



QUARTERLY MARKET COMMENTARY

Second Quarter 2007

Please take time to consider the following: “It’s different this time.”

I am always reluctant to accept a “new era” explanation for market behavior that defies historic precedent. At the same time the data demand that we acknowledge unique conditions in evaluating the current market environment. In fact, those conditions provide a framework for potentially explosive stock market moves, either up or down, in the months and quarters ahead. Current conditions should force all investors to examine carefully their personal appetites for speculation.

Interest rates rose throughout the second quarter, leading to losses in all but the shortest maturity bonds. Stocks recovered from a flat first quarter with a good performance in quarter two. That strength now extends to four and one-quarter years the length of the stock market’s advance without even a single correction of 10% or more. This is the longest such stretch in more than a century, fueling a very high level of investor optimism and leading individuals and institutions worldwide to assume increasingly greater levels of risk. Until the recent disruptions in the subprime mortgage market, assumption of risk in almost all asset categories has been rewarded, not penalized. Sober investors have to evaluate the probability of that phenomenon continuing.

Underlying the persistent increase in asset prices worldwide is the greatest expansion of liquidity in history. Contrary to what most people hear and read, prices aren’t reaching record levels because of earnings or economic growth. Throughout the decades, market prices have shown low levels of correlation with economic strength, the growth of corporate earnings or the level of interest rates. Because those factors seem logically related to stock price movements, it’s easy to believe in the relationships when commentators refer to them. When, as frequently happens, the correlations break down, commentators shrug it off with some variation of the claim that the news was already factored into the price. In the short run, what really moves prices in either direction is investor attitude and the availability or lack of liquidity. Both of those factors are currently hitting on all cylinders.

Not surprisingly, investor attitudes are strongly positive after persistent price levitation for more than four years. And most factors that have promoted the liquidity explosion are still in full bloom. If those conditions continue, market prices have no upside limit.

All but the truly inexperienced, however, know that markets and the factors that affect them are cyclical. While we all look for that which will foretell the future, looking back will help us to identify typical investor behavior triggered by specific conditions and the consequences that characteristically follow.

The central banks of the world, including the U.S. Federal Reserve, continue to increase the money supply aggressively. While domestic inflation, which is the normal concern in a loose money environment, remains a bit above the Fed target range, the world has so far been able to avoid the more virulent inflation that has often led to restrictive central bank action that has halted stock market advances.

Lenders remain eager to lend. Although lending standards have tightened somewhat due to the increased incidence of delinquent and defaulted real estate loans, most lenders are still aggressively seeking borrowers. A compounding of the problems in real estate or increased concern with the ability of hedge funds to repay their loans could, however, restrict the availability of loans. Just as the expansion of liquidity contributed to rising asset prices, a restriction of that supply could depress prices.

Borrowers, especially hedge funds and private equity firms, appear to have an unquenchable thirst for more capital with which to make levered market bets. That trend plus other corporate mergers and acquisitions continue to provide strong positive support for stock prices. The history of prior M&A booms, however, has not been pretty. Despite great hope and expectation at the time of takeovers, about two-thirds of such deals fail to add shareholder value in the long run. We don't seem to learn from experience, and the longer a boom goes on, the more speculative the deals tend to become.

The current M&A boom is the third in the last 50 years. The first two, in the late 1960's and the late 1990's, preceded the biggest stock market declines since the Great Depression, the declines from 1969 to 1974 and from 2000 to 2003.

Even earlier history saw the same sequence. The era of the "Robber Barons" around the turn of the 19th to the 20th century led to the long weak stock market cycle from 1901 to 1917. Late in the "Roaring 20's" the United States experienced unprecedented investor euphoria accompanying all sorts of M&A related financial engineering. The most savage stock market decline in U.S. history followed with equities still down by half 13 years later.

Participants in today's M&A boom certainly hope for a different sequel. While all such booms have ultimately ended badly in this country, they often continue far longer than common sense would indicate to be likely.

Throughout modern history, the Federal Reserve has viewed its role to include dampening excessive financial speculation. In addition to influencing short-term interest rates, the Fed has directly affected stock market speculation by setting margin rates. In recent decades it has left the amount that can be borrowed to buy stock at 50%. The explosion of derivative creation in this decade, however, has made a mockery of the margin rate. For example, through a total return swap, one might be able to buy the price change in \$100 of a given stock for \$5, compared with having to put up \$50 to buy the stock on 50% margin. Warren Buffet recently commented that the widespread use of such swaps makes the leverage that preceded the 1929 crash "look like a Sunday-school picnic."

Such speculation is hardly limited to stocks. Defenders of the vast proliferation of derivative securities point to their potential function as risk hedges. Far more derivatives exist, however, than are necessary to hedge against risk. The vast majority serve no economic purpose, but rather

serve as chips to facilitate gambling. For example, there might be \$1 trillion of credit default swaps on just \$20 billion of a large corporate finance issue, or 50 times the amount of the bond issue.

The urge to gamble is perhaps most evident in the emerging stock markets of the world, China most prominent among them. The Chinese market is up about 250% since 2005 with perhaps 70% of the listed companies not fit for investment by Western security standards. And this is far from the first price surge in emerging markets, although it is the largest. Within the past decade and a half there have been two prior price advances of 100% or more. In each of those earlier instances the entire price gain was erased in a year and a half or less. The current price surge need not end like its recent predecessors did, but the danger level is extremely high with Chinese price-to-earnings levels somewhere between 38 and 55 according to various analysts.

Investors went through a similar suspension of belief in traditional fundamental measures about 20 years ago. In the mid to late 1980's the Japanese stock market surged upward, reaching unprecedented levels of valuation. Apologists justified the action because Japan had apparently developed the new industrial paradigm, dominating such industries as automotive production and electronics.

At our 1987 investment conference, I admitted my lack of expertise regarding Japanese stocks but stated that the price surge and then current valuation measures clearly made no sense and that lower prices would certainly be seen. Prices continued higher. Undaunted and still firmly convinced that such conditions could not continue, I made the same forecast at our 1988 conference, then again in 1989. Nothing stopped Japanese stocks until they reached the 39,000 level on the last trading day of 1989. Then began a more than 80% decline over 13 years. Prices today are still below the levels when I issued my initial warning over 20 years ago.

More recently, in the late 1990's, I offered similar cautions about the U.S. market. Equity valuations had become unrealistic and clearly unsustainable, and lower prices would certainly result. Prices continued higher through early 2000, from which point the stock market began its biggest decline since the 1929 crash. For the seven and one quarter years since that peak our clients' portfolio returns have exceeded the returns on the major stock market indexes, bond market indexes and short-term cash equivalent indexes, notwithstanding the current four year surge in stock prices.

Because we do not believe that the weak stock market cycle that began in 2000 has ended, we have positioned our portfolios accordingly. Our total portfolios have lagged the more aggressive stock market returns during the rally of the last few years. We strongly suggest that caution will yet be more fully rewarded following at least one more major stock price decline. This is the high probability conclusion.

On the other hand, the grand worldwide financial experiment with unprecedented debt and leverage could conceivably lead to a different result. It is an open question as to whether the world can borrow its way to ever-increasing prosperity. If nothing goes wrong, there is no ceiling to prices, and there is no time clock that signals the end of the game.

We are, however, experiencing the first events that could lead to a dramatic shift in investor sentiment. For some years, until very recently, buyers and lenders behaved as though real estate could only go up in price. The inevitable excesses that flow from such a naïve view are just now

becoming evident with growing defaults in the subprime lending arena. This week Bear Stearns indicated that two multi-billion dollar hedge funds, heavily leveraged and invested in impaired mortgages, were likely worthless. At this stage it is unclear how far the ripples will extend.

Some leading bank lenders are adding voices of caution. Discussing current lending practices, Wells Fargo CEO Richard Kovacevich recently said: "I am not a forecaster of the future; I'm a historian. And history says this will blow up. It always has. And there will be some blood on the street." Bank of America CEO Ken Lewis predicted that the so-called credit bubble is about to burst after six years of historically low interest rates and relaxed lending criteria. He added: "We are close to a time when we'll look back and say we did some stupid things."

With a stock market still rising after more than a four year virtually uncorrected run, accompanied by record amounts of debt and leverage, investors may be facing their greatest risk/reward decisions in history. No one likes to turn away from a stream of profitable returns that could continue indefinitely if the virtuous circle of circumstances remains unbroken. On the other hand, as happened almost overnight to the "worthless" Bear Stearns hedge funds, a broader catastrophic unwinding of leverage in a debt default environment could lead to the greatest loss of asset value in world history. This is not a "normal market" question like: Will I make 15% this year if things go right, or could I lose 5% if things go wrong? It is rather a question of whether you could make explosive returns if, in fact, we have entered a new era in which central bankers can provide massive liquidity with no negative consequence. Off-setting such a prospect, if things go very wrong, is the specter of a violent unwinding of unprecedented debt levels with huge, unpredictable financial consequences. Because of the massive intricate chains of derivatives that wrap around the world, which regulators admit they can neither quantify nor get their arms around, a major financial accident could produce its consequences overnight.

This is not a suggestion to avoid all speculation, but rather to recognize clearly the difference between investment and speculation and that the line between them has shifted. Because of the giant levels of debt and leverage in the system, allocations that have historically been considered prudent for investors may in fact today involve far greater levels of speculation than ever before.

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