



Boston  
Washington, D.C.  
West Palm Beach  
Naples

## Perspectives

January 18, 2008

Brian Katz, Chief Investment Officer

Seth Hieken, Managing Director

If one were forearmed with the following financial headlines from 2007, one might logically have spent the year invested solely in cash. Yet of the three major domestic asset classes, cash proved to be the worst performer. Despite a rocky fourth quarter, the S&P 500 finished the year with a total return of 5.46%, while 10-year Treasury bonds returned 10.27% and cash (represented by 3-month Treasury bills) lagged with total appreciation of 4.98%. Here is some of what investors had to absorb last year:

- The first nationwide drop in home prices since the Great Depression
- Gridlock in large swaths of the bond market, including the critical commercial paper market
- Multibillion-dollar writedowns of mortgage securities by some of the most prominent financial institutions in the world, including Citigroup, Merrill Lynch, and UBS
- Widespread loss of confidence in counterparties to interbank lending, leading to a severe widening of spreads in interbank lending rates
- Questions about the Federal Reserve's understanding of the depth of the credit problems and

the effectiveness of its monetary policy (complacency)

- Oil approaching \$100/barrel and gold crossing \$800/ounce
- The dollar losing almost 7% of its trade-weighted value during the year
- The first year-over-year decline in quarterly S&P 500 profits in over five years

The reasons for the apparent anomaly are as numerous as the above list and lend insight into how markets may behave in 2008.

### FINDING FOXHOLES

So how did stocks largely sidestep the subprime salvo and its concussive impact? A simple rule of thumb in 2007 was that the farther away from U.S. housing-related activity a security was, the better its performance. Most issues were outside the blast range and turned in solid profit growth. Operating profits of the S&P 500 excluding the financial sector advanced +6% during 2007, including an estimated +11% rise in the fourth quarter. The Energy sector, arguably the most distanced from the fallout, had the highest total return (+34.4%), boosted by both the demand-driven rise in oil prices

and the weaker dollar, while Financials absorbed the biggest blow (-18.6%). The only other sector in the red for the year was Consumer Discretionary, hounded by worries that falling home prices will dampen spending growth.

As is typical during tumultuous periods, investors flocked to the relative safety of U.S. Treasury bonds. While government bonds put in their best relative since 2002, fixed income securities with even a modicum of credit risk were trounced. Credit spreads are waiting for the all-clear signal from the Fed in the form of an aggressive rate cut response before another tightening phase begins.

The pivotal question for the direction of stock indices this year is whether we face a recession (or indeed are already experiencing one) or whether we are in the midst of a mid-cycle slowdown akin to the type experienced in the mid '80s and mid '90s, when growth nearly halted before recovering to extend the cycle another several years. More succinctly, will the healthy segments of the economy succumb to the housing/structured finance contagion? If the economy finds its footing with the help of monetary policy, there is enough valuation support to drive stock prices higher despite the near-term deterioration in profits.

To spice things up further, toss in a Presidential election, which for the first time in 80 years features no incumbent President or Vice President vying for the top job. All the leading candidates seem to be running on a platform of “change,” which could include allowing the 2003 tax cuts on capital gains and qualified dividends to expire, giving investors one more potential plague.

### COUNTEROFFENSIVE

The consensus forecast has been that the U.S. economy would experience only a growth scare (mid-cycle slowdown), not a recession; that projection is being put to the test by recent economic data and a cautious and apparently divided Fed. There remains solid support for a return to uptrend, however. Consider that:

- The greater the distance from the U.S. housing and structured finance markets, the better the fundamental outlook, and most of the global economy still resides outside the blast zone.
- Corporate balance sheets, including those of banks, were historically strong entering the debt downturn.
- The labor market has held firm; the U.S. economy has added jobs for 52 consecutive months. Corporations did not hire at the usual post-recession pace in 2003 (recall the “jobless recovery”) and therefore are not under pressure to pare payrolls.
- The Fed is aware of the risks to the economy and is easing monetary policy; the primary cause of bear markets is excessively tight monetary conditions. The latter may seem an attractive way to

“purge the excesses” from the financial system and punish speculation, but such an economically grueling gambit would be politically unpalatable, especially in an election year.

- Global monetary policy is also accommodative, and central banks are coordinating efforts to promote alternative liquidity sources to relieve the stress on interbank funding.
- The housing woes are profoundly deflationary, and traded goods markets remain highly competitive, minimizing the probability that higher oil and crop prices will mushroom into broad-based inflation. Inflation expectations, as measured by the spread between the 10-year Treasury and the 10-year inflation-protected Treasury, have remained anchored within a range between 2.3% (the current reading) and 2.7% for more than four years.
- The dollar is stabilizing, as its decline against other developed market currencies has acted as a brake on those economies, tilting expected future growth back toward the U.S.
- Foreign capital is increasingly flowing into the U.S., seeking attractive returns. Middle Eastern and Asian sovereign wealth funds (SWFs), flush with cash from petrodollars and trade surpluses, have pumped almost \$18B into Citigroup, Merrill Lynch, UBS, and others, with word of more to follow as we write. A main concern of commentators who fret about a weakening dollar is that it will divert the flow of capital away from the US, but the opposite appears to be occurring thus far; the Treasury Department just reported that net foreign capital inflows jumped

62% in November. It is critical to note that none of the sources of excess savings have an incentive to stop funding our current account deficit.

- Domestic equity valuations are alluring. The S&P 500 is trading for less than 14 times estimated 2008 earnings. While we readily concede that earnings estimates may come under additional pressure as the economy slows, there is a cushion for stocks to absorb more bad news. Large cap U.S. stocks, in fact, sport their most attractive valuations relative to overseas stocks in at least ten years.
- Cash is again building on the sidelines. Reminiscent of the early years of the decade, assets in retail and institutional money market funds are swelling to record levels. As the Fed continues on its easing path and short-term rates erode, investors will be pressed to seek higher returns.

On balance, we continue to favor the soft landing scenario, but we are acutely aware of the spreading economic risks and are positioning portfolios incrementally more defensively. Nevertheless, we are constructive on the intermediate-term outlook for stocks, though we expect the winners to narrow further. While we recognize that elements of the above list are backward looking, the endpoint of additional economic malaise will be very low equity valuations coupled with very low short-term interest rates, a potent combination for higher stock prices. We would be unsurprised if 2008 proved to be a more active year than is typical for us given the enhanced uncertainty, and we remain ready to adjust portfolio strategy as circumstances and data change and evolve.

- Seth Hieken, CFA