Strategic Financial Management Group

Investment Strategies & Insights

3rd Quarter 2007

Behind The Curtain

During the 3rd quarter, the financial markets experienced significant turmoil as rising defaults in sub-prime loans began to expose the risks of pooled mortgage investments that had been packaged by the brokerage firms. As the market for these securities dwindled, several large hedge funds in the U.S. collapsed. Within days, it became apparent that the credit saga knew no geographic bounds as portfolios around the world were tainted by the now illiquid investments. As hedge funds tried to quickly raise cash, stocks were sold off creating a correction in the equity markets as well. As the fear increased…and the possibility of a panic became real…all eyes turned to the Federal Reserve and its new chairman, Ben Bernanke, to see if they would come to the rescue.

With the waving of his wand, the new “Maestro” cut interest rates by 1/2% and the markets sighed in relief and stocks promptly rallied because the Fed had saved the day once again. However, it became very clear that the Fed was once again reacting to forces within the markets, as opposed to anticipating problems and getting out in front with proactive policies. It is apparent that the markets still respond to Federal Reserve actions, but one begins to wonder if the dynamics of the markets have now seized control, causing the policies to simply reflect what has already occurred. If so, the “wizard” is simply behind the curtain…pulling the levers and speaking loudly to proclaim that all is well in the land and that he is still in charge.

In The Shadows

The original “Maestro”, Alan Greenspan, has been back in the news as a result of his new book on his time as the Federal Reserve chairman. Mr. Greenspan faced many crisis during his tenure and responded in such a way that averted any disaster for the U.S. economy. But in the latter stages of his career, he began to encounter criticism for reacting too slowly, and once having done so, going too far in either raising or cutting interest rates. As a result, over the last ten years rates have swung dramatically and often created excesses in the financial markets….the last being the housing bubble.

Mr. Greenspan testified before the Senate prior to leaving the Fed that he had “no regrets” in reducing rates to the lowest point in nearly forty-five years. Now he is acknowledging that he did not appreciate, until recently, “the impact of adjustable-rate mortgages and their sub-prime character on the housing market”. Also, in previous comments, Mr. Greenspan has asserted that hedge funds serve a useful purpose in the creation of capital and are not in need of regulation since they make the markets more efficient. These statements appear naïve at best when the combination of the availability of sub-prime mortgages and the aggressive use of them by hedge funds led to the credit markets seizing up until central banks stepped in to provide liquidity.

In the aftermath of this crisis, what has emerged is a “shadow” banking system that is made up of the hedge funds and private equity firms that have created a new financing source that is different than anything seen in the traditional banking system for years. The question that remains is if Greenspan’s Fed was slow to grasp what was going on in the real estate and credit markets, does the new leadership totally comprehend what happens when the non-banking private system suddenly stops flooding the market with credit? The Fed will need to adjust its policies to a world dominated more and more by private capital flows and begin to act in a more anticipatory manner. This was Mr. Bernanke’s first trial by fire and time will tell if he will be more proactive than his predecessor.

“Do not meddle in the affairs of wizards, for they are subtle and quick to anger.”

J.R.R. Tolkien

Summary:

Domino effect of defaults on sub-prime mortgages ripple through credit markets.

Fed provides liquidity and cuts interest rate by 1/2%.

The impact of a “shadow” banking system of private capital is seen in the credit crisis.

Economy is slowing but ultimate outcome depends on how far housing market falls.

Strong employment & wage increases are key to soft landing in housing.

Global economy growing at twice the rate of U.S., favoring U.S. companies with international revenues.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.

So What Is The Economy Really Doing?

Inside the Economy

Inflation and Interest Rates

- General expectations for inflation have diminished as the U.S. economy has begun to slow.
- A short-term spike could occur in the 4th quarter due to year-over-year comparisons to very low inflation numbers in the last part of 2006.
- With the Fed's cut of .50%, short-term interest rates remain low but the 10 year Treasury yield moved up slightly.
- Initial indications are that the bond markets are dictating where interest rates fall and the Fed is reacting to the market.
- Rates could move upward for the short-term, but the longer-term trend should be downward.

Economic Output and Direction

- This downward trend in rates will be in response to our slowing economy.
- The leading economic indicators have been declining over the last several months, but sub-par growth is expected as opposed to recession at present.
- Risks have increased, but the continued strength of the global economy could be enough to limit the U.S. to a mid-cycle slowdown.
- The impact of the slumping housing market and the related sectors of the economy remain the wild card.
- If the landing is soft….and soon…then a recession could be averted.

Business and Consumer Indicators

- The service sector continues to be the source of strength for the U.S. economy.
- New job growth has slowed, but the unemployment rate remains at a favorable 4.7% level.
- This is reflected in the continued increase in personal income…up 6.6% year-over-year.
- More personal income has translated into stronger than expected retail sales showing that the U.S. consumer is alive and spending.
- The expected drag on consumption by the slumping housing marked could be offset by high employment and rising wages.

Inside The Markets

The Stock Markets

- The U.S. markets rallied from a –9% correction in mid August to a positive +2% return for the quarter.
- The sell-off was spurred by problems in the hedge funds that were forced to liquidate stock positions to raise cash to cover their problems in the sub-prime mortgage fiasco.
- As liquidity returned to the credit markets and the Fed cut rates, buyers returned to the equity markets worldwide as the international markets were up +2.5% for the 3rd quarter.
- U.S. companies that have demonstrated the strongest earnings are those with substantial revenues from foreign markets.
- As a result, we favor large cap U.S. companies with international revenues that are able to take advantage of the continued global expansion and benefit from the falling dollar as well.

The Bond Market

- We have frequently commented on the absence of investor concerns over the risks of owning lower credit quality bonds.
- As panic gripped the credit markets when the magnitude of the liquidity risks in the sub-prime were exposed across the globe, we think many investors learned a costly lesson.
- We believe that quality is the key in our bond holdings, whether it is in the U.S. or globally.
- Foreign bonds should continue to provide better total returns as the dollar remains weak against foreign currencies.

Commodities & Alternatives

- Commodity prices pulled back during the stock market correction but bounced back quickly to reach new highs for the year as oil prices moved above $80 per barrel.
- We believe that the long-term uptrend in prices remains, but using more indirect investments should reduce potential risk.
- The analogy that is used is that instead of buying the gold…buy the picks and shovels.
- Consequently, we are currently reviewing opportunities in agriculture, infrastructure, water, and alternative energy.

Closing Thoughts

We have known that with the increased flows of capital into the hedge funds and private equity funds over the last several years that the impact on the financial markets would be increased as this money was deployed. There are hedge funds that employ conservative strategies that are geared to provide absolute returns and reduce volatility. However, many funds that are geared to produce high-octane returns often have to take on the risk of debt to be able to provide this performance. The danger of this strategy came out of the shadows with the recent collapse of several hedge funds.

The domino effect resulted in tremendous losses for the brokerage firms that created the investment vehicles… that packaged the low-credit mortgages... that sold them to the hedge funds…that borrowed against them at the banks to leverage their other investments. When the banks realized that the value of their collateral was not what they expected, they called the loans and the dominos began to fall.

After recent announcements by the world's biggest banks, it is now projected that losses related to the recent credit problems will be more than $20 billion. On the brokerage side, Merrill Lynch alone projects a $5.5 billion write down when it reports 3rd quarter financial results. The magnitude of the losses incurred by the traditional banking system only points to the enormous amounts of capital that have been moving behind the scenes in funds that are not subject to any government oversight. Until the hedge fund industry is regulated, the systemic risks, and associated volatility in the markets, will be difficult to anticipate and react to.

However, the bigger issue is how these credit market problems will impact the housing market and the availability of mortgages to marginally qualified borrowers. Many of the mortgage originators that received their funding from outside sources have simply disappeared. The vast majority of new mortgage applications will now return to the banks. Having been stung by recent losses, the loan qualification standards have been raised significantly. All of this puts additional pressure on a housing market that has been in steep decline for well over a year.

Additionally, a large percentage of the mortgage resets (adjustable rate mortgages) will come up in the first half of 2008. If values have fallen too much for those that were late buyers in the real estate boom, the likely outcome will be to simply walk away from the property. Rising foreclosures will also put downward pressure on home prices.

The good news is that not everyone bought at the top of the real estate market. Although home prices have declined by a record amount in the last year, real house prices have still risen by 10% in the last four years. As a result, many homeowners have substantial equity in their homes and can afford to ride out this downturn in the market.

The concern for those homeowners is that they remain employed and their income continues to keep pace with inflation. We believe that the key indicator to watch in the coming months will be the employment data and personal income. Our overall economy remains relatively strong, although slowing. If the housing market can come to a soft landing by the end of 2008, then we believe the financial markets should continue in a positive direction.

The continuation of the global expansion also offers opportunities for not only foreign companies, but for U.S. companies that are competitive abroad as well. The continued development of the emerging economies with their large populations will burden our natural resources as they develop their infrastructure. This translates into investment opportunities that we will continue to evaluate and implement in our portfolio design.

Best Regards,

Craig Greenway

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is written by the scribes at Strategic Financial Management Group.

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