



Market Outlook August 2008



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There's Got to Be a Morning After...

In our January 2007 Outlook, we said: "Some have called the bottom in housing, which we feel is premature. There has been little to no blood in the streets (or Wall Street). Where are the bankruptcies, job losses, bank failures, and investor fear?" Well, wonder no more. Realized housing-related losses to the financial system are estimated to eventually approach \$1 trillion.

Little did we know that over a year and a half later, there would still be no sight of a housing bottom. The credit crunch shows few signs of abating despite aggressive Fed easing the past year and the addition of numerous other props to the financial system, such as various liquidity facilities to banks and Fannie Mae and Freddy Mac. Additionally the Federal government just passed a major housing bill and essentially issued a blank check to FRE and FNM to guarantee their debt. Nonetheless, LIBOR rates remain elevated, credit spreads (including mortgages) are at historically wide levels, and monetary growth has stalled. Essentially, the private markets, through increased risk averseness, have more than offset the Federal Reserve's easing efforts.

Until housing stabilizes, the markets and financial system will remain vulnerable to additional shocks. Meanwhile, the economy, which may have officially entered a recession the fourth quarter of 2007, continues to falter as the fallout from the housing crisis continues to spread to other parts of the economy via the banking system. The primary

stabilizers of the housing market (jobs, income growth, and mortgage rates) have all deteriorated, leaving lower home prices as the only variable that would make homes more affordable. Consumers, banks, and investors are embarking on multi-year deleveraging process; necessary, but painful and excruciatingly slow.

Meanwhile, elevated headline inflation has put the Fed between a rock and a hard place, torn between its dual mandates of promoting growth and fighting inflation. Thus, the Fed is on hold indefinitely.

Okay, other than that, Mrs. Lincoln, how was the show? Seriously, though, there are a number of offsetting factors that should ultimately cushion the equity market and eventually provide decent upside potential.

Headline inflation (as opposed to core), which includes the volatile energy and commodities components, is approaching 5%, primarily due to oil's sharp ascent from \$100 to \$140 in about 6 weeks in May and June. It has since retreated to under \$120 per barrel. We expect the oil correction to continue as the moribund U.S. economy will be followed by probable recessionary conditions in Europe and slower emerging market economies. Therefore, further demand destruction is likely, resulting in still lower oil prices.

The housing crisis and deleveraging process are definitely deflationary, and higher food and energy costs have not been passed through to wages. We expect inflation readings to soften by the fourth quarter, perhaps dramatically, which would give the Fed the flexibility to further lower rates or at least not raise them, as many investors fear. Thus, interest rates have room to come down, which would be another likely catalyst for the stock market.

The Fed and the U.S. Treasury have taken numerous steps to provide stability to the financial system, and Congress just passed a major housing bill, all necessary steps, but probably not sufficient to put a floor under housing. A number of respected people have been calling for more aggressive action, perhaps similar to the RTC (Resolution Trust Corporation) act of the early 1990s. We agree that something of that nature will probably need to be enacted, which should help put a bottom under housing and allow the market to begin discounting an eventual recovery. However, there is still significant downside to housing prices until they reach more affordable levels and inventory levels begin clearing.

Once the market senses the worst is over for housing, losses can be quantified, uncertainty will ease, and credit spreads should contract. This will all take time, however, as will the deleveraging process as consumers, investors, and banks rebuild their balance sheets.

The markets are already discounting a lot of bad news, with the S&P 500 trading at around 13 times forward earnings and credit spreads at recessionary levels. Assuming the government gets more aggressive, as discussed, we see decent appreciation potential for the stock market over the next 12 months, but the next several months will continue to be rocky, so wear eye protection!

We now favor domestic equities over international, since the U.S. is about a year ahead of the slowdown taking place in the rest of the world, and our Fed has been much more aggressive than the Bank of England and the European Central Bank. Thus, we think the dollar has bottomed versus the euro and could even strengthen modestly. Emerging markets should continue to correct as many of them have commodity-induced inflation issues, and their central banks are raising interest rates.

Within the U.S. stock market, we continue to prefer large cap stocks with their more attractive valuations, relative stability, and higher quality income streams. It is still too soon, generally, to aggressively bottom fish in financials and housing-related industries, although select opportunities exist. Investors will pay premiums for earnings growth in these troubled times, and that means technology, health care, and select consumer staples names. In essence, the further away a company is from housing and consumer discretionary purchases, the better, since rampant deflationary pressures persist in those areas. Companies with pricing power and tight cost controls should continue to outperform on a relative basis.

In the bond market, we see some value in Treasury prices, higher quality corporate bonds, agency-insured mortgage backed securities, and municipal bonds. Municipal bonds, despite their tax advantages, are still trading at comparable yields to Treasuries, so value exists there as well.

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