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Market Outlook

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Despite ongoing turmoil in the credit markets and record high oil prices, the stock market continued to climb, thanks to an additional 1⁄4 point cut in short-term interest rates by the Federal Reserve on October 31. The major market averages are now within striking distance of new all-time highs. The Dow Jones Industrials (+.4%), Nasdaq Composite (+5.8%), and Standard & Poor's 500 (+1.6) all recorded gains for the month. Technology led sector performance with a gain of 7.1%, while the financial sector was the worst performer, posting a loss of 2.0%.

While we expected and welcomed the 1⁄4 point cut in rates, we have serious concerns about the statement that accompanied its announcement, as well as the first signs of dissension amongst voting members over the recent move. The statement intimated that an additional 1⁄4 point rate cut at the December 11 meeting was unlikely, even though the Fed expects very weak housing data in the months ahead. The Fed stated that despite further weakness in housing, the risks of higher inflation and slower growth were "balanced," and that rising energy and commodity prices may lead to "upward pressure on inflation." We strongly disagree! Kansas City Fed President Hoenig went as far as to vote against the most recent 1⁄4 rate cut. This Federal Reserve Board's recent record of forecasting economic events does not instill confidence. We are reminded of Ben Bernanke's testimony before Congress in April, when he stated that the problems in the sub-prime housing sector were well-contained and not likely to spread. Perhaps Stan O'Neil, the now former CEO of Merrill Lynch, took him at his word. Merrill Lynch blindsided the market with a staggering $8 billion in losses on high-risk mortgage-related securities in the most recent quarter.

The initial report on economic growth in the third quarter was a robust 3.9% thanks to an improving trade deficit, an up-tick in capital spending on technology by corporations, and back-to-school sales in September. This is yesterday's news. Home and auto sales continue to deteriorate. Retail sales numbers for chain stores are abysmal. We had warnings from low-end companies like Walmart and Target, as well as high-end retailers like Coach and Tiffany. The Fed is not acknowledging the negative wealth effect that lower home prices will have on consumption – the life's blood of this economy. In our November 2006 Market Outlook we stated that "existing home prices are likely to post their first annual decline on record." Home prices have now declined 8.4% from their peak set nearly two years ago. We believe the combination of adjustable-rate resets, tighter lending standards, and rising delinquencies and foreclosures over the next year will lead to an additional 10-15% decline in existing home prices over the next one to two years. Because home equity has been the primary source of discretionary income for consumers since the current expansion began in 2003, this reversal of fortunes will have an unprecedented negative impact on 70% of the U.S. economy – consumer spending. The number-one risk facing this economy and Federal Reserve policy is slower economic growth.

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Conventional wisdom states that an increase in money supply combined with lower borrowing costs (fed funds rate) will lead to greater demand for goods and services and upward pressure on inflation. This has been the case in previous economic cycles and remains a key concern for the Fed. We think it is different this time. Food and energy prices will continue to rise due to the explosive demand for commodities from developing economies, but the impact on the rate of core inflation (minus food and energy) will be minimal.

The two largest components of core inflation are wages (labor costs) and rents (or homeowner's

equivalent rent). Brazil, Russia, India and China (BRICs) make up 12% of the global economy, while other developing countries total an additional 18%. The developing world, which accounts for 85% of the global labor force, is, on average, working for less than our minimum wage. This phenomenon has put tremendous downward pressure on wages in the United States. The fact that these developing economies are growing 6% per annum is putting tremendous upward pressure on commodity prices, which in turn increases food and energy costs in the U.S. As more discretionary income is diverted to necessary food and energy costs, it limits consumer demand for other goods and services, which in turn limits pricing power for U.S. companies. These companies then look to offset their limited pricing power, in order to maintain profit margins, by reducing labor costs. This results in either outsourcing jobs to developing economies or reducing wages and benefits in the U.S.

As the number of homes for sale has skyrocketed at the same time that demand has fallen, many homes are moving to the rental market, as indicated by the steady rise in the housing vacancy rate. The combination of lower home values and downward pressure on rents due to increased supply is likely to contain any increase in the rent component of the core inflation rate. The deflationary pressures on wages and rents will keep the rate of core inflation within the Federal Reserve's targeted range of 1-2%, paving the way for future rate cuts.

It is our contention that the economy will be much weaker than the current consensus view, that home prices will fall and consumer spending will slow much more than the consensus expects, and that the Federal Reserve will ultimately lower short-term rates to as low as 3% by next summer. The Fed must reduce rates at each of its next several meetings in advance of the inevitable decline in the growth rate of consumer spending in order to avert recession in 2008. We believe the Fed will indeed lower rates by 1⁄4 point at its December 11 meeting, but if they do not, we will consider modifying our investment strategy and take steps to recession-proof our investment portfolios.

The divergence in economic growth between the developed and developing worlds is at the core of our investment strategy. We are concentrated in those sectors that are less sensitive to a slowing domestic economy, and which derive a significant percentage of their earnings from current developing market growth and a weakening dollar. These include the technology, industrial, energy and material sectors. We are in the early stages of a long-term bull market in commodities that will last another decade, fueled by the ongoing industrial revolution in the developing world. While developing economies account for only 30% of the global economy, their central bank reserves exceed $4.4 trillion, compared to $1.4 trillion for the developed world. Much of this wealth is the result of profits from record high oil prices at the expense of U.S. consumers, but it is being spent on infrastructure projects abroad to the benefit of global U.S. companies, and invested in financial assets to the benefit of U.S. markets.

It is the explosive growth in liquidity around the world, combined with low inflation, a weakening dollar, and slowing yet positive corporate earnings growth, that underlies our bullish stock market outlook. It is paramount that the Fed continues to lower interest rates now in order to lower borrowing costs for consumers and corporations, and re-inflate financial assets to offset declining home values.

In an environment of slowing domestic economic growth, large global company stocks have historically outperformed smaller domestic-based company stocks. As earning growth shrinks, growth investing has historically outperformed value investing. We see both trends continuing for the foreseeable future. Despite mounting losses in the credit markets in the months ahead, we see long-term investment opportunities within the financial sector, as interest rates decline and negative sentiment towards the group peaks. ■

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