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Market Outlook

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Revelations that record levels of delinquencies and foreclosures on residential mortgages are resulting in losses on mortgage-backed securities put pressure on the stock market in June. The Dow Jones Industrials (-1.6%), Nasdaq Composite (-.05%), and Standard & Poor's 500 (-1.8%) all recorded losses for the month. Energy was the best performing sector with a gain of 1.7%. The utility sector was the worst performer, posting a loss of 5.3%.

Economic growth likely rebounded in the second quarter from the dismal first quarter performance as a result of an increase in vehicle production and the rebuilding of inventories. Wall Street cheered government reports showing robust monthly employment gains, as well as a tame core inflation (minus food and energy) number of just 0.1% for May. Core inflation is now approaching the top end of the Federal Reserve's targeted range of 1-2%. In response to the reacceleration in economic activity, long-term bond yields (10-year treasury) rose to 5.3%. We believe this reacceleration is temporary.

Economists and market strategists alike are embracing the view that economic growth bottomed in the first quarter of this year, that the problems in the sub-prime mortgage market have been contained, and that consumer spending will pick up in the second half of 2007. Treasury Secretary Henry Paulson was quoted as saying the housing slump was "largely contained," with the correction mostly "behind us." In addition, record amounts of liquidity and easy credit which are driving private-equity deals and corporate stock buybacks, are providing the market with a solid foundation to move higher.

We believe the underbelly of this overly optimistic consensus view is not so pretty. The inflation numbers are outstanding—so long as you don't eat food or drive a car. The government's calculation thus has no relevance to day-to-day living. Nominal inflation (which includes food and energy) is up 5.3% so far this year, and is far outpacing real wage gains for consumers.

Creative accounting by the Bureau of Labor Statistics (BLS) has been distorting employment growth since the third quarter of 2006. The BLS reported payroll employment rose 157,000 in May. But did it? The BLS modified its method of determining monthly job gains back in 2001 by adding in a new computer-generated component to account for job creation in small businesses not included in its real-world monthly survey. We mentioned in last month's Market Outlook that it was a revision to this "guesstimate" that erased 479,000 of the 498,000 jobs reportedly created in the third quarter of 2006. The BLS report for May added 203,000 small business jobs by computer modeling, resulting in a net gain of 157,000. If this job "guesstimate" is as accurate as it was for the third quarter of 2006, we will have lost 46,000 jobs last month.

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Perhaps Treasury Secretary Henry Paulson is relying on the National Association of Realtors for his updates on the state of the housing market. This organization is predicting a 1% decline in home prices for 2007, yet foreclosures surged 90% year-over-year in May to 176,000. New and existing home sales continue to decline as inventories continue to rise. We are now entering a period where the volume of sub-prime mortgages due to reset to higher rates will increase from approximately $15 billion to $40 billion per month through next summer. Record volumes of adjustable rate loans with two- and three-year teaser rates, which were originated in 2004 and 2005, will reset with rates as high as 11%. This will occur as home prices continue to drop and lending standards

continue to tighten. We see home prices declining as much as 10% over the next year.

We believe the stock market is inebriated on liquidity, and when it sobers up, it may not share the optimistic outlook for the second half of the year embraced by the consensus. We are convinced the sobering blow is taking shape in the form of a financial disaster in the fixed-income market. Every Fed-tightening cycle has ended with a financial disaster in one form or another, but consistent ingredients have been leverage and speculation.

This time the financial disaster is unfolding in the mortgage-backed securities market. Wall Street devised financial instruments called collateralized debt obligations, or CDOs, to meet investor demand for higher yielding fixed-income investments. A CDO is created by pooling together a variety of mortgages and loans, then securitizing them to be sold to investors. CDOs represent the fastest growing segment of the bond market, valued in excess of $1 trillion. About half of the $500 billion in CDOs sold in 2006 owned significant percentages of sub-prime mortgages. These products were sold to pension funds, mutual funds, hedge funds and individual investors. The value of a CDO and the interest payments it makes to investors is dependent on borrowers making timely mortgage payments and not going into foreclosure.

The first signs of trouble emerged last month when two Bear Stearns hedge funds were forced to sell bonds backed by sub-prime mortgages because of significant losses. These funds raised approximately $1 billion in early 2007 and borrowed an additional $6 billion from banks and other brokerage firms to invest in mortgage-backed bonds. As delinquency and foreclosure rates rose this year, so did the losses for the funds, until they were finally forced to liquidate their holdings. The worst is yet to come.

The collapse of these funds and ultimate sale of many CDOs may serve as a catalyst to significantly lower the value and credit ratings of all mortgage-backed securities. As the monthly volume of sub-prime mortgages due to reset to higher rates increases three-fold later this year, rising delinquencies and foreclosures will lead to significant losses in CDOs. A slew of downgrades by rating agencies (S&P, Moody's, Fitch) will force more sales by banks and pensions funds that are mandated to invest only in investment-grade securities. We believe these events will lead to widening credit spreads in the corporate bond market, which will drain much of the liquidity that has fueled the recent market rally.

Credit spreads are the difference between corporate borrowing costs and Treasury yields. The stock market has a strong inverse correlation with credit spreads. These spreads peaked as the economy began to recover from the recession of 2001-2002. They are now as narrow as they have been in the last decade, with junk bond yields at a record low 2.3 percentage points above U.S. Treasuries. Increased borrowing costs will be a headwind for the private equity deals and corporate stock buy-backs that have driven recent market gains.

We expect to see a repricing of risk in the bond and stock markets that may lead to as much as a 10% correction in the S&P 500 from the 2007 highs. Long-term Treasury yields should fall back below 5% as credit spreads widen and bond investors shift from higher yielding fixed-income investments into the safe haven of U.S. Treasuries. We believe the Federal Reserve will have to respond to continued weakness in the housing market, rising unemployment claims, and a slower rate of growth for consumer spending with rate cuts in the second half of this year.

We are maintaining our cautious stance with respect to our investment strategy until we see some acknowledgement of the risks we have outlined in the markets. We continue to favor high quality, large multinational companies that are leveraged to the global economy over small- and mid-sized companies dependent on domestic growth. ■

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