

# The Oarsman Outlook

## Third Quarter 2007

Although belied by the final figures, the July-September quarter was as turbulent as any in recent memory. By the end of the period, most categories of financial investments had posted solidly positive three-month returns (although small-company stocks slipped slightly), adding to already-healthy year-to-date figures. However, the June 30-September 30 comparison masked unnerving swoons in nearly every asset category (the highest-quality bonds – U.S. Treasuries – being the notable exception), occasioned by a near-meltdown in the credit markets during August.

Within the U.S. stock market, the best-performing sectors were Energy, Technology, Basic Materials and Consumer Staples; lagging sectors included Financial Services, Consumer Cyclical and Communication Services.

### Benchmark Performance – Equities

	<u>Third Quarter 2007</u>	<u>Year to Date</u>
S&P 500 Index	+2.0%	+9.0%
Dow Jones Industrial Avg.	+4.2%	+13.4%
NASDAQ Composite	+3.9%	+12.0%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+2.0%	+9.0%
Small-Cap Stocks (Russell 2000)	-3.1%	+3.1%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+3.2%	+16.1%

### Benchmark Performance – Fixed Income

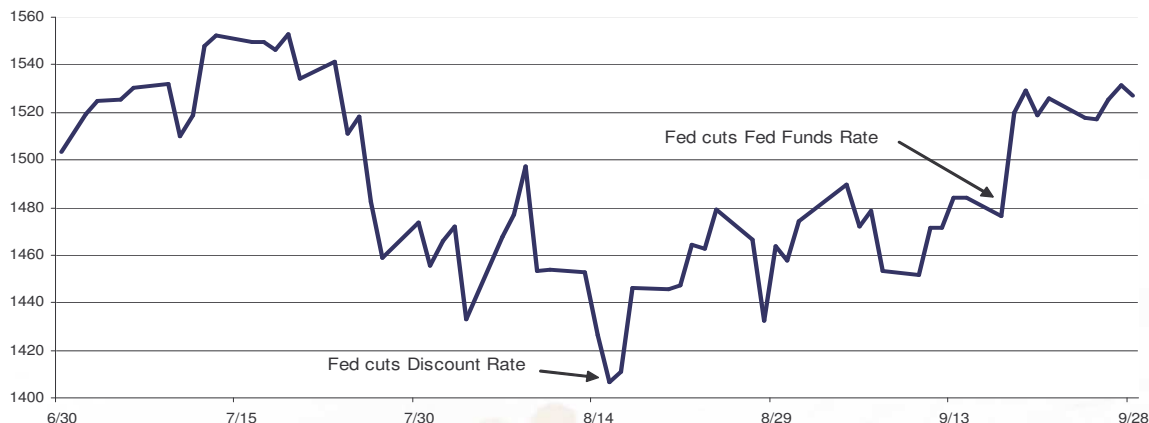
	<u>Third Quarter 2007</u>	<u>Year to Date</u>
Lehman Aggregate Bond Index (taxable)	+2.8%	+3.8%
Lehman Municipal Bond Index (tax-exempt)	+1.8%	+1.9%

### Review

The first three weeks of July saw global stock markets tacking onto healthy second-quarter gains, with the Dow Jones Industrial Average passing 14,000 and the S&P 500 Index moving decidedly above its March 2000 peak. However, toward the end of the month, the market for certain arcane but voluminous credit securities (e.g., collateralized debt obligations (CDOs), asset-backed commercial paper (ABCP)) abruptly short-circuited for reasons that are not fully understood. Suddenly, there were essentially no bidders for billions of dollars of securities that had been considered triple-A credits, drastically impairing their value as collateral for short-term financing that provides essential liquidity to financial institutions, institutional investors and even non-financial firms. As the problem spread from one type of debt security to another, banks and other intermediaries lost confidence in their ability to gauge the creditworthiness of their peer institutions, and short-term lending essentially stopped. Desperate for liquidity and/or eager to reduce portfolio risk, many sought to close positions in more liquid markets (e.g., stocks, exchange-traded funds (ETFs), plain-vanilla

corporate bonds), causing prices to plunge: between July 20 and August 16, the Dow and S&P 500 declined 8% to 9% (well over 10% on an intraday basis); more volatile indicators, such as certain emerging-market ETFs, plunged more than 20%.

S&P 500 Index (Daily Close; July – September 2007)

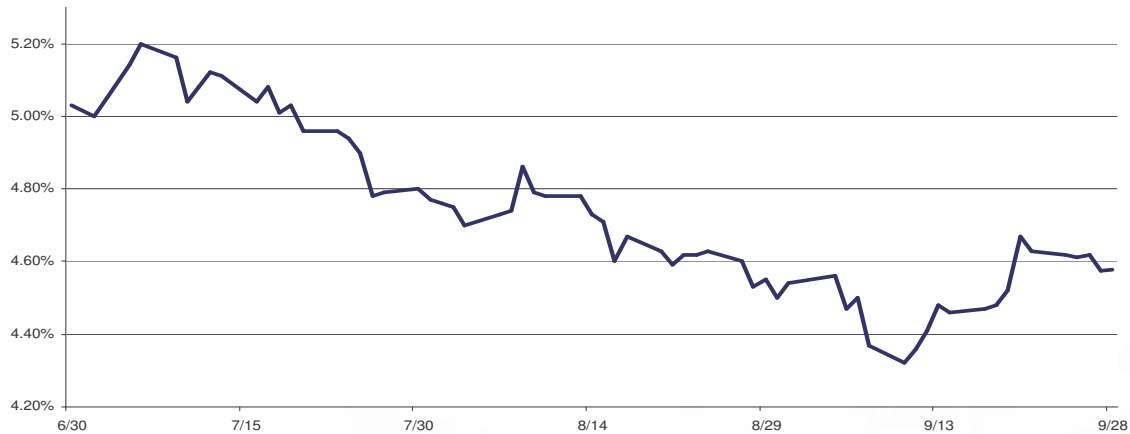


Anxious to avert financial catastrophe (more than one seasoned financial executive averred that they had never seen a worse credit-market dislocation), global monetary authorities stepped in to restore order to the credit markets. Their efforts began with liquidity injections during August and culminated in the Federal Reserve's aggressive half-point cut in the overnight "Fed Funds" lending rate on September 18<sup>th</sup>. The intervention appears to have been successful, as conditions had improved meaningfully by the end of September: volatility measures had subsided, credit spreads had narrowed, the commercial paper market had resumed functioning, and Treasury yields had risen from panic-induced lows. Equity markets rallied impressively, posting their best two-week performance in years and surpassing the July highs during the first few days of October. Although not quite an "all clear," most signs suggested the worst had passed.

The financial-market turmoil upstaged mounting signs of softness in the "real" economy, many of which predated the credit-market dislocation. Most prominent was the ongoing malaise in the housing market. House prices in most of the U.S. have now been falling for more than a year, and recent data indicate the declines may be accelerating. Importantly, the credit-market problems have curtailed the availability of certain types of mortgages, while increasing the cost of most others, effectively removing potential buyers from the market. While bubble corrections are notoriously fickle, the record volume of unsold homes and reluctance of sellers to cut prices continue to augur a protracted adjustment likely to drag on at least through next year.

Away from real estate, a startling sign of flagging growth came with the August payroll report, which showed a *loss* of jobs for the first time in several years; previously reported employment growth was revised downward, as well. Although the September statistics indicated a fairly sizable rebound in hiring, additional weakening trends were discernible in the ISM purchasing-managers' indices, consumer confidence surveys, durable goods/factory orders, retail sales and Treasury bond yields.

**Ten-Year Treasury Yield (Daily Close; July – September 2007)**



### **Outlook**

As previously noted, it seems premature to declare an end to the credit-market crisis. Even absent renewed turmoil, recent events have impaired, perhaps permanently, a meaningful segment of the vast and complex non-bank credit-creation system that has evolved over the past two decades. While traditional intermediaries (read: banks) will step in to fill some of this void, there may well remain a significant disruption of the way our credit-dependent economy has been functioning for years. Wall Street in particular and the U.S. economy as a whole are remarkably flexible and adaptive, but the intermediate- and longer-term impacts of this disruption will take time to make themselves felt.

Outside the financial sector, the unfolding real estate correction continues to loom over the U.S. economy. As noted in past letters, houses represent the bulk of Americans' net worth – for the vast majority, a much larger portion than is represented by securities investments. If, as seems likely, real (inflation-adjusted) house prices are stagnant (at best) for a protracted period, consumer confidence and spending are bound to suffer. To date, healthy employment/wage gains and rising stock prices have eased housing-related pain. As we look ahead, then, prospects for the corporate sector seem increasingly crucial. There, balance sheets are strong, profitability and competitiveness are healthy, and there is still pent-up demand for capital investment in areas such as infrastructure and information technology. Stronger overseas economies and the competitiveness-enhancing effect of a weak U.S. currency will provide an additional boost to globally-oriented industries (e.g., capital goods, technology, consumer products). Recall, however, that corporate investment and exports account for only some 25% of the U.S. economy, so strength in these sectors is hard-pressed to offset weakness in the 75% tied to consumer spending and residential investment.

We believe Federal Reserve policymakers are acutely attuned to the potential for the housing slump – especially as exacerbated by credit-market turmoil – to push the U.S. economy into recession. While some have criticized the recent Fed easing as a sop to Wall Street, we view it as being aimed squarely at Main Street. The Fed's move probably bailed out some speculators whose comeuppance might have been a healthier long-term outcome. However, this "moral hazard" seems an acceptable price for restoring confidence in the financial infrastructure that underpins much of the "real" economy.

With inflation indicators continuing to abate (having peaked roughly a year ago), we believe the Fed has ample room to continue lowering rates should they judge additional stimulus is warranted. In fact, we suspect apparently worsening housing data may prod the Fed to err on the side of caution, and cut rates more than might otherwise be expected. A useful rule of thumb is that an accommodative Fed funds rate is no greater than nominal GDP growth – that suggests overnight rates could be cut several more times from the current level of 4.75% to 4% or lower.

Historically, U.S. stocks have performed well in periods of Fed easing, even in the face of decelerating economic (and corporate profit) growth. According to Standard & Poor's, there have been eleven Fed easing cycles over the past 60 years. In the 12 months following the first rate cut, the S&P 500 posted an average gain of almost 19%, and rose in ten of the eleven periods (the post-tech-bubble easing of 2000/2001 was the lone case where stocks failed to rally). We date the current easing cycle from mid-August, when the Fed began intervening in the credit markets and laying fairly explicit groundwork for the September rate cut. Using that starting point, stocks have already rallied more than 10%, suggesting further upside may be limited (using the historical average as a target). Still, if exports and currency-translation effects support corporate profits, and employment/wage growth remains sufficiently healthy to prevent consumer spending from tanking, the tailwind provided by falling interest rates should be enough to buoy the market in the period ahead.

The biggest risk to the outlook may be any apparent resurgence of inflation, which could cause the Fed to withhold the monetary accommodation that the housing slump and slowing economy demand. Happily, we currently see few danger signs in this area, despite headlines about soaring energy and gold prices. As noted, most hard measures of inflation peaked in 2006 and have been trending gradually lower. Moreover, implied expectations of future inflation, as evidenced in the inflation-indexed bond (TIPS) market, have been stable or declining. Finally, both the housing correction and the credit-market dislocation are *deflationary* events that most economists project will result in six to eight quarters of below-potential (i.e., non-inflationary) economic growth.