit the mark on the inflation call. Despite forecasts from many analysts that slowing growth would subdue inflation, rising demand apparently could not be met by strained supplies due to weather disruptions, geopolitical turmoil, and limited natural resources. Oil came close to $150 per barrel, gasoline neared (and in some areas surpassed) $5 per gallon, and Americans embraced the "stay-cation" as an alternative to hitting the roads this summer. But as we explain in our June 11, 2008 research piece "*Great Expectations*," just cutting down on driving in no way eliminates the consumer's dependence on oil. Everything from plastic bottles to deodorant to panty hose is made using petroleum-based inputs, and as these higher costs began creeping into a broad array of products, Americans began cutting back wherever possible.

Second Half Outlook:

- The Federal Reserve is facing a conundrum: Interest rates are low but credit is tight, while domestic growth is slowing and inflation is rising. As mentioned in the "Subprime Mortgage Crisis" section above, the Fed's rhetoric turned hawkish in early June but they quickly tempered their comments when markets began expecting a rate cut by the fall. In our opinion, further interest rate decreases would do little to loosen lending conditions, and would boost long-term inflation expectations. However, we feel that

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given the innovative ways the Fed has provided windows of credit to institutions, it is possible for them to raise rates without cutting off liquidity to banks. We believe that a rate hike would go a long way toward reestablishing confidence in the Fed's commitment to price stability. The markets need to rebuild confidence, and there are few things more detrimental to the long-term health of an economy than accelerating inflation. Up to this point, we have not seen employees demanding higher wages to maintain living standards, but without some indication that the Fed is willing to act aggressively to fight inflation, this could begin to happen.

- The situation in the U.S. is complicated by the world-wide inflation environment. In today's globalized economy, a central bank is somewhat more beholden to other countries' monetary policies than in past cycles. The U.S. is importing inflation from abroad as emerging economies grow at a robust pace, driving up global commodity prices. Inflation fighting must be a coordinated effort as a number of countries around the world are experiencing decades-high inflation rates. In both Europe and the U.K. inflation is running at annual rates nearly double the official target of 2%. The European Central Bank raised rates this month despite slowing growth, while in the U.K., official Bank policy has remained on hold, but Chancellor Alistair Darling called on workers to show restraint in their wage demands to avoid an inflationary spiral.
- We believe that inflation remains the biggest long-term threat to a recovery in the U.S. Fed Chairman Bernanke admitted in his recent semi-annual Congressional testimony that inflation is "too high," leading us to believe that in the coming 6-9 months the central bank will see the need to raise rates At least until that time, we advise holding positions in gold and other commodities to provide a defensive hedge in portfolios. Global inflation protected securities also have proved a beneficial holding, but we will continually monitor their valuation going forward as their total return potential could diminish as interest rates increase worldwide.

The U.S. Dollar and Gold

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- The U.S. dollar is in structural decline. The Fed will continue lowering rates in the year ahead, which will keep downward pressure on the dollar. We do not expect a significant recovery in 2008. Gold is an excellent investment option, both as an inflation hedge and a defensive play against the falling dollar.

First Half Wrap-Up:

- The dollar continued to decline through the first half of the year, hitting a record low against the euro just last week. Even sovereign wealth funds, which had played a role in helping to recapitalize some U.S. banks, are beginning to diversify their holdings away from dollar-denominated assets in light of the continuing market upheaval.

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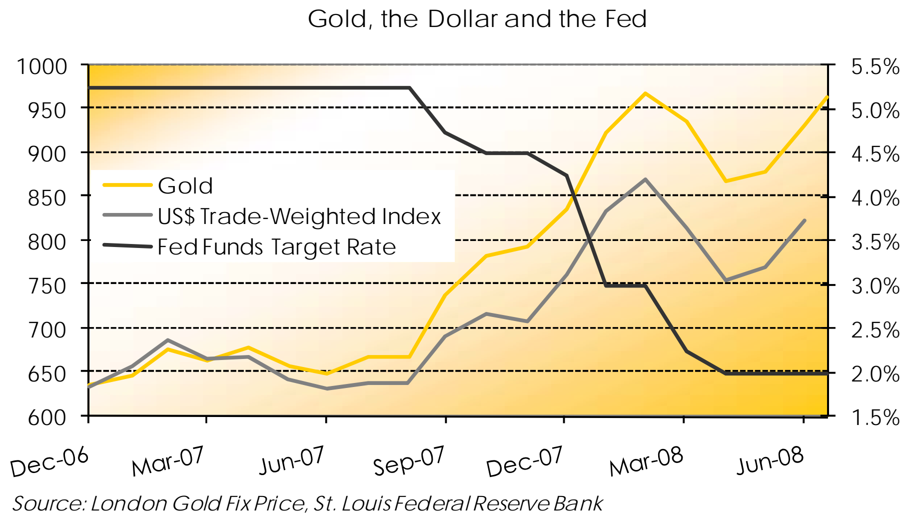
- The weak dollar has been a factor in the relentlessly ascending price of oil. The commodity, which is priced in dollars, becomes relatively cheaper for buyers based in currencies strengthening against the dollar. As a result, demand destruction will not occur as rapidly in countries whose currencies are appreciating relative to the greenback.



Source: London Gold Fix Price, St. Louis Federal Reserve Bank

- Please see our May 16, 2008 research piece, "*Dollars and Sense*" for a detailed look at the implications of a weak currency for American consumers and investors.

Second Half Outlook:

- With real interest rates languishing below zero (nominal interest rate – inflation = real interest rate) we see no potential for the dollar to attract foreign investment. The European Central Bank has already raised rates, and the Federal Reserve has a long way to go before it could bring rates above European levels. Despite strong-dollar rhetoric from Treasury Secretary Hank Paulson, we see no moves to encourage currency appreciation. In fact, a weak dollar is supporting the U.S. economy through cheaper exports. This could help sustain some level of positive growth while the American consumer takes a breather. We continue to favor positions in gold to hedge against inflation and a weak dollar.

The U.S. Economy

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- Regardless of the label, we know that growth is slowing. Chairman Bernanke bluntly stated that the central bank was ready to act aggressively to protect against downside risks. The American consumer has been remarkably resilient during the current business cycle. Deteriorating labor market conditions are both a real and psychological threat to the consumer. We believe that domestic growth in emerging countries will help maintain strength and those regions of the world other than the U.S. and Europe will absorb slack in demand. Non-dollar denominated assets are attractive for U.S. based investors, real assets should provide protection against the falling dollar and the possibility of inflation gaining traction. The housing market in the U.S. has more room to unwind, and we believe that real estate-related investments in western economies will languish for awhile longer.

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First Half Wrap-Up:

- The U.S. economy weakened throughout the first half of the year, but to this point we have seen no real evidence of negative growth. The housing crisis worsened as more homes moved into foreclosure, and the hottest real estate markets like Southern California, Miami and Las Vegas were hit the hardest.
- While it was expected that many low-quality borrowers would lose their homes, the most surprising result of the mortgage debacle was the vulnerability of the lenders. A drastic unraveling of securities dressed up to look like investment-quality debt caused huge unexpected losses for some of the world's largest banks. Federal policy makers have used innovative solutions to extend credit to banks and other lenders which otherwise would have not been able to meet their obligations. We saw the demise of a major investment bank, the near collapse of government-backed agencies Freddie Mac and Fannie Mae, and the largest failure of a commercial bank in more than two decades.
- As consumers dealt with the fallout from the mortgage and credit crisis, they were also faced with soaring costs for day to day necessities. As discussed in the section on "Inflation," a gallon of gas in the neighborhood of $5 has put a major dent in the consumer's disposable income and mobility.
- The employment picture has weakened, but not collapsed. The economy is now reporting job losses on a monthly basis, however many of these have come (as expected) in the housing and manufacturing sectors. The unemployment rate remains at 5.5%, well below the peak of 6.3% seen during the previous economic downturn.

Second Half Outlook:

- The U.S. is experiencing a crisis of confidence. With 90 banks on the FDIC's list of "troubled banks," worries not seen since the Savings and Loan crisis are emerging. Americans will need to regain confidence in the financial and banking industry before a real recovery can be sustained.
- A massive deleveraging has occurred and credit has all but dried up. A nation built on debt will have to find a way to recover without ample access to easy liquidity. In the financial markets, hedge funds that rely specifically on leverage to generate returns will have to find other ways to generate outperformance.
- In early June, it appeared that the Fed had some clarity on economic growth, citing diminished risks to the downside. However, during recent Congressional testimony it became clear that policy makers are no longer confident that a real recession has been averted. We believe that this change in rhetoric has further damaged investor confidence. As discussed above, we feel that the current Fed needs to establish itself as an inflation-fighting central bank in order to restore confidence in long-term growth. Until that time, we expect the general markets will lack direction.
- We have reduced our exposures to core U.S. equity and core European equity in favor of short-term cash-equivalent positions. Despite the fact that markets have already fallen close to 20% from their autumn 2007 peaks, our analysis of similar historical

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periods (including the post-Tech bubble cycle) leads us to believe that an additional 10% to 15% decline is possible. Please see our July 7, 2008 research report "*The Case for Scenario Analysis*" for a full comparison of the current downturn against the post-bubble period of 2000-2002. Currently, we see no fundamental underpinnings for a sustained recovery of developed equity markets in the short term.

Oil & Alternative Energy

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- It's likely that we will see oil prices remain elevated even as the U.S. economy slows. While growth and demand in the U.S. are falling off, global demand for oil is booming. Higher fuel costs will continue to affect American consumers at the gas pump and through the indirect cost of bringing goods to the marketplace. This reduces the amount of disposable income Americans have to pump back into the U.S. economy, potentially hurting domestic equity markets. The importance of energy security and independence intensifies with the lingering threat of geo-political turmoil in the Middle East. These phenomena could direct more funding toward developing alternative energy sources, and boost sectors of the economy focused on developing green technologies.

First Half Wrap-Up:

- The price of oil and the equity market moved inversely throughout the first half of 2008, and most days, oil was up. There have been many debates over the reason for the oil price run up; but whether it has been due to speculation, demand pressures, supply constraints or geopolitical turmoil the results have been largely negative for equities.
- Oil approaching $150 per barrel led to gasoline of almost $5 per gallon, forcing U.S. consumers to either explore public transportation or cut down on driving. Less car trips means less visits to restaurants, stores, movies and other entertainment, further sapping an already-weakening economy.
- We saw a marked shift in Americans' behavior as the price of oil continued to rise. Stories circulated of SUVs and minivans being abandoned as the price of filling up moved out of reach for many people. Ailing auto makers have ended production of gas guzzling models like the Hummer, and are scrambling to produce hybrid and electric cars. There are waiting lists to purchase hybrids such as the Toyota Prius, and we have begun to see the euro-style Smart Car on the roads in the U.S.
- Alternative energy sources are attracting high profile investors. Oil man T. Boone Pickens announced a large-scale project he is funding to reduce America's dependence on "foreign oil". His plan involves building the infrastructure to harness wind energy across the Great Plains states, and using it to divert general electricity production away from petroleum and natural gas.

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Second Half Outlook:

- We believe that there are fundamental underpinnings to the increasing price of oil, as emerging countries build the infrastructure necessary for a middle-class economy. We do, however, feel that there is some degree of speculation behind the speed of the run-up. Speculation should unwind when equities regain enough strength for a sustainable rally.
- While Americans have markedly reduced their consumption of oil, the U.S. is not a major factor in the growing demand for energy. Non-OECD (developing) countries are responsible for most of the demand growth today, while major developed nations are cutting back.
- We are skeptical of oil prices hovering near the $150 mark, but see retrenchments from this level as an opportunity to buy into diversified commodity ETFs. If and when equity markets show sustainable strength, we expect speculative money to exit the oil trading market, leaving prices to reflect the real supply/demand equilibrium.

Change in Oil Consumption, 1Q 2007 to 1Q 2008	
	Millions of Barrels/Day
U.S.	-0.9
Euroland	-0.1
Japan	0.0
Other Developed	-0.1
Total Developed Market Change	**-1.1**
Russia + Region	0.5
China	0.3
Emerging Asia ex-China	0.3
Latin America	0.2
Emerging Europe	0.1
Middle East	0.0
Total Emerging Market Change	**+1.6**
Total World Demand Change	**+0.5**

Source: Bridgewater Associates

- The motto of the late 2000's is "Green is Good". A positive spin on the skyrocketing cost of energy is that we have seen real demand destruction in the U.S. People are changing their lifestyles and are demanding more environmentally friendly ways of life. We expect long-term investment in alternative energy sources to grow. Investments in this area have proved volatile, but remain a good source of diversification over the long term.

The Presidential Election

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- We do not believe that the U.S. Presidential election will have a major impact on the broad market in 2008. At this point it's unclear what the priorities will become for the new administration. The economy hasn't been a major campaign issue. Not yet, anyway. The focus is on change, change and more change. That spells uncertainty, uncertainty, and more uncertainty so we'll have to wait for the national campaign to gear up before we can get a better idea of what to expect from the candidates' mainstream platforms. Candidates from both parties, however, are in some way embracing universal healthcare as well as environmentally conscious programs.

First Half Wrap-Up:

- The economy has certainly become a major campaign issue. We saw Obama suffer during the primaries in manufacturing states, as Hillary was seen as more of the

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"everyman" candidate in tune with the hardships of blue collar workers. Debates over how to protect American jobs, ease the burden of high gas and food prices, and pay for medical care became key topics in winning voters.

Second Half Outlook:

- We are coming up on an historic election, and not only for the obvious reasons. For the first time in decades we have two candidates who both have a legitimate claim to centrist voters. Given economic conditions, we expect the candidates to devote significant time to tax and economic policies as we move past the conventions.

Emerging Markets

January Pre-Game Analysis (*from "The Year Ahead: 2008"*):

- We believe that the strength we've seen in Emerging Markets has room to run. The debt products at the source of the western subprime mortgage crisis were largely absent from emerging market economies, and they held up remarkably well. The much-hyped "emerging middle class" story in China and India has undeniable power. We favor index-like exposure to high growth economies to offset any potential regionalized market disturbances.

First Half Analysis:

- Emerging Markets were more volatile than Developed markets in the first half of 2008, as concerns that slowing western economies would dampen growth in the emerging world. At the same time, rising commodity prices were fanning the flames of inflation as the price of oil consistently reached new highs. Equities in China and India fell from all-time peaks as fears of overvaluation and lack of sustainable growth overshadowed the markets. Resource-rich countries like Brazil held up very well, and our opportunistic investments in Latin America offset some of the losses seen in the U.S. and Europe.

Second Half Expectations:

- We believe claims that the global economy could stall as the emerging markets cool down are overblown. Yes, their growth rates are slowing, but they are still in the high single digits. Relative to the anemic 1%-2% growth expected in the western world, 7% growth in Asia looks attractive.
- We still see support for the emerging middle class story, and the infrastructure required to support it. Chinese and Indian consumers are morphing into the Americans of the 1940s and 1950s. They are buying cars, investing in domestic stock markets, and changing their diets to incorporate more western staples like meat. These structural forces are propping up demand for global commodities while developed nations reduce consumption. Please give our April 11, 2008 research piece "*Emerging Market Growing Pains*" another read for a detailed analysis of our view on emerging markets.
- Investments in emerging economies are more volatile than those in developed markets, and we expect that when emerging markets bounce back it will be on a

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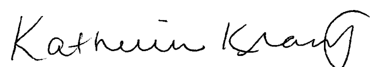
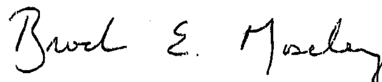
large scale. We maintain broad emerging market exposure, as well as investments in basic materials to capitalize on the commodities required for the building of infrastructure.

Conclusions

During the past 6 months, we have not made significant changes in our major, long-term investment themes. Protecting our clients' assets from inflation, investing in the long-term strength of emerging markets, and benefiting from continued dollar weakness remain our core priorities. In the medium term, however, our more cautious outlook for the U.S. economy has led us to shift a portion of our developed equity market allocation into cash-equivalents. Investing in tax-efficient, lower cost ETFs is an efficient way to avoid unnecessary erosion of capital in a low return, inflationary environment. At this juncture, we believe that the best offense is a solid defense.

July 18, 2008





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