



HOWE & RUSLING

# INVESTMENT STRATEGY NEWS

OCTOBER 2007

## 3rd Quarter 2007 Stock Market Overview

### This Quarter had all the Makings of a Great Drama—Fortunately, with a Happy Ending

There were highs and lows, fear and joy, happiness and sorrow and maybe at the depths of the financial crisis, even a few tears. With moderation in economic growth, inflation and stock valuations, and company valuations the stock market enjoyed steady appreciation and peaked on July 19th with the S&P up over 10% for the year. Then the bottom fell out and the stock market declined steadily until August 15th when it had given back all of its gains. The stock market completed its round trip and near the end of September was almost completely recovered up 8.5% by September 25th. This has all made for a very exciting summer!

### The Crisis—What Happened?

Although it seems difficult to remember, it was not too long ago when the Fed funds rate stood at 1%. With rates that low it becomes tempting for Wall St. firms and banks to borrow money cheaply and deploy it out at higher rates. Investors of all types also look for ways to increase the yield on their investments because 1% money market rates are not that exciting and neither are 10-year Treasury bonds yielding 3½%. This led to the perfect storm of investors hungry for yield (income) combined with Wall St. willing to provide it.

The sub-prime mortgage market exploded in a big way in this environment. Sub-prime refers to borrowers who have credit that is substandard or that cannot afford to put much, if any, money down. Because they are sub-prime borrowers the interest rates charged by the banks were higher and many were interest only and variable rate mortgages. Because of the hunger for yield, the mortgages were packaged and sold to different investors such as mutual funds, hedge funds, banks, brokerage firms and insurance companies.

The inevitable happened and interest rates moved up from their lows. Interest only variable rate loans became more expensive and sub-prime mortgage defaults increased. The sub-prime mortgages became much less desirable and decreased in value and the market for sub-prime loans dried up.

This had several effects. The brokerage firms, banks, hedge funds and mutual funds that owned sub-prime mortgages fell in value dragging down the stock market. A mortgage company specializing in sub-prime debt failed and it looked for a time that a large mortgage lender, such as Countrywide might fail. With the rise in interest rates and the tightening of credit standards, residential construction slowed considerably. The market for other types of debt that were backed by assets whose creditworthiness was suspect also dried up, which included some corporate paper that was in money market like short-term debt funds. Concern grew over the ability of many companies to issue new debt or rollover old debt.

The Fed acted to diffuse the crisis. First the Fed added liquidity to the market by cutting the discount rate at which commercial banks could borrow. And in mid-September concerns over the impact of the financial crisis on employment and economic growth caused the Fed to cut the Fed funds rate. The Fed intervention fueled the stock market rally, which had begun a month earlier.

### How to Handle a Crisis?

We actually received a heads up on the crisis when the sub-prime lender, Countrywide experienced its liquidity crisis in March and the Dow Jones Industrial stock average fell more than 300 points. Prior to that time our fixed income committee, at the recommendation of our Director of Fixed Income Research, was growing concerned over the easy credit available and the impact of rising rates. We intentionally reduced exposure to corporate bonds, more specifically financial corporate bonds and even more specifically corporate bonds of brokerage firms. The early reduction led to good performance of our fixed income during the crisis.

Heading into the crisis, our core equity portfolio was fairly well positioned. We did not own any of the money center banks, mortgage lenders or builders. We did own the most well-positioned brokerage firm. However, it fell along with all the brokerage firms, but is now coming back strongly, much ahead of the others.

*Providing professional investment management to individuals, retirement plans, and charitable organizations since 1930.*

### AT A GLANCE

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During the financial crisis and subsequent fall in the stock market, our equity committee met frequently to discuss potential changes to the mix of stocks and bonds in our balanced accounts and changes to the stocks in the portfolio.

Our Director of Equity Research led a review of each stock in the portfolio and the debt structure to make sure we didn't own any companies that would have trouble if they were unable to issue debt. Performing this action led to confirmation that the balance sheet risk of companies in the Howe & Rusling portfolio tends to be minimal. Using our model for picking stocks, a company with substantial debt will not rank as highly and, in general, will not pass our screens.

When we performed our review, we confirmed that only two of our twenty-two non financial stocks had much debt and those companies had plenty of debt coverage. Even though the brokerage company we owned dropped dramatically along with the other brokerage firms, we were comfortable with the company and felt it would recover quickly with the market. We liked the companies we owned prior to the drop due to the financial crisis and we liked them better after they fell to even more reasonable prices.

We also felt that making wholesale changes to the portfolio or major changes to the asset allocation would not serve our clients well because we did not believe anything fundamental had changed. We felt that the crisis would be accounted for and short-lived and then isolated to the sectors that should be

directly affected. This proved to be the correct decision as the Fed stepped in to calm the financial markets.

## Where Do We Go from Here?

As of the end of September, the financial markets have stabilized and the equity markets have recovered most of what they have given up. The Fed acted on concerns that the economy is slowing because of the financial crisis just passed. The question now is whether the Fed acted in time to stimulate a growing economy. On the positive side, the Fed did act, and stock market valuations remain approximately at the historic averages. Although the stock market reacted instantaneously, typically it takes one to two years for the economic impact of Fed fund rate cuts to be felt.

## So Where from Here?

The returns we achieved in the first half of 2007 were mostly lost in the first half of the third quarter, but (at the time of this writing) have been nearly totally recouped in the second half of the quarter. Volatility is unsettling and for the most part unwelcome, but we seem to be weathering this period in good shape. Short of a severe shock to our financial system which could be caused by geo-political factors, the continuance of strong corporate earnings, a reasonably good jobs market, low inflation and moderate interest rates combine to provide an excellent backdrop for the stock market to do well in the next few years.

## 3rd Quarter 2007 Bond Market Overview

### *Bond Market Rally – Sign of economic weakness?*

The positive performance of bonds this past quarter has been impressive. However, not all fixed income sectors have benefited proportionally. The following table illustrates that relative performance has been greater for U.S. Treasury Notes and U.S. Government Agencies. This is indicative of investors shunning higher risk sectors in favor of higher quality sectors when economic uncertainty becomes more apparent.

Start Date: 6/29/2007      End Date: 9/14/2007

Index	Return for Period	Annualized Return
Intermediate U.S. Government / Credit	2.58%	12.84%
U.S Treasury: Intermediate	3.46%	17.49%
U.S. Agency: Intermediate	2.74%	13.66%
Intermediate: Corporate	1.20%	5.81%
Invest. Grade: Industrial - Intermediate	1.85%	9.09%
Invest Grade: Financial Institutions - Intermediate	0.52%	2.49%
Intermediate Utility	1.73%	8.45%
Municipal Bond: 1-10 Yr Blend (1-12)	2.26%	11.1%

### Worst Performing Sectors

Start Date: 6/29/2007 End Date: 9/14/2007

Index	Return for Period	Annualized Return
ABS Home Equity	-0.89%	-4.13%
Invest. Grade: Financial Institutions - Long	-0.47%	-2.21%
GNMA 5/1 Hybrid ARM: U.S. Aggregate	0.00%	0.00%
GNMA 7/1 Hybrid ARM: U.S. Aggregate	0.00%	0.00%
GNMA 10/1 Hybrid ARM: U.S. Aggregate	0.00%	0.00%
Invest. Grade: Financial Institutions	0.37%	1.76%
Invest. Grade: Financial Institutions - Intermediate	0.52%	2.49%
GNMA 3/1 Hybrid ARM: U.S. Aggregate	0.75%	3.61%
Asset - Backed Securities	0.82%	3.96%
Asset - Backed Securities Aaa	0.90%	4.33%

Source: Lehman Brothers, 2007

There's no denying that we have experienced a significant change in the outlook for the economy. The recent problems associated with the mortgage market and declining home prices have begun to have a negative effect on consumers' spending. Additionally, the most recent job creation statistic (change in non-farm payrolls) for the month of August showed that the "other shoe may have dropped." The economy actually lost 4,000 jobs in the month of August, rather than adding close to 100,000 which was expected. While this is only one month's worth of data, it is a big difference in expectations and could very well give more justification to the Federal Reserve Bank easing monetary policy and lowering the Fed Funds interest rate, which we recently observed.

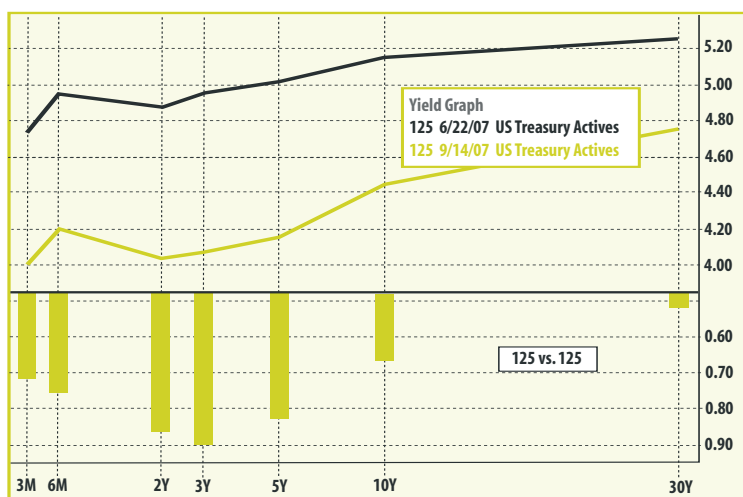
### Best Performing Sectors

Start Date: 6/29/2007 End Date: 9/14/2007

Index	Return for Period	Annualized Return
U.S. Treasury: 20+ Year	6.83%	36.75%
U.S. Treasury: Long	6.01%	31.87%
U.S. Government: Long	5.88%	31.08%
U.S. Agency Long	5.19%	27.09%
U.S. Aggregate: Government Related Long	4.85%	25.16%
Supranational Long	4.70%	24.31%
Sovereign: Long	4.35%	22.35%
Long Foreign Agency	4.34%	22.29%
Long Non-Corporate	4.33%	22.27%
Long Foreign Local Government	4.24%	21.77%

Source: Lehman Brothers, 2007

### YIELD CURVE GRAPH



Source: Bloomberg, 2007

The worst performing sectors this past quarter are also indicative of how nervous investors are about the market for home mortgages, home equity loans, and the financial institutions that provide these loans and Asset – Backed Securities.

Not surprisingly the best performing sectors are all related to Government securities (U.S. and Foreign). Additionally, securities of longer maturities have outperformed. The recent shift in the Treasury yield curve has benefited longer bonds more than short or intermediate ones.

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The Federal Reserve has the dual mandate of maintaining a monetary policy that leads to maximum employment and stable prices with moderate long-term interest rates. It would appear that the bond market had already anticipated the easing of monetary policy given the change in the yield curve to the left. We also believe that the Federal Reserve will be compelled to continue to ease monetary policy in the near future in light of weak employment figures. Once the easing cycle begins, it will take some time for the effects to be apparent and give a "boost" to the economy.

*The anticipated continuing lowering of short-term interest rates by the Federal Reserve is justified and we repeat will provide “stability” to the financial markets. However, we do believe that the bigger issue of too much debt by consumers, government, and corporations will have to be addressed by the market and there is a risk that too much stimulation (low short-term interest rates) may in the longer term be inflationary and put our economy at risk. Stay tuned.*

However, what we would expect to see immediately is:

- Stabilization of the financial markets from the volatility that we have seen in equities and certain sectors of the bond market.
- A weakening of the U.S. dollar as lower rates make dollar denominated investments less attractive than investments in other parts of the world.
- Lower cost of existing financing that is indexed to the Prime rate (which normally is 3% above Fed funds).
- A steeper yield curve with long rates higher than short rates.

What we may not see immediately, that gave rise to the most recent market problems is the stabilization of the housing and mortgage markets. There are deeper rooted problems in certain sectors of the mortgage market (sub-prime) that will not be eliminated by lower short-term rates. We continue to be cautious regarding credit risk as corporate bonds continue to exhibit poor performance, especially financial institutions. We still believe that Government agency bonds will continue to be attractive and that tax-exempt municipal bonds also provide relative value in this market. However, we do believe that the recent rally in the bond market may be the “harbinger” of weakness in the economy that gives us reason to be cautious with respect to risk taking. As we have said in the past about the market clamor for lower interest rates: *be careful what you wish for.*

### **Home Prices & Interest Rates – The Chicken or the Egg?**

We have all heard the old expression: *Neither a borrower nor a lender be*<sup>1</sup>. In the world we all live in, that is not very practical. The financial markets would not exist if it were not for borrowers and lenders. What should have been said (excuse me, Mr. Shakespeare) is: Don’t borrow unless you can pay it back and don’t lend unless there’s a good chance you’re going to get your money back.

That “modified” motto is what more lenders and borrowers should have heeded over the last 4 to 5 years. It is precisely the inability of some consumers to repay their debts that has given rise to the financial distress we’ve experienced of late.

The increased volatility, impaired liquidity, and credit market deterioration we have experienced in the capital markets recently are a result of “seeds” planted four to five years ago. The current market environment is the “hangover” from cheap money that was pervasive throughout our capital markets during the period from 2002 to 2006. The catalyst for the excesses which are being re-evaluated in the markets today was the Fed funds rate reaching a low of 1% in June of 2003 and remaining at that level for approximately 1 year.

Perhaps the consumer sector that showed the biggest growth as a direct result of low borrowing costs was housing. Home prices in many areas of the country increased dramatically over this period of time, not so much because there was a scarcity of new or existing homes, but rather because demand was driven by low mortgage rates and home equity lines of credit. Consumers found buying a home (or two) much more affordable. Speculation on real estate values also contributed to increased demand for mortgage loans. All of the money available to lend did not find its way to creditworthy borrowers. The problems of the “marginal” or sub-prime borrower have been well publicized over the last three months and need not be repeated here. However, what is important to mention is that a great many of these loans found their way into the capital markets as securities where investors looking for higher yields in a low interest rate environment were eager to buy them. What could be better than finding a high yielding AAA rated security? The answer is nothing, provided that the funding machine for this market sector does not break down. We all now know that AAA rated securities does not mean they are riskless. The rating system is designed to evaluate credit risk or the issuer’s ability to repay. It does not take into consideration interest rate risk or liquidity risk. It is the latter that the capital markets are trying to work through right now.

So, what happens as the Federal Reserve lowers the Fed Funds rate? Will everything return to “normal”? Will over-extended consumers be able to buy overpriced homes? Will sub-prime borrowers be able to refinance their overpriced homes? We don’t believe that is going to happen in the near future. Many of the lenders that originated these mortgages are no longer in business and many of the buyers of these mortgages are no longer as eager to buy them. Furthermore, many prime borrowers will be faced with refinancing at higher rates and many will not be able to refinance the total outstanding balances on their mortgages. In most cases, loan to value ratios are too high, which means many will have to use savings or other sources of funds to pay down their loan balances. So while home prices appreciated due to low interest rates, consumers were able to “monetize” the equity in their homes. In most cases, that is no longer an option.

The anticipated continuing lowering of short-term interest rates by the Federal Reserve is justified and we repeat will provide “stability” to the financial markets. However, we do believe that the bigger issue of too much debt by consumers, government, and corporations will have to be addressed by the market and there is a risk that too much stimulation (low short-term interest rates) may in the longer term be inflationary and put our economy at risk. *Stay tuned.*

<sup>1</sup> Hamlet, by William Shakespeare, 1603.

If you are interested in learning more about our affiliate, SouthernSun Asset Management, and their small-cap portfolio management, please contact your portfolio manager or Craig Cairns, President of Howe & Rusling.