

# THE MARKET OBSERVER

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Stocks continued to show resiliency during the remainder of the third quarter despite lingering concerns over the decline in the US housing sector and the on-going sub-prime lending crisis. The S&P 500 closed the quarter up approximately 9% for the year, only slightly below its July 19th all-time high of 1,553.

Leading into the last three months of the year, the markets clearly expected the Fed to drop the Fed funds rate at least an additional 1/4 point (to 4.5%) as further precaution against the economy falling into a recession and to allow the credit markets to continue to work their way through the repricing of risk we discussed last month. Stocks have also been helped by strong overseas economies (especially China and other Emerging Markets) which seem to be decoupling from the slowing US economy. Foreign stocks, as measured by the MSCI EAFE index, were up approximately 14% for the year through the end of September, while Emerging Markets (as measured by

the MSCI Emerging Markets Index) advanced 35%.

The Fed did, in fact, follow through with the expected .25 point drop in Fed fund rates on 10/31. However, it also seemed to throw cold water on the possibility of further rate cuts by hinting that the risk of slowing growth was no greater than the risk of rising inflation. Markets initially reacted favorably to the drop in rates, however, these advances were more than erased over the next week, (once again due to housing and sub-prime concerns) leaving the S&P 500 now up approximately 4% for the year through November 7th (approximately 5.5% including dividends).

Large US companies with strong balance sheets and secure and visible earnings have continued to outperform large cap value as well as smaller capitalization companies that may be more exposed to a slowing economy. Larger companies also stand to benefit from the continued strength of overseas economies as a larger

percentage of their earnings come from abroad. These exports will also be aided by a declining dollar (falling due to our declining interest rates) which makes dollar priced exports less expensive.

It is important to remember, however, that China and other Emerging Market economies cannot continue to spur world economic growth at a rate of 5% plus per year without some help from the US consumer. So far, our housing decline has not spread into a drop in consumer spending, and recent reports forecast US growth to be at least 2% in 2008. Such a spread would be bound to have a negative, compounding effect on world trade (over 20% of China's exports were to the US last year).

Meanwhile, the "resolution" of the lending crisis continues. Merrill Lynch recently took an \$8B hit to earnings after writing down the value of sup-prime related securities on its balance sheet. Countrywide Financial took a similar hit of \$3B. Fitch ratings announced

it is expecting to downgrade \$38.6B of Collateralized Debt Obligations (\$23.9B of which are currently rated AAA and could be dropped to junk status). Citigroup followed suit in announcing losses that could reach as high as \$8-11 Billion.

Understandably, the S&P 500 Financial Sector was down over 14% through 11/4, while the Consumer Discretionary Sector was off 7%. Meanwhile, the energy, basic-materials and information technology sectors were all up more than 20% (WSJ 11/5/07).

In their fourth quarter *Global Market Prospective*, Schroders Investment Man-

agement shines additional light on the possible impact of sub-prime losses:

*“There are about one trillion in sub-prime mortgages outstanding. If 25% of these default, and the loss on those defaults is 50%, that results in about \$125 Billion in losses in the sub-prime market. Also (US Household net worth is approximately sixty trillion. Therefore 125 Billion represents 0.2% of total household net worth.”*

Meanwhile stocks continue to trade at reasonable levels especially when competing with the 4-5% yields available from bonds. Corporate cash levels also appear secure after

a number of years of double digit profits. Reflecting on the pessimism that continues to surround the financial markets (and the angst that quickly comes to the surface at the first signs of increased volatility), it is important to remember that markets are not always efficient. It is the responsibility of investors, as Martin Sosnoff reminds us in a recent Forbes article, “Not to panic when incremental news that comes as a surprise moves stocks sharply up or down.”



Source: Thomson Datastream, Schroders

