CURIAN CAPITAL

Special Report
July 7, 2008

Heavy Weight Oil

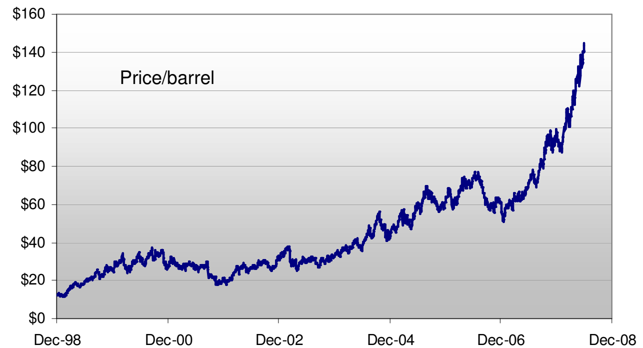
Stock prices fell just below the previous lows established early in the year as the weight of high oil prices are pressuring both the economy and stock investors. (see graphs below) The low points for the S&P 500 in January and March occurred during periods of high stress related to the subprime/housing crisis and the related ensuing credit crisis. At the time oil prices were escalating as well, but in the $90 to $100 range versus the $140+ per barrel in recent days.

Today, while the credit crisis may be past the pinnacle of maximum pain in the form of peak write-offs, the parabolic rise in oil prices is proving to be the primary determinant of stock prices. As a consequence stock prices could fall lower than first quarter levels, needing to establish a new floor before resuming any sustained upward trend. If oil prices retreat in the very near term however, then stock prices may firm.

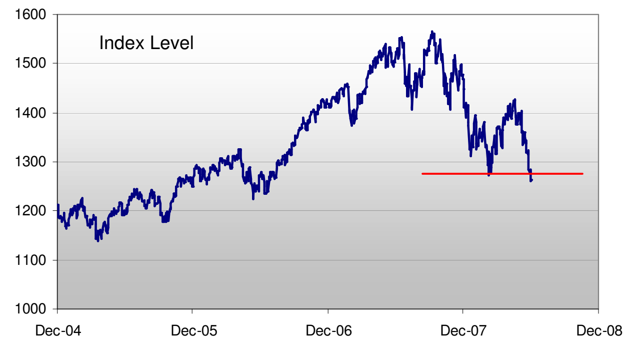
Demand Destruction

Interestingly the weight of high priced oil is working to dampen the demand for the commodity and should work to halt the parabolic nature of future price increases. Admittedly, demand pressures will likely persist with China accounting for as much as 70% of the world's incremental growth in oil demand in recent years. There is however the potential for a post-Olympics deceleration in China's economic growth, compounded by the deceleration in China's trading partners economies, both of which could provide some incremental relief beyond the demand destruction being caused by high prices.

For frustrated stock market investors, the strong inverse connection of stock and oil prices may be an incentive to stay invested if oil prices were to pull back. In fact, if the oil price trend were to break down, the influence of hedge fund and futures managers could accentuate the downturn, just as "speculators" have likely accentuated the pace of increase.



Source: Bloomberg



Source: Bloomberg

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Past performance is not a guarantee of future returns

Financial Comeback?

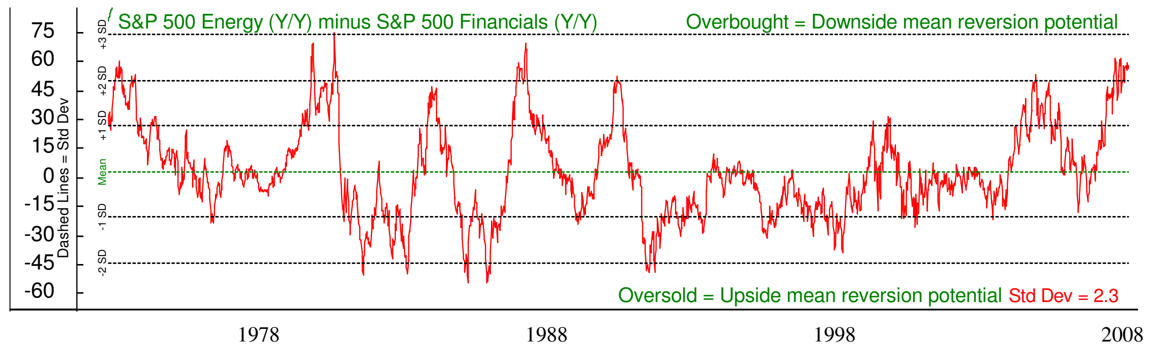
The other ails of the market appear less onerous compared to oil prices. Financial service company earnings that have been torpedoed by losses in the subprime/credit debacle are the stand out sector with dismal earnings expectations for 2008. The sector's earnings are projected to fall over -27% this year following a -39% decline in 2007. While it must be acknowledged that future earnings estimates are subject to the same downward adjustments experienced in recent quarters, any return to normalcy for the financial sector could have a meaningful positive impact on the entire market's earnings power.

S&P 500 Sector Earnings Growth

	2007A	2008E	2009E
S&P 500	-5.9%	6.4%	23.8%
Consumer Discretionary	-15.7%	-2.2%	35.0%
Consumer Staples	10.1%	11.1%	9.7%
Energy	6.1%	26.6%	6.3%
Financials	**-39.4%**	**-27.6%**	88.4%
Health Care	15.9%	11.2%	13.6%
Industrials	11.8%	5.3%	10.9%
Information Technology	14.7%	16.5%	22.9%
Materials	4.7%	4.8%	14.1%
Telecom Services	3.8%	24.7%	13.5%
Utilities	1.5%	11.8%	9.0%

Source: S&P, 6/30/08

Finally, the relative performance of the two sectors that have had the most influence on stocks for the last year, Financials and Energy, are at an historic extreme. (See graph below) Thus if the usual reversion-to-the-mean tendency persists, a shift in the relationship may help improve the health of the overall market.



Source: Ned Davis Research

With the realities of a bear market facing investors, by this time next year we may look back on the summer of 2008 as a buying opportunity for equities. Shorter term, the market may need some help from a pause in oil prices while the housing and credit markets evolve from crisis levels to something more stable.

Heavy Decisions

Selling out of stocks following particularly weak periods has not been especially productive. In fact following a month like June where the Dow Jones suffered a 10% price decline, the market has more often than not recorded solid subsequent performance at least over the short-term. There has been only 9 other such challenging months since the 1940's where the Dow was off more than 10%. In 8 of the 9 instances the market was higher 6 months later. (see table)

Dow Jones Industrial Average

	Month Price Return	1 month later	6 months later
May-40	-21.70%	4.86%	12.72%
Nov-73	-14.04%	3.48%	-2.44%
Aug-74	-10.41%	-10.42%	8.91%
Sep-74	-10.42%	10.72%	26.37%
Oct-87	-23.22%	-8.02%	1.95%
Aug-90	-10.01%	-6.19%	10.24%
Aug-98	-15.13%	4.03%	23.44%
Sep-01	-11.08%	4.77%	17.59%
Sep-02	-12.37%	11.00%	5.27%
Jun-08	-10.19%	**?**	**?**

Source: BayPoint Trading

While basing investment decisions solely on historical tendencies is not the foundation of a solid investment process, neither is selling out of the market when stocks are 20% cheaper than they were eight months ago.

Investors who have difficultly tolerating the market's volatility may be better served with a more defensive exposure to the equity market or even a more conservative overall allocation to less volatile asset classes. But those investors able to tolerate market downturns, periods that can be considered consistent with historic tendencies, are likely to be rewarded for their perseverance.

Curian Capital, LLC
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