

April 2008

To: Our Friends and Clients

From: Robert Bingham, CFA John P. Wright
President Director of Research

Re: First Quarter 2008 - Review and Outlook

“Every banker knows that if he has to prove that he is worthy of credit, however good may be his arguments, in fact his credit is gone.”

- Walter Bagehot (1826-1877, former editor-in-chief of The Economist)

The first quarter of 2008 finally closed, with its many difficulties now behind us. The S&P 500 declined 9.4% during the quarter while the Dow Jones Industrials fell 7.0%. The NASDAQ Composite lost 13.9%. (Performance shown is inclusive of dividends.) This past quarter will be remembered as one of the most difficult quarters in years, and JP Morgan Chase’s absorption of Bear Stearns will probably be the quarter’s most remembered event. Since that announcement on March 16th, our American stock markets have bounced back by roughly 3.0%. Although it is possible that unforeseen events could cause the market to retest the January lows, we continue to believe that stocks will gain strength as the year progresses.

Interestingly, other stock markets fared even worse than ours during the quarter. The major indices of Germany, France and Great Britain declined by 19.0%, 16.2%, and 10.4% respectively. Japan’s major index fell 17.5%, while China’s declined 33.9%. Even India’s recently hot market fell by 22.8%. (Performance is inclusive of dividends and quoted in local currencies.)

With our mortgage markets reputedly at the center of the market’s problems, and with the U.S. economy reputedly heading into a recession, why might our markets have outperformed other countries’ major indices? The chief answer is that our world leadership remains in place, as does our ability to solve major problems. So even though we were overly lenient in underwriting home mortgages, and very good at exporting troubled bonds, our leadership in rectifying these problems remains respected. And our markets continue to be viewed as safe havens. Ultimately, the U.S. financial system will operate with less leverage, and that will be a good thing. In the meantime, the transition will lead to slower economic growth, as risk is repriced to more rational levels and borrowing costs rise.

One bright spot is the low levels of debt that major U.S.-based, non-financial corporations are carrying. After being caught with too much leverage at the end of the 1990s, companies have been accumulating cash and retiring debt. Simultaneously, they have been expanding operations overseas to take advantage of new and growing markets. So while domestic spending may slow, companies operating globally should fare reasonably well, as their non-U.S. businesses buffer the domestic lethargy. And fortunately, unlike the last recession, stock prices are inexpensive for high quality global companies, so the likelihood of further, dramatic stock declines seems remote to us. Having said that, market volatility will persist, and only time will tell whether stock prices currently discount the difficult economic environment which we are facing.

Outlook and Commentary:

An investing truism states that the seeds of the market's next growth cycle are sewn during periods of economic decline. So we thought that with investors focused on the banking system and its recent troubles, and the stock market's first major slump in 5 years, it would be wise to explore trends that might lead the market out of this malaise. After some consideration, we decided to drill in on 3 thematic categories: 1) Infrastructure spending; 2) Healthcare spending and medical cost containment; and 3) Carbon caps and their implications.

Infrastructure spending - The U.S. interstate highway system is now 50 years old; the rail system is considerably older. The most recently built nuclear power plant was completed in 1996. According to a survey of 47 municipal water and sewer systems nationwide, the average age of these systems' water and sewer piping is 33 years. A rule of thumb suggests that the life expectancy of a water pipe is 50 years.

The American Society of Civil Engineers (ASCE) estimates that it will cost \$1.6 trillion to upgrade our nation's infrastructure to be competitive with our global competitors. Last year's failure of the 40 year old Interstate 35W bridge in Minneapolis has drawn attention to the need to upgrade our country's infrastructure. To compete globally in the 21st century, transportation and energy infrastructure must be modernized. In a world of "just-in-time" inventory management, companies can't afford to have truckloads of goods sitting on a 3 mile bridge for two hours during rush hour. A company like United Technologies would fire any manager that allowed such production delays on a regular basis. But that is, in effect, what suppliers and their customers face all over the country today.

The demands placed on the electrical grid in the United States have also grown steadily from ongoing population growth and greater use of technology. Despite this growth, the last nuclear power plant was completed in 1996 by the Tennessee Valley Authority. Since then, 9 reactors have ended their useful life and been decommissioned. Capacity utilization of all reactors in the U.S. has grown from 76% in 1996 to 91% in 2007 (source: Energy Information Administration). Nuclear provides roughly 20% of U.S. electricity and is a critical component of the so-called "base-load" supply. This power is always on and runs independent of the peaks and troughs of the demand cycle. Another source of base-load electricity comes from coal-fired plants, but global warming concerns have killed plans to add electricity through the construction of new coal fired plants. A recent article in Scientific American (www.sciam.com) quotes a source in the Nuclear Regulatory Commission as saying that plans for three new nuclear plants may soon be approved. Advances in solar and wind generation are driving down costs in these emerging technologies, so investment in these areas is likely to continue growing as well.

With a new President coming shortly, and lawmakers looking for ways to stimulate economic growth, a new infrastructure spending program seems probable. The need is here and the political will seems to be growing. Recent proposals have suggested a new Government Sponsored Enterprise (GSE) to raise and spend money for infrastructure projects. Calls to privatize infrastructure will be strong, but seem unlikely to gain too much traction. The formation of a public/private GSE-type partnership could succeed. How it might be funded is a matter of debate, but look for fossil fuel tax increases to be proposed. The justification for a fossil fuel tax will be twofold: 1) Oil producers like the Saudis effectively pay half the tax; and 2) It will promote greater fuel efficiency and therefore result in fewer carbon emissions.

Also, new toll technology like New York's high speed E-Z Pass could become ubiquitous. New York's proposed congestion pricing plan could serve as a model too, where toll rates are tied to traffic density. Other proposals have included embedded computer chips in automobiles which could track mileage driven upon which taxes could be levied.

It is estimated by ASCE that for every \$1 billion in infrastructure spending, 47,500 new jobs are created. (We think this number is high.) But the argument will certainly carry weight with politicians if the slowdown in the U.S. continues to worsen.

Energy infrastructure spending has accelerated worldwide as energy prices have risen. When oil and gas prices were low, energy infrastructure spending often was cut. But with prices high, energy infrastructure spending makes economic and political sense. Exxon Mobil, which is notoriously tight with their cash, recently announced an increase in their capital spending budget to \$125 billion over 5 years to expand their exploration efforts, production facilities and distribution network. Spectra Energy is building a 3rd pipeline to add capacity to their existing gas pipeline servicing the North East and Mid Atlantic states. The additional capacity was sold before they even started construction. And new plans are being devised to transport to refineries in Texas oil produced from the sands in Canada's western provinces.

Many infrastructure related stocks are reasonably priced due to recession fears and the downturn in the construction market, but as we emerge from the economic slowdown, they could become interesting.

Focus Stocks: Halliburton (HAL, \$44.08, 4/14/08); Spectra Energy (SE, \$23.54, 4/14/08); Praxair (PX, \$87.21, 4/14/08)

Medical cost containment and the growth of medical product unit volumes - It is estimated that Medicare spending will increase by 6.7% per annum over the next 10 years as the baby-boomers retire and begin to claim their benefits. The Congressional Budget Office (CBO) projects that over the next 25 years, medical-related spending will rise to become 30% of GDP if no action is taken. Needless to say, the system will collapse under its own weight. Medical cost containment is going to become a very pressing issue.

The demographic bulge will drive unit growth of all types of medical services. But services with excess profits will likely be targeted. For example, a recent survey of drug prices indicated that Pfizer increased prices by 9% in 2007. Headlines like this will eventually draw legislative attention. Another area ripe for change is in biotech where no framework for generics currently exists. This is because manufacturing proteins is an inexact science at best, with products "grown" and harvested from living hosts. As a result, variability in lots can be significant, and patents are process driven, not product driven. Given the cost of biologic products, a framework for generics is likely to emerge, although it is unlikely to resemble the model used for "small-molecule" chemical drugs. Profits are likely to be higher and the expertise required could set off a feeding frenzy of acquisitions to acquire the talent needed to successfully implement generic biologics programs.

Medical supply manufacturers should be well positioned. They stand to benefit from rising unit volumes, but their margins are not so high as to attract undue attention from regulators. Problems in the market for municipal finance could lead to weakness in producers of medical equipment in the short-term as hospitals postpone spending until financing returns to the market. But this weakness could prove to be a great buying opportunity for investors who are willing to look through the current problems in municipal finance.

Focus Stocks: Becton Dickinson (BDX, \$84.46, 4/14/08); Medtronic (MDT, \$49.45, 4/14/08); Roche Holdings (RHHBY, \$86.45, 4/14/08); General Electric (GE, \$31.75, 4/14/08)

Carbon caps and their implications - A growing consensus believes that carbon emissions must be reduced. Companies, whose businesses can benefit from the imposition of caps and the sale of products which are carbon-reducing, have begun to lobby in favor of schemes to reduce carbon emissions. Investment banks which make markets in all manner of securities and commodities are ready to do their part in setting up and trading carbon credits in new markets.

The imposition of carbon caps will likely affect the economy in many ways, some obvious and some not so obvious. Just as the evolution of the Internet has changed the rules for all media companies and indeed any producer of content which can be digitized, so too will the imposition of carbon caps lead to substantive changes in all aspects of business and life. We will see winners and losers. Some of the winners will be entirely new companies. Some of the losers will be companies which heretofore have been viewed as rock solid. In the months ahead, we will be assessing all investments for the probable impact that carbon caps will have on their business models.

Focus Stocks: Applied Materials (AMAT, \$18.89, 4/14/08); Exelon (EXC, \$83.45, 4/14/08); General Electric (GE, \$31.75, 4/14/08); Praxair (PX, \$87.21, 4/14/08)

Final Thoughts:

Problems in the banking system first surfaced a year ago with New Century's failure. Then last summer Bear Stearns announced that 2 of their hedge funds froze redemptions due to problems in the market for sub-prime mortgages. Since then, banks have written down almost \$300 billion in assets. While we expect further write-downs will be required as banks reserve for additional non-performing loans, we also believe that the worst of the write-downs is behind us. That said, first quarter earnings will be mixed and investors will want to see the results before making substantive new commitments to stocks. With the earnings season upon us, we expect some surprises, both good and bad. But assuming there are no major disasters, the markets could resume an upward bias once earnings and management comments are reviewed.

As we move forward, we will look to enhance portfolios by emphasizing global leaders. Many of these stocks are inexpensive but have bright futures as they benefit from some powerful emerging trends.

As always, we welcome your questions and comments.

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