

INVESTMENT OUTLOOK & COMMENTARY

Second Quarter, 2007

Summary: We're not yet calling for a U.S. economic recession, but with U.S. housing in recession and a mortgage debt market in peril, risks of lower markets and/or a recession have elevated. If housing prices continue to fall, U.S. consumers should weaken, raising the likelihood of weaker equity markets, particularly in many overseas markets. We have switched to more defensive portfolio positions with higher allocations in cash. Within equities, we favor large, quality U.S. issues.

We've argued—and had been early at this call—that investors are underestimating risk and should soon begin re-pricing risk into risky assets. Re-pricing would mean more volatile performance in equities, especially equities of inherently riskier markets like China and Latin America . This re-pricing exercise may have begun on February 27, when Chinese equity markets fell almost 10 percent, and the Dow Jones Industrial Average, after completing its longest streak in 107 years without a 2% single-day drop, fell 416 points.

Up until this quarter, volatility has been historically low and markets have trudged steadily upward, sprinting in some markets like China . Watching the markets now is largely a nail-biting vocation as equity markets have swung wildly on economic data, company earnings release, and emotions.

But there is much to fear. Slowing worldwide economic growth, slimmer corporate profit growth, and rising global trade tensions are transpiring and are of concern; however, issue number one today is the U.S. housing market.

Housing in Flux

The U.S. housing market is now in recession, and its fallout is likely just beginning to be felt. Why the economy and stock markets depend so much on housing is rooted in the factors that helped boost American home ownership and home values over the past decade—securitization and leverage.

To begin, America 's residential mortgage market is huge, consisting of some \$10 trillion of loans, of which 75 percent are repackaged into debt securities and sold to investors. Most of this securitization comes from the government-sponsored organizations Fannie Mae and Freddie Mac, and most mortgage securities are comprised of mortgages of individuals with good credit and ample equity in their homes.

However, in the latest housing bull market, banks and other financial institutions have increasingly securitized mortgages, even those of weaker borrowers, and investors worldwide have increased demand for the resulting higher-yielding debt securities. With strong investor demand, loan originators have issued loans to just about anyone, resulting in an explosion of mortgage issues to those without good credit. Subprime mortgages now account for 10 percent of all mortgages in the U.S. ; some 40 percent of all mortgages originated last year were subprime or one level higher, “Alt-A”. Most subprime and Alt-A mortgages have been adjustable rate mortgages (ARMs), often issued with low “teaser” introductory rates and requiring little or no income verification or down payment.

ARMs and other creative financing were not isolated to subprime borrowers; many prime borrowers needed more than a traditional mortgage to meet rising home values, others saw an opportunity to lever and invest cheaply in a hot market. However, with home values now in decline and billions of dollars of ARMs resetting to higher interest rates, lower credit borrowers are being hit first and hardest. Subprime mortgage delinquencies rose to over 13 percent at last reading, compared to 5 percent the overall mortgage market. Both figures should continue rising as many face higher payments and lower or negative equity—a nasty combination that should add to today's whopping 3.5 million of unsold home inventory. Combine this with tighter scrutiny of the subprime mortgage industry by lenders and politicians alike, and the U.S. housing market may take more time to recover than most think.

At no time has housing wealth been more closely tied to the economy. Today, trillions in mortgage debt and mortgage-related derivatives are held by the world's banks, investment firms and pension funds. Perhaps more importantly, a fall in home prices could slow American consumption. America 's \$20 trillion in aggregate housing wealth has largely accounted for the bold and resilient American consumer who now has a negative savings rate. Should housing weaken further, it's hard to imagine U.S. consumer spending will expand at previous paces, if not shrink altogether.

Elevated Risk

It's in our investment DNA at Cadinha & Co. to be highly paranoid when it comes to risk; it's quite necessary when you have a preservation-of-capital bent. Often times, when we pick up on something that's got more than a slim chance to knock the markets over, we opt to hide in safer investments like money market funds. I'll admit that such a disposition at times leaves positive returns on the table—assuming risk does lead to reward in many instances. However, the disposition also leads us to miss much of the real downdrafts that can truly damage one's retirement prospects.

That being said, we think the chances of a U.S. recession in the next year or so are better than slim...say a 30% chance. Wall Street thinks that number is lower, arguing the Federal Reserve would cut interest rates at recession's first sign. There are a couple of problems with this rationale. First, Ben Bernanke is not Alan Greenspan who was ever-willing to manage the economy and asset prices through monetary policy. Rather, Bernanke believes in using

monetary policy almost exclusively to keep inflation low and stable. Current inflationary data reads roughly 2.5 percent, which is above his goal of 1-2 percent inflation. Rising commodity prices and still-abundant liquidity in the economy should give him pause to cut rates anytime soon. Second, even if the Fed does cut interest rates, monetary policy has a lagged effect on the economy of anywhere between six months to a year and a half. At this point, it's unlikely the Fed would perfectly time a rate cut that would prevent a recession.

Defensive Positioning

We've raised cash holdings in client portfolios. With cash paying near 5 percent, it's a good place to be while we continue to investigate the future health of the economy. Housing in particular will be closely watched. Bonds continue to be range-bound, swinging between a 4 and 5 percent yield. With 2.5 percent inflation, bonds seem fairly priced at its current 4.6 percent annual yield. We see no reason to dive in; less we feel more strongly that recession is imminent. As for equities, we continue to favor quality large cap stocks, which at 15x 2007 earnings, seem pretty reasonable, particularly with their solid dividend yield, remarkable balance sheets that should continue to attract private equity and leveraged buy-out funds, relatively stable earnings performance, and low interest rates.

In a consumer-led U.S. recession, many foreign economies and markets would likely fare much worse. Most foreign economies, especially “emerging” ones, are still very much levered to American consumption. Look no further than China, where exports and fixed investment accounts for some 80% of its GDP, to illustrate this fact. Although China's export-focused growth has allowed for many years of double-digit economic growth, it leaves China highly dependent on those countries who buy their goods, particularly the U.S. ¹ So lopsided is China's economy that Premier Wen Jiabao declared in an extraordinarily blunt fashion during his annual press conference following the National People's Congress that China's economy is “unstable, unbalanced, uncoordinated, and unsustainable.”

It will be years before China can reform itself into an economy driven more by private consumption; in the meantime, that means Chinese equities, as well as much of the world's emerging markets, would be hard hit by a stumbling U.S. economy.

While I've spent some time trying to illustrate principal risks to investors, we've not given up on the U.S. and global economies just yet. Should housing recover, we suspect equity markets will, too. Expect then for us to increase equity exposure with companies we feel offer solid growth and value and markets that should outperform in an expanding global economy.

Neil Rose, CFA Chief Investment Officer

¹ Another consequence of such an export-led economy is pollution. Based on sulfur dioxide (SO₂) measures of air pollution, seven of the ten dirtiest cities are in China. The other three are Tehran, Iran (#4); Rio de Janeiro, Brazil (#8); and Istanbul, Turkey (#9). Source: World Bank