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Show Me The Money

On Thursday, June 5, the Dow Jones Industrial Average (DJIA) surged 214 points, only to plummet 400 points the next day.

Why the disconnect? How can Wall Street lift stocks almost 2% one day, only to hammer them with more than -3% the very next? Are we in a recession? Is inflation as tame as the CPI data suggests? What will it take for the banks, a critical sector of our economy, to clean up their balance sheet and once again pave the way to prosperity?

The stock market is a leading indicator and it trades today at what "it" believes the economy could produce in six months to a year ahead. Despite these stomach turning gyrations, though, the markets have held up surprisingly well during current economic conditions.

Until now, most of the financial damage to banks has come from the housing crisis. Homeowners across the U.S. have felt the brunt of the financial crisis with the continuous decline in real estate values and vanishing equity in their homes. Once viewed as the most reliable

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Rally! Really?

The Dow Jones Industrial Average (DJIA) began 2008 at 13,265, while the S&P 500 index (S&P) started the year at 1,468. The downward slide during the fourth quarter of 2007 continued in the first quarter of this year, sending both indices to their March lows of 11,740 for the DJIA, and 1,273 for the S&P—a loss of -11.5% and -13.3%, respectively.

The market rally that ensued helped erase the losses investors incurred during the first quarter, leading some bullish investors to claim that "the worst of the credit crisis is over," and that we have "reached a bottom" in real estate price declines and mortgage delinquencies.

For a while, these predictions seemed to make sense, and the scolding investors had given the market seemed unjustified. For us, the question is simple, "What would it take for the DJIA to end the year above 14,458, and the S&P to reach 1,600?" Although these numbers represent a 9% gain for the year, they are 18.4% and 17.6% above the DJIA and S&P June 6th levels, respectively.

We believe four important events must occur in order to have a sustainable rally. They are:

1. The housing market must find a bottom.
2. Jobs market must improve.
3. Oil prices must fall below \$100 per barrel.
4. Corporate earnings must reverse their current decline.

One theory for the first event, a turnaround in housing, is that foreigners who hold a stronger currency than the U.S. dollar are able to buy homes and real estate here in the U.S. at a discount (due to current U.S. economy slowdown and stronger foreign currency), and help wipe out the monster inventories of unsold homes. This, pundits claim, would set the bottom to falling real estate prices and will in turn bring certainty to the financial markets, thereby allowing them to extend credit once again. The "action-reaction" will thus help the U.S. economy continue to chug along.

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Rally! (continued)

While this theory is sensible, and is likely occurring to some extent, it underestimates the significance of the second point, job market decline. Most of the job losses have been in the real estate related industries (construction, manufacturing, mortgage, etc.). The trend has inflicted, and will likely continue to inflict, other sectors as well. Just about the only sectors that bucked the trend are healthcare and utility companies.

Real estate prices are a function of job growth—the more employment opportunities in a given region, the higher the demand for homes. The U.S. national unemployment rate in February stood at 4.8%—relatively consistent over the past few years. Current unemployment rate jumped to 5.5% in just three months. Add to that the number of newly graduated college students who are anxiously entering the job market this summer, the likely hood of a continuous rise in unemployment seems almost certain for the next few months at least. Given this reality, when added to the “spent up” consumer troubles, it is hard to believe that a bottom of real estate will precede a clear reversal of unemployment trends.

So the question then becomes, “Why is the unemployment rate on the rise?” The obvious answer points to higher energy costs and a firm’s inability to pass on those costs to consumers, a slowing economy and a deteriorating consumer spending patterns. These troubles directly affect corporate earnings. This explanation also plays an important role to the current uptrend in unemployment, as firms begin to cut payroll in order to maintain earnings. Another factor may also help explain the decline in earnings trend, and may come as a surprise to many.

Collateral Debt Obligation (CDO) and Collateral Mortgage Obligation (CMO) are complex debt instruments that, until recently, were relatively conservative and liquid. These vehicles provide companies a place to “park” their cash and realize better returns than holding cash or government bonds.

In the past, placing a value to these securities was relatively easy due to the abundance of buyers and sellers. Over the past year, however, the mortgage backed securities market dried up, and the securities have become far less liquid and difficult to value. While it is common to find these products on a financial firm’s balance sheet, over the past few years they have appeared on many non-financial company balance sheets. As we have learned from the likes of Bear Stearns and other financial

firms, the values assigned to these instruments are questionable due to the lack of liquidity they are now confronted with. If a company finds itself having to liquidate its securities to fund operations in the current market, they will likely not receive the amount listed on their balance sheet, ultimately leading to a “write down” of assets and incurring a loss.

By now we are all aware of the energy inflation that has gripped the nation for the past 5 years. Oil prices have enjoyed a steady run up since February 2003, with price per barrel having gone up four fold. Much of the price acceleration can be attributed to greater global demand (especially in emerging markets such as China and India), and production & refinery limitations. But the contribution to the high prices as a result of a weak U.S. dollar can not easily be dismissed.

The dollar has been on a decline since February 2002, loosing almost 40% of its purchasing power. Because oil is a dollar denominated commodity, a weak dollar means that it will take more of it to purchase a barrel of oil—thus putting upward pricing pressure to oil.

Conversely, when the dollar regains strength, it will help push down the price of oil. But that is not the only factor that will change the direction of oil prices. Emerging markets, China, for instance, are known to have an enormous appetite for oil, among other raw materials. They have been buying large sums of “black gold”, and some think that this will continue for many years to come.

Here, the outlook for China’s continued oil consumption gets tricky.

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“..inflation pressure will take center stage...”

Rally! (continued)

Many factors must be taken into account when determining the demand for oil. Those who believe China's demand for oil will continue, argue that a nation's population and income increase oil consumption, therefore placing upward price pressure on the commodity. As the Chinese are over one billion strong, and have certainly benefited with the continuous pouring of wealth in that country, we do not disagree with such an assessment.

China will undoubtedly continue to consume oil around 5% per year on average (more than two times the world average*) through 2010. But its recent spike to 6.8% since 2006** deserves a closer look.

Our finding is slightly different and perhaps less popular. We believe that China's consumption role in the oil market will likely be reduced by the end of 2008 for two reasons. The first is the effect of a global economic slowdown and inflation to its export driven economy. And the second is that the spate of buying during 2006 could be explained by the wave of investments that hit its shores during that time, followed by stock piling in 2007.

The Olympics have caused a flurry of economic activity and are certain to bring China a lot of tourism dollars and global attention this summer. The Chinese government has taken steps to ensure that the event goes smoothly, including stock piling oil for the Olympic event as well as an unforeseen or catastrophic event similar to the earthquake they experienced earlier

in the year. The buying in excess, too, is helping to keep oil prices elevated. Once the Olympic Games are done and the traffic dispersed, China's consumption will likely drop substantially.

We have already mentioned that higher energy costs weigh down corporate earnings and directly influence the job market. It therefore stands to reason that a 40% drop in oil will have an immediate impact to a company's growth expectation and the economy overall.

The inflation pressure will likely take center stage in the coming months, prompting the Federal Reserve to increase interest rates almost as fast as they reduced them beginning in September 2007. Since then, the Fed dropped the Federal Funds Rate 3.25% to its current 2%.

The catalyst to the above four events is a stronger U.S. dollar. We believe these scenarios will unfold this year, resulting in a "V" shape rise for the dollar, and an inverted "V" for the price of oil. These events would lead to sustainable long run economic growth.

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* SOURCE: International Monetary Fund

** ChinaCCM.com (China Commodity Marketplace)

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source of long term savings, real estate is not the darling it once was just two years ago.

The effect of the real estate crisis caused Bank of America, Citigroup, Washington Mutual, AIG and many others—lest not forget the company formerly known as Bear Stearns—to feel the brunt of the pain. They are all currently trading at a fraction of their valuations of just a few months ago. (With the exception of Bear Stearns which was sold to JP Morgan for about \$10 per share, down from its peak of \$171 per share set in January 2007.)

In anticipation of future write downs and loan losses, financial institutions have been rapidly increasing “loan reserves” (an account which banks are supposed to set up in anticipation of bad loans). Banc of America, for instance, increased its credit loss provision to \$6.01 billion in April, up from \$1.24 billion. The increase represents a loss rate of approximately 8% to 10%.

Not all, however, have been exercising good

corporate discipline. Wachovia, for instance, ended 2007 with a book value of \$76.9 billion and a loan-loss allowance of \$4.5 billion. Its current market capitalization (share price times numbers of shares outstanding) is \$40.9 billion as of Friday, June 6, 2008. The \$36 billion gap is a clear indication that the company has inadequately funded its loan reserves and will likely require longer time to shore up its books—a severe disadvantage to the nation's 4th largest bank. If, on the other hand, the real estate market improves suddenly (a “V” shape trajectory), then Wachovia stands to recoup much of its stock price loss quicker due to their aggressive position for reserve requirements.

As investors, banks rapidly increasing their “loan-loss” provisions should provide us comfort for two reasons:

1. Adequate reserves will help blunt the impact of foreseeable write downs, and
2. If the loan-loss provisions turn out to be over estimated by these companies, then the cash would lead to immense returns once real estate fundamentals improve.

Let's hope for the latter.

Vital Signs

<u>Year</u>	<u>Dow Jones Industrial</u>	<u>S&P 500</u>	<u>10 Year Bond Yield</u>	<u>1 Year Treasury Yield</u>	<u>30 Year Mortgage</u>	<u>Fed Funds Rate</u>
2008						
May	12,638	1,400	4.05	2.05	6.04	1.98
April	12,820	1,386	3.76	1.74	5.92	2.28
March	12,262	1,322	3.50	1.55	5.97	2.80
February	12,266	1,330	3.74	2.05	5.92	2.98
January	12,650	1,378	3.74	2.71	5.76	3.94
2007	13,264	1,468	4.63	4.53	6.34	5.02
2006	12,463	1,418	4.80	4.94	6.41	4.97
2005	10,717	1,248	4.29	3.62	5.87	3.22
2004	10,783	1,211	4.27	1.89	5.84	1.35
2003	10,453	1,111	4.01	1.24	5.83	1.13
2002	8,341	879	4.61	2.00	6.54	1.67
2001	10,022	1,148	5.02	3.49	6.97	3.88
2000	10,788	1,320	6.03	6.11	8.05	6.24
1999	11,497	1,469	5.65	5.08	7.44	4.97
1995	5,117	616	6.57	5.94	7.93	5.83

Source: Dow Jones, S&P, Freddie Mac, Federal Reserve, and Wall Street Journal