

Update on Current Market and Economic Conditions—Spring 2008

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An Update on Current Market and Economic Conditions.

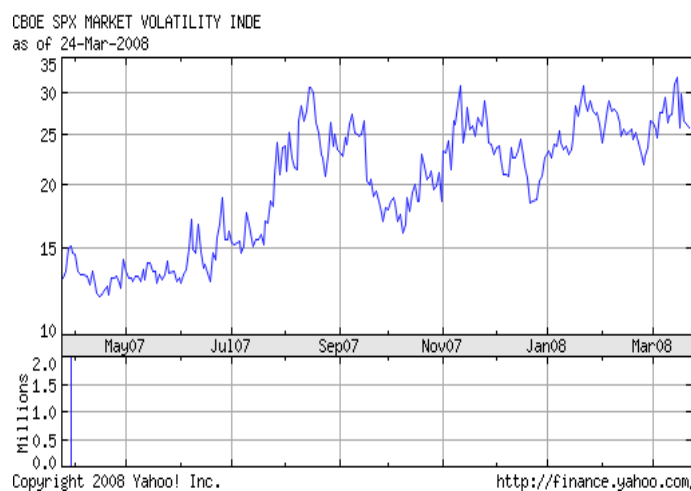
Brokerage Account Protection

Highlights:

- The on-going credit crisis has caused a downward spiral in nearly all financial assets.
- Market volatility has increased and is expected to remain high. This volatility creates investment opportunities for skilled managers.
- The Federal Reserve seems intent on maintaining a low interest rate environment to keep the economy growing. This approach may have adverse consequences longer-term.
- While foreclosures and construction lay-offs will continue to weigh on the U.S. economy over the next couple of years, the impact will be reasonably offset by strong export markets, government sector spending, and strong monetary stimulus.
- In the event of a brokerage failure, the Securities Investor Protection Corporation (SIPC) will work to ensure that customers don't lose their cash and securities. In addition, private insurance coverage is often in place to provide further protection for customers.

The near collapse of Bear Stearns and concerns over bond insurers and other financial firms are additional manifestations of an on-going credit crisis in the United States. Successive rounds of forced liquidations of assets to meet loan collateral requirements caused a downward spiral in virtually all financial assets (Treasury securities excepted).

The good news is that forced liquidations of stocks and bonds tend to be swift and then abate. The pattern set during the July 2007 and January 2008 declines followed by sharp recoveries could be the same pattern for the March 2008 market decline. The U.S. S&P 500 volatility index (the so called "fear" index), rose to over 30 in mid-March, as can be seen below.



Each time this has occurred in the last year, volatility has receded and the credit and global stock markets have had a strong rally. With a decline in the most recent peak and a strong re-

bound, we appear to be past the most recent crisis.

Nevertheless, the general level of volatility is expected to remain high. Sharp declines and equally sharp increases appear to be the norm for the present. Certain hedged strategies and adept managers can take advantage of this volatility. As the risks increase, so do the opportunities. Additionally, during these episodes of forced liquidations, fundamentally sound assets get sold off with the less sound assets.

Most stocks had good earnings growth through year-end 2007. This was not true for financial stocks and certain others, but why were solid earnings stocks also pummeled the last several months? Certainly fear of a U.S. recession is evident, but some sectors of

our economy would be little affected by recession. Companies that provide healthcare, oil services and those that serve foreign markets are expected to do just fine. In some cases their prospects have never been better. Outside the U.S., some foreign companies are suffering from an increase in their currencies vis-a-vis the dollar, making them less competitive. Yet, for the most part, non-U.S. economies range from moderate growth to the very high growth rates evident in China, India, Russia and elsewhere. In addition, the

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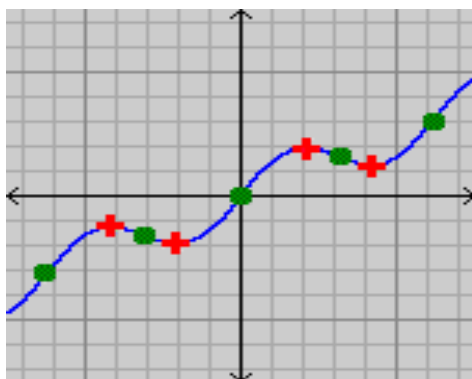
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continued appreciation of their currencies (decline in the dollar), continues to increase the value of foreign stocks and bonds when prices are converted back to U.S. dollars.

The Federal Reserve seems to be continuing its post-Volker role as providing whatever it needs to do to keep the U.S. economy growing. This low interest rate stimulus approach, while having its merits, also contributes to the decline in the dollar. Both this dollar decline and still strong worldwide demand for oil, wheat, other commodities and finished goods is contributing to an escalation in inflation. If unchecked, the U.S. economy may recover nicely, but be prepared for higher costs and eventually higher bond yields (and lower bond prices).

Being prepared now does not mean selling off everything and going to cash, CDs and the like. "Markets climb a wall of worry" is an old, but still insightful Wall Street saying. There is a reason that the U.S. stock market is a leading economic indicator. It can turn upward more than 6 months prior to the trough of an economic downturn. These inflection points reflect a change of direction rather than absolute tops or bottoms (In the next chart, the

inflection points are represented by the large green dots and indicate when concave curves turn to convex—and visa versa—and which occur well before tops and bottoms).



Avoiding financial stocks and other highly indebted entities, including residential real estate, certainly makes sense in this weak domestic economy. Foreclosures and construction lay-offs will continue to be a drag on the U.S. economy for perhaps another 2 years. Nevertheless, strong export markets, government sector spending and recent strong monetary stimulus should exert a significant positive counterweight. Looking backward can provide useful information, but finding opportunities and avoiding pitfalls are best found by looking forward.



Brokerage Account Protection

With the recent news regarding troubled financial services firm

Bear Stearns, many individuals are naturally concerned about the security of the assets in their brokerage accounts. Fortunately, in the case of a brokerage firm failure, most people can be fairly certain that their assets are safe due in part to the efforts of the Securities Investor Protection Corporation (SIPC).

Congress created the SIPC in 1970. Its job is to replace an individual's cash and securities should they become lost or stolen by an insolvent brokerage firm. Under such a scenario, the SIPC will usually have a federal court liquidate the brokerage firm and return the securities to its customers. Should a shortfall exist, the SIPC has a reserve fund that provides coverage for the remaining claims up to \$500,000 per customer (of which no more than \$100,000 can be for claims on uninvested cash balances).

Major brokerage firms, including those WESCAP recommends to our clients, carry excess insurance coverage. This supplementary coverage generally has significantly higher maximum claim limits relative to the SIPC coverage and kicks in after the SIPC limits have been reached.

For further information on the excess insurance coverage provided, please visit your broker's website.