

Investment Outlook & Commentary First Quarter, 2008

Summary: The effects of the financial crisis of 2007 continue to unravel. While a massive and coordinated effort is underway by the Federal Reserve, the Treasury, and the White House to re-inflate capital markets and assist a million homeowners who face possible foreclosure, the threat of deflation and recession is a real one. Either way, volatility should continue in the markets as the credit crunch and an eventful election year play out. We enter 2008 with a continued defensive posture and will wait for better buying opportunities. Within equities, we continue to lean towards those sectors and companies with more predictable growth.

Greetings from Japan. About this time of year, I'm instinctively pulled here like some migratory bird that one day knows it must fly to its other home. However, I come here when it's cold, and my visits are brief—just a week to spend time with my mother's side of the family and enjoy the quiet beauty of Tokoroyama: an oasis of winding, pine-covered mountains and clear, trout-filled rivers. It's a great place to think, evaluate the year just passed, and to plan and prepare for the year ahead.

This visit seems especially relevant; not because Japan is a place we're significantly invested or because Japan will soon be a big economic or market-driver. Rather, it's a timely reference point by which to analyze the U.S.'s current credit-based financial crisis. Japan is the world's deflationary fable, the story of a country that levered cheap financing in the 1980s to spin a powerful virtuous cycle of higher asset prices and more credit; and in so doing, created history's biggest financial bubble. The aftermath in Japan has been torturous, marked by nearly 20 years of falling asset prices and bouts of economic recession.

While we don't believe this financial crisis will precipitate Japanese-style deflation, we think that the U.S.'s handling of financial crises—by always fixing a financial crisis caused by cheap and easy credit with more cheap and easy credit—itches us closer to a similar fate.

The Unwinding

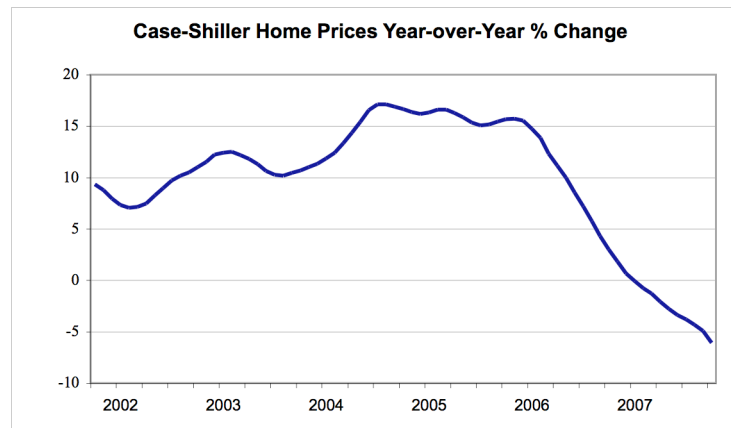
The current financial crisis has hit many hard. Foreclosure rates continue to rise and banks and other financial institutions have so far announced at least \$100 billion in losses in mortgage-related securities. These losses have mostly come through various kinds (and often esoteric forms) of mortgage-backed securities—many of which were rated by credit-rating agencies "AAA", the same quality rating given to U.S. Treasury obligations.

Banks have been fighting for their financial survival as \$1.3 trillion in subprime mortgage exposure alone have threatened to put some banks below federally mandated capital requirements. The result has been banks selling significant equity stakes to large investors—mostly at fire-sale prices to foreign billionaires and large, government-owned investment funds called "sovereign wealth funds".

The near future doesn't look promising for stretched homeowners and mortgage-security holders alike as home prices nationally continue falling at an accelerated rate (see chart) and roughly \$800 billion in adjustable rate

subprime mortgages will reset to higher interest rates over the next two years. In addition, banks are expected to announce some \$100-200 billion in additional losses, and subprime's biggest investors, hedge funds, should finally begin confessing their blunders to investors.

The credit crunch has many talking about the "R" word. While we think a recession is not likely just yet, the probability of one in the near term is high enough to be considered in formulating asset allocation.



Peddling Moral Hazard

A coordinated (and controversial) effort is underway in Washington to contain the crisis. The White House and the Treasury recently announced brokering a plan with lenders intended to help hundreds of thousands of subprime borrowers by postponing for five years their scheduled interest rate increases. The Federal Reserve has provided over one hundred billion dollars in short term financing to beleaguered banks and has lowered interest rates to add liquidity and counter the evaporating effects of tighter credit.

The Fed finds itself in a difficult position. It supposedly operates under a "price rule" whereby monetary policy is set in order to maintain a low and steady inflation rate. However, during this financial crisis, the Fed realizes that despite inflation currently running higher than their 1-2 percent preferred range, it can't let the system implode. Thus, the Fed will likely side with re-inflating the economy over maintaining an inflation discipline and lower interest rates are likely going forward.

While it's unknown how successful the government's efforts will be in saving homeowners, banks, and investors in the near term, what is apparent is the government's willingness to trade longer-term and structural soundness in favor of more popular shorter-term relief. Politicians are caught in a trap: letting those who did stupid things with cheap credit implode which will be political suicide; or, create bailouts and cheaper credit which will encourage more debt and risk-taking. Either option may lead to greater problems later on. And what we have to look forward to at that time may be what the Japanese have experienced over the past 20 years.

More Volatility in 2008

At current stock market levels, the markets seem to have "priced in" a successful Washington intervention. While we continue to lean toward a similar "soft-landing" scenario in the shorter-term, we think the markets have temporarily overlooked both the magnitude of the crisis's contagion and other risks facing investors in 2008. Realization of these risks should ensure continued volatility in 2008.

The crisis is not limited to subprime mortgage stakeholders. While subprime has been the main culprit of financial institutions' woes, we expect the crisis to spread more to other areas of the credit markets and affect prime mortgages, corporate debt, auto loans, and credit cards. In addition, as Harlan Cadinha commented recently, states and municipalities may fall victim to the credit crunch. MBIA and Ambac, the nation's largest providers of insurance to municipal bond issuers who purchase policies to guarantee interest payments to investors and achieve "AAA" credit and lowering borrowing costs, recently announced they were also big insurers of toxic subprime mortgage securities. Hundreds of billions of dollars worth of municipal bonds may re-price lower, potentially causing further strain.

The 2008 election seems off investors' radars as well—despite several presidential candidates promising tax increases of various magnitudes. All the advocates of tax hikes have pledged to raise the 15 percent federal tax on capital gains and dividend income. This possibility of tax increases in 2009, combined with protectionist rhetoric from both sides of the political aisle, could also cause investors to re-value equities.

As volatility should remain escalated in the near term, we remain relatively light on equities for balanced accounts heading into 2008. We have lengthened bond maturities—mostly to hedge our equity positions and the possibility that the economy continues to slow. We're keeping an eye on the longer-term bonds, however, as the Fed's re-inflating efforts may prove inflationary.

Within equities, we've maintained a bias towards those non-cyclical companies who typically grow revenue and earnings irrespective of the economic cycle. Going forward, these "growth" types of stocks should derive a nice premium to "value" and more cyclical stocks.

Our dollar hedges in the Euro, Yen, Canadian dollar, and gold holdings persist, although we're decidedly less bearish on the dollar. After years of weakness, most of the dollar's devaluation is likely behind it.

Avoiding bonds with any trace of credit risks and REITs, and steering clear of financial stocks (the market's biggest and worst-performing sector) for most of 2007 has served client portfolios well. The next quarter should give us more insight as to the true magnitude of the financial crisis and whether the government's re-inflation efforts will ultimately work. While we're concerned about the current financial crisis and the longer-term risks associated with moral hazard, a combination of lower interest rates, continued growth in many parts of the world, and a still-robust job employment picture in the U.S. should buoy the financial system and provide some opportunities to raise equity exposure. The "R" word in 2008 may very well be "resiliency".

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