

# Red Granite Advisors LLC

## Second Quarter 2008 Commentary

Surging energy prices and more fallout from the bursting of the credit and housing market bubbles aborted the stock market's spring rally. The worst June for US stock prices since 1930 resulted in the Russell 1000 Growth Index returning +1.25% and the Standard & Poor's 500 Index falling -2.66% during the quarter. Aided by health care, energy and materials exposure, Red Granite's Large Cap accounts generally matched the Russell Index; consumer and financial stocks were detractors. Year-to-date, our returns are well ahead of the Indices (S&P 500 -11.85% and Russell 1000 Growth -9.06%).

With food and energy price increases pushing up inflation, the Federal Reserve recently signaled a shift in its focus from shoring up credit markets to containing inflation. Although the Fed has increased its anti-inflation rhetoric, their stimulative policy stance implies that they expect a weak US economy to keep inflation contained. If the Fed errs, it will likely be on the side of "ease," suggesting a continued period of rising inflation amid slowing economic growth (stagflation). While many foreign central banks are contemplating raising interest rates to fight inflation, we believe the Fed's anti-inflation rhetoric conflicts with the precarious situations of the financial and consumer sectors.

Pressures are building on consumer spending which is 70% of Gross Domestic Product. Although tax rebates helped support spending in recent months, home prices have fallen on average 15% nationally over the past year depressing wealth by more than \$3 trillion. Rising food prices, \$4 per gallon gasoline, and bad news from the job market are sapping consumer confidence. Odds favor at least a mild recession in the US and increased probability of a prolonged downturn if energy prices don't subside.

A significant decline in energy costs would likely reduce inflation pressures and boost consumer confidence. Energy prices have risen due to demand from emerging economies, geopolitical supply constraints and the inability or unwillingness of oil producers to increase output. Also, since oil is priced in US dollars on world markets, foreign oil producers have an incentive to keep prices high to compensate for the dollar's decline. However, the demand for oil is beginning to fall in response to high prices as economies weaken and some governments reduce energy price subsidies. Should these trends become more pronounced, it is possible for oil prices to ease later this year, while remaining elevated relative to historical levels.

The market decline has its underpinnings in the credit crisis and the related losses reported so far and expected in the future. Additional investment risks will likely relate to profit margin pressures emanating from falling revenues and rising input costs. Higher inflation and increased volatility in growth and profitability should translate into rising long-term interest rates making bonds vulnerable to price declines. We believe that the stock market is facing further downward adjustments to profits expectations and price-to-earnings multiples.

We continue to counsel caution with an emphasis on managing risk by holding high-quality companies with market leading positions in global businesses that have low debt and access to capital. We also maintain high cash reserves while seeking buying opportunities that should appear as valuations more fully discount the near-term risks we perceive and provide attractive investment returns for our long-term approach.

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