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Market Outlook

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Investor sentiment has swung from greed and euphoria, as the Dow Jones breached the 14,000 level, to fear and dismay, as last week the market suffered its greatest two-day loss in five years. The Dow Jones Industrials (-1.5%), Nasdaq Composite (-2.2%), and Standard & Poor's 500 (-3.2%) all finished the month with losses. The industrial sector was the best performer with a gain of 1.0%. Financials were the worst performing sector, posting a loss of 7.9%

Large amounts of liquidity combined with easy credit have historically led to speculation and leverage that artificially inflate asset prices. Eventually something breaks, sending ripples through the financial markets. Investors move from euphoria to fear over the uncertainty of what lies ahead. This uncertainty leads to increased volatility and lower market prices, but also presents opportunities for astute investors.

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The housing market has been likened for some time to a bubble that will burst, but in reality it more nearly resembles a train wreck in slow motion. The leverage and speculation employed by individuals to inflate home prices artificially have led to rising delinquencies and foreclosures. The worst of the housing decline is still ahead of us, as record volumes of adjustable rate mortgages reset at higher rates over the next 12 months. Stricter lending standards will prevent many home owners from qualifying for lower fixed-rate loans. Home prices will continue to decline until the existing supply of homes for sale falls in line with demand, and the leverage employed in recent years is reduced. We see the repercussions from this event in a further retrenchment in consumer spending and slower economic growth in the second half of the year.

The credit crunch is upon us! The stock and bond markets are now recognizing that institutions have used easy credit to leverage and speculate in mortgage-related securities, and the losses that are mounting are massive. Rising delinquencies and foreclosures have led to the forced sale of highly illiquid mortgage-related securities by over-leveraged hedge funds and lending institutions. As creditors demand repayment on funds borrowed, these institutions are being forced to sell stocks and bonds unrelated to the mortgage market. The days of highly leveraged buy-outs by private equity firms may be over, as credit spreads have widened to increase borrowing costs dramatically.

The decline in the stock market over the past two weeks does not come as a surprise. In our

July *Market Outlook* we stated: “We expect to see a re-pricing 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.” The market has declined over 6% from the highs established on July 13th. While there may be further downside in the days ahead, we feel the market will find its bottom soon, as it prices in the risks related to mortgage-backed securities and the housing market. The stock market should recover its losses and move higher in the second half of the year.

Every tightening cycle by the Federal Reserve has led to some form of financial crisis when the weakest link in the economy breaks. Some lead to recessions and some do not. When we have had a financial crisis that has not led to a recession, it has been very good for the stock market. We do not currently see a recession on the horizon, but a steady slowdown in economic growth that will eventually lead to rate cuts by the Federal Reserve, easing the burden on borrowers. From this standpoint, bad news for the economy in terms of rising unemployment and a retrenchment in consumer spending will be good news for stocks, because it will mean we are closer to rate cuts.

Despite the deterioration in housing-related industries and their drag on the domestic economy, the global economy is strong, and the main influences that have led to higher stock prices over the past four years remain in place. We do not believe the market is dependent on leveraged buyouts by private equity firms to move higher. The core inflation rate (minus food and energy) has fallen within the Federal Reserve’s targeted range of 1-2%. Corporate earnings growth has slowed, but remains positive, and stock valuations are very reasonable by historical standards. Long-term interest rates (10-year Treasuries) have fallen below 5%. The weakening dollar continues to benefit large multi-national U.S. corporations.

The divergence between developing economies and the U.S. economy is unprecedented. As the U.S. economy continues to slow, developing economies, which now account for a staggering 30% of the global economy, continue to power ahead at a rate of approximately 6%. We believe the strength in developing economies will mitigate the drag on the U.S. economy as the global infrastructure boom continues.

We continue to maintain a cautious stance with respect to the stock and bond markets as this correction unfolds. Credit spreads should continue to widen in the months ahead, and treasury yields should continue to decline as money moves from high-yielding, low quality bonds into the safe haven of U.S. Treasuries. We continue to favor high-quality large multinational companies whose businesses are leveraged to the global economy, and whose earnings benefit from a weakening dollar.■

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