YSWM, LLC Client Letter

April 29, 2008

Looking For The Turn
The Economy
Financial Market Update

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LOOKING FOR THE TURN

Preparing the quarterly client letter is always a challenging endeavor; however one might best describe this edition as down-right difficult because so many components of the economic landscape are shifting concurrent with a highly engaged Federal government. In our last letter we used the analogy of juggling an increasing number of balls at an increasing speed to depict the likelihood of mistake; i.e., incorrect government policy change(s) or relative market pricing of various security classes.

Since our last report released on January 29th, the overall stock market has improved slightly with many sectors up sharply despite most economic measures continuing to soften during Q1 and early April. The news flow has been quite negative with the presidential election process also contributing to declining business and consumer sentiment. While uncertainty is still quite high, many market indicators of fear have actually improved since our January report with credit spreads appearing to peak on March 11th and the stock market appearing to bottom on March 17th.

Credit market conditions have started to improve slightly in April helped in part by a number of important and innovative FOMC actions; 1) opening up the discount window to investment banks with a 2.5% borrowing rate 2) widening the scope and size of their auction facilities to primary security dealers for 28 days and 3) accepting both agency and private-label mortgage-backed-securities (MBS) as collateral. Financial markets remain under stress, as lenders remain very wary of low rate loans and highly leveraged transactions, but the wheels are turning. The FOMC cut the Fed Funds rate another 75bp in March which brings the total reduction to 300bp since Aug07. Fed fund futures indicate a very high likelihood of another 25bp reduction at the FOMC April meeting with a growing consensus for a pause thereafter. Two FOMC members voted against the 75bp cut in March and preferred less aggressive action. The monetary policy gas pedal if you will is at the floor and future market prices suggest that Fed policy will shift soon and the Fed fund rate will start rising by the fall of 2008.

Unfortunately, thirty year conventional mortgage rates have remained around 6% despite much lower bank borrowing costs (5.25% to 2.25%) as many large lenders are strapped for capital due to large loan losses. The blunt force of rate cuts has been far less effective than the aforementioned structural changes. The Fed has followed the market lower for the most part but did eventually recognize what was occurring and adjusted accordingly. The dollar has declined which has further fueled energy related inflation and thus made the Fed’s dual mandate of sustainable growth and low inflation increasingly difficult to achieve for the foreseeable future.

The economic data flow since late January has decisively confirmed that the credit-crunch has spread into the broader economy. Both Q4 and Q1 real GDP growth hover near zero and real retail sales remained negative for the last five months. Nominal GDP growth has been positive but only as the result of higher prices rather than increasing demand. Consumption patterns are adjusting as middle-market consumers trade-down helping the discounters like Wal-Mart and Costco but hurting discretionary merchants and the sale of big-ticket items. Going-out of business sales and growing consumer debt are signs of the time.

Current stock prices (S&P500 at 1,390) likely reflect the economic slowdown as investors' focus now shifts to how deep and long it will be. While most stock benchmarks dropped sharply in Q1 as valuations adjusted to lowering expectations, the below **Table 1** depicts recent improvements across many key sectors comparing the 4/24 and 1/29 closing prices. Recent favorable market action suggests that the global economy will decouple from the slowing U.S. economy with some optimism that the slowdown will be relatively mild and short.

Table 1: Sector Price Change #

Sector Description	% Chg
Energy	15.0%
REIT	11.1%
Basic Material	8.3%
Technology	5.0%
Utilities	4.5%
Industrial	3.2%
Consumer Non-Cyclical	1.6%
Consumer Cyclical	0.6%
NASDAQ Biotech	0.0%
Healthcare	-5.2%
Telecommunications	-5.9%
Financial	-7.5%

Sector ETF's Price Change 1/29 to 4/24/08

First quarter corporate reports help explain much of the performance difference in **Table 1** such that companies with more international sales beat on revenue and earnings while businesses deriving a majority of their revenue from U.S. sales missed both top and bottom line expectations and often guided lower for the coming quarter and full year. The weakening dollar provided a substantial revenue boost to many large industrial conglomerates and technology bellwethers like IBM and Intel.

The fear premium as reflected by a very low two-year Treasury yield has also made a substantial reversal in recent weeks and is now trading above Fed Funds with a 2.4% yield, up over 90bp since mid-March after bottoming around 1.5%. The ETF 1-3 year Treasury equivalent (SHY) peaked at $84.50 on 3/17 and has subsequently slipped almost 2%. The Ten-Two Treasury bond spread also appears to have peaked in March at just above 200bp and has drifted below 150bp in recent weeks.

It has been a very busy start to 2008 and as discussed in our last report, long or rapid periods of economic expansion will push the relative values of different asset classes and segments of the economy to extreme points. It seems increasingly likely that we have reached such a point for the credit crisis with the 3/17 Monday morning announcement of the government funded JP Morgan acquisition of Bear Sterns looking increasingly like the turning point for both stocks and bonds.

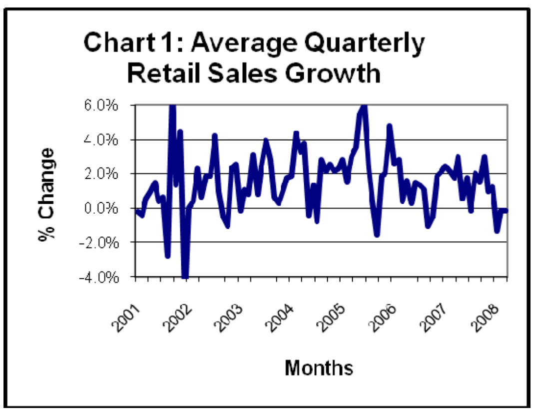
These are very interesting times indeed with three government policies being levered at very high utilization rates. Monetary, fiscal and military policy are currently consuming resources at what appears to be an unsustainable level which is creating concern that unexpected outcomes are already occurring but the consequences are often hard to measure in a timely manner. The sheer absolute dollar value of the combined policy actions are quite staggering although global investors are still quite willing to buy Treasury securities at very low interest rates. There is a pecking order to informational flows with market prices theoretically reflecting these outcomes in real time while economic data and corporate reports explain what is occurring with a weekly or monthly lag. Obviously the markets can get it wrong and stock prices could decline once again if the decoupling fails or the U.S. contraction worsens.

Consider the following questions; what are the most powerful things controlled by mankind? The first and most obvious would be the U.S. military arsenal, while second and less obvious is U.S. monetary policy with U.S. fiscal policy likely a close third. Market volatility is often related to uncertainty which tends to increase with the level of government intervention. Current high policy utilization rates and their long-run impact on the functioning of markets, financial or otherwise, remains an important issue for investors. Also the presidential election process has generated concern on Wall Street that there will be more government social spending in addition to already high levels of military and defense spending.

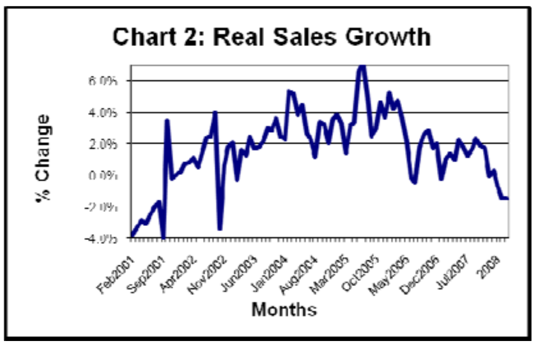
The good news is that the rebate checks are in the mail but the bad news is that federal taxes will likely increase. Interest rates need to rise to reflect a more normal yield structure relative to current inflation and credit. Risk pricing remains challenging in many bond market segments but the trend seems to be improving. The dollar should recover and help to stabilize inflation as the so called "safety-trade" into short term Treasury securities unwinds. Markets remain under stress but show signs of improvement despite deteriorating economic data. The **deleveraging process** has likely progressed as well as could be expected during the last three months. Numerous large transactions were successfully funded using both private equity capital and public offerings including debt and convertible equity securities.

THE ECONOMY

The domestic economy was flat to down in Q1 depending on the relative measure of growth. Real retail sales growth (nominal aggregate retail sales growth less CPI-u) weakened further into negative territory while industrial production declined slightly but improved from Q4. Final Q4 real GDP was unrevised at 0.6% while Q1 likely dropped near zero. The consensus real GDP growth forecast for 2008 remains slightly positive on a full year basis with better quarterly growth expected in the second half.

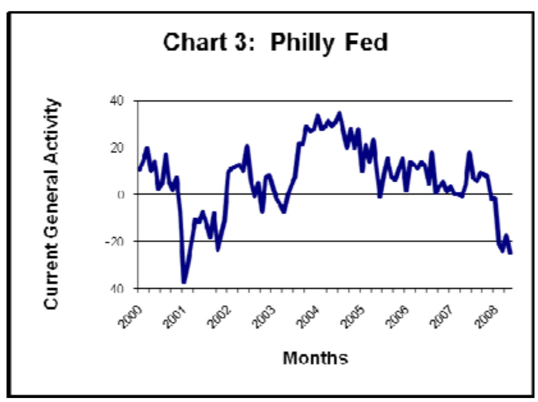


First quarter **consumer spending** as measured by retail sales declined at an average annual rate of -0.4% down from positive 2.8% in Q4. Higher energy prices continue to weigh on same-store sales with most of the sales revenue growth due to higher prices rather than increases in sales volume. **Chart 1** captures the recent decline using a rolling average quarterly sales growth rate annualized. Q1 was the weakest quarterly period since post-Katrina in 2005. **Chart 2** shows the growth trend in real retail sales with a rolling-twelve-month average adjusting for inflation: monthly retail sales growth less the monthly change in CPI-u compounded over a rolling twelve month period. Clearly the trend is down, breaking the zero line in 2008 and approaching levels not seen since the 2001-02 recession.



The Conference Board's **consumer sentiment** index dropped to 62.3 in Apr08 which is down sharply from the four-year high of 112 in Jul07 and is well below the Q1 average of 76. To help understand the severity of the decline, we had to go back to the early 1980's to find a similar reading noting that the index only reached the low 80's after 9/11. The U of M sentiment index softened throughout the quarter averaging only 72.9 in Q1 as compared to 77.5 during Q4. The April reading dropped sharply to 63.2 down almost 30% on a y-o-y basis and also reaching a multi-decade low point. Gasoline prices remain well over $3 per gallon with the national average hitting $3.50. It appears that regular prices could reach $4/gallon by Memorial Day due to summer reformulation. Gasoline inventories remain relatively high and refiners have reduced output to reflect a 7% y-o-y decline in demand. Many segments of the economy are watching profit margins and discretionary spending budgets get squeezed by higher costs. A recent Gallup poll (4/22) indicates that 73% of Americans are worried about rising food prices and this week's Business Week cover story, "The New Economies of Food" clearly suggests widespread concern. Oil and gold have worked their way onto the home page of most media gaining the same prominence as traditional stock and bonds indices.

Business sentiment dropped during Q1 with the Institute of Supply Management's (ISM) purchasing manager index averaging only 49.2 down from 49.8 in Q4. The index has remained below 50 for three consecutive months but has held above its Jan08 low of 47.7 which surprised stock investors and started the sell-off on the first trading day of 2008.



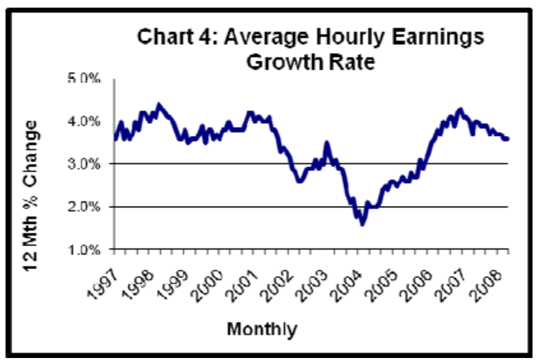
The Philly Fed index of regional manufacturing growth was down sharply for the last four months, averaging negative 20.8 in Q1 before reaching a new cycle low of -24.9 by April. Interestingly, the stock market did not sell-off after the April report helped in part by an uptick in the six-months-from-now diffusion index which improved slightly from negative 0.5 in March to positive 13.7. **Chart 3** depicts the severity of the decline in business sentiment and confirms the contraction signal we discussed in our January 29 report.

Capacity utilization has finally started to weaken after remaining quite stable in 2007. Average monthly utilization dropped sharply from 81.5% in Q4 to only 80.7 in Q1 with pressure from autos and other durable-goods sectors. **Industrial production** remained in negative territory with an average Q1 decline of -0.4%, improving slightly from -0.8% in Q4. The recent contraction in production breaks a seven-year expansion period although the growth rate has fallen sequentially in recent years; +2.5% in 2006, +1.3% in 2007 and now turning negative in 2008. Both indicators have softened since our Jan08 report.

Non-farm payroll **employment** contracted sharply in Q1 dropping at an average monthly rate of 77k jobs as compared to an increase of 80k per month during Q4. Total employment contracted 232,000 during Q1 with many announced layoffs likely to impact employment growth statistics during the balance of 2008. Manufacturing and construction payrolls continue to account for a majority of the decline although professional and service payrolls have also started to decline. The unemployment rate has drifted above 5% while average hourly earnings have softened slightly and now appear to be growing slower than the CPI inflation rate.

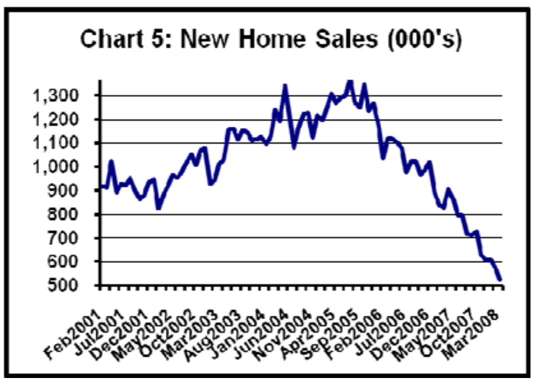
Weekly jobless claims have been trending higher although the most recent weekly report showed a surprising 30k drop to 342k. The 4-week average remains elevated at 370k which is up sharply from 314k in late January.

Chart 4 depicts the rolling twelve month change in hourly earnings growth from 1997 to 2007. Growth has slipped to around 3.6% annually after peaking at 4.2% in early 2007. Inflation has moved higher and the dollar index much lower during this period which are combining to erode consumer purchasing power and contributing to the current U.S. economic slowdown. The Euro was up 13% and Yen 12% year-over-year at the end of Q1, climbing even higher by mid-April before reversing in recent days as described above.



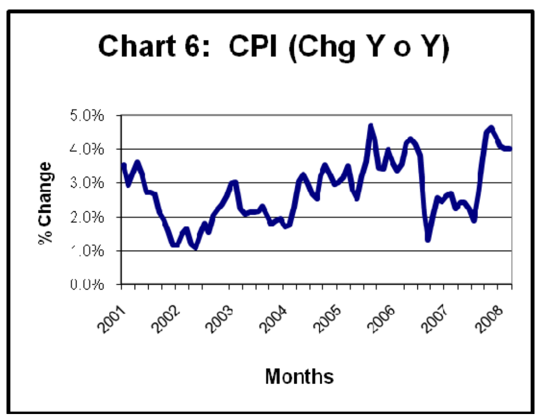
New home sales and housing starts have dropped over 60% from their peak as the industry continues to struggle with too much inventory which still remains quite high at 468k unsold homes. The supply of new homes for sale remains elevated at 11 months, a new cycle high. During Q1, annualized unit sales averaged only 569k down sharply from a revised 853k last year. In Mar08, the median home price was $227k and average price $292k down 14% and 11% respectively from Mar07 but up slightly from the December bottom.

The below **Chart 5** illustrates the steepness of the recent decline as annualized unit sales have dropped to early 1980's recessionary levels. Home prices likely need to adjust further as the market continues to search for a break in a very steep downward sales trend. Publicly traded home builder stocks likely bottomed in early Jan08 and didn't decline following the release of much weaker March sales at only 526k annualized units which is well below the current U.S. home formation rate of approximately 800k homes. **Housing starts** dropped below one million annualized units in March for the first time in many decades, down over 36% y-o-y and averaging only 1.035m annualized starts during the first quarter as compared to 1.15m in Q4.



Like new homes, **existing home sales** are weak with Q1 sales running 22% slower than 2007. The number of existing homes for sale remains quite high at 4.06m units as supply appears to be drifting higher again at 9.9 months. Inventory levels tend to increase going into the spring selling season as more property comes to market. The median selling price drifted slightly lower from $208k during late 2007 to around $201k in March, down almost 8% from the previous year. The national average selling price dropped to $247.7k down 6.6% from last year. The West region's prices dropped 11% in March while the east price declines moderated, down only 3%. The Midwest and the South experienced 7% to 8% price declines. The **affordability index** remains a critical driver to sales growth recovering as does owner equity capital and the availability of credit. As mentioned above, recent declines in the ten-year Treasury bond yield have not yet filtered through to lower mortgage rates.

Inflation jumped sharply during Q4 and has remained elevated thus far in 2008. Headline CPI-u is currently holding at around 4% as shown in **Chart 6.** The core CPI inflation rate increased slightly and is above the upper-end of the Fed's comfort zone. The slowing economy has not slowed inflation as many had forecast. This moderation will have to occur in direct opposition to Fed easing. The PPI has also jumped sharply in recent months and suggests consumer inflation will move higher in the spring unless energy prices begin to decline.



In sum, U.S. **economic fundamentals softened further in Q1** as weakening retail sales and falling industrial production resulted in flat economic growth. The consensus outlook suggests sluggish real GDP growth during 2008 as relatively high inflation continues to reduce real purchasing power as earnings growth moderates. Consumer and business sentiment declined throughout the quarter and will likely produce another 25bp rate cut at the April FOMC meeting.

FINANCIAL MARKET UPDATE

To get a better understanding about what is driving the stock market, we compared the current structure of the S&P500 to that at the end of 2000 as depicted in **Appendix A**. First and foremost, the market capitalization (cap) of the S&P500 is only 3% higher than it was at the end of 2000, up only 5% using the index level (1,390 and 1,320) with both suggesting a range bound market for the last eight years. Looking inside the index, natural resource sectors are up sharply while bigger market cap segments like health care, financials, and technology with many more companies are all negative. The average market cap of health care is down 34% to 27b and its index level -17% and information technology stocks' average market cap is down 16% from $32b in 2000 to 27b with the index level declining 22%.

The average market cap of energy companies has increased 61% to $48b with just 36 companies representing over 14% of the S&P 500 or $1.7 trillion in market cap. The energy index has increased 161% since 2000. By way of comparison, big telecom companies reached an average market cap of $53b per company in 2000 but only accounted for 5.5% of the S&P 500. The average market cap of the Material sector has increased 152% since 2000 with the index level up 110%. The financial sector allocation has fallen sharply from 22% in early 2007 to 17% with an average market cap of 22.4b, down from almost 28b in 2000.

The performance differential between the groups illustrates the potential return impact of unfavorable sector rotation. Timing extreme points becomes increasingly dangerous as momentum builds and the risk-reward ratio increases. The tendency with many investors is to follow momentum, eventually buying high with expectations of selling higher.

Energy and related natural resource sectors have become disproportionally important both in relative market value and impact on day-to-day price volatility. The S&P500 energy and material sectors' beta have jumped to number two and three out of the ten sectors, currently at 1.22 and 1.23, respectively as calculated with daily returns over the last year. Historically they have been among the lowest beta sectors. The high beta sectors during the last extreme point when the focus was solely on intellectual rather than physical capital are now among the lowest beta sectors; e.g., technology .91 and health care .57.

High commodity prices seem to beget higher prices despite clear signs of weakening demand. Energy prices are clearly in the driver's seat on Wall Street with energy price inflation slowly working its way into just about every sector of the economy. Commodities have become everyone's favorite asset class although they lack an internal rate of return which is characteristic of other asset classes. If we think about this analytically, there is no interest or dividend cash flow nor an earnings growth but instead a zero-sum-game based on price change. If you recall, the dot.com investments also lacked an internal rate of return; many IPO's had no earnings and no revenue for that matter just great investor expectations of selling at a higher price.

The below **Table 2** indicates that all equity benchmarks were down sharply in Q1 with the Lehman total bond index up 2.2% as investors sold stocks and rushed into Treasury securities and cash. The US dollar index remains under pressure after stabilizing around 76 during January and February. The index hit another cycle low in mid-March at 71 before recovering slightly in recent weeks to trade between 72 and 73.

Table 2: Benchmark Returns*

Index	1Q08
S&P Large Cap 500	-9.9%
S&P Mid Cap 400	-9.2%
S&P Small Cap 600	-7.7%
EAFE (International)	-9.5%
Total Bond Market	2.2%

Source: Standard & Poor's / Lehman Bros.
* Price Change

Table 3 depicts sector returns for the S&P500 during the first quarter and second quarter-to-date ending 4/25/08. Q1 ended with most sectors trading near their low for 2008 with varying degrees of negative return. Staples, materials and industrials had the smallest losses while the technology, financial and telecom sectors were all down sharply during the quarter. As mentioned, market conditions have improved during April with the S&P500 up almost 6% to reverse almost 60% of the Q1 decline. Energy and material sectors provided leadership once again while the financials showed surprising strength in the face of more write-downs and liquidations. The energy and material sectors are also in positive territory year-to-date 2008 and now trade at record highs, up 3.4% and 5.4% respectively. While the rally has provided some much needed relief for worried investors, the continued concentration of cash flows into "hard-asset" sectors and large dispersion of returns raise concern with respect to the market's ability to break-out of its recent range.

Table 3: S&P 500 Sector Returns *

Sector	1Q08	2Q08
Energy	-7.5%	11.8%
Materials	-3.6%	9.2%
Industrials	-4.5%	2.0%
Consumer Discretionary	-6.3%	4.8%
Consumer Staples	-2.8%	-0.5%
Health Care	-11.9%	2.5%
Financials	-14.7%	8.3%
Information Technology	-15.4%	7.7%
Telecommunications	-14.6%	2.4%
Utilities	-10.7%	5.9%
S&P 500	**-9.9%**	**5.8%**

Source: Standard & Poor's / * Price Change

AMG Data reported a sharp reversal of fund flows during Q1 following a very strong 2007 as shown in **Table 4**. Domestic's equity funds experienced large out flows totaling in excess of $22b during Q1, non-domestic equity funds had net redemptions of over $7b and municipal bond funds out flows of $8.6b. Emerging market funds, recent years' big winner, accounted for all of the non-domestic out flows while funds covering developed Europe and Japan actually experienced cash inflows due in part to continuing dollar weakness.

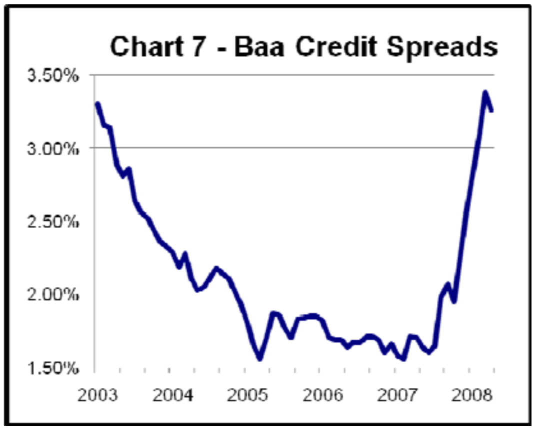
Taxable bond funds reported another strong quarter with $55.7b inflows building on Q4's $154b inflow. **Money market fund inflows reached another quarterly record of $348b during Q1** as investors reduced risk exposure. Safety or risk avoidance clearly dominated fund flows throughout much of Q1 although investors have started to rotate from Treasury bonds back into stocks.

Table 4: 1Q08 Fund Flows

Segment	Flows($b)
Domestic Equity	(22.5)
Non-Domestic Equity	(7.2)
Total Equity	(29.7)
Taxable Bond	55.7
Money Market Fund	347.7
Municipal Bond Fund	(8.6)

Bond credit spreads continued to widen into Mid-March then appeared to peak on 3/17/08 when the Baa spread reached 350bp. Credit and term spreads have been contracting in recent weeks with the Baa spread falling to 325bp by mid-April and was trading near 310bp as of this report. The below **Chart 7** depicts the sharp break upward in the Baa credit spread shortly after the credit crunch began in Aug07 and the recent break lower. Credit conditions seem to be improving in April helped in part by the Fed's innovative steps to inject liquidity and buy risk.

Thus far in 2008 the net performance differences remain quite pronounced across the risk spectrum as higher yielding corporate bonds experienced losses and lower yielding Treasury bonds gains. Treasury inflation protected securities (TIPS) have dropped sharply since mid-March as inflation expectations appear to be declining despite elevated consumer and producer inflation indicators. For example, our core Treasury inflation protected bond ETF (TIP) has dropped 3.6% and is now trading below $107 after peaking at $111.50 on March 13.



Volatility has remained surprisingly contained in recent weeks after the CBOE Volatility Index (VIX) reached 37 in January then retested its high in Mid-March. The VIX is currently trading at its lowest point in 2008 holding well below the bottom-end of the Q1 trading range (24 to 37) at around 20. Recent weak economic data including record low consumer sentiment and housing data has not resulted in the typical selling patterns and perhaps suggests that much of the bad news is already priced into the stock market. Market mood swings have been quite dramatic in 2008 so cautious optimism is likely most appropriate until more evidence becomes available.

Written By: Robert Samrah, CFA

1) Form ADV II, as filed with the SEC, is available upon request. Also, quarterly client letters are available on our web site (www.yswm.biz).

2) Our privacy policy, as per regulatory requirements, is mailed annually and is available in PDF on our web site.

APPENDIX A: S&P 500 Index Structure and Change from Dec2000

Sector Description	2008 Market Cap *	% Change from 2000	2008 Avg Market Cap *	% Change from 2000	2008 Number of Companies	Change in Companies from 2000	2008 Sector Allocation	Allocation Change from 2000 (bp)
S&P 500	12,100	3%	24	3%	500		100%	
Energy	1,720	123%	48	61%	36	10	14.2%	765
Materials	453	68%	16	152%	28	-14	3.7%	145
Industrials	1,425	15%	25	42%	56	-13	11.8%	124
Consumer Discretionary	1,034	-14%	12	-16%	86	2	8.5%	(171)
Consumer Staples	1,274	34%	32	21%	40	4	10.5%	244
Health Care	1,377	-18%	27	-34%	51	10	11.4%	(295)
Financials	2,058	1%	22	-20%	92	19	17.0%	(31)
Information Technology	1,924	-23%	27	-16%	71	-7	15.9%	(547)
Telecommunications	391	-39%	43	-19%	9	-3	3.2%	(222)
Utilities	444	0%	14	26%	31	-8	3.7%	(11)

* Value shown in billions of U.S. Dollars on 4/18/2008