

## QUARTERLY MARKET COMMENTARY

### First Quarter 2007

Although not without excitement, most securities markets effectively moved sideways in the first quarter. The S&P 500 provided a total return of 0.6%. The more speculative NASDAQ Composite finished a sliver above zero, while the Dow Jones Industrials closed just below the break-even mark. Most bonds were barely better. Major bond indexes advanced by 1.2% to 1.5%. Risk-free U.S. Treasury Bills returned 1.25% for the quarter.

Such benign results masked some attention-getting, intra-quarter volatility. On the bond side, the beginning of the quarter saw the continuation of the interest rate rise that began in December and saw the 30-year U.S. Treasury bond yield go from 4.5% to 5.0%. That resulted in big losses in principal value to long bond holders. Rates then reversed direction during the month of February, retreating toward 4.6%, leading to a recovery of most of the lost principal. The last month of the quarter saw rates rising again into the low 4.80's. Lots of action, but not much change from the beginning of the quarter.

Sharp stock market moves gained far more press coverage. Stock prices moved modestly higher through January and most of February. Suddenly, on February 27, for reasons largely attributed to a dramatic market sell-off in China, U.S. stock prices fell 4%. Prices worked a little lower over the next two weeks then began a quarter-ending rally that brought equity prices slightly back into the plus column for the quarter.

By the end of the quarter positive momentum had been reestablished in the stock market, and that continues through today. As we have discussed many times in these letters, momentum is a powerful force, and it dictates the short-term path of least resistance. More often than not, the financial headlines are consistent with the current trend, as they are today. Good news follows good markets. Domestic corporate earnings, while slowing, are still positive. The rest of the world has arisen and is progressing faster than we are in the United States. Interest rates, while no longer low, are not high. Consumer and investor sentiment is still optimistic. Because nobody has been hurt in stocks for four years, many investors are aggressively bullish.

We don't share their enthusiasm. It's not that stocks can't go higher from here. Of course, they can, and they might. Our reticence is based on an evaluation of the potential stock market rewards at this point relative to the risks that would have to be assumed to obtain those rewards.

Our economy and stock markets have been cyclical for two hundred years and will continue to be cyclical. It is remarkable that people are consistently surprised when cycles change direction. While the timing of cycles remains imprecise, the existence of cycles is incontrovertible. Recognizing that imprecision, we attempt to evaluate how much risk we would have to assume at

any point in time to obtain reasonably foreseeable rewards. That evaluation is always made in light of the return then currently available on essentially risk-free investments. That risk-free return has risen over the past four years to more than 5%. Everything yielding more than that today bears some degree of risk.

On the fixed income side we could make a reasonably strong case for either rising or falling interest rates over the months ahead. With the yield curve still partially inverted, we have chosen to concentrate at the short end of that curve and accept slightly higher yields than are available on longer maturities. By staying short we forego the potential for larger gains that would accrue to longer bonds if interest rates should decline. At the same time, we preclude the losses that would befall longer bonds if interest rates should rise. Since there is far more room above current interest rate levels than below, we believe that the risk-reward equation argues for accepting the lower risk, higher interest rates available at the short end of the curve.

Of course, one can also obtain higher yields by owning lower quality bonds. In an environment in which the yield spread between high and low quality bonds is historically slim and in which an increasing number of bonds are being down-graded by the rating services, we believe this to be the wrong time to stretch for yield below the top-quality level. We also believe that the instant liquidity offered by U.S. Treasuries will provide the potential opportunity to move these funds into higher yielding assets at lower prices following any significant price declines.

The equity side offers an even more challenging evaluation. It has been four years since the S&P 500 has experienced as little as a 10% correction. To put this in perspective, consider that the market has experienced at least one decline of 10% or more in 56 of the 67 years preceding this recent surge. It is normal behavior for markets to advance, then contract. When they move in either direction without a significant countermove, investor sentiment becomes one-sided in that direction. When prices are advancing, as they have been since the spring of 2003, and nobody has been hurt owning stocks, caution is progressively discarded. The news is inevitably positive. Everybody becomes bullish, and equity allocations rise.

History has not been kind following such periods of euphoria. While not every persistent advance has been followed by a giant decline, the four biggest declines of the modern era (1929-'32, 1973-'74, 1987 and 2000-'03) have all followed periods in which today's market dynamics were present.

Equity valuations are still far above long-term norms. In fact, most are typical of the levels from which this century's great stock market declines have begun and are nowhere near levels from which significant advances have been launched. By virtually all historical standards, stocks are expensive, not cheap.

The current economic advance, while not nearly the longest ever, is already far longer than normal and is slowing. As referenced earlier, we are experiencing an inverted yield curve (short interest rates higher than long interest rates). This is the eighth inverted yield curve condition in the past half century. Six of the seven previous episodes preceded recessions. While the inversion in the mid-1960's, the only exception, was not soon followed by a recession, it did

introduce a long weak stock market cycle in which equity prices did not break permanently above their 1966 level for 16 years.

The present four-year uncorrected stock market rally is now near record length.

Speculative fever has returned to stock trading. Within the last few weeks the NASDAQ stock market issued a warning that margin debt (money borrowed to buy stocks) has risen to its highest level ever, exceeding its former peak at the height of the 1999-2000 dot.com bubble. NASDAQ officials thought it prudent to warn investors that margin leverage cuts both ways. Just as gains are leveraged, so are losses. From its prior peak of leverage, the NASDAQ market plummeted 80% from 2000 to 2002.

High levels of debt have characterized all speculative peaks that have marked stock market tops. That we now have greater debt in the United States than ever before, not just on an absolute basis, which would not be surprising, but as a percentage of our economic output, cannot be reassuring. We have been living recently through the greatest credit expansion in world history. Invariably, when lenders compete to float loans, their borrowers tend to become less and less credit worthy the longer the cycle goes on. We're starting to observe a striking example of that in the real estate area. As home prices have stopped rising and as some variable rate mortgages have been reset to higher rates, large numbers of sub-prime mortgages have fallen into default. There is a long and inglorious history of lenders ignoring credit worthiness in their rush to push loans out the door. Remember the oil patch and LDC (lesser developed countries) loans of decades past that led to the bankruptcies of major banks. What is striking in the current episode is the speed with which major bankruptcies have hit sub-prime lenders. Of course, we have no way of knowing now how significant this housing slowdown will ultimately become.

Ominously, Yale Professor Robert Shiller is interviewed in the May issue of *Money*, just on the newsstand. He believes that homes today are roughly as overvalued as stocks were at their 2000 peak. It's easy to dismiss such a view as fear-mongering, but it is instructive to review Professor Shiller's credentials. He co-founded Case Shiller Weiss, which has done the definitive work on U.S. housing prices over the past 120 years. He spoke at our 1997 client conference and published his book *Irrational Exuberance* right at the 2000 stock market peak. In it, he made the case for the stock market crash that followed immediately.

Because real estate is so much greater a factor than stocks and bonds in the U.S. consumer's wealth profile, any significant hiccup in home prices is likely to have a very large negative impact on the U.S. economy. Of course, the Federal Reserve Board knows that as well and seems inclined to do whatever it must to prevent a business slowdown that could turn into a recession.

The relevant question is whether the Fed can ward off a potential recession without creating problems with inflation, the dollar and the U.S. debt markets. Because the Fed and central bankers around the world have a flawed record of warding off major financial upheavals, it is safer to bet ultimately on logical market consequences rather than on master planners. After all, they are the ones whose policies have permitted us to get into position as the greatest debtor country in world history. Our debts and deficits require that about \$2 billion every day flow

from foreign hands into the United States. So far those lenders, primarily the Japanese and Chinese, continue to send their money here. As long as they remain willing to do that, we may be able to keep the debt bubble afloat. If, for economic or political reasons, those countries decide to allocate their money elsewhere, there could be a monumental upheaval in our securities markets.

I have wandered far from a short-term analysis of probable stock market direction. The discussion is directly relevant, however, to an investor's decision about whether to assume or to avoid a significant position in equity securities in the current market environment.

I characterize the decision as a choice between investing and speculating. The investment merits of stocks at this level are weak for the reasons expressed earlier. Conditions like ours today have more often than not led to below-average returns.

Speculation, however, is not a four-letter word and sometimes proves very profitable. The positive momentum we are currently experiencing could continue indefinitely as long as investor attitudes don't turn south. Weighed against that potential are the probabilities that historically normal patterns will soon cut short both the economic and market advances. Of heavier weight, but less likely to be of short-term influence, is the ponderous specter of record debt levels and the potential dislocations that can spring from that condition.

As highly sophisticated an investor as Warren Buffett has continued to profile the explosive proliferation of derivatives that flow from debt as "financial weapons of mass destruction." In any given time period it is unlikely that a derivative blowup will lead to an instantaneous market crash. Similarly, although we all recognize the potential danger, a major terrorist attack in any prescribed time period is unlikely. We continue to counsel both individuals and institutions with largely irreplaceable capital, however, that no matter how unlikely any such event might be, if you could not survive a major loss of capital, you must factor its potential into your decision about how much risk you can accept.

We urge the investor to be cautious. The speculator can take his/her chances, but we would suggest an eye be kept on the exits. We anticipate at least one more major stock price decline, possibly from higher levels, before the long weak cycle that began in 2000 eventually concludes. Remember, too, that aggressive equity allocations from here will prove more profitable than risk-free income only if the stock positions are sold before such a major decline or if the markets never again get back down to today's levels. We believe both scenarios to be unlikely.