



RICHMOND CAPITAL MANAGEMENT
Experience, Knowledge, Service

Second Quarter 2008

Interest Rate Trends

Quarterly Newsletter

The U.S. recession has been forecast for many months, but has not yet materialized. Nevertheless, the economic environment for U.S. consumers is pressured by job market weakness, high food and energy prices, and declining home values. Interest rates fell in response to that weakness through April, but reversed course and rose in May and June. The bond market is watching higher inflation statistics and considering the possibility that the Federal Reserve might actually hike short term rates in response.

Index Returns			
	Qtr.	1 Yr.	3 Yr. Ann.
Lehman Aggregate	-1.02%	7.12%	4.09%
Lehman Govt/Credit	-1.51%	7.24%	3.84%
Lehman Int. Govt/Credit	-1.53%	7.37%	4.27%

Source: Lehman Brothers

As of June 30, 2008

Economic Activity

➤ **Housing** continues to decline as measured by the S&P/Case Schiller Index. On June 24th, the reading was -15.3% (year over year). Readings have been negative for more than a year and are steadily growing in magnitude.

➤ **Consumer confidence** took a big hit at the end of June with the release of the Conference Board Survey. The 50.4 reading was the lowest since 1992, a steep decline from 58.1 previously. At the same time, **Durable Goods Orders** were reported flat for the month of May and are only modestly negative year to date in 2008. This series shows some business sector strength in the face of consumer weakness.

➤ **GDP** was finalized at 1.00% for Q1 on June 26th. Despite weakness in housing and confidence, the GDP series remains positive in the face of growing expectations for recession. Components adding support to GDP have been government spending, business spending and exports.

➤ The PCE series at the end of June also contained some economic good news, but the improvement is considered to be temporary. Thanks to the tax rebate checks, **Personal Incomes** rose by 1.9% and **Personal Spending** rose by 0.8%.

➤ Looking out longer term, consumers care more about their jobs than temporary stimulus. **Employment** remains in modest contraction. As of May's non-farm payroll report, job losses have averaged -65,000 per month in 2008. The unemployment rate rose to 5.5% from the 5% level it had previously held.

Treasury Market Yields		
	6/30/08	3/31/08
2 Year	2.62%	1.58%
5 Year	3.33%	2.44%
10 Year	3.97%	3.41%
30 Year	4.52%	4.29%

Commodities		
	6/30/08	3/31/08
Oil (\$ bal)	\$140.00	\$101.58
Gold (\$/oz.)	\$928.30	\$921.50
CRB Index	\$462.74	386.89

Spread Product (Spread to 10 Yr. Treasury)		
	6/30/08	3/31/08
10 Yr. "A" Corp	+2.03%	+2.30%
GNMA Current Coupon	+1.71%	+1.63%
10 Yr. "AA" Municipal	+0.03%	+0.42%

Inflation & The Federal Reserve

The Federal Reserve Board met to decide the course of interest rates on June 25th. They decided to hold the Federal Funds rate constant at 2.00%. Going forward, this "rate decision" could get complicated. On the one hand, the economy is weakening and lower rates might fend off recession. On the other hand, rates may need to be raised because inflation has arrived. The **CPI** has risen to 4.2% through May. Food and energy are the big drivers of inflation and when removed leave the "**Core CPI**" at a more benign 2.3%. Language from the recent Fed meeting indicates that Fed voters are now biased to be more concerned about inflation than recession.

Summary

The Federal Reserve bias toward guarding against higher inflation has interest rate futures traders pricing in a small increase in short term rates in September. Recently, however, fear of a heightened "Credit Crunch" (see article on page 2) has driven the stock market into retreat. Given the strength of these opposing forces, the trading range of the first half of 2008 (10 year U.S. Treasury trading up and down around 4.00%) could persist in the second half.

Equity Crunch

The current investment cycle has come to be known as the Credit Crunch of 2008, but ironically fixed income, including the investment grade credit sector, has managed to hold steady so far this year. The stock market, on the other hand, has been in decline. Halfway through 2008, the Credit Crunch is “crunching” equities more than fixed income.

Performance Chart:	
Index	YTD Return (6/30/08)
DJIA	-15.20%
S&P 500	-13.61%
Lehman Aggregate	+1.13%
Corporates	-0.84%
Agency Mortgages	+1.93%

The downfall of the subprime mortgage market and subsequent collapse of derivative structured products has led to a major Wall Street retrenchment. **To date, commercial and investment banks have taken approximately \$400 billion in losses and write-downs worldwide. To be sure, that figure is staggering and some analysts**

have projected that it will double before the cycle is complete. However, another figure of impressive magnitude is that of the total capital raised by these same institutions to shore up their weakened balance sheets. Roughly \$300 billion has been invested in these banking institutions in the form of common stock, preferred stock, hybrid securities, and subordinated debt.

In the process of raising capital, Wall Street has been forced to favor their bondholders. Obviously, adding equity to the capital structure is in itself a bondholder-friendly activity. But, in the current “credit crunch” environment, financial institutions have also been forced to cut dividends and pledge to operate with less leverage. This behavior stands in stark contrast to that of the previous 5 years when stock buybacks and LBOs were commonplace. **It is perhaps an unintended consequence of the capital raising activities, but in the new “tight money” environment bondholders find themselves in a stronger relative position.**

	Average Spread to Treasuries	5 Year Std. Deviation
6/30/2007		
Lehman Aggregate	+0.70%	1.07
Corporate Sector	+1.02%	1.46
6/30/2008		
Lehman Aggregate	+1.66%	1.03
Corporate Sector	+2.79%	1.29

Another way to articulate the improved environment for investment grade bonds is to look at valuation and the risk/reward tradeoff that exists today compared to one year ago. **Total return prospects going forward are greatly enhanced by the wider yield spreads now available.** The adjoining chart

illustrates that yield advantage which occurs without the additional risk of higher volatility (as measured by standard deviation).

Equity investors this year have suffered dilution and poor returns. It is impossible to predict whether that trend will continue or reverse. However, at the midpoint of 2008, one thing that is certain is that bond investors get significantly more risk adjusted reward than they did one year ago.