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Market Outlook

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Despite aggressive policy action taken by the Federal Reserve and Congress in recent weeks, including passage of the stimulus package that will distribute $100 billion in rebate checks as soon as May, the stock market continued to probe for a bottom from the lows established in January. The Dow Jones Industrials (-3.0%), Nasdaq Composite (-5.0%), and Standard & Poor's 500 (-3.5%) all finished lower for the month. Energy led sector performance with a gain of 6.7% as oil prices surged above $102/barrel, while continued write-downs of mortgage-related securities resulted in financials being the worst performing sector, posting a loss of 11.4%.

The markets are struggling for direction because investors are torn between hopes of an economic recovery later this year and fears of recession, stagflation and further losses on mortgage-related securities. Lawmakers are scrambling to rescue distraught homeowners with rate freezes, bankruptcy bills, government bailouts, and a variety of other proposals designed to stall a rise in the rate of delinquencies and foreclosures, stem the decline in home prices, and improve the availability of credit. The law of supply and demand will ultimately decide when and at what level the housing market will bottom. Achieving equilibrium will depend on future adjustments in home prices, wages and credit conditions. If home prices decline 10% in 2008, and another 10% in 2009, while wages rise 5% in both years, then median home prices will have reverted to their historical average of 2.7 times median income. Many are wondering why lending standards continue to tighten despite the decline in short-term interest rates. Wells Fargo announced last week that it is increasing the required down-payment to 25% for a jumbo loan origination. Why? Wells Fargo doesn't want to risk a delinquent borrower with negative equity in his home should the home value fall 20%. This may be a prudent move, but it only serves to exacerbate the already strict lending environment. Ironically, the faster home prices decline so that supply and demand reach equilibrium, the sooner credit availability will improve.

> What continues to feed our optimism about future stock market gains is the ever growing mountain of cash held by individuals and institutions that sits on the sidelines in money markets and CDs.

We believe the stock and bond markets have more than compensated for the losses that will ultimately be realized from the decline in housing and the resulting credit crisis. As an example, Alt-A (one notch below prime) mortgage securities are now trading at approximately sixty-cents on the dollar. These valuations assume that 80% of all Alt-A borrowers default on their loans, and that the recovery rate on the underlying collateral (the home) is a mere 50%. This is unrealistic by any measure, yet markets are forward looking and reflect expectations, which are rarely consistent with reality over short to intermediate periods of time (6-12 months). The mark-to-market losses, or write-downs, on mortgage-related securities that have plagued the financial sector and resulted in tighter lending standards will eventually lead to mark-to-market gains on the same securities as the rate of delinquencies and foreclosures decline.

The credit crisis that resulted from this housing bubble has similarities to the stock market crash that resulted from the tech bubble in 2000. Back then, the supply of stock was well in excess of demand at a time when corporate earnings were declining, and the Federal Reserve was raising interest rates and

removing liquidity from the financial system (limiting credit availability). Stock prices plunged, ultimately bottoming in 2003, yet eight years later the Standard & Poor's 500 is still 6% below its 2000 level. The housing market is likely to follow a similar timeline. Home prices peaked in 2006, and will probably bottom in 2009, before they begin a gradual recovery that will take years. One major difference with respect to the stock market is that if we strip out tech sector earnings from the S&P 500 back in 2001, corporate profits were still plunging 20%, but if we strip out financial sector earnings today, profits are rising double-digits. We would argue that stocks are currently as undervalued as homes are overvalued relative to their historical average (20%).

Many of Wall Street's most respected market strategists and economists have concluded that since the housing market is in decline and the American consumer is either ailing or on life support, the economy must be in, or near, a recession. Based on this assessment, the stock market poses too much risk for investors until there is an improvement in the outlook. We emphatically disagree. The economy grew 0.6% in the fourth quarter of 2007, and the most significant detractor from growth (-1.3%) was the biggest decline in inventories since the second quarter of 2003. Inventory rebuilding will now have a positive impact on growth in the first quarter along with exports. Consumer spending is on track to increase this quarter, and we have yet to see the boost that will result from rebate checks in the second and third quarters. The boom in demand for agricultural products from an emerging middle-class in developing economies has resulted in a 25% year-over-year increase in US farm sector output. While this sector represents a small percentage of the overall economy, it is on pace to add 0.5% to economic growth in 2008. Corporate earnings outside the financial sector grew 14% in the fourth-quarter of 2007, and we have yet to see the impact of 125 basis points of Fed easing that occurred in January. If we were going to have a recession this year, it would have already started.

Even if we assume the economy to be in a recession, this is not a good rationale for selling stocks. In January 1980, the economy entered a recession that did not officially end until July, yet the stock market (S&P 500) rose nearly 15% during that seven month contraction. The economy fell back into recession in July 1981, yet by the time the recession had ended in November 1982, the stock market was again higher than when the recession began. More applicable to today's environment is the 1990-91 recession tied to declining home prices and a collapse in credit. The stock market reached all-time highs in July 1990, just one month before the economy entered a recession in August. Despite the fact that the stock market bottomed 20% lower just one month later in September, the recession continued until March 1991. By that time, the stock market had rallied 25% to new all-time highs from the lows established in September 1990, when the economy was in the early stages of recession.

What continues to feed our optimism about future stock market gains is the ever growing mountain of cash held by individuals and institutions that sits on the sidelines in money markets and CDs. The rates of return on these instruments has plummeted from what was 5% to what will shortly be 2-3%, as the Federal Reserve continues to lower short-term interest rates. This mountain of cash has grown 25% over the past year to approximately $4.3 trillion. We believe this money will work its way into a stock market that gradually rises up in the months ahead as recession and inflation fears dissipate and the credit markets normalize. The US economy will continue to grow a sluggish 1% in 2008. The developing economies that have served as the global growth engine will also slow, but to a lesser degree, leading to overall global growth of 2-3%. While commodity prices may remain elevated, this slower growth environment should alleviate some of the inflation concerns that have depressed stock prices. ■

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