

# Southern Capital Perspective

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## FIRST QUARTER OF 2008: A DIFFICULT ONE

By Terry Nager

The first quarter of 2008 was the roughest since the third quarter of 2002 which, as everyone will recall, was in the midst of the severe bear market. The peak of the market came in October of 2007 and has since declined almost 20% in terms of the popular indices. Our portfolios have fared better but, after 10% gains in 2007, have declined about 6% during the first quarter with a small rally in early April. That relative performance was gratifying but the question remains, "Are we in a bear market?" Our reply is the same as it has been. That is no, we believe that we are experiencing a correction of the bull market that began at the triple bottom bear market low in 2002-2003 (see graph below). This very large bull market run went from a low of about 800 on the S&P 500 Index to about 1575 without a significant correction. So, the long overdue correction had finally arrived but in the following paragraphs we will explain why we are unconvinced that it is a full blown bear market.

First, from a technical standpoint, the market seems to be acting in a manner that occurs at market bottoms. This is best described as volatile moves up and down without trending in either direction. If you look at areas that have boxes drawn around them on the graph, which is a 10 year history of the S&P 500 Index, you will see that at the bottom of the bear market there was an extended period (almost a year) that a volatile trading range from 780 to 950 was established. This period was marked by violent up and down moves but no trend until the market broke out to the upside in the second quarter of 2003. Next look at the most recent period box and the trading range of 1250 to 1400. As we have seen, the market during 2008 thus far has been experiencing many days with greater than 1% moves up or down and yet we seem to be locked in this trading range with no clear trend. This is not conclusive proof that this is the market bottom but it is one piece of the puzzle that indicates that it might be.



Second is the incredible amount of bad economic news that is coming out day after day and week after week. Yet the market has not fallen out of the bottom of the trading range. This is very curious action if we are indeed in the throes of a bear market. Think of all the negative news items you hear almost everyday. For example, the sub-prime mess seems to be growing as more financial institutions are having to write down additional billions of dollars (\$19 billion just the other day); housing prices are continuing to decline and more foreclosures are adding to the already large inventory which is putting more downward pressure on home prices; corporate earnings have been declining, mainly due to the banks and brokerage firms, and GE missed their earnings forecast which triggered a recent 2% sell-off in the market; the unemployment rate has been edging up although it is still at a low level on an historic basis; oil prices are at an all-time high; the inflation rate is starting to increase; and taxes may be going up depending on the political outcome of the election.

The list goes on and on but I will stop here because I believe the point that we have been suffering an avalanche of bad news is made. However, the interesting aspect of all of this is that the market has not been plunging to new lows day after day. Why? The answer may be that the mid-January and mid-March lows may have already discounted the

seemingly unending stream of bad news that we have been experiencing. Remember, the market usually moves in one direction or the other before the economic news confirms the validity of the move. A market that does not decline on bad news may be at or near its bottom.

Third is what is called “negative sentiment” from investors, financial newsletter writers and a majority of financial advisors who have a negative or bearish view. This may sound like a bad thing but actually it is just the opposite. Historically, when there is so much negativity among investors, advisors and the general public (think of your friends, relatives and neighbors), it is usually wrong. Remember in late 2002 and early 2003 when almost everyone felt negatively about investing in the stock market and yet it was a major market bottom and a wonderful time to be an investor. The present sentiment is definitely negative although not as much as in 2002-2003. It still may be enough to indicate that we are close to a bottom.

Fourth is the action of the Federal Reserve Board (FED). Interest rates have been reduced to 2.25% and it is likely that another rate cut is coming. Also, the FED has been dramatically increasing the money supply and taking extraordinary steps to salvage the financial system. All of these actions are designed to combat an economic downturn. Consequently, as a byproduct, these actions serve to combat a bear market. There is usually a time lag before the actions of the FED begin to have an effect. This is the reason that they often overshoot raising or lowering interest rates on the way up as well as on the way down. They have been reducing rates for months and the cumulative effects should begin to be felt. This is likely to have a positive effect on the market. Therefore the FED action should put a limit on the depth and severity of any market decline.

Fifth is the fact that we are in an election year. Election years seldom are down because politicians like to stay in office, or in the case of a lame duck administration, like their party to remain in power. The so-called stimulus package is a classic example of this phenomenon in action. The Democratic congress and the Republican administration eagerly joined together to give away \$160+ billion in order to mollify the electorate. The terms of this boondoggle giveaway will undoubtedly stimulate the economy in the short-run, but will do so in a grossly inefficient manner and at a much larger cost in terms of the gaping hole it blows in the budget. Nevertheless, this massive financial injection that is supposed to begin in May, when checks go in the mail, will serve to retard downward market pressure because of the positive impact it will have on corporate earnings.

Conclusion - The factors enumerated in the above paragraphs are the primary basis for our conclusion that we are in a correction rather than in a bear market. Obviously this is a judgment call based on the analysis of the available information. Also, it is important to understand that the market could remain locked in its trading range for a significant period of time as was the case with the 2002-2003 bottom. As always, if our read on the situation proves to be inaccurate we will modify our stance and take the appropriate steps to deal with the existing condition.

Outlook - Starting from our premise that we believe to be correct, the market should work through the correction and in our opinion turn positive for the calendar year of 2008. If a decent year-end rally materializes, we expect our portfolios to fare pretty well for the year.

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#### SOUTHERN CAPITAL OFFICE IN NEW LOCATION

By Eric Nager

Southern Capital's home office has been located in Daphne, Alabama, since the move from Mobile in 1995. From then our company grew and prospered through the fabulous bull market of the late 1990's, held our own during the challenging bear market of 2000-2002, and then grew solidly again, posting double-digit returns on behalf of our clients over each of the past five years. (Please note that past performance is no guarantee of future returns.) During this time the staff changed and grew as Eric Nager replaced Dutch Coppejans, and Mark Nager was hired in June 2007. By then it was clear that the office needed renovation or more space.

Happily, some ideal space opened in the same office complex in the building next door. While still on the second floor, the new office is on higher ground such that it's equivalent to the third floor of the previous building, with clearer, better views of Mobile Bay. Upgrades from the old office include more square footage, new office furniture, hardwood floors, and more monitors throughout the office to view market performance and analysis. The signature space is a corner conference room for hosting our clients, business associates, and prospective clients. Great credit goes to Michelle Hunt, our interim office manager, for orchestrating a smooth move. The staff at Southern Capital looks forward to many more years of service in its new location.