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Market Update

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With the first quarter of 2008 over, most investors find themselves shell-shocked by the events of the past three months. Until recently, few would have believed conditions in financial markets could have become so precarious that a “meltdown” scenario would become a distinct possibility. Yet this seemed very real in the wake of the sudden collapse of Bear Stearns. Fortunately, Fed policymakers were able to avert a domino effect, as they backstopped a quick sale of the firm and, at the same time, set a precedent by extending “lender of last resort” privileges to other securities firms that are not under the Fed’s jurisdiction. In addition, the Fed eased monetary policy, lowering the federal funds rate to 2.25% from 3.0%.

These bold actions have lessened market turbulence and restored liquidity to higher-quality areas of the non-Treasury market such as agencies and MBS. Nonetheless, it is too early to sound the “all clear” signal, because the key forces behind the crisis are still at play. First, the slump in housing does not appear to be winding down: Housing prices in major metropolitan areas have fallen more than 10% from their peak – the steepest drop since World War II – and inventories of unsold homes remain at very high levels. Second, the market-induced credit crunch that began with subprime mortgages has spread among many other areas of credit markets, and there is still considerable leverage in the financial system that needs to be unwound. Third, a surge in oil and commodity prices is eroding the purchasing power of U.S. consumers when household net worth is also falling.

These three forces now appear to be pulling the economy into recession. The debate today is whether the period of economic weakness will be short or protracted. The consensus view is that the soft spell may last through summer or fall, but the economy is expected to gain traction later this year in response to monetary easing, forthcoming tax rebates and possible legislation designed to alleviate home foreclosures. Much depends, however, on whether conditions in housing and credit markets stabilize.

Looking beyond the near term, we believe the economy will experience sub-par growth for several years. The principal reason: Credit availability will be tighter than in the past, and U.S. households will have to bring their debt more in line with personal income. This means Americans will have to save more out of current income than they have in recent years. The personal saving rate has been abnormally low for more than a decade, mainly because households benefited from a surge in the stock market in the second half of the 1990s and from the real estate boom in the first half of this decade. However, the period of unusually large wealth creation appears to be over.

Weighing these considerations, we find the current environment to be challenging and complex. Investors who are close to their strategic asset allocations and have well diversified portfolios should be well-positioned to ride out the storm. On a tactical basis, we think high-quality portfolios are likely to outperform until conditions stabilize. Investors with such portfolios should be well positioned to benefit from opportunities that are being created in debt and equity markets.



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