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Quarterly Investment Outlook

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Sub-Prime Chapter Two: Rescuing the Credit Markets

In our September Outlook, we warned of foreclosures on Main Street creating serious problems for Wall Street. During the just-ended quarter it's become apparent that these problems extend not only to Wall Street but beyond to central banking systems across the globe. A number of major banks, brokers, and bond insurers have posted significant losses as they see their sub-prime related holdings plummet in value. The financial engineering and borrowing related to sub-prime paper has exacerbated the problem, erasing massive amounts of bank capital. As we begin a New Year, there is no bottom to the housing market in sight and experts can only speculate as to the extent of the damage done to the Financials sector. While the banks tally up the damage, the Fed, the Treasury, and the foreign Central Banks are working to prevent a problem in the credit markets from becoming a financial crisis. It will be at least several quarters before we'll know how successful their efforts are and how much of the pain will spread to the broader economy and equities markets. In the meantime, we have our own idea as to whether there is a US recession and a global slowdown in our future.

No Shortage of Bad News

Here's a quick review of where we are today: Foreclosures are at record levels and increasing; Home inventories are building to record levels as well; Banks and brokers who hold sub-prime paper are writing those assets down and seeing both their capital and lending capacity depleted; Those that built their houses of cards on insuring and leveraging CDOs and SIVs are on the verge of collapse. **The result? Too many homes for sale, too few buyers, and too many banks with too little money to lend.** What many had hoped would be a housing price decline isolated to the "hot" markets of several years past is spreading across the US as home inventories swell to record levels with prospective buyers unwilling or unable to make a purchase. **The effects of the housing decline are spreading virally through the mortgage-backed securities markets and doing significant damage to the income statements and balance sheets of financial institutions around the world.**

It's become a daily occurrence. Whether from a major bank, broker, insurer, home builder, or mortgage lender, the news is bad and the conclusion incontrovertible: The Real Estate Bubble has burst, triggering a crisis in the credit markets that could have far-reaching effects. At this time, no one is quite sure as to the extent of the damage and what that will mean for the economy. Opinions range from those who believe the losses will slow only the US economy to others who believe we are already in a recession, one that will spread to the rest of the world. As usual, the truth lies somewhere in between. **We believe the US economy has tipped into recession in recent weeks and will slow, but not derail, the global expansion.** Our best bet is that we'll see low or negative growth begin to surface in the first quarter of 2008. The length and severity of the downturn will be defined by what the Fed, the Treasury, and the Central Banks are able to do over the next several months. Together, they are lowering the cost of borrowing and aggressively pumping capital into the banking system to provide badly needed liquidity. In addition, a rescue plan to aid homeowners is in the works. We believe the banks, not wanting to be in the real estate business, will be motivated to rework lending agreements with distressed borrowers. Our biggest fear is that Congress will attempt to ride to the rescue in an election year with poorly crafted legislation that subverts market forces. If so, we could be in for a long economic winter.

Buying Time for the Credit Markets

With each passing week, it becomes more apparent that the best brains in the business are struggling to find a way to unwind the many layers of leverage and liability that have come back to bite the mortgage and banking industries. As home values fall and foreclosures increase, lenders are naturally reluctant to mark their sub-prime collateral to the market. They hope that time will heal the real estate market and their balance sheets. This is the path that Japan took to avoid the consequences of its banks' poor lending practices. The result was a decade-long recession and lower stock prices caused by credit concerns and liquidity constraints. Their economy languished despite prime lending rates dropping to below 1%. Capital was cheap, there just wasn't a good reason to borrow in a no-growth economic environment. This is what our Fed and Treasury are intent on avoiding. While continuing to pump liquidity into the system, they plan to temporarily postpone resets on adjustable rate loans. This should buy time for banks to quantify the damage and allocate losses in an orderly manner. **We believe they will succeed in preventing a dislocation in the credit markets from becoming a financial crisis that cripples the US economy and creates panic in its markets.**

To be sure, there is value in the properties that secure sub-prime mortgages. The primary lender on the underlying property or the buyer of that first position mortgage is at the top of the food chain and should recover some value on the foreclosure and sale of the property in the event that the borrower defaults. For buyers who bought securitized mortgages or leveraged them to make other investments, a small drop in the value of the property can translate to a much bigger problem. Leverage is a sword that cuts both ways. It's a friend when expectations are realized and your worst enemy when they're not. For those who pledged sub-prime structured products as security for loans, a small number of defaults can wipe out their entire equity interest and worse, require that they pay the lender to restore the value of their collateral. **Until banks and brokers mark those assets to the market and accurately disclose the value of the sub-prime collateral they hold, there can be no recovery in the Financials.** Compelled by the auditors and Financial Accounting Standards, the banks will likely have aired out their dirty laundry by the close of Q1. At that time, we should then be able to venture a guess as to the extent of the damage and factor that into our projections for the period following the downturn.

There's a Light but How Long is the Tunnel?

Opinion is divided among experts over the prospects of recession in the US. We are among the minority who believe we are already there and are just waiting for the data to confirm it. There are others who believe the consumer will continue to spend and allow us to skirt recession. We're not buying it. With oil prices being what they are, we see little difference between negative growth and 1% growth and believe consumers and investors won't appreciate the difference either. We think the downturn looks something like this: The Real Estate bubble has burst and foreclosures are at record levels; The banks are hit with record losses as they write down the value of their mortgage-related assets; Homeowners, already stressed by record high oil prices and higher food costs, see their homes depreciate in value and rein in spending; Lower consumption tips the US economy into recession and slows the global expansion; The Fed, seeking to avert a financial crisis, is forced to provide the banks with liquidity by lowering rates while the Treasury prints more money; Once the crisis is averted the Fed could be forced to raise rates to combat the resulting surge in inflation and arrest the fall of the dollar. **We believe this could play out over the next 12 months or perhaps even less, depending on the amount of losses reported by the banks at the close of the current quarter.**

How is this likely to play out in the equities market? We believe a good portion of the pain has already been priced into stocks in the last several months. Financials and Consumer Discretionary companies have led the broad market down to more than 12% off its highs. The Industrials and Basic Materials are beginning to follow as the reality of recession sets in. We'd look for Technology, Telecom, Energy, and Foreign stocks to sell off to a lesser extent. Defensive sectors such as Consumer Staples and Healthcare stocks offer the best chance to out-perform the indices in 2008. Given what we know today, we expect the Financials to regain their footing by mid-year as mergers and capital infusions from foreign investors sort out the winners from the losers. Those banks and financial companies that survive should thrive. **In the second half of '08 we would expect those stocks, along with Technology, Industrials, and Consumer Cyclical issues to lead the market back to the upside as it discounts the beginning of recovery for the US economy.** However, the question still remains: Will today's market correction become tomorrow's bear market? The answer depends on how aggressively the Fed provides liquidity and how quickly the banks can repair their balance sheets. We should have an answer to those and other questions by quarter's end. Stay tuned for Chapter 3.

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