

# INVESTING WITH DISCIPLINE

NEWSLETTER

JUNE 30, 2008

## MARKET UP-DATE

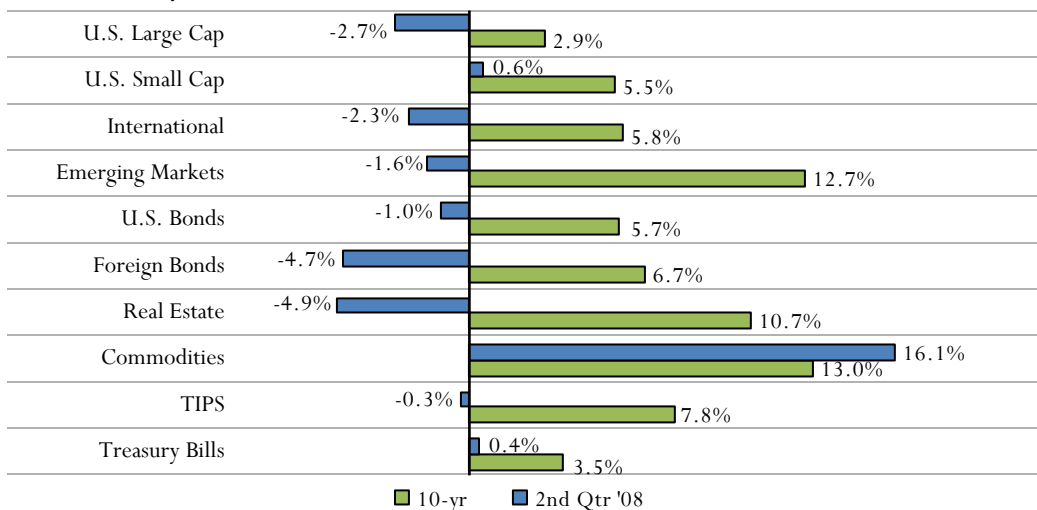
The second quarter of 2008 witnessed the worst single month for stocks in 50 years. Losses in June overwhelmed modest gains from April and May. These declines were mostly fueled by continued trouble with financial firms, surging oil and food prices, and concern about the health of the economy.

Below is a chart that helps put our recent experiences into perspective. First of all, it's easy to see that nearly every type of investment lost money in the quarter. However, it's equally clear that every category gained in value over the previous 10 year period of time. Thus, holding stocks for the long-term is a sensible choice, but with a caveat.

Upon closer examination, Large-Cap U.S. stocks (the S&P 500 index) averaged a compound annual return of 2.9% over the past 10 years, which merely breaks even with inflation and trails all other categories. In contrast, emerging market stocks and commodity investments boomed, earning double digit annual returns over the same time period. The disparity is proof that you cannot allow your portfolio to become dependent on one type of investment. The stock portion of your assets must be spread broadly across large, small, foreign, and domestic stocks. We strive for such diversification in all of our portfolios.

Please visit the Archive section of our website to see additional charts and information about the previous quarter in our Quarterly Review & Outlook.

### Performance by Asset Class



## WIT & WISDOM

*"If we are facing in the right direction, all we have to do is keep on walking."*

- Buddhist Proverb

## INDEX SCORE-CARD

### QUARTERLY RETURNS

US Large Cap:	-2.73%
US Small Cap:	0.58%
International Stocks:	-2.25%
Emerging Markets:	-1.58%
US Bonds:	-1.02%
Foreign Bonds:	-4.72%
REITs:	-4.93%
Commodities:	16.08%
TIPS:	-0.28%
Treasury Bills:	0.43%

All data as of the period ending 06/30/08

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## QUARTERLY TOPIC: IMBALANCES & INFLATION

In our December newsletter article, we noted the rising threat of mild-stagflation – slow economic growth and above average inflation. This threat has become a reality. In addition, these difficult times highlight a world of imbalances. Two causes are fuel subsidies and currency manipulation by foreign governments. These market distorting practices are unattractive in the best of times; in our current situation they reinforce the inflationary cycle. Fortunately, change is in the wind.

Consumers are clearly aware of inflating fuel and food prices. It might be startling to know, then, that a Mexican driver can buy gas for about \$2.50 per gallon when just across the border we pay over \$4.00. According to Morgan Stanley, “Half of the world’s population enjoys fuel subsidies.” In other words, about one-quarter of the world’s oil is sold below market prices. Fuel subsidies distort the oil market, holding down gas prices and artificially fueling demand. Consumption of oil in the U.S. and Europe is falling for the first time in decades. However, demand from emerging markets with fuel subsidies is still growing strong.

The rapid ascent of oil is finally catching up to the subsidizers: China, India, Taiwan, Sri Lanka, Malaysia, and Indonesia have all raised fuel prices. Simply put, the subsidies are becoming too expensive for these governments to maintain. Indonesia is an extreme example. Before the recent cut, fuel subsidies cost the country 7% of its GDP. Economic reality is pushing these governments to curb oil demand, which could eventually help bring down prices.

Currency manipulation is another long-standing cause of imbalance in the global markets. Now, besides creating imbalance, it is creating inflation and hampering the ability to combat it. The value of a nation’s currency should reflect the underlying strength and productivity of its economy. Changes in the relative value of currencies provides the world with a self-correcting mechanism – a rising currency tempers rapid (inflationary) growth and a falling currency makes the goods and services of a struggling country more competitive.

Currency manipulation occurs when governments enter the foreign exchange market, buying or selling U.S. dollars, to influence the value of their currency versus the dollar. Emerging markets have a long and inglorious history with runaway inflation and many have decided to ‘peg’ their currency to the dollar, i.e. hold their currency’s value in constant proportion to ours. The dollar ‘peg’ in theory links the fate of their money to a strong and stable U.S. dollar. Ironically, the dollar pegs are now causing inflation. As the U.S. dollar has declined over the last 5 years, pegged currencies have followed suit. Depreciated currencies make foreign goods they purchase more expensive.

In addition, countries that peg their currency to the dollar hamstringing their ability to fight inflation. For example, if China raises interest rates to curb inflation, Chinese investments become relatively more attractive to global investors and money will naturally flow into the country. Demand for Chinese currency will rise and it becomes more difficult for them to maintain the roughly pegged Yuan-to-Dollar ratio. Maintaining the currency pegs is becoming more expensive and perilous for emerging markets. As with fuel subsidies, currency manipulators are being forced to reconsider their ways.

Fuel subsidies and currency manipulation create highly problematic imbalances that will not be corrected overnight, but modest change does appear to be happening. Market forces and the economic reality of stagflation are pressuring emerging market governments from Asia to the Middle East to consider new policies that could prove painful in the short term yet beneficial to the global economy and the emerging markets in the long run.

As a firm, we continue to invest in emerging markets and believe they will provide attractive returns over the long haul. Short term volatility can be disconcerting, but these investments are part of a larger strategy to protect wealth and grow assets throughout a variety of economic outcomes.

Regards,

Brian J Lawrence, CFA

### Index Definitions

**US Large Cap:** A U.S. large company stock index measured by the S&P 500. A group of 500 of the most widely traded stocks in the U.S., as chosen by Standard & Poor’s.

**US Small Cap:** Measured by the Russell 2000. The index is comprised of the smallest 2000 stocks in the Russell 3000 Market Index.

**International Stock:** An international stock index measured by the MSCI EAFE. It is comprised of stocks from developed markets in Europe, Australia, Asia, and the Far East.

**Emerging Markets:** An international stock index that tracks non-developed markets throughout the world. It is measured by the MSCI Emerging Markets Index.

**US Bonds:** A measure of the Total U.S. Bond Market by the Lehman Aggregate Bond Index. It takes into account corporate, government, mortgage and asset backed securities.

**Foreign Bonds:** Measured by the Citi World Gov’t Bond Index. The fund is comprised of primarily investment grade bonds from around the world.

**REITs:** Measured by the FTSE NAREIT Index which is a composite of Real Estate Investment Trusts traded on U.S. exchanges.

**Commodities:** Performance is represented by the PIMCO Commodity Real Return Strategy Fund, which uses the DJ AIG Commodity Index as a benchmark.

**TIPS:** Performance is represented by the Lehman Brothers US Treasury Inflation Protected Securities Index. TIPS are government bonds that have adjustable coupon payments based on the rate of inflation (as measured by the CPI).

**Treasury Bills:** Short-term government issued securities with maturities less than 90 days. Because they are government issued, T-Bills are free from default risk.

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