

3rd Quarter 2007

THE MARKET AND THE ECONOMY

A new crisis has arrived in the form of subprime mortgages. The third quarter was extremely volatile in the stock and bond markets as greed and fear both emerged. The stock market hates uncertainty more than anything. The uncertainty is what impact will subprime lending have on our economy and the global economy. It is taking its toll on the financial sector for sure. Wall Street's greed has gotten it in trouble once again. It just had to create another bubble; this time in the mortgage market. There is fear that Merrill Lynch, Citigroup and others have not addressed the whole problem of subprime debt on their balance sheets. Merrill Lynch has fired its CEO and Citigroup's CEO looks like he is on his way out as well. That won't solve the problem but someone has to take the blame for falling earnings. The biggest fear is whether the housing decline caused by subprime mortgages will cause consumer spending to decline to the point that will cause a recession. As you know, recessions cause the stock market to fall and the bond market to go up because of falling interest rates. At least that's what happened when Alan Greenspan headed up the Federal Reserve. Now that Mr. Bernanke is at the helm will it work the same? Where is Greenspan when you need him?

Bill Gross at PIMCO and Van Hoisington at Hoisington Investment Management, two bond managers, believe the economy will get weak because consumer spending will dry up as the housing industry collapses causing the wealth effect felt by consumers to disappear. They also believe that rising energy costs will contribute to the economic slowdown. Gross says that the Fed needs to lower the Federal Funds rate to 3.5% in order for mortgage rates to get low enough to allow homeowners to refinance at rates they can afford.

James Paulsen, Chief Investment Strategist at Wells Capital Management agrees that this could happen but it may not happen. He points out that this crisis is the seventh since the economic recovery began in 2003 and he thinks that the crisis could just be another pause in an ongoing economic and stock market recovery. He points out that there are some "Crisis Offsets".

**James W. Paulsen, Ph.D., Chief Investment Strategist
Wells Capital Management
(from his newsletter September 2007)**

Crisis Offsets!!!?

Every crisis has its epicenter—currently, it's housing and subprime mortgages. Often the epicenter of a crisis is less important to its eventual resolution than what surrounds the epicenter. In our view, what surrounds the contemporary crisis is far healthier compared to past crises. Essentially, there are many more "crisis offsets" compared to the past which bodes well for a more favorable ultimate outcome.

Economic Policy Accommodative

Most crises are preceded by periods of restrictive economic policy. By contrast, this one was preceded by long-term yields which inexplicably refused to rise during the recovery, by a Fed which quit tightening short-term interest rates more than a year ago, by growth in the domestic money supply which has been accelerating in the last year, by highly stimulative fiscal spending and finally by a weakening dollar (stimulative force) throughout the recovery.

Strong Global Growth

Has the U.S. ever experienced a crisis when annual growth in global real GDP was near 5 percent? During many crises of the 1980s and 1990s, the U.S. was often the "sole locomotive" for global growth. Nobody and nothing else was there to take up the slack. Not the case today!

U.S. Trade Improvement

Throughout the 1980s and 1990s, the U.S. economy was chronically weakened by an ever-worsening U.S. trade deficit. Eroding U.S. international trade constantly weighed on overall economic growth throughout the Orange County 1994 crisis, the Asian/Russian crises of the late 1990s and the dot-com crisis of the early 2000s. Conversely, today, the U.S. trade deficit has actually "added" to real GDP growth in the last year.

Manufacturing Sector Recovery

It is fortunate to be facing this crisis with a manufacturing sector recovering from an inventory liquidation cycle last year. Most ISM manufacturing surveys show a sector in expansion and the outperformance of S&P 500 industrial stocks also suggest improving momentum in this key sector.

Unspent U.S. Corporate Buying Power

It is calming to face this crisis with perhaps the strongest corporate balance sheets since the early 1960s. Corporations possess considerable buying power, normally exhausted by this point in the recovery, which should help offset any fundamental crisis fallout.

Low Inventories

The U.S. simply does not face the typical inventory overhang it normally has in past crises. Without the need to realign inventories, perhaps indeed even the need to lift stockpiles, crisis fallout should be lessened.

In combination, these positive forces should mitigate the fallout from elevated credit rates and perhaps result in a crisis far less serious and persistent than most currently fear.

Will Housing Take Consumption Down????

By itself, continued and even deeper weakness in the housing industry is not that alarming. Despite both housing and autos being in recession the last couple of years, the overall economy and the stock market have continued to advance.

Housing and autos comprise less than 9 percent of real GDP but are off by a nasty 10 percent in the last year. Regardless, however, the remaining 91 percent of real GDP has risen by a healthy 3.1 percent! Obviously, the problem and concern is not solely housing and autos contracting—this has been going on for awhile and the rest of the economy has remained fine—rather the question still is will fallout from the housing collapse impact broader consumer spending trends?

The mechanism most believe ties residential investment to consumption is “housing prices.” Many fear falling home prices, something very uncommon in the post-war era, will erode consumer confidence and ultimately cause consumption to slump. We offer a couple of considerations.

Anxiety is spreading that this rare home price decline will soon start to erode consumer confidence and spending. We believe the recent decline in housing prices is more reflective of how high and for how long prices have risen in recent years, rather than signaling a fundamentally damaging force for the consumer. Even though they are off by a record amount in the last year, real home prices are still up more than 10 percent in the last four years—one of the greatest and most sustained advances in the post-war era! True, some buyers which bought at the top of the housing market are hurting. But for the vast majority of homeowners, perhaps the adage “house prices have fallen to levels most never thought they would get up to” is most applicable! Is a mild decline in house prices after years of recordsetting advances really that destructive for most homeowners?

Historically, there has been a very close relationship between housing spending and consumption spending.

Fortunately, there is also historical precedent for a much looser relationship between housing and consumption. During the decade of the 1960s, the correlation was only 0.25 and in the mid-1960s, although real housing spending suffered an even deeper decline than it has in this recovery, consumption growth remained remarkably healthy. What is most encouraging, however, is the correlation between housing and consumption “in this decade” (at only 0.07) suggest the two have been virtually independent! The relationship between housing spending and consumption spending has never been as weak at any time in the post-war era as it has been in the current decade! At the very least, in the contemporary recovery, something very different seems to be happening with the relationship between housing and consumption. If whatever it is that has changed continues to persist, consumption may remain stronger than most expect even if housing continues to liquidate.

Is the Crisis Overblown???

This is a real crisis and we do not want to leave an impression otherwise. The freeze-up in parts of the fixed-income markets—some parts still without much of a bid—is quite serious indeed! And there will be at least some economic fallout from the recently elevated yield levels.

However, as often happens during financial panics, many of the initial events which contributed to the crisis later prove overblown and much more easily and quickly reversible than most fear. We offer a couple examples in the current crisis where initial events dramatically adding to the sense of a “spreading contagion” have already subsequently proved far less damaging.

In early August, BNP Paribas announced it had to freeze three asset-backed securities funds because they could not fairly value holdings due to subprime fears. At the time, this announcement rocked the financial markets and added to a growing sense of market meltdown. Then on August 29, BNP announced it reopened two of the three funds (and would soon open the third) and the values of both reopened funds were nearly unchanged from when they were closed. They went on to report the funds were fine since most of the assets were rated AAA or AA and as such never really posed a real failure risk. This example causes us to wonder how may other initially reported “fund problem rumors or announcements” may largely be resolved with little or no long-term fallout? For example, how much of the “frozen” asset-backed commercial paper market will eventually mature and be fine?

No doubt this crisis is real and will have real fundamental consequences. However, much of the frenzy in recent weeks, initially legitimizing this event as a crisis, has either already been corrected or may prove much easier and quicker to correct than most currently think.

What About the Financial Markets????

Although encouraged by recent action suggesting at least an initial crisis bottom in the financial markets, volatility will remain a central feature for the next few months. In the next 90 days, economic reports will take center stage as crisis fallout is evaluated. While we remain optimistic the U.S. economy is likely to come through this period in a relatively healthy state, it will not be unscathed. We fully expect additional trying days in the stock and bond markets as initial crash lows are tested and retested in the next couple months.

Crises tend to shorten investment horizons. They force everyone to think about next month, next week or even this afternoon. While this is part of a trader’s day, most investors should fight to stay calm and remain focused on a longer-term horizon. .