

# OUTLOOK

TRANSAMERICA INVESTMENT MANAGEMENT, LLC

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## Summary

The Federal Reserve's aggressive monetary stimulus program has been largely offset by the continued unwillingness of financial institutions to extend credit. Consequently, a prolonged period of slow economic growth is likely. Consumer discretionary spending will remain under pressure due to high food and energy prices and a weak labor market. Sharply higher raw material prices will probably lead to a rise in inflation, but a rising unemployment rate will likely prevent the formation of a traditional wage-led inflationary spiral. Against this backdrop, the Federal Reserve will probably stay on hold until the economy shows signs of stabilization. Earnings should be impacted, suggesting further volatility for the market.

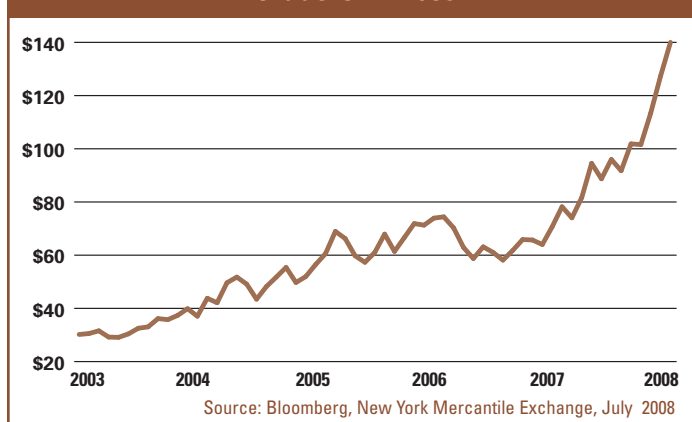
Banks and credit institutions continue to struggle with asset quality issues, which have resulted in reduced lending capacity. As a result, they are unable to provide credit to consumers and businesses as generously as in the past. This scarcity of credit will continue to weigh upon the economy and, consequently, the markets.

THIRD  
QUARTER  
2008

## CONSUMER SPENDING

High food and energy prices and a weak labor market will continue to pressure consumer discretionary income, suggesting lower consumption levels and more "trading down" to lower-priced consumer goods. While most commodity prices have experienced upward price pressures, crude oil price increases have probably garnered the most headlines. Crude oil prices rose 38% during the second quarter to \$140 a barrel, an all-time high in both real and nominal terms. This has translated in short order to higher gasoline prices. Although food price increases have generated fewer headlines, they have similarly impacted the consumer, resulting in reduced disposable income.

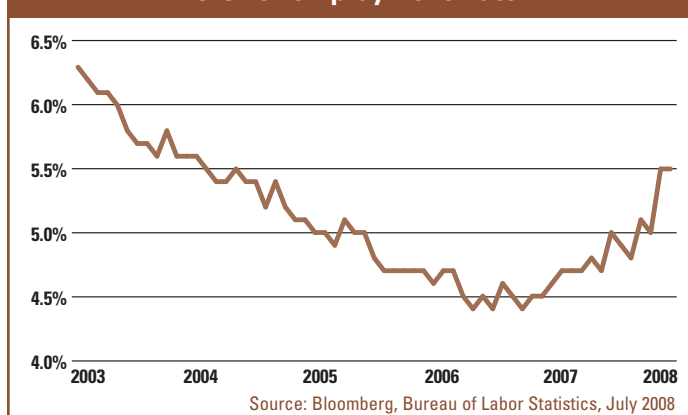
### Crude Oil Prices



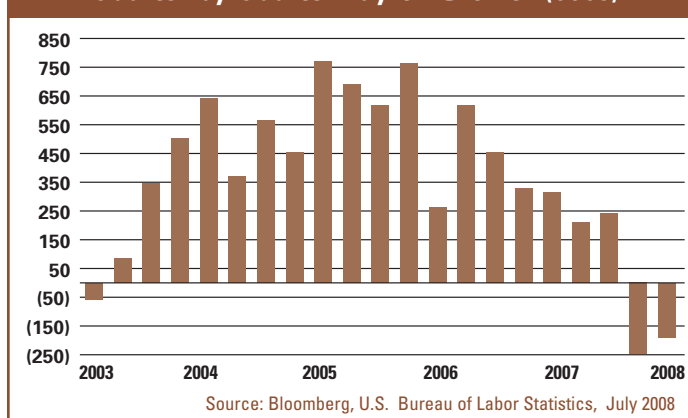
Consumer income growth has not kept up with price increases due to labor market weakness. Job losses and a commensurate increase in the unemployment rate have diminished the ability of workers to ask for and receive higher wages. The U.S. unemployment rate rose from 5.1% to 5.5% during the second quarter as an additional 191,000 jobs were lost on top of the 247,000 lost during the first quarter.

Wage growth in recent years has been capped due to the long-standing decline in union membership and global competition from lower-wage countries. While a 5.5% unemployment rate

### U.S. Unemployment Rate



### Quarter-by-Quarter Payroll Growth (000s)



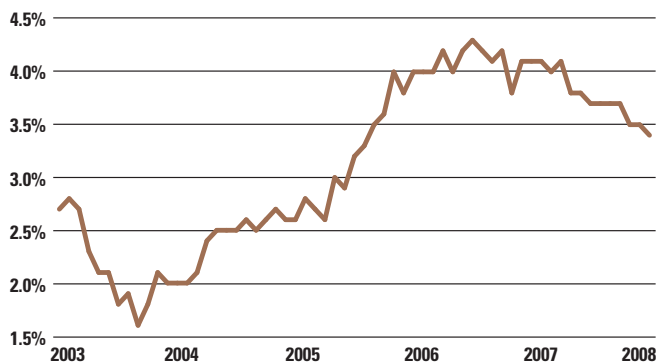
is low by historical standards, the fact that it is rising has further pressured wage growth rates downwards. Accordingly, the annualized U.S. average hourly earnings growth rate slowed from 3.7% at the end of the first quarter to 3.4% at the end of the second quarter.

The decline of home prices to 2005 levels and an overall reduction in credit availability have reduced the ability of consumers to supplement their spending power with home-equity withdrawals. Although existing home sales volume

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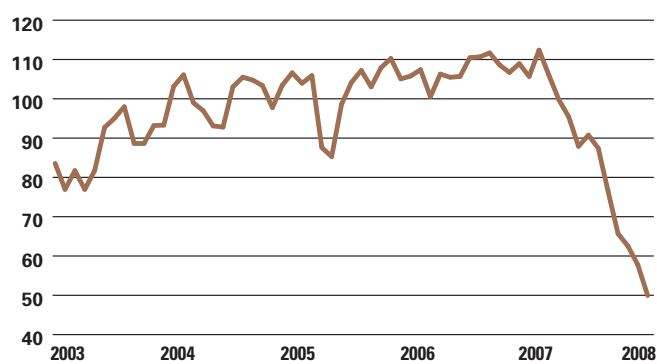
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### U.S. Average Hourly Earnings (Year-Over-Year % Change)



Source: Bloomberg, Bureau of Labor Statistics, July 2008

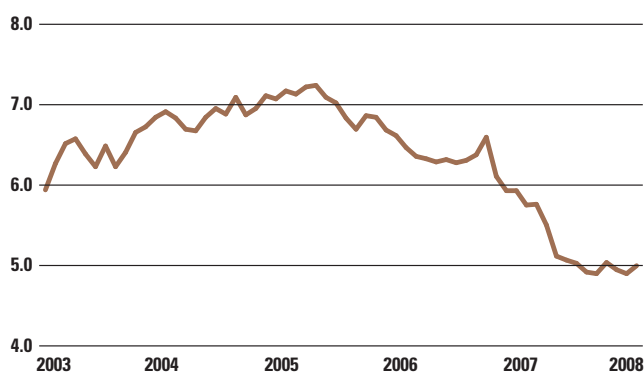
### Conference Board Consumer Confidence Index (1985=100)



Source: Bloomberg, Conference Board, July 2008

appears to have stabilized, home prices remain weak. Moreover, the inventory of unsold existing homes equates to 11 months of supply, a cyclical high, suggesting a longer period before the housing market recovers. Consumer aggregate net worth, which hit a record high last year, has declined this year due to weak home and stock prices.

### U.S. Existing Home Sales (Millions, SAAR)



Source: Bloomberg, National Association of Realtors, July 2008

Consumer confidence by most measures has hit multi-decade lows as wages, home prices, and stock prices have come under downward pressure. The Conference Board Consumer Confidence Index, which measures consumer appraisals and expectations regarding business and employment conditions, has plummeted this year to levels last experienced in 1992.

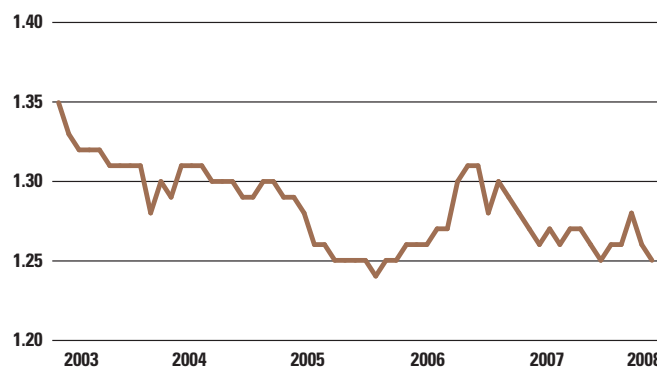
On a brighter note, the \$150 billion tax rebate plan did temporarily boost retail spending during the second quarter. However, with the last rebate check scheduled to be sent by mid-July, there will be only minimal stimulus for the rest of the year. There has been scant evidence that this boost has had a follow-on impact on production or employment growth, as had been hoped. With the headwinds facing the consumer unlikely to abate in the near future, tepid consumer demand and continued "trading down" will probably remain a part of the economic outlook for the quarters to come.

## BUSINESS OUTLOOK

Weak domestic demand, tight credit conditions, and political and tax uncertainty have reduced business confidence, suggesting a diminished propensity to hire and invest. According to the National Federation of Independent Business, its business optimism index hit a 28-year low in February. Later, in May, Challenger Gray reported that announced job cuts hit a 29-month high.

Although this outlook is undoubtedly bleak, there are a few bright spots. Inventories remain very low by historical measures, suggesting that further production cuts are unnecessary and that demand growth will spur production increases. Furthermore, businesses exposed to faster-growing markets overseas should continue to perform well. Finally, the accelerated depreciation allowed on capital expenditures made in 2008 (part of the \$168 billion fiscal stimulus package) should encourage companies to move their investment spending plans forward to 2008.

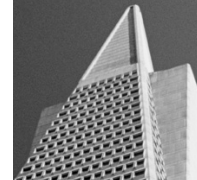
### Business Inventory-to-Sales Ratio



Source: Bloomberg, U.S. Census Bureau, July 2008

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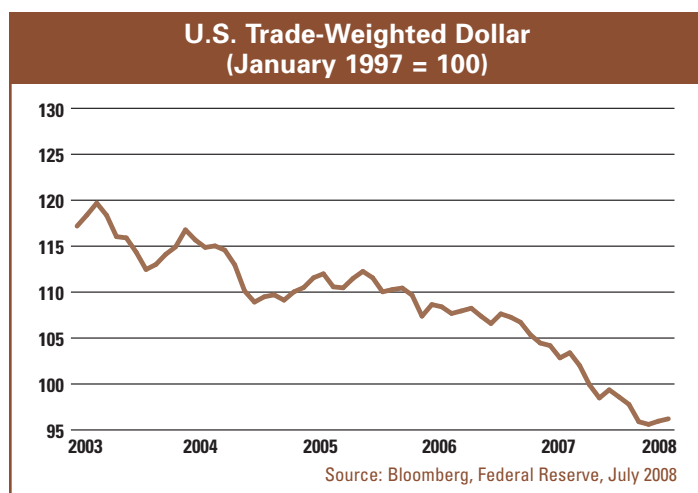
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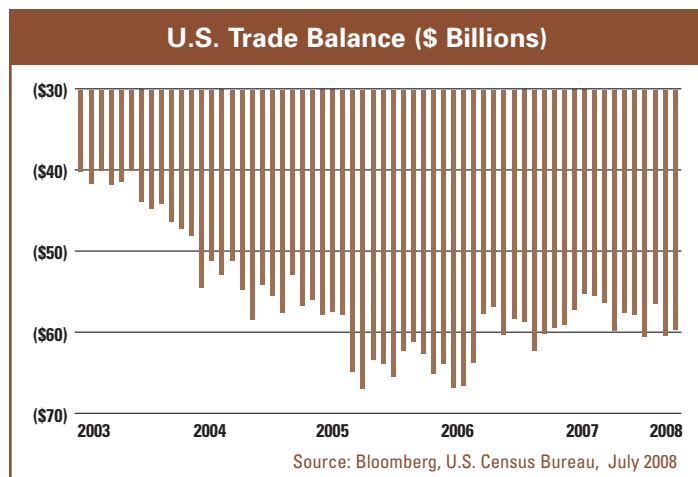
## GOVERNMENT SPENDING

Election-year politics and diminishing returns from the mostly disbursed \$150 billion tax rebate program have triggered discussions of a second stimulus package. Measures under consideration include infrastructure spending packages, tax cuts, and most likely to succeed, a housing market relief bill. There is strong bipartisan support for such a bill, which would probably include tax breaks for new homeowners, more affordable government-sponsored mortgages for beleaguered existing homeowners, and a permanent increase for agency home loan limits in high-priced housing markets. Reducing the budget deficit is unlikely to be a high priority this year given political and economic realities.

## TRADE AND INTERNATIONAL OUTLOOK



The U.S. dollar slowed its longstanding decline against many of its trading partners during the second quarter as the market began to anticipate a Federal Reserve ("Fed") rate hike. The dollar should remain range-bound in the coming quarter as slowing overseas growth results in more accommodative foreign central bank policies, thereby increasing the relative

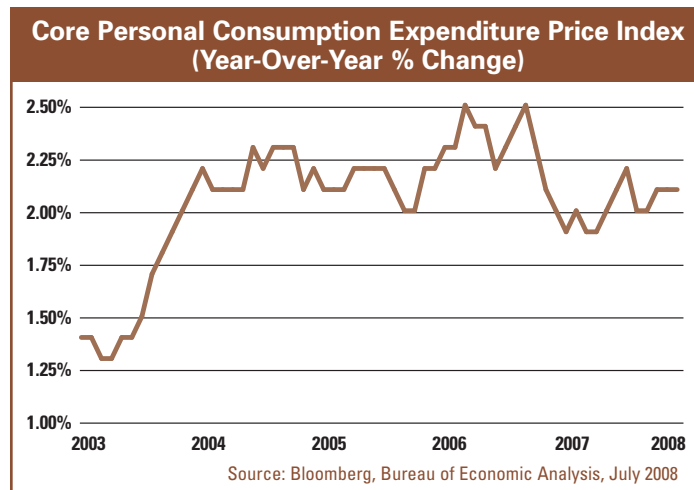


attractiveness of the U.S. dollar. This is particularly likely against the currencies of the developed economies, which have experienced more marked slowing.

Robust overseas demand and the secular decline in the dollar contributed to a modest narrowing of the trade deficit in 2006 and 2007, but the deficit has widened so far this year. This deterioration has been caused primarily by rising oil prices, as the U.S. is a net importer of crude oil.

## INFLATION

The core (excluding food and energy) personal consumption expenditure price index remains tame at 2.1% despite soaring commodity and energy prices. This indicator, the Fed's preferred inflation gauge, is currently just above the Fed's unofficial 2.0% tolerance level. However, neither the Fed nor the consumer seem to derive much comfort from this indicator, as it does not accurately reflect consumer expenditures (which do include food and energy) and price increases yet to occur.



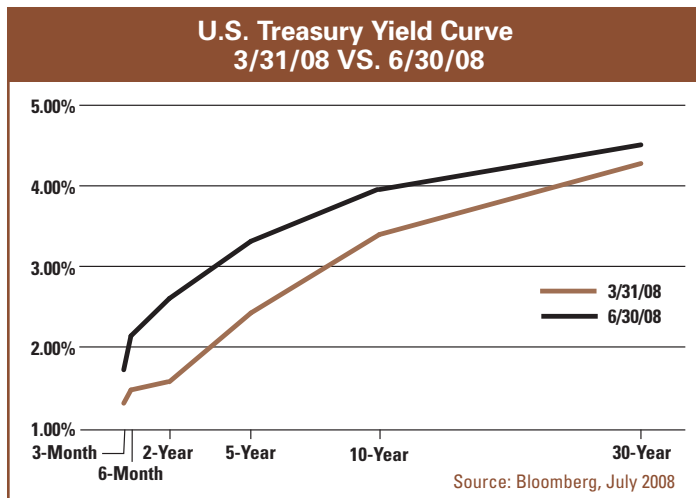
Prices for goods and services are likely to increase in the months to come given the magnitude of the cost input increases experienced. Although raw material price increases have been extreme and of concern, wage increases have not accelerated and have in fact decelerated. Without wage increases, the inflationary spirals last experienced during the 1970s are unlikely to take hold soon. Given the weak outlook for employment, higher goods and services prices are more likely to result in reduced standards of living for the consumer than in an inflationary spiral.

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## INTEREST RATES

U.S. Treasury yields rose during the second quarter as market attention shifted away from the credit crisis towards the economy. As flight-to-quality demand for Treasuries declined, inflationary concerns grew, pressuring yields upwards. Shorter-maturity yields, which are more sensitive to the Fed's rate-setting activities, increased more than longer-maturity yields as the market began to anticipate that the next Fed move would be a rate hike.



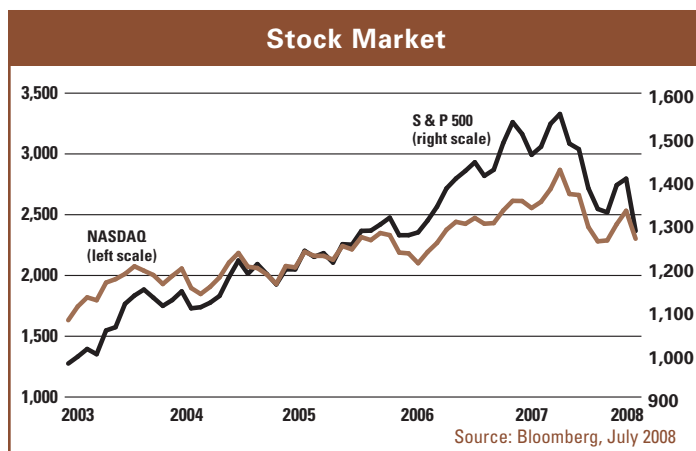
The Fed is in a quandary – economic conditions merit a rate cut, yet inflationary pressures support a rate hike. The Fed has straddled these competing directives by “talking tough” on inflation, although rate hikes are unlikely until the economy definitively stabilizes.

Inflationary pressure and an increasing fiscal deficit will probably lead to higher rates in the coming quarters. During this adjustment period, money market and short-maturity bond funds will offer more stable returns with less interest rate risk.

## STOCK MARKET

The stock market initially rallied during the second quarter as credit conditions stabilized, but sold off in June on the prospect of continued financial sector write-downs, growing inflationary pressures, and increased earnings risk. Subsequent weakness in early July took the stock market into bear market territory, defined as a 20% drop from the peak, which was established on October 9, 2007.

Earnings remain challenged, with second-quarter operating earnings for the S&P 500 expected to decline by a double-digit amount, the fourth straight negative quarter in a row. Disappointments have been concentrated mostly in the financial, auto, and home-building sectors.



Continued economic weakness has generated concern that construction, home equity, and credit card loans will be the next asset classes to experience write-downs. This will necessitate additional financial sector balance sheet repair in the form of equity infusions and dividend cuts, thereby diluting shareholders' equity and negatively impacting stock market returns. The economy and stock market will probably continue to struggle against this uncertain backdrop, suggesting tremendous stock bargains to come, continued outperformance for companies with earnings visibility and pricing power, and underperformance for companies overly reliant on access to credit.

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