Market Commentary

First Affirmative Financial Network, LLC

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An Unpleasant Ride

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The second quarter of 2008 began with hope that the worst of the credit crunch was over, and that earnings would grow and stocks would gain. As it became clear that the credit crunch was not over and that consumer spending was likely to contract, investors' hopes were dashed.

By the end of the quarter, the Dow Jones Industrial Average had officially entered "bear market" territory, with the S&P 500 Index hovering barely above the generally accepted threshold for a bear market: a 20% decline from the peak.

The pain was felt around the globe. Since January 1st, the rate of

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Bond Markets Do Not Favor the Bold

Charles Sandmel, AIF®, CFP® | Portfolio Manager | with Anne Lawson

The U.S. bond markets ended the second quarter down, as reflected in the Lehman Aggregate return of -1.0%. Inflation indicators and renewed credit concerns were two major drivers. However, U.S. bonds are still up 7.1% in the past year, handily beating equity performance.

The Lehman Municipal Bond Index outperformed for the quarter, returning 0.6%. The intermediate maturity area (4–6 years) has proven to be the market's "sweet spot," sagging this quarter but slightly ahead of the Aggregate for the preceding 12 months on a tax-adjusted basis.

In spite of S&P and Moody's June downgrading of two large bond insurers, AMBAC and MBIA, insured issues were a bit stronger than over-

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Quarterly Performance Benchmarks

Passive Benchmarks*	Q2-2008	Y-T-D	1 Year	3 Year†	5 Year†
S&P 500 Index	-2.7	-11.9	-13.2	4.4	7.6
Domini 400 Social Index	-3.8	-12.9	-14.3	2.9	6.0
DJIA (reinvested dividends)	-6.9	-13.4	-13.3	5.8	7.2
S&P MidCap 400	5.4	-3.9	-7.3	7.5	12.6
Russell 2000 (Small Cap)	0.6	-9.4	-16.2	3.8	10.3
MSCI EAFE (Europe, Australasia, Far East)	-2.3	-11.0	-10.6	12.8	16.7
Lehman Aggregate Bond	-1.0	1.1	7.1	4.1	3.9
Lipper Mutual Fund Benchmarks*					
Average US Diversified Equity	0.2	-10.5	-12.5	4.7	8.8
Large Cap Growth	1.6	-10.1	-4.8	5.5	7.0
Large Cap Value	-3.9	-13.0	-17.0	3.5	7.8
Mid Cap Growth	5.0	-8.5	-5.7	8.2	11.2
Mid Cap Value	0.0	-9.4	-16.9	4.5	11.4
Small Cap Core	0.7	-9.2	-17.0	3.4	10.2
International Equity	-1.8	-10.8	-9.4	13.3	16.1
Real Estate	-5.1	-3.9	-15.0	3.7	13.2
Intermediate-term Bond	-1.3	-0.8	3.5	2.4	2.7

Performance data represent past performance and do not guarantee future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks not directly available for investment. Lipper Mutual Fund Benchmarks are compiled by Lipper, Inc., a Reuters company. Information has been obtained from sources considered to be reliable; however, neither First Affirmative nor its agents guarantee the accuracy of the numbers reported.

* Sources: *The Financial Times*, KLD (www.kld.com), MSCI, and *The Wall Street Journal*.

† The 3-Year and 5-Year returns are average annual returns for that benchmark.

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all municipals, returning 0.86% for the quarter. This suggests the market had priced in the possibility of future downgrades of AMBAC and MBIA during the first quarter.

Overall, municipal bonds declined modestly in value in the first half of 2008, but the risk profile of municipals as a category has not materially changed. In addition, insured issues represent selective opportunity for new money, given that they are priced-to-sell relative to uninsured bonds. The spread in yields for 10-year insured bonds relative to “natural” AAA bonds widened from 0.19% to 0.24% last quarter.

Worldwide, inflation pressures have increased with the demand for oil and other commodities, exacerbated by speculation. While costs of consumer necessities are rising, inflation in the U.S. has been limited by the lack of credit for big-ticket items.

The Federal Reserve is unlikely to act to rein in inflation by raising interest rates this year because of the weak economy. Thus, continuing softness in the U.S. economy may further reduce demand for credit and mitigate the risk of inflation.

At the same time, the Federal government needs to borrow to fund the deficit in the face of declining tax revenues and the likely need to support its housing finance agencies. We can expect foreign sovereign investors to demand higher rates as their capacity for Treasuries overloads.

The recovery from recession (and we are in one now, no matter what the numbers say) is likely to take at least two quarters, assuming that all the bad news has been disclosed and discounted—and maybe longer.

Viewing bonds as the conservative portion of any balanced portfolio, we are not recommending tactical reactions to the current situation. The bond market rarely rewards heroics.

Charles Sandmel is a First Affirmative Investment Advisory Representative. A 30-year veteran portfolio manager and past Director of the National Federation of Municipal Analysts, Charles manages separate fixed-income accounts for First Affirmative clients. Anne Lawson, a 16-year veteran credit analyst, performs securities analysis and assists in portfolio management. All yields and spreads mentioned in this Market Commentary are retrospective and subject to change.

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global inflation has increased from 3.5% to 5.5%, courtesy of soaring food and energy prices. Despite the fact that the global economy is weak, central banks may have to raise interest rates in order to slow the rise in commodities prices.

In the U.S., a combination of the worst housing crisis since the Great Depression, along with shocking increases in energy prices, have slowed economic growth to near zero.

Two things must occur for the global economy to recover: the U.S. housing market must regain its footing and commodities prices must reverse their upward direction.

That both of these events will happen is inevitable. Mortgage reform will lead to absorption of excess housing inventory, and prices will stabilize. And, expanding production will cause commodities prices to fall. *When* these events will unfold—and precisely *how*—is anyone’s guess.

Successful investors recognize that the greatest opportunities are present not during periods of abundance and optimism, but during periods of anxiety and pessimism.

At First Affirmative, we understand that these are difficult times for investors. Many of our clients have had to adjust their expectations, while some have had to adjust their portfolios to be able to sleep at night or to be able to withdraw money at a sustainable rate for the long term.

The financial markets are unpredictable, and that is precisely why investors need a disciplined investment process. For those who abandon the process, any success or sense of relief will be temporary. Those who follow a disciplined process are more likely to succeed, even though the ride may be bumpy and even painful.

Remember that your investment adviser is available to help you. If you experience doubt or anxiety—or just want to revisit your investment plan to confirm that it is still well-designed for your circumstances—let your adviser know. He or she is there to help you when you need it most.

Kevin O’Keefe serves as First Affirmative’s Chief Investment Officer. He is responsible for due diligence and monitoring of mutual funds and separate account managers, and leads First Affirmative’s Institutional Consulting Services Group.

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