

# Q3 2007 Quarterly Investment Commentary



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Fall is a time of change, of leaves turning colors, nights becoming cooler, kids heading off to a new school year. As far as the markets were concerned, fall came early with the reemergence of volatility this last quarter. With the credit markets freezing up, we suffered through a weak August only to be followed by a strong September.

As in prior periods, there was a wide degree of variation across asset classes. Value benchmarks were negative for the quarter, while growth indices did considerably better, led by large-cap growth stocks generating over 4% returns. For the first nine months of 2007, growth stocks are significantly ahead of value stocks after trailing value stocks for seven consecutive years. International stocks gained over 2% in the quarter, moderating after their run of impressive returns, while emerging market stocks excelled. REITs (Real Estate Investment Trusts) managed to post a positive quarterly return around 2% though they are still down over -4% for the year. With continued strength in energy and agricultural products, commodity futures gained over 6% for the 3<sup>rd</sup> quarter. The stock market, as represented by the S&P 500, is up 9.1% for 2007.

The credit crunch (initiated by sub-prime home loan problems) and the continuing weak housing market affected the investment markets in the third quarter, and will continue as major influences for at least the upcoming six months. These two factors will drag on the economy, offset by positives such as corporate spending, a booming global economy, and an already weak dollar.

## **The Challenge: Credit Crunch and Weak Housing Market**

Rapid price appreciation for residential real estate over the last five years led to higher risk actions. Speculators purchased multiple homes with little money down, all on the bet that prices would continue to rise. Borrowers with poor credit history were extended home loans with little to no money down and low initial interest rates. These riskier loans were then packaged into large pools, cut into tranches (slices) and then large parts of the pool were given very high quality ratings, and sold to investors the world over. Some lower quality tranches were then pooled again, rated and resold, magically giving a good portion of these riskier tranches a high quality rating. When house prices quit rising rapidly and the initial loan periods expired, these loans began to have a much higher incidence of default than the investors had been promised. Bond investors

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suddenly refused to buy additional mortgage-backed securities, causing a liquidity crunch. The same rating agencies then lowered their ratings on these loans, causing large losses to the mortgage holders and a further lack of trust.

Although the Federal Reserve's 0.5% September rate cut partially stabilized the bond markets and restored some sense of normalcy, the credit markets will not soon be back to the way they were. Easy credit for large private equity buyouts of public companies has diminished significantly, particularly after the losses that have been booked and the billions of dollars of loans remaining unsold on the balance sheets of large money center banks. Even today, the Treasury Department is working with large U.S. banks to provide a fund that will buy mortgage-backed securities from other investment funds in order to prevent further pricing collapses. With easy lending and Wall Street's packaging of mortgage loans into derivatives, it's difficult to know where risk is sitting and how it might show up next.

Though the situation has improved since August, mortgage loans are more difficult to obtain than prior to this summer, and more expensive outside the standard conforming loan arena. Not surprisingly, this has adversely affected the housing market, reducing the number of people that can afford to purchase at a given price. With demand falling and inventory rising, housing prices have begun to fall in many parts of the country, and are expected to continue facing chill winds for at least six months. During the recent housing boom many jobs were created for building, financing, remodeling, selling and furnishing homes. Jobs in housing-related fields have already begun to fall and will continue to do so for some months to come. In addition to generating jobs, the rising housing market was also a major source of cash, as homeowners turned to the "housing ATM" to withdraw over \$1.3 Trillion in home equity for home improvement and personal consumption from 2002 through 2006. With this source of cash gone, the economy potentially faces a material cutback in consumer spending — the primary driver of economic growth.

### **The Positives: Corporate Spending, Booming Global Economy and Exports**

U.S. corporations are flush with cash and have been spending to increase capacity. While not equal to the 70% of the economy driven by consumer spending, corporate capital spending is a factor which should continue to support a growing economy.

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Corporate spending and profits have been rising partly due to the strong global economy, which is less dependent on the U.S. than it used to be. According to Goldman Sachs, for instance, the four largest emerging market economies—Brazil, Russia, India, and China—are responsible for a significantly larger portion of the global demand growth than is the U.S. With improved economic policies in general, emerging markets are growing their economies and their middle classes rapidly, thereby playing a much more important role in the global economy.

Because Americans have been importing so many consumer goods from around the world and the economy is showing signs of slowing, the dollar has weakened considerably. While this has the potential to be inflationary (by making imported goods more expensive), a weaker dollar definitely makes U.S. based companies more competitive with their products and services in world markets. U.S. exports have been contributing to U.S. GDP growth by growing more rapidly than imports; export strength is helping the bottom line of U.S. firms that do business globally and adding to U.S. demand for labor and capital spending.

The economic outlook is murky. Due to the credit crunch and continued weak housing market, a recession is more likely than economists had earlier anticipated, but is not a foregone conclusion. We think GDP growth will slow to 1.5%-2.0% through mid-2008, but that we will avoid a recession.