

**Investment Outlook & Commentary
 Fourth Quarter, 2007**

Summary: In the third quarter, our strategy turned increasingly defensive amidst a mortgage-related financial crisis. In addition, our fears of political headwinds continue as the possibility of protectionism and increases in taxes have yet to be digested by markets. The most attractive investments remain those exposed to international economic growth and a weaker U.S. dollar, and as we begin the fourth quarter, we remain slanted toward these types of equities.

Phew! After a quarter that introduced the financial crisis of 2007, market gyrations and volatility not seen since the bear market five years ago, and two months of 3:30am mornings for us here at the Firm, we’re admittedly a little exhausted. More so, we’re glad portfolios remain relatively unscathed, because this market could have (and perhaps should have) gotten a lot worse.

And it may indeed get worse. However, Federal Reserve Chairman Ben Bernanke is using everything at his disposal to fight lower asset prices and possible recession. It’s now apparent Bernanke has sustained the “Greenspan Put”—the idea that the Fed will ease monetary policy by enough to keep the economy and markets afloat—after providing over \$100 billion in short term loans to U.S. banks and lowering the Fed Funds rate 0.50 percent to 4.75 percent.

Not a Panacea

With the “Bernanke Put” in place, investors seem to believe the worst is over, and the market has rallied sharply from the August lows to near the all-time high set in July. However, such optimism may be premature: We’re still concerned with tremendous macro-economic headwinds that even a white-knight Fed may be unable to stem.

Despite lower short term financing from the Fed, the worst is not yet over in real estate and mortgage-related securities. The latest S&P Case-Shiller housing price indexes, arguably the best measures of the state of residential real estate, show prices are falling at an accelerating rate (figure 1). As of July, home prices in general fell 4 to 4.5 percent versus a year ago, the biggest drop since 1991.

The last housing correction started in 1990 and lasted three years with an 8.3 percent cumulative decline, as measured by Case-Shiller. So far in the current correction, we’re just over one year with a 4.8 percent decline. Meanwhile, a flood of home listings (figure 2) should put downward pressure on prices. With the recent bull market in real estate far greater in magnitude than the one in the late 1980s and fueled by looser credit and more leverage, the correction likely has a ways to go. Historically low interest rates and creative, even reckless, financing vehicles served a significant role in real estate’s bullish run.

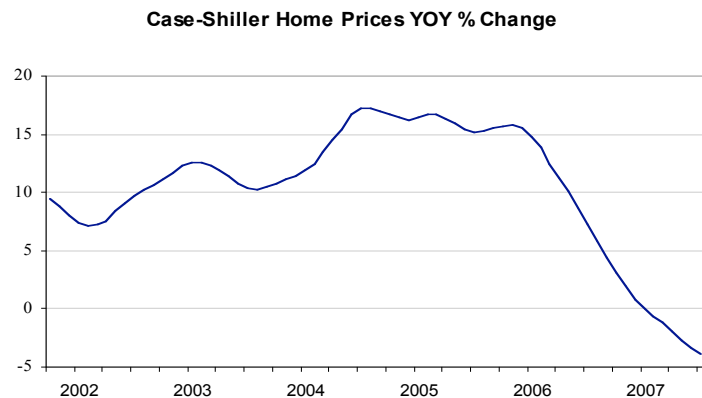


Figure 1

Financial Crisis of '07

These included loans of all kinds, including subprime and adjustable rate mortgages—often with little or no income documentation and high loan to value ratios. Subprime originations rose to \$600 billion in both 2005 and 2006 from \$160 billion in 2001. Roughly \$300 billion of prime and subprime adjustable rate mortgages will reset to higher interest rates over the next year as low “teaser” rates adjust upward—most to the near-10 percent range.

Higher mortgage payments and lower home values are raising delinquency rates, precipitating a crisis among the trillions of dollars worth of mortgage securities held by financial institutions, investment firms, pension funds, and individual investors alike who bought pools of mortgages since they offered higher yields than U.S. Treasury debt with seemingly similar credit as rating agencies like Moody’s and Standard & Poor’s stamped most of these pools “triple-A” (even ones with subprime exposure).

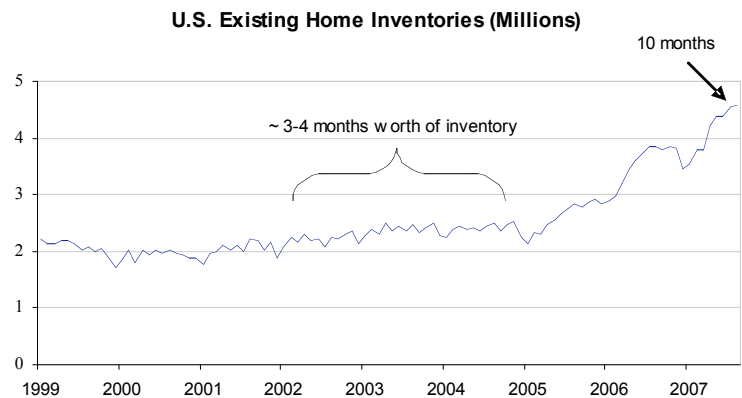


Figure 2

A myriad of hedge funds, mortgage brokerages, and even a few banks have collapsed thus far, and more victims are likely to surface as many institutions still don’t know exactly the damage done to their portfolios and what liabilities lie within their balance sheets. Ultimately, it will take some time and many discounted sales before the true value of the massive amounts of mortgage-backs are known. Should these values be lower than expectations, a significant number of banks, insurers, and investment funds will experience painful write-downs.

Challenges Ahead

Bernanke’s decision to intervene comes as a surprise. Most Fed-watchers had thought Bernanke a monetary purist who would set monetary policy using only inflation targets as his guide. Whether his decision to loosen his monetary belt was the result of pressure by politicians and Wall Street executives, and/or by a desire to prevent what could be a financial crisis-induced recession, remains unknown. Regardless, the move to inject massive amounts of money may have consequences ahead.

Since the Fed’s 0.50 percent rate cut, long bond yields have climbed, gold has surged to a 27-year high and the already weakened U.S. dollar has fallen to a new all-time low largely on fears the Fed has become complacent about inflation, which is still on the upper-end of the Fed’s preferred range of 1 to 2 percent. In addition to inflation risk is what economists call moral hazard, or the risk taking stemming from the prospects of not having to carry the full burden of risk, among financial institutions (see Harlan Cadinha’s September 26, 2007 commentary *Moral Hazard?*). While Bernanke has vowed not to underwrite a bail-out of financial institutions and mortgagees who have over-extended themselves, the Fed’s interventions over the past month suggest otherwise. Further easing by the Fed will encourage extreme risk taking by America’s financial institutions. We can’t help but think that continued “Put” actions by the Fed serve to delay an inevitable market crash and ensure that the longer the “Put” is in place, the larger that crash will be.

Beyond the monetary and debt challenges facing the U.S. is an upcoming fiscal battle in Washington, D.C. In last quarter's *Outlook*, we highlighted the likely tax increases on investors coming perhaps as early as 2008. This is still a major concern for us as increased tax rates—federal dividend tax rates are set to rise to 40 percent from 15 percent, and capital gains tax rates to between 28 and 40 percent from 15 percent today—would cause an adverse revaluation of stock prices.

Now the Good News

Most of this *Outlook* focuses on the major risks we see. However, while downward markets and even recession in the U.S. have a respectable probability of materializing, the global economic growth story remains intact. Combine this with a depreciating dollar, and our typical equity holdings—large multinational growth companies—remain poised to out perform. In addition, their strong balance sheets with low debt and high cash generation make them less affected by the re-pricing of credit. Other beneficiaries should include our holdings in foreign equity markets, Euro and Yen currencies, and gold.

Although we are concerned with the possibility of an escalating credit crunch, we're not calling for a recession just yet. While many indicators, such as consumer spending, have materially weakened in recent months (this is a big one as 72 percent of our GDP is from the consumer), employment remains very strong. Interestingly, we've never had a recession without unemployment claims spiking (Figure 3).

Weekly Initial Unemployment Claims (000s)

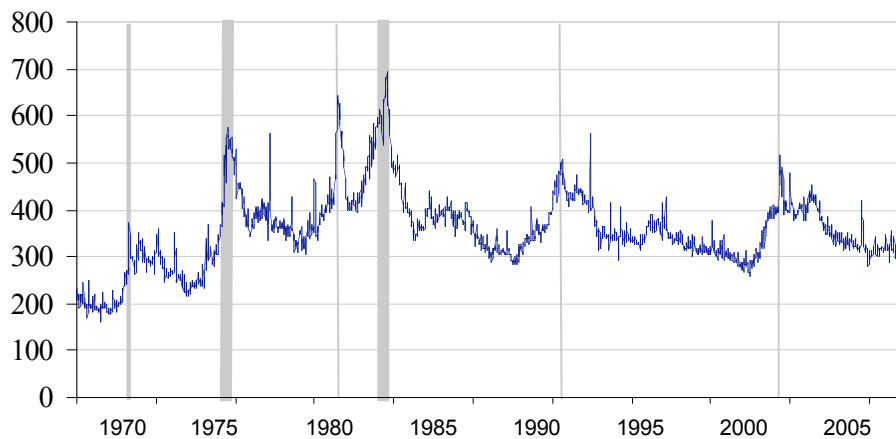


Figure 3 (Shaded region indicates recessionary periods)

We remain relatively light on bonds and heavy in cash equivalents yielding roughly 4 percent. With the Fed now in easing mode and the dollar falling, longer term bonds at 4.6 percent don't seem that enticing given the risk of future inflation. However, should the chance of recession increase, expect an allocation in longer term bonds.

At Cadinha & Co., more early mornings will continue as this market still needs to be closely monitored. Meanwhile, our investments contain a healthy, but not a bullish allocation in stocks; a significant tilt towards equities benefiting from foreign exposure; smaller direct currency allocations in the Euro and Yen; some gold; and a light bond exposure.
