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Market Outlook

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The stock market plunged during the first three weeks of November following the 1/4 point cut in short-term interest rates by the Federal Reserve on October 31. The statement accompanying the rate cut intimated that the Fed, believing that the economy should stabilize and then rebound in 2008, would probably not lower rates further. The stock and bond markets did not agree. The Dow Jones Industrials, Standard & Poor's 500 and Nasdaq Composite all corrected 10% from their October highs before finishing the month down 4.4%, 4.0% and 7.0% respectively. Fed Chairman Bernanke finally got the markets' message when he hinted in a speech last week that additional rate cuts might be necessary. Consumer staples led sector performance with a gain of 2.9%, while the technology sector was the worst performer, posting a loss of 8.1%.

The stock market has been weak this year. Home prices are falling at the same time that lending standards are tightening, and mortgage rate resets are increasing. Employment growth and wage gains are both slowing. Energy costs continue to climb. Consumer confidence is at levels not seen since the recession in 1990-91 and Hurricane Katrina two years ago. The rate of growth in consumer spending is likely to slow from 4% to 1% in the months ahead. Corporate earnings growth vanished in the third quarter for the S&P 500, while at the same time the cost of borrowing funds has increased dramatically due to the credit crunch. There are signs the rate of growth in capital spending by corporations is starting to slow. This is not a positive backdrop for the stock market.

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The topic of recession has dominated the news headlines for several weeks, which is one reason we don't see one occurring at this stage in the business cycle. There couldn't be a better contrarian indicator than Treasury Secretary Henry Paulson, who recently said he was "not sure we've seen the worst" of the sub-prime crisis. The financial crisis resulting from losses on sub-prime mortgages has now touched companies, countries and markets across the globe. The good news is that the scale and scope of the losses, which may exceed $200 billion, are spread out so far and wide across the global financial system that the magnitude of its impact may be manageable. The stock market is a collective perception of reality. It has and always will continue to overshoot in terms of pricing in both positive and negative events before they materialize. We think stock and bond markets have already priced in a worst-case scenario in terms of losses related to the current financial crisis. The most important factor in continuing the current economic expansion and upward move in stocks is monetary policy.

We believe the ultimate end point in short-term interest rates is likely to be where 2-year Treasury yields are today, 3%. We also see nominal economic growth for 2008 at 3.0%. The Fed can't prevent a decline in home values, but it can minimize the collateral damage by easing the burden on adjustable-rate borrowers and financial institutions with lower short-term interest rates. Lower rates will also inflate stock prices, which in turn will help offset the negative wealth effect of declining home values and help spur capital spending by corporations. We don't think the Fed has any other alternatives. We continue to believe, despite recent Fed Governor testimony to the contrary, that the Federal Reserve will lower rates by 1/4 point on December 11, and at each of its next several meetings, until short-term rates reach 3%. We believe the Bank of England and the European Central Bank will begin to reduce short-term rates in the first quarter of next year, igniting a liquidity induced rally in stock markets around the world. We expect the current U.S. economic expansion to continue well into 2008.

The fact that history repeats itself provides us with valuable reference points when formulating investment strategy. Those forecasting recession are pointing to

the decline in year-over-year corporate earnings for the S&P 500 in the third quarter and the mounting downward revisions in growth for the fourth quarter. We would point to the economic slowdown in 1985-86, when corporate earnings declined in both the first and second quarters, yet the economy avoided a recession and stocks prices rose. While most of the recent decline in earnings is attributable to financial services companies, the numbers are not as bad as most financial journalists report. An important distinction must be made between a decline in revenues that results in lower net earnings and a mark-to-market write-down of securities held by a corporation, charged as an expense that results in a decline in net earnings.

Because the vast majority of mortgage-related debt held by financial institutions does not regularly trade in the open market like a common stock, it is very difficult to value. An index called the ABX is created every six months to allow investors to speculate on and hedge the value of mortgage debt originated in the previous six-month period. The value of this index is nothing more than the market's perceived value of the loans represented by the index and is subject to huge volatility. Accounting rules force public companies to value the mortgage-related debt they own at the end of each quarter, in part, based on the ABX index. When a company marks-to-market the value of a debt security, and it has lost value based on moves in the ABX index, the company must write off the loss in value as an expense, despite the fact that it is unrealized and may never be sold. A write-down does reduce the value of capital held by financial institutions, which determines how much they are able to lend, but it also reduces taxable income and net earnings, despite what may be an increase in revenue. If the debt that was written down recovers in value, it has no accounting ramifications, other than increasing capital.

As a result of mark-to-market write-downs, financial sector earnings were down 25% in the third quarter from a year ago. Provisions for loan losses rose $9.2 billion to $16.6 billion, the highest since 1987, when the S&L and residential real estate market was in total meltdown. Yet loans to commercial and industrial borrowers experienced record growth, due to the complete shut down of the commercial paper market. The near $90 billion in new loans was in excess of the $83 billion of loans and leases non-current in payment of interest and principal at the end of the quarter.

Financial stocks have suffered their biggest decline since the 1990 recession and are currently valued as though we are in a recession. Hence, if we avoid one, this sector is likely to provide some of the best returns of any sector in 2008. It was in 1991 that the financial services industry in the US was last paralyzed by huge losses on commercial real estate and delinquent loans to Latin American countries. It was then that Saudi Prince Alwaleed acquired a major stake in what is now Citigroup. He is today its largest shareholder. Last week the Abu Dhabi (capital of United Arab Emirates) sovereign wealth fund acquired a $7.5 billion stake in the same company. We think history is repeating itself, and that this event will mark the bottom in valuation for the financial sector.

The $2.5 trillion of liquidity in sovereign wealth funds around the world, derived mostly from oil profits, is another critical component of our bullish outlook. This excess of investment dollars will inevitably work its way into and inflate financial assets. U.S. stocks have no competition on a valuation basis from competing asset classes like real estate and bonds. We think the U.S. stock market will be the ultimate beneficiary of all this global liquidity in the months ahead.

Investment results are produced by managers who study the real world on a day-to-day basis and have the intellectual understanding and experience to turn the daily information into an intelligent and gradually adaptive investment strategy. This has been and always will be our objective. We remain extremely bullish on the stock market over the short-to- intermediate term, and we believe stocks will soon discount several additional rate cuts by the Fed, resulting in new highs for the S&P 500 in early 2008. We have increased our weighting in financials on the presumption the bottom has been formed. As the U.S. economy continues to slow, large company stocks should continue to out-perform small and growth-style investing should outperform value.■

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