

MARKET UPDATE

We are pleased to again be named as one of America's "Top Wealth Managers" for the 4th consecutive year!

By Bloomberg Wealth Manager Magazine

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RISING COST OF INFLATION

The first half of 2008 has been a difficult period for investors with the S&P 500 off 12.9% and the Dow Jones Industrials off over 14%. Measured from its October highs last year, the S&P 500 is now down almost 20%; a decline used by many to define a "bear market". Foreign markets have not fared much better with the EAFE Index down almost 11% and emerging markets down over 9% for the same period. These declines not only reflect the ongoing housing crisis and the de-leveraging of the global financial system, but also the re-emergence of global inflation. With almost 70% of U.S. GDP driven by consumer spending and consumer confidence approaching 30 year lows, the risk of 1970s-era stagflation remains present.

The Consumer Price Index (CPI) is running at 4.2%, which does not truly reflect the rising costs that consumers are absorbing. Food was up over 14% and gasoline prices increased more than 30% over the last year. Spending on fuel as a percentage of wages has gone from 4% to close to 8% and some economists calculate that if gas prices remain stable and the rise in food prices slows to 4%, the incremental cost to consumers would be approximately \$180 billion or over \$1,500 per household.

Not just a U.S. phenomenon

Rising inflation is not just a U.S. phenomenon as the rapid economic growth of emerging markets has helped create a broad commodity price boom. The severity of this commodity cycle has been

worsened by the fact that it has been met by a sluggish supply response and a belief that demand will wane as global economic growth slows. While industrialized countries are challenged by rising costs, the difficulties are even greater for emerging countries where food costs represent a greater percentage of annual income. Accelerating food, fuel and labor inflation in these markets, combined with a weakening U.S. dollar, has only increased the cost of imported goods and exacerbated domestic inflation problems.

The recent rise in inflation has also put the Federal Reserve in a very difficult position. Given the housing/credit crisis, the Fed was forced to react by significantly cutting interest rates seven times by a

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OPPORTUNITIES IN ENERGY EFFICIENCY

An energy crisis is upon us, caused by surging demand of booming emerging economies, limited new supply from constrained oil producers, and slow advancements towards new energy solutions and energy efficiency. Many recall the 1970s energy crisis when OPEC limited exports to the U.S. The U.S. survived this energy shock through huge efficiency improvements led by government and major corporations and large investments in alternative solutions such as nuclear energy and mass transit. Ford and GM began selling front-wheel drive powered vehicles and

Japanese car-makers Honda and Toyota began winning market share with their highly fuel efficient alternatives.

These solutions proved short-lived as Americans stopped focusing on efficiency efforts when oil became plentiful again. Today, although many exporters, particularly OPEC, declare that oil supplies remain abundant; many energy traders remain skeptical of these assertions because oil production has not increased in response to significantly higher oil prices. Additionally, many of the most important oil exporters such as Saudi

Arabia have for years refused to allow Western geologists to survey and verify their reserves. While we don't subscribe to the more radical views that oil shortages will eventually destroy the world economy and lead to famine and war, we do believe that we are close to the "tipping point" of

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RIISING COST OF INFLATION... (CONTINUED)

total of 3.25%. They also continued to open the Fed window to provide liquidity to both traditional and non-traditional borrowers, including brokerage firms and Fannie Mae & Freddie Mac. Though the Fed actions have saved many financial institutions, so far it has not filtered down to businesses or consumers. Fed Chairman Ben Bernanke recently commented that in many cases, banks are de-leveraging or are reluctant to raise the extra capital needed to take advantage of the

business opportunities. Unless recent rate cuts benefit those who need credit – businesses and consumers – economic growth will continue to stagnate. The Fed is in a very precarious situation because, though the recent rate cuts are not sufficiently benefiting the economy, raising rates now to quell inflation would likely push the economy into a recession similar to the circumstances of the early 80's. This paralysis by the Fed, combined with the fact that for-

eign central banks are willing to raise rates to stem their inflation problems (most recently Europe and China), will also continue to put pressure on the U.S. dollar as global capital seeks higher returns.

Ebbing U.S. demand?

As for oil, given that supply is limited, prices will rise to a level where they will begin to meaningfully reduce demand. Fortunately, there are early signs that we are near a tipping point with the U.S. consumer now more conscientious about energy costs and adjusting behavior accordingly. As Americans, we might claim to be addicted to our cars but over the last few months we have already seen an increase in the use of public transportation

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ENERGY EFFICIENCY... (CONTINUED)

another, perhaps even more painful, energy crisis.

So what are the alternatives?

Non-renewable sources are generally fuels that must be mined from the ground. These fuels produce energy very efficiently and relatively cheaply in comparison to other sources, but are finite. Renewable energy is vastly more abundant than non-renewable sources. Unfortunately, these sources are generally more difficult to exploit. Hydroelectricity, tidal, solar and geothermal sources in particular, require massive investment and continued innovation to become economically viable.

There are also some unintended consequences of rapid deployment of some alternatives, such as bio-fuels. As farmers choose to allocate limited land resources to

bio-fuels such as ethanol, food production is declining. Many experts are now questioning the cost/benefit of ethanol because of the enormous subsidies that our government is providing to farmers, and the resulting increase in corn and other grain prices, which are actually contributing to inflation and famine around the world.

We recently attended a conference on the future of solar energy that attracted hundreds of industry and scientific thought leaders in renewable energy. One key take away from the event was that the balance of falling costs through evolving solar technology, coupled with rising costs for traditional nonrenewable power, will also soon reach a tipping point that could dramatically accelerate the

adoption of solar energy or technology. Lower prices facilitate the proliferation of renewable power, but the industry will likely become largely commoditized over time which, together with expensive stock valuations, reduces our enthusiasm for these investments.

Similar capacity build-outs are being seen in the wind turbine industry as demand has grown. These investments are sure to accelerate cost parity between renewable & non-renewable sources. We think the greatest opportunities lie not necessarily in the companies that are producing the technology, and are likely to be victim to technological shifts & intense competition, but rather those that are ena-

Crestwood Advisors' Philanthropic Commitment



The Inner City Scholarship Fund
The Catholic Schools Foundation, Inc., through its Inner-City Scholarship Fund (ICSF), grants scholarship assistance annually to needy students attending primary or secondary Catholic schools in the Archdiocese of Boston. Scholarship assistance is awarded to students without regard to race, color, gender or creed.

For further information, we encourage you to visit http://www.csfboston.org/programs_services/inner_city_scholarship.asp

bling it.

The low hanging fruit: energy efficiency

Albeit a “less sexy” investment idea than hydrogen powered cars or coal degasification, changing the way we use energy by becoming more efficient could have the greatest short-term impact on resolving the energy crisis. As one of the fastest, least expensive and most environmentally friendly solutions, energy efficiency is the “low-hanging-fruit” of solutions for the energy problem.

An enormous area for opportunity lies on factory floors and within heavy industrial applications. The largest energy consumers in the

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RIISING COST OF INFLATION . . . (CONTINUED)

and a decrease in vehicle miles traveled. These initial adjustments won't dramatically change America's dependence on foreign oil and swapping SUVs for hybrids and building wind farms will clearly take time. Many Asian governments had been subsidizing oil prices to facilitate con-

“As these pricing trends work through the economy, consumers have little choice but to accept the additional fees & price increases...”

tinued economic growth. This practice is now starting to change as countries like Malaysia and China are removing subsidies, which is leading to higher consumer energy prices and cur-tailing demand. Over time, reduction in demand

will likely reduce the price and oil may be lower by year end.

Industries where commodity costs made up the largest portion of their total costs, such as chemical companies and airlines, were the first to raise prices to their customers. Dow Chemical cited the largest price increase in their history and airlines have begun to charge for each bag checked on flights. As these pricing trends work through the economy, consumers have little choice but to accept the additional fees and price increases, forcing them to curtail their behavior.

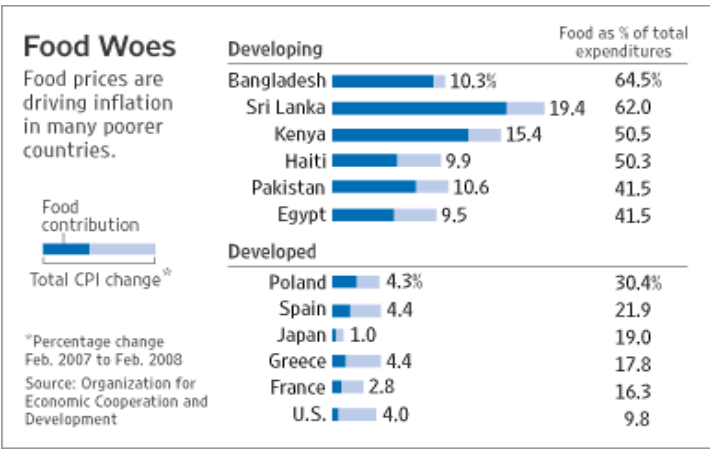
Away from food and energy, we are continuing to experience inflation in other areas of our lives including health care, education, government spend-

ing and potentially taxes. Fortunately, inflation has not appeared in wages, historically a major component of inflation. This has led many economists to argue that this inflation cycle will not be as severe as those in the past. Additionally, deflation remains present in industries such as technology, telecommunications and housing.

Slow growth and rising inflation: What are we doing?

Today, we are focused on the balance between preserving principal and striving to keep long-term purchasing power ahead of inflation. We recognize that holding large amounts of cash feels safe in this environment, but with money market yields hovering around 1% and inflation approaching 5%, this is not a successful long-

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ENERGY EFFICIENCY . . . (CONTINUED)

world are the hundreds of millions of industrial drives and motors that account for about 70% of industrial energy consumption. **ABB Ltd**, a Swiss company that we believe has one of the most attractive competitive positions in energy efficiency, has proven that they can dramatically reduce industrial consumption with their variable speed drive technology. Essentially, variable speed drives regulate the amount of power delivered to the motor, depending on the task required vs. traditional motors that operate at full speed and use throttling & braking systems, which is akin to driving your car at very high speeds with both feet, operating the accelerator and the brake simultaneously. At under 10% of installed motors, the market for this technology is severely under-penetrated in the U.S.; however, Europe has had tremendous success. ABB estimates the installed

base in Europe annually conserves enough energy to power 33 million homes, or about the annual energy consumption of the entire country of Ireland.

When you think of energy in a life-cycle context, you can further see the value proposition that ABB offers. Typically when extracting energy in a deep-sea drilling rig, for example, almost 15% of the energy is lost during production. ABB sells motors and automation technology that eliminates half of this wasted energy, making its products attractive to energy producers. Similarly, at point of delivery, ABB is also reducing waste as their high-voltage transformers and transmission equipment reduces energy lost through power-lines. Further, much of the current power transmission infrastructure today was built in

the 1970s in response to the OPEC energy crisis and is now well past its useful life (remember the summer of 2004 “blackout”) and needs to be replaced in the years ahead.

Thin-film solar, wind power & hybrid cars are typically the solutions that the media and politicians focus on. While there is a need for these revolutionary technologies, and some of these will most assuredly be part of the longer-term solutions, they will take decades of investment to make a meaningful difference and are unlikely to avert a near term energy crisis. ABB is poised to take advantage of the most immediate solution of greater energy efficiency and, as the world's largest provider of power generation and distribution equipment, ABB is well-positioned to benefit when these

renewable power sources do become economically attractive options regardless of who the eventual winners will be.

We believe owning a company like ABB demonstrates how we seek to add value by finding companies that have solid fundamentals, attractive competitive positions within healthy industries and a well defined growth strategy. While the world adjusts to \$140 oil, the threat of terrorism and a rapidly growing population, ABB's products and services address some very real problems. We may not be able to find more energy and it may take some time to find alternatives, but ABB offers solutions to get much more out of what we have today.

RISE IN COST OF INFLATION... (CONTINUED)

term investment strategy.

To grow assets in real terms, portfolios need to include investments that can grow in excess of inflation. Historically, examples include companies with pricing power, real-estate and commodities. While we continue to avoid U.S. residential real estate, as this remains an unattractive asset class, commodities have been a core investment for several years. Over the last six months we have increased our clients' positions by adding direct investments in iron ore, timber, fertilizers and gold. As for equities, we continue to see opportunities in global franchises

(i.e. **Novartis**), companies that are problem solvers (i.e. **Schlumberger, ABB Ltd.**), and companies that have the ability to pass prices onto consumers (i.e. **Colgate Palmolive, Syn-genta, Vale Rio**). Additionally, though global growth is slowing, re-source-rich emerging mar-kets continue to look attractive as many are still experiencing economic growth in the high single digits. As for our fixed income portfolios, we

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continue to see selective opportunities in short and intermediate corporate and municipal bonds, bank loans and global bonds.

We also believe that, in these market environments, returns come not only from where you are invested, but where you are not. We are still avoiding con-

sumer-oriented investments such as retailers, restaurants, travel, housing and autos as

consumers are going to continue to carefully monitor their budgets. We also continue to stay away from both money centers and regional banks. Though we may have seen the darkest days in this area, until housing prices stabilize, we believe it will be difficult for these institutions to return to their historical profitability levels.



BRAVERY DURING A BEAR ATTACK

It was easy for wariness to give way to downright distress during the second quarter. Since June 30th, the term “bear market” continues to proliferate the news, encouraging market pessimism as economic growth, corporate earnings, the health of the financial system and the future of oil prices all remain uncertain. Everyone wants to know what to expect in the near and longer term, and the question “Are we near the bottom?” is really asking whether the present risks have already been discounted into the equity market. Historically, entering “bear market” territory has provided a favorable entry point for long-term investors.

Despite the severe drop in consumer confidence over the sec-

“At some point, all current negativity is priced into equity prices, and depressed sectors begin to turnaround, often seemingly for no apparent ‘good reason’.”

ond quarter, history shows that when bearish sentiment overwhelms bullish sentiment by a ratio of 2 to 1, positive performance has followed (current level is approximately 2). At some point (and this is why bear markets are exceptionally difficult to “time”), all current negativity is priced into equity prices, and depressed sectors begin to turn around, often seemingly for no apparent “good reason.” There has never been a headline indicating the exact timing of the bottom of the market (or at least a correct one!). Indeed, when headlines turn positive, it is a sign that the turnaround in the market is already underway.

In addition to history suggesting

that opportunities may be present in bear markets, current valuations appear attractive. The S&P 500 is currently trading at about 14 times consensus earnings. This represents the lowest price-to-earnings (P/E) valuation since 1988. This P/E is likely to rise as equity markets stabilize and confidence gathers for earnings expectations. Earnings remain uncertain, but extremely pessimistic expectations have contributed to falling stock prices. Financial & consumer discretionary stocks are suffering lower earnings, but the broader market remains healthy and increasing earnings will only drive prices higher. Overall market valuations will also benefit if inflation drops, quite likely led by energy prices moderating.

And speaking of energy prices, higher energy prices are putting a damper on the broader economy; negatively impacting top line

growth and corporate profits. If this continues, a reversal in oil prices will likely support a rally in the stock market.

While timing the bottom of the market may be impossible, we are confident that our global investment strategy at Crestwood Advisors and our focus on healthy business fundamentals (as well as sectors postured defensively from many of the current economic risks) will allow our clients to benefit when economic news eventually becomes positive. Meanwhile, we continue to be attentive to re-balancing portfolios, ensuring alignment with each client’s risk tolerance. For long term investors, the current economic and stock market environments represent an opportunity to invest long term capital at attractive valuations.

Providing comprehensive investment solutions to high net worth individuals, foundations and endowments