

BEYOND THE HORIZON

2nd Quarter, 2008 Issue

MARKET UPDATE

In lieu of a traditional quarterly newsletter, we are sending this abbreviated version to communicate with clients our thoughts regarding the recent turmoil in the financial markets and the economy. In doing so, our intention is NOT to predict what we think is going to happen. Even the sharpest minds in our business have difficulty doing that. Instead, our goal is to share information with clients to help them put things into perspective.

To help understand where we are today merits a look back. The current crisis in the financial markets was caused in part by extremely low interest rates for an extended period of time. Beginning in November of 2001, during our last recession, Alan Greenspan and the Federal Reserve continued to cut interest rates until their low of 1.00% in order to stimulate the economy. However, rates stayed low for quite some time. As a result, money was cheap to borrow. So cheap that everyone from consumers to businesses alike were borrowing. Adjustable rate loans with incredibly low rates enticed many to borrow beyond their means. Low rates spawned severe competition by lenders which resulted in aggressive lending practices. By the time rates rose back up to 5-1/2% in June 2006, housing prices began to fall, hence beginning the collapse in the housing sector. We have a very complex economy that's made up of many other sectors besides housing. However, the housing woes are now impacting other sectors of our economy, such as the financial system. To what extent this might continue will determine the overall impact the housing crisis will ultimately have on our economy.

What we're seeing now are remarkable similarities to issues we faced in the early 1990s. The headlines then were dominated with the Savings & Loan crisis and the Gulf War (Iraq). Today it is the subprime loans and Iraq. In looking at data collected by Hays Advisory, there were other striking similarities between 1990 and today in the patterns of the equity markets, consumer sentiment, unemployment claims, the growth rate of median home prices, the spike in oil prices, the Fed aggressively cutting interest rates, and the sinking U.S. dollar. As for 1990, there were rewards in the market to follow. Whether or not the same will happen today remains to be seen. But if the same correlation continues, we could have hit our low point in the market. But that doesn't mean we won't have more setbacks.

On a positive note, two stock market rebounds we experienced last month were not only extremely encouraging signs, but historically rare ones. The 420 point gain by the Dow Jones Industrial Average on March 18th after the Fed's rate cut of 0.75% resulted in the biggest one-day gain in more than five years. Only a week earlier on March 11, the Dow had another significant day gaining 416 points. But the most significant part of these gains was that the volume of NYSE-listed stocks that went up versus those that didn't was a ratio of 90% or greater. This historically has had bullish significance.

As for the S&P 500, the swing from its peak of 1565.15 (on October 9, 2007) to its low point to date of 1273.37 (on March 10, 2008) was an 18.6% decline. Since then we have recovered nearly half of that decline. According to research from American Funds, declines of 15% or more occur about once every 2 years. But the last occurrence of such a decline has not been since October 2002.

Regardless of the credit crisis which was the impetus for the decline, we were overdue for one. That same research also tells us that the average length of a “severe” decline is 216 days. If this cycle follows the norm, the current period of decline could be coming to an end soon.

Whether or not we are in a recession remains to be seen. For now, not all parts of the country nor all sectors of the economy are experiencing a slowdown. Fortunately, returns of the S&P 500 historically have been quite favorable after reaching a low during a recession. Data from American Funds points out that of the past 10 recessions dating as far back as 1949, the mean gain in the S&P 500 three months after a recession low was 15.8% and as much as 32.4% twelve months after the low.

We in no way mean to imply that the current issues facing our markets and economy are not serious ones—they are. But history reminds us that we have always had crises and market turmoil to overcome. We must remind ourselves that we can neither predict nor control the inherent risks in the markets. Instead, we can manage that risk with a sound investment strategy which includes proper asset allocation and patience. Remember, it is time — not timing — that leads to rewards.

CAPITAL GAINS TAX BREAK STARTS IN 2008

As we mentioned in our last newsletter, 2008 brings a new tax break on qualified dividends and capital gains. In the past, qualified dividends and long-term capital gains were taxed at either a 5% rate or a maximum 15% rate. The 5% rate applied to taxpayers in the 10% or 15% tax bracket. For 2008 that would be single filers with less than \$32,550 of income and marrieds with less than \$65,100. The 15% rate applied to taxpayers who had higher income and fell into higher tax brackets.

For the years 2008 through 2010, filers who are in the 10% or 15% tax bracket will now pay a 0% rate on qualified dividends and capital gains versus the former 5% rate. Qualified dividends and capital gains can be earned either from mutual funds as well as individual stocks not held in a qualified retirement plan and are not taxed at the 25% and 28% tax rates.

This presents an opportunity for earnings from mutual funds and stocks. However, it is not necessarily a reason to take significant capital gains this year. It is important to note that IF the capital gain would cause a taxpayer’s taxable income to exceed the 15% tax bracket, they would pay taxes at the maximum 15% instead of the 0% rate on the amount of qualified dividends or long-term capital gains that are in excess of the 15% bracket. Additionally, depending on the outcome in the November election, this tax break could be repealed sooner than 2010.

Highlighting this topic in no way implies that it is applicable to everyone. For more information on this or other tax rules, please contact your tax advisor or our office.

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