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Perspectives

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The just-concluded quarter was in many ways a louder echo of the first quarter, when subprime mortgage woes first interrupted the long-running bull market in risk assets. While the winter witnessed only a brief seizure that was contained within the subprime credit market, August saw fear spread across asset classes and geographies. With risk aversion rising to the point where even creditworthy borrowers were being denied access to loans, the Federal Reserve felt forced to act, first slashing the discount rate (the interest rate at which Fed member banks may borrow directly from the Fed) by a half percent in mid-August and then cutting both the federal funds rate and the discount rate by a half percent a month later.

As the epicenter of the third quarter's financial earthquakes was located squarely in the riskiest areas of the credit markets, equities escaped relatively unscathed, with the nadir approaching, but not exceeding, the 10% loss defined as a "correction." With capital flowing as far away as possible

from the U.S. housing market, foreign stocks, especially emerging market issues, performed particularly well. The MSCI Emerging Markets index soared 14.4%, and the MSCI EAFE index of developed international markets rose 2.2% during the quarter. The S&P 500 index of large capitalization stocks closed the quarter with a total return of 2.0%, while the Russell 2000 index of small caps fell 3.1%, hurt by its proportionally higher exposure to bank and retail stocks.

Treasury bonds were beneficiaries of the flight from risk, with the benchmark 10-year note finishing the period yielding 4.59%; the 2-year note, more sensitive to changes in monetary policy, saw its yield fall even further, ending at 3.99%. Meanwhile, commodity markets received a lift from a declining dollar and continued perceived strong global demand. September saw record highs for everything from crude oil to wheat.

YES, WE HAVE NO POTATOES

In our last letter, we noted that credit can remain nominally inexpensive, but if lenders are not willing to lend, then the price of money becomes moot. Such a situation abruptly manifested itself in August, resulting in a virtual shutdown of certain segments of the bond market. The sharp interruption in the availability of credit, despite ample bank liquidity, reminded us of an old Hungarian joke told during the days of Soviet hegemony over Eastern Europe:

A customer asks a private merchant how much a kilo of potatoes costs. The merchant replies: "30 forints." "What!" the customer exclaims, "across the street, in the state shop it is only 8 forints!" "Well," says the merchant, "then why don't you buy them in the state shop?" "Because they don't have any potatoes," comes the ready answer. The merchant scratches his head. "Yes, yes," he says, "if I didn't have any, I too would sell them for 8 forints."¹

It has become apparent that one of the downsides of the new era of risk slicing and sharing is a lack of transparency as to the ultimate risk bearers. Indeed, the damage is emerging in some unexpected places (*e.g.*, regional German banks). While the Fed was more than content to let ostensibly sophisticated investors take their lumps, once the crisis crossed the line from financial to economic, it coerced the Fed into action. As we write, it appears that the twin rate cuts have provided some relief, achieving the Fed's primary goal of avoiding a 1998-style "no potatoes for sale" bond market.

Chairman Bernanke's work may not yet be done, but the macroeconomic backdrop appears conducive to further non-inflationary rate cuts. U.S. residential housing is in one of the worst slumps since the Depression, and housing costs comprise 30% of the Consumer Price Index. The intense competitiveness of the global traded goods marketplace has not allowed raw materials price increases to seep into consumer prices. Furthermore, the dollar, though depreciating, has not yet reached purchasing power parity with other major currencies, signaling that its decline is not inflationary.

Meanwhile, the Fed has plenty of dry powder left: at 4.75%, the federal funds rate is well above projected nominal GDP

growth over the coming year, an indicator that monetary policy remains restrictive. Employment, the biggest driver of consumer spending, is softening but not rolling over, as corporations did not rush to hire during the expansion. In sum, the odds favor the U.S. economy skirting a recession.

DECOUPLING

While the domestic stock markets as a whole have embraced the Fed's change of heart, the criteria, going forward, for companies with advancing share prices likely will be more selective. As economic growth in the rest of the world continues to outpace that of the U.S., and support for the dollar, in the form of higher interest rates, continues to slip, investors are increasingly turning to companies that garner a greater portion of sales and profits from overseas activity, a trend that we believe has yet to run its course despite its increasing popularity.

The current economic cycle differs from past cycles, in that non-U.S. activity is less dependent upon and therefore less correlated with U.S. growth. Nascent domestic demand in the Far East coupled with a resurgence of domestic demand in Europe have lessened the impact of a U.S. downturn on the rest of the world. The fact that stronger foreign currencies keep interest rates lower than they otherwise would be reinforces the effect

while also stimulating demand for U.S. exports. BCA Research notes that "according to national income data, the profits of domestic based companies increased by 4.2% in the year ended June 30, while the earnings of U.S. corporations' overseas subsidiaries rose by 14.7%." And since the 4.2% figure includes earnings from exports, the gap is actually understated. Consequently, our equity portfolios remain positioned to favor companies with worldwide end markets.

CREDIT OPPORTUNITIES

Credit spreads have retraced somewhat after flaring suddenly during the subprime storm. Unlike the first quarter's tempest, non-asset-backed investment grade securities were also negatively impacted. Should economic growth continue to decelerate, the preconditions appear to be in place for better returns in the fixed-income markets, particularly in investment grade corporate bonds, where our buying currently is concentrated for non-taxable accounts.

- Seth Hieken

¹ Volgyes, Ivan, *Politics in Eastern Europe* (Chicago: The Dorsey Press, 1986)