

Perspectives

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Global markets underwent the most wrenching fluctuations in a year following some relatively bearish economic remarks by former Federal Reserve Chairman Alan Greenspan, a one-day plunge in the Shanghai stock market, and the much-hyped meltdown in the market for less creditworthy, or subprime, mortgages. After an uninterrupted rise since last summer, the equity markets' reintroduction to risk was less than graceful, but the fall proved brief and failed to meet the accepted definition of a "correction," a loss of more than 10%.

Nor did the downturn dislodge the established pattern of domestic large-cap stocks underperforming their smaller and international counterparts. For the first quarter, the S&P 500 index eked out a gain of 0.6%, while the small-cap Russell 2000 index rose 2.0%. The MSCI EAFE index of developed international markets closed up 4.2%, while the MSCI Emerging Markets index added 2.1%.

U.S. Treasury bonds proved the only safe harbor during the decline, with the yield on the 10-year note dipping as low as

4.50% when stocks were at their nadir. The bellwether note ended the quarter yielding 4.65%, a shade below the 4.71% year-end figure. Oil, too, was buffeted by demand and supply crosswinds, falling more than 20% to below \$50/bbl at one point in January before rebounding strongly to finish at \$65.87, up 8%.

For all the *sturm und drang*, the only real turnabout came in the market for federal funds futures, where traders speculate on the direction of short-term interest rates. Until late February, the economy was surprising on the upside, leading traders to believe that the Fed was as likely to raise rates as to lower them. Then the subprime storm hit, and with it came a deluge of more pessimistic forecasts, markedly lifting the odds of a fed rate cut to relieve the stress.

The Fed itself further clouded the picture with its statement released in mid-March that omitted its prior bias toward raising rates but again noted that its chief antagonist was stubbornly high inflation. It appears to us that the Fed is positioning itself for maximum flexibility, with a keen eye on

the resolution of the subprime situation.

FROM THE SUBPRIME TO THE RIDICULOUS?

"The sublime and the ridiculous are often so nearly related that it is difficult to class them separately." - Thomas Paine

Absent the support of continuously rising home prices (and common sense), subprime quickly turned ridiculous, with forged borrowers' signatures, false loan records, and fees that were never disclosed to customers leading to accelerating delinquencies and the widespread failure or forced closure of originators targeting the less-creditworthy. The confluence of rising home values, lax lending standards, a mortgage-backed security market fed by an insatiable appetite for yield, and investor complacency nourished the rise of the subprime mortgage market from tiny afterthought to headline newsmaker. While we shed no tears for lenders such as New Century Financial and NovaStar Financial, the debacle is setting up as an acid test of the latest innovations in risk slicing and sharing.

Still, there is little unique about the current circumstances. Virtually every interest rate cycle peak has been defined by some form of financial crisis. In 2000, it was the collapse of the technology stock bubble and the IPO market. In 1998, it was the Russian debt default and the Fed-engineered bailout of hyper-leveraged hedge fund Long Term Capital Management. In 1994, it was the Mexican peso crisis and the rogue trading of the Orange County, CA treasurer.

We find the last period, and subsequent events, most relevant to today's markets. Then, as today, the economy was recovering from a devastating downturn at the turn of the decade, and inflation was creeping higher cyclically. The Fed was preemptively raising interest rates in a bold attempt to restrain inflation's momentum without choking off economic growth, and it was ultimately successful.

While there are no guarantees that history will repeat this time around, we note that pricing power has quickly evaporated upon any slackening of demand, allowing the Fed considerable leeway to lower rates going forward if economic conditions weaken. In 1995, the Fed began slashing rates mid-year and stocks responded powerfully, with the S&P rising 38% for the year. We are certainly not predicting returns on that order of magnitude, but we made the case in our January letter for an expansion of stock valuations that could carry us through this period of slower profit growth.

SUPPLY SIDE SUPPORT FOR STOCKS

While profits of S&P 500 stocks are forecast to rise less than 8% this year, snapping a string of double digit advances dating back to 2002, there remain several support mechanisms in place for stock prices. Most critically, returns on invested capital continue to exceed the cost of capital, while access to capital remains unimpeded, stoking merger and acquisition (M&A) activity. M&A transactions set yet another record in the first quarter, totaling \$1.1 trillion worldwide (\$437B in the U.S. alone – the equivalent of a \$4.9B company being taken over every day!).

Additionally, corporations are using excess cash flow to repurchase shares (\$548B in 2006 according to Federal Reserve data); when combined with cash M&A and offset by IPOs and secondary issuance, the net supply of publicly traded domestic equity shrank nearly 5% in 2006 and is on track to shrink further in 2007 (*source: Morgan Stanley research*).

Other sources of support for stocks are the feeble competition from other asset classes (bonds, cash, real estate), the inherent stabilizer of lower long-term rates in times of distress, and the desynchronization of the world economy (Europe is accelerating, while Asia continues to grow smartly, supporting U.S. exports). Before the equity valuation expansion case can gain traction in the market, however, investors must be willing to extrapolate future

economic growth; *i.e.*, recession fears must fade.

Ironically, the likely catalyst for such an occurrence is diminishing growth itself, coupled with decelerating inflation. One silver lining of the housing troubles is that the rent factor of the Consumer Price Index, which accounts for about 30% of the benchmark, is quite likely to decline. Lower inflation readings would allow Fed Chairman Bernanke to reduce rates if necessary without sacrificing his inflation-fighting credibility, and would also encourage longer-term rates to fall.

Still, we appear to be some distance from the unfolding of this scenario. The unemployment rate, the metric most closely correlated to consumer spending, just fell to a six-year low, and hourly wages are advancing at a 4%+ annual clip, figures not normally associated with recession. As such, the Fed is quite content to let the subprime strait self-correct for now. Unless the mess causes credit to dry up outside the mortgage sphere (and there is no evidence that this is happening; commercial banks are well-reserved and in good shape to ride out the storm), the Fed probably will not act again until inflation and economic growth have established a clear direction. In the short-run, that may cause risk tolerance levels to swing unpredictably, much as they did in late February. Nevertheless, as long as recession can be avoided, the outlook for stocks seems bright.

- Seth Hieken