

BARNETT & COMPANY

INVESTMENT COUNSEL

Quarterly Review and Outlook

2nd Quarter 2007

Someone's been Eating my Porridge

Goldilocks has been the talk of the town for the past year. It seems that stock investors have bought into the presumption that the economy has been expertly guided to a soft landing characterized by moderate inflation, stable unemployment, sustainable economic expansion and eternal growth in corporate earnings. This confluence of the Fates, dubbed the "Goldilocks Scenario", postulates just enough of a slowdown in the economy to tamp out any smoldering inclination by the Federal Reserve to tighten (the secret fantasy of every central banker), and ultimately to nudge the Fed toward cutting rates before the end of the year. In other words, the economy is by this construction not too hot, not too cold, but just right. So what would our Heroine have done had she not been so rudely interrupted from her nap? Buy stocks, of course. Which is exactly what investors did in the second quarter, sending share prices higher and disregarding the danger signs.

Virtually every stock index around the world advanced during the second quarter of 2007. International markets led the parade once again as the torrid growth in the Asian economies was complimented by a respectable showing in the Euro zone. Emerging market stocks jumped 15% for the quarter and are up a whopping 45% over the past year. Closer to home, the Dow Jones Industrial Average racked up a 9.11% gain for the quarter, while the S&P 500

gained 6.28%. Since the end of the quarter the party has rocked right along, with the Dow finally crossing the 14,000 marker and setting new all-time records along the way. Growth stocks outperformed value stocks by almost two percentage points as technology issues found their mojo. The only major equity sector to get hammered was the REIT market, as evidenced by the 9.04% decline in the NAREIT Equity REIT index that tracks real estate investment trusts.

Meanwhile, the bond markets recounted a story of increasing risk from a variety of sources that could cause Goldilocks to bolt and run away through the woods. The price of bonds in general took a beating, driving up yields (which move in opposition to prices). The 10 year Treasury bond started the quarter at a 4.65% yield (just about where it had been a year earlier), but settled at 5.03% after having briefly reached 5.32%, the highest level since 2002. Bond investors (or *dis*-investors in this case) were reacting to the gathering storm clouds of mounting inflationary pressure and the unfolding meltdown of the sub-prime loan market.

The conventional wisdom has inflation well contained. The core CPI inflation gauge for the second quarter came in at a seasonally adjusted annual pace of 2.3%, a pretty tame reading on its face. But this core measure omits food and energy costs on the

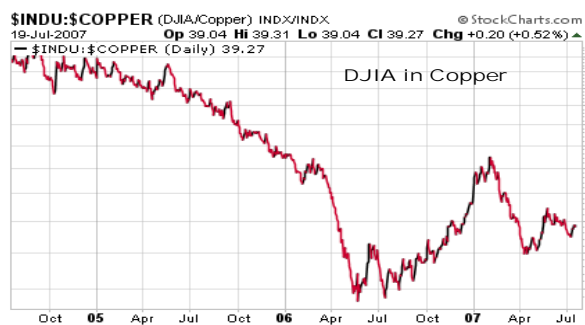
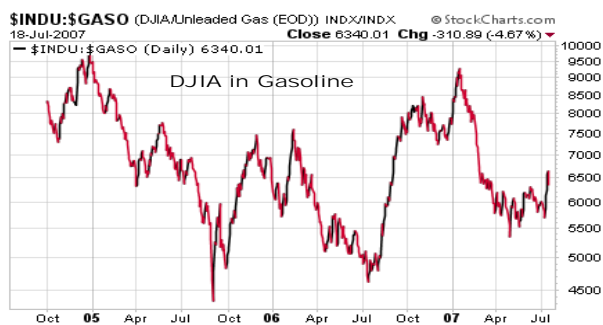
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assumption that their inherent volatility makes the measure more unstable and less useful. However, energy cost inflation eventually feeds back into the loop as an increase in the cost of other inputs (transportation, pharmaceuticals, plastics, chemical feed stocks, and so on). Furthermore, basic commodities from copper to nickel to iron ore have doubled or tripled in price over the past three years, largely in response to the tremendous expansion of Asian demand. So, while the Dow was soaring to record heights in dollar terms, the picture is not so rosy when the index is valued in terms of other commodities for which we must spend our dollars. The charts below illustrate the performance of the Dow Jones average when it is measured in gasoline, copper, gold and crude oil. When an investor cashes in on his market gains and spends the dough on filling the tank, the net result is obviously somewhat less satisfying, especially after paying taxes on the dollar gains.

The Federal Reserve Board appears to

understand. While subscribers to the Goldilocks scenario were anticipating rate cuts this fall, the Fed and Ben Bernanke have all but thrown a wet blanket on the equity bulls, so far to little effect. In his recent Senate testimony, Chairman Bernanke was quite direct: "With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC [Federal Open Market Committee] has consistently stated that upside risks to inflation are its predominant policy concern." Translation: don't look for a rate cut anytime soon. Nevertheless, investors were afraid of missing out on the rally, and continued to buy stocks in the face of mounting obstacles.

Meanwhile, as the bulls roamed the stock markets, the bears came calling on the bond markets. It seems that there really is no free lunch, and all of these sub-prime home loans actually do come with some risk, no matter how many are packaged together. During the great real estate boom the



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lending industry experienced a remarkable transformation. No longer are the banks largely responsible for initiating and servicing your home loan. It became highly profitable for independent mortgage brokers and small mortgage companies to originate the loans for a handsome fee, and then to sell the loans to a large investment bank for securitization. In this process the investment bank packaged together large pools of these individual mortgages, sliced them up into three or four different levels of risk based upon the likelihood of default, and then sold securities that represented a share of the underlying pool (much like a GNMA bond). Furthermore, the banks convinced the rating agencies (S&P and Moody's) to give the newly created bonds an investment grade rating (from AAA down to BBB) on the assumption that overall default rates on the individual mortgages would be small as a percentage of the total.

Well. Sounds great when home prices were shooting upward, refinancing was cheap and easy, and the mortgage pool was protected by the gains in property values. Alas, many of these loans should never have been made, and were underwritten with little or no documentation. Many had adjustable rates that now threaten to choke the borrowers, and some were created with artificially low initial "teaser" rates that adjusted dramatically higher one or two years hence. But all good things come to an end, and this one is beginning to look very ugly. As the residential real estate market has tanked, home values are falling and eroding collateral values. Mortgage defaults on sub-prime loans have doubled over the past year and look to worsen still further going forward as the teaser rates continue to jump. And the rating agencies

(with egg on their faces) have announced that some \$17 billion worth of these bonds with investment grade ratings will have to be "re-evaluated". Nearly 40 mortgage companies have been driven into bankruptcy, and the investment banks and hedge funds are paying for their exuberance. The value of the lowest-rated slice of the mortgage bonds has fallen to around 40 cents on the dollar, and Bear Stearns has admitted that two of their large hedge funds holding these securities are essentially worthless.

The effect of this meltdown in the sub-prime market has been to make *all* bond investors and lenders more risk-averse; tightening lending standards, requiring more documentation proving ability to repay, and demanding more return for their investment (a higher yield to compensate for the increased risk). This expansion of the risk premium on bonds has directly impacted our clients in the form of a decline in the prices of bonds in their portfolios. Even though we have no direct exposure to the weakening mortgage debt sector, all bond prices are responding to a systematic increase in the additional return demanded by bondholders. During periods of falling prices on bonds in the high-yield sector especially, it is important to remember that our strategy incorporates two important premises: maintain a relatively short average maturity of 5-6 years in the portfolio, and hold the bonds to maturity unless they are called or sold for a compelling investment reason. These important principles allow bondholders to be somewhat more philosophical about the fluctuations in price over the short run.

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