

## QUARTERLY COMMENTARY

### **Third Quarter 2007**

There was a lot of action in the equity market in the third quarter but little net change when all the dust settled. Investors experienced a few scary moments from mid-July to mid-August as the S&P nearly saw its first 10% decline since early 2003. It didn't quite happen, however, and stocks rallied for the remainder of the quarter, essentially recovering the entire intra-quarter decline.

As the credit crisis began to freeze many fixed income markets, there was a dramatic flight to safety into U.S. Treasury obligations, which made top-quality bonds the best performing asset class in the third quarter. Lower quality credits did far less well.

The Federal Reserve surprised most market observers with an aggressive easing of interest rates, dropping the discount rate by 50 basis points on two occasions as well as the Fed funds rate by 50 basis points on the second occasion. Based on his earlier intimations that he would break ranks from the easy money policies of former Fed Chairman Alan Greenspan, Chairman Ben Bernanke surprised analysts by falling right in line with his former colleague. Wall Street immediately celebrated the Fed's largesse with a strong rally. Various Fed governors issued stern warnings that they would not come to the rescue of firms that had overspeculated, overleveraged and lost huge amounts of money. The big interest rate drop with the implied promise of more to come, however, will indeed help to rescue a great many firms that might otherwise fail in a free market environment. The Fed again reinforces the concept of "moral hazard," as its predictable actions offer no reason for aggressive financial engineers to be more circumspect in the future. After all, a benevolent Fed stands ready to pave over today's potholes without regard to the longer-term damage it may cause to the nation's economic path.

Notwithstanding the Fed's past and prospective actions, economic conditions are deteriorating. Third quarter corporate profits are expected to have declined from the same quarter a year ago. The fallout from the bursting housing bubble is unknown. Prices in most locations remain under pressure, foreclosures are increasing, record inventories of homes for sale are still growing, and many adjustable rate loans are due to be reset at higher rates in the year ahead.

Until recently, the savings-starved U.S. consumer has been borrowing heavily against increasing home equity through most of the current decade. It is almost inconceivable that the removal of this source of funding will not have a profound effect on consumer spending in the year ahead. The potential for a recession is clearly rising. In an environment in which government, business and consumers are loaded with debt, the Fed will certainly fight the prospect of a recession as aggressively as it thinks necessary within the constraints of what markets will allow.

Most analysts believe that worldwide economic growth will continue, even if the United States should slip into a recession. Stephen Roach, Chairman of Morgan Stanley Asia, argues, however, that the "... capitulation of the American consumer spells considerable difficulty for the global economy." While expecting the effects to be felt unevenly among different Asian and European countries, he adds that "... the Asian growth dynamic is actually quite vulnerable to a meaningful slowdown in U.S. consumption growth."

Exacerbating the Fed's difficulty in trying to prevent recession is the condition of the U.S. dollar. The multi-year decline in the dollar to 40-year lows relative to a basket of major currencies has reduced the value of all U.S. securities held by non-U.S. investors. Since this country consumes far more than it produces, we run massive annual deficits. We are, in fact, able to maintain our consumer-oriented lifestyles only because of the kindness of strangers. In other words, such deficits are possible only because foreign investors send us \$2 billion to \$3 billion every day, 365 days a year. Should they become unwilling to send us that steady stream of money, we would either have to reduce consumption or raise interest rates to a level necessary to attract the funding. That puts the Fed between a rock and a hard place. The more they drop rates to ward off recession, the weaker the dollar could become, and the less likely current and prospective owners of U.S. securities will want to keep money in U.S. assets. The weaker dollar also makes imports more expensive, contributing to inflation, which in turn could lead the Fed to raise interest rates if inflation grew unacceptably strong.

The Fed faces no easy choice, but it appears probable that it would risk rising inflation to avoid recession. In a world awash in unprecedented levels of debt, the Fed and the world's other major central banks have apparently concluded that the risk of a catastrophic unwinding of that debt must be avoided at all cost. While inflation could be an undesirable byproduct of such reflationary efforts, central bankers have wrestled with inflation before, and they would far prefer to grapple with it again than risk a deflationary debt collapse.

The Fed and other central bankers, however, can't solve all financial problems. The financial engineering of the past decade has produced all sorts of esoteric financial constructs. Because most of them rely on leverage to magnify returns, rising markets have produced legions of apparent financial geniuses. The unraveling of the subprime mortgage market, however, has created unforeseen problems. Shockingly and suddenly, a few hedge funds and banks became insolvent as billions of dollars of such mortgages were declared worthless. Erstwhile celebrity managers were revealed to be less than geniuses.

Within the past few weeks, Bank of America, Citigroup, UBS, Merrill Lynch and others have written off billions of dollars of such impaired investments. Massive amounts of "emergency" liquidity have been injected into the system by the Fed and other world central banks. This infusion has partially restored the interrupted workings of the credit markets, but the biggest problems remain. Investors still do not know the worth of suspect securities. A great many potential borrowers can't raise money because lenders don't know what kind of "toxic waste" rests on the borrowers' balance sheets. No one knows the scope of this festering problem, but the extremely rapid and aggressive action by coordinated central banks should provide helpful clues as to how seriously they view the situation. It will be interesting to see how much disclosure auditors will demand at the end of public corporations' next fiscal year.

While the extent and ultimate consequences of the credit crisis are not yet known, they add a huge element of uncertainty to any investor's bag of questions and considerations. Perhaps there are no more hidden landmines, and we have seen the worst. Nonetheless, that wouldn't make conditions better; it would just keep them from getting worse. On the other hand, there is no limit to what consequences the imagination can conjure up should a worsening housing market lead to further failures in the hugely leveraged mortgage-backed securities markets.

Most investors have no idea how extensively this suspect debt has been spread. Even short-term money market funds, supposedly ultra-safe, have been boosting their yields by investing in structured investment vehicles (SIV's) with high credit ratings that are now seen as highly suspect. According to *The Wall Street Journal*, many funds were holding 10% to 20% of their portfolios in debt issued by SIV's.

In our quarterly commentary at mid-year, we outlined how levels of speculation had increased dramatically. That trend towards increased speculation has accelerated and remains one of our primary concerns. I encourage interested investors to reread that message at [www.missiontrust.com](http://www.missiontrust.com).

As we have pointed out previously, speculation need not have a negative outcome. If nothing goes seriously wrong, risk assumption and extreme leverage can result in giant returns. Speculation has, in fact, been a major positive factor in the almost uninterrupted stock market advance since early 2003. Even conservative investors, personally not leveraged, have benefitted from the extreme levels of leverage in the markets generally.

Remember, however, that leverage can cut both ways. By time-tested measures of valuation like price to earnings, price to dividends and price to book value, today's equity markets are historically expensive, not cheap, and, therefore, more vulnerable than usual. If the uncertain outcomes to the housing decline and/or the credit crisis should lead to a change in investor attitudes, a resulting stock market decline could be magnified greatly by unprecedented levels of leverage.

While we are pleased that the equities we owned have done well, we are comfortable waiting for more attractive valuations and a reduction of the risk profile before committing to a more substantial equity position.