October 5, 2007

2007 Third Quarter Review

The third quarter had it all: action, heartache, drama, suspense, and a "last-reel" ride to the rescue by the U.S. Cavalry in the guise of the Federal Reserve Board. Our last two quarterly reports effectively outlined the plot of this movie including the mortgage-related problems that eventually came to the surface and the cliff-hanger ending with the Federal Reserve acting to lower interest rates only as calamity seemed near. As we mentioned last quarter might happen, the "fear vs. greed" pendulum swung from overconfident optimism in July back to near panic in August as mortgage related investments plummeted and the Dow Jones Industrial Index fell over 10% from the highs of July 19th.

The previously austere Ben Bernanke and his Federal Reserve cavalrymen finally heard the cries of distress coming from corporations unable to find buyers for their "commercial paper," short-term debt instruments. With the potential for the credit crunch that we had warned about becoming a reality, Bernanke et al twice lowered the discount rate (the rate at which member banks can borrow money directly from the Fed) and finally lowered the Fed Funds rate (the rate at which member banks can borrow overnight from each other) on September 18th to bring them both down to 4 ¾%. The general slide in stocks bottomed in mid-August and the indexes have been rising steadily since then, with a boost coming on the decision by the Fed on September 18th to finally begin lowering interest rates with the first "Fed Funds" rate cut in years.

After all the volatility and drama in the slide and recovery in stocks, the S&P 500 gained little more than 1 ½ % for the quarter to end September 30th with a gain of 7.65% so far this year. However, it made a big difference what you were invested in during that quarter, since many mortgage related investments are still deep in a hole with a long way to go before their investors see the light of day. Financial stocks such as banks and brokerages were hard hit as the credit crunch threatens their profitability as well as their assets. Stocks benefiting from the build out of "global infrastructure" went on a tear, as did mining and "inflation hedge" stocks. The divergence in performance among the major indexes is remarkable, and that between individual stocks is stunning. The S&P 500 is now up 7.65% for the year, the Nasdaq composite is up 11.85%, while the Russell 2000 "small cap" Index is up only 2.26% and the Lehman U.S.Treasury Index is down 0.41%.

There are quite a few cross currents in the economy that are causing these divergences. The most obvious cross current is that the housing decline is bad for the economy, but the Federal Reserve lowering interest rates is good. The effect of either in isolation would be easy to predict. The problem is that they are not isolated and that the economy is so complex that it is impossible to know which current will have the stronger effect and when. The important question with a problem like the housing and mortgage crisis is how far it will spread through the general economy. The important question with Federal

Reserve actions to lower interest rates is whether it will be too little, too late to avoid a recession, or whether it will be too much and reignite inflation. Fed Chairman Ben Bernanke is sometimes called "helicopter Ben" because of a comment he made during a deflation scare several years ago before he became chairman. As stock prices were plummeting with the burst of the tech stock bubble after 2000, Bernanke said that he would "drop dollar bills from helicopters" before he would allow deflation to spread. That, of course, leads many to believe that the current Fed will err on the side of reviving inflation to avoid a recession. While the Fed has lowered interest rates, the dollar has dropped in value versus other currencies. This benefits corporations with most of their sales abroad while it puts upward pressure on the prices of all the things we import. The government has fiddled with the components of the consumer price index, excluding many things that are essential, so that many economists now feel that it already under-reports the true state of inflation. All of this explains why gold has recently hit a new high and stocks in commodity related businesses have moved up so much. The market is saying that "The Many Lives of Inflation" may be coming soon to a theater near you.

Since we can't know the outcome of these events, we look for investments with a margin of safety that will give us some protection when the currents move against us. We have done well by avoiding the worst of the landmines represented by low-quality mortgages and their derivative financial instruments. This is why I was so much against "reaching for yield," taking on much greater risk to increase income on our investments by a little. The market was not offering the appropriate "risk premium" in yield that we mentioned in our letter several quarters ago. That premium returned with a vengeance as those investments were finally marked down to reflect the potential problems, and their yields finally went back up to a premium where they should have been. Fortunately, we avoided those losses now realized by investors who thought too much about yield and not enough about risk.

As we approach year-end, the stock market feels the tailwind of an "accommodative" Federal Reserve Board for the first time in several years. That may ignite inflation and/or another bubble in stocks. Others think it was too little, too late and we are bound for recession and economic contraction no matter what the Fed does. In either case, we don't have to predict the market's direction, but it is helpful to know the context and the environment in which we have to act. As always, we will try to avoid the disasters, remain aware of the risks and position ourselves to take advantage of the opportunities afforded us as the drama continues.

Sincerely,

Claude R. Carmichael CFA