

# THE MARKET OBSERVER

SEPTEMBER 2007

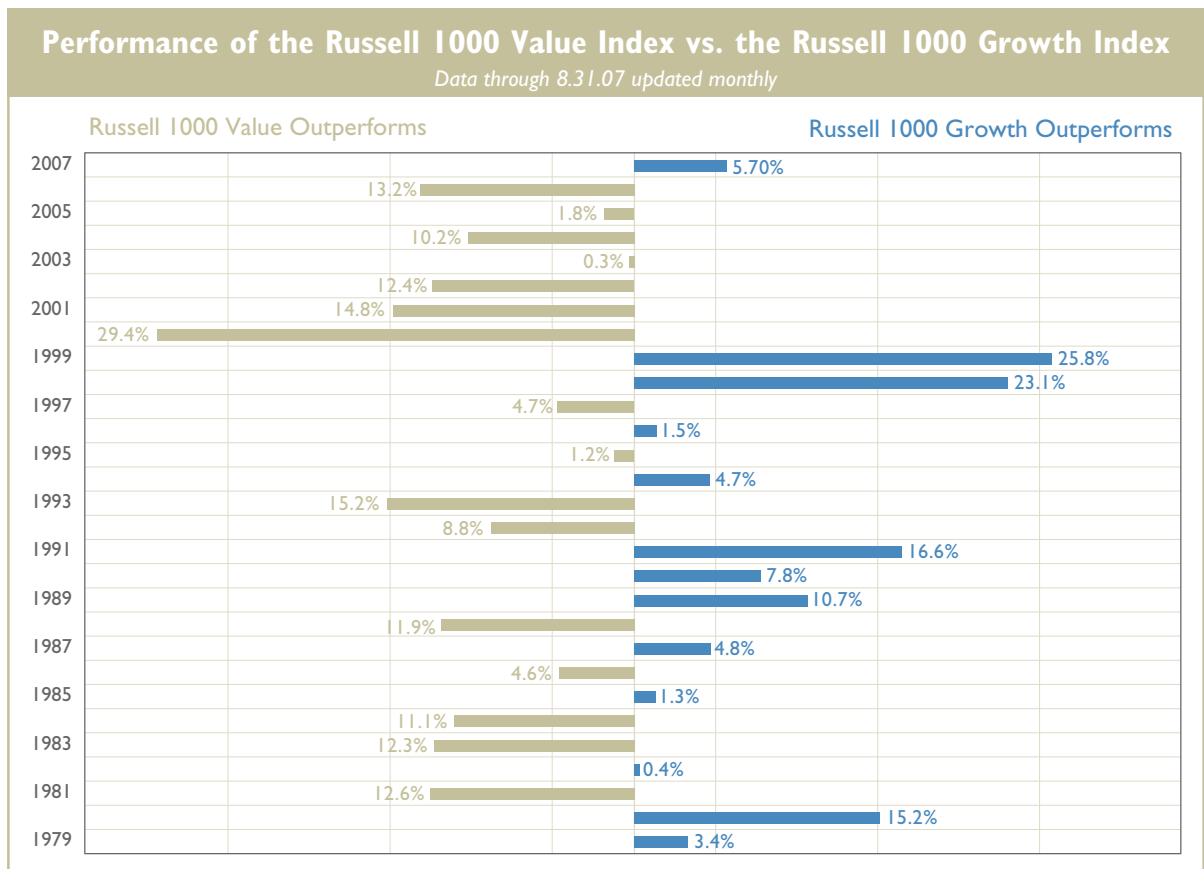
Stocks rose 6% during the second quarter and were up 7% for the year as of 6/30/07. The rally continued through mid-July before the tide turned after July 19th. Stocks subsequently declined, trading as low as 12% below its new all time high before stabilizing. The market has since recovered approximately 8% from its 8/16 intra day low.

As of August 27th the S&P 500 is up just shy of 4% for the year and approximately 15% over the past 12 months (excluding dividends).

Price volatility was already increasing before this decline gained momentum, fueled by heightened sub-prime concerns. Fixed income, equity and derivatives markets alike now seem to be searching for

solid ground while trying to assess the ramifications of (as Phil Orlando of Federated Investments puts it) “a possible leakage from the housing/sub-prime sector into the broad economy.” The markets settled down a bit after the Federal Reserve began injecting liquidity into the monetary system.

Meanwhile, the US economy seemed to pick up steam



Source: MBO Cleary/Russell

again after slowing during the first quarter. Most forecasters have raised their estimates of earnings growth for the S&P 500 from 3% to 7% for the year with the overall economy advancing just under its long-term average of 3%. Overseas economies are expanding at a more rapid rate, pushing overall world GDP growth to 5%. This helps US companies doing business overseas, especially as they repatriate their profits as the dollar is declining.

While the S&P 500 is up slightly since the beginning of 2007, most overseas markets (developed and emerging) are faring a bit better with the Dow Jones World Index (excluding the US), up approximately 6% since January. Also, we are finally starting

to see a rotation of market sentiment toward growth stocks. As mentioned in previous updates, the rally over the past few years has benefited to a larger degree often lesser quality, “value” issues. (See table on page 1.)

At any rate, at long last it seems that the no money down, low teaser rates “party” fueled by Federal Reserve monetary policy, Wall Street securitization and Hedge Fund leverage is finally turning into a hangover. Whether this hangover lasts any longer than the fallout from previous binges (1989 S & L Bailout, 1997 Asian crisis, 2000 tech bubble) remains to be seen.

While the collapse of two Bear Stearns “Hedge” Funds (single

strategy funds that were not actually hedged) makes for alarming headlines, investors being wiped out by using leverage of over 25 to 1 (only 4% equity leaves very little room for any price declines) should not be such a surprise, nor should it be viewed as a precursor to the collapse of our investment markets. Markets, as they always do, are adjusting their prices to reflect the risk associated with underlying investments. Prices on all sub-prime mortgage related securities are falling in the process, which is causing reverberations in other markets as well. Investors who took the risk of buying these investments on high margins are paying the price. Altair Advisors, in their second quarter commentary, referred to a timely quote from Bill Gross of PIMCO—“if not taken too far, and there is no hint yet of a true crisis, these developments may be just what the fed has been looking for—easy credit becoming less easy; excessive liquidity returning to more rational levels.”

Meanwhile, the S&P 500 now stands at approximately 1470 with expected earnings of over \$100 per share over the next 12 months and is selling at a PE multiple of just below 15 (slightly below its long term average). Recall that the S&P 500 was selling at a multiple of 28, with earnings of \$55 per share, at its last peak in March, 2000.

Profile: Bear Stearns Mortgage Hedge Funds		
	Bear Stearns Credit Strategies Fund <i>(started April 2003)</i>	Bear Stearns Credit Strategies Enhanced Leverage Fund <i>(started October 2006)</i>
<i>Positions as of 3/31/07</i>		
Equity	\$925 million	\$638 million
Long Positions	\$9,700 million	\$11,500 million
Short Positions	\$4,000 million	\$4,500 million
Risk Positions	\$13,700 million	\$16,000 million
Leverage Ratio <i>(Risk positions/equity)</i>	15 times	25 times
Equity Ratio <i>(equity/Risk positions)</i>	6.7%	4.0%
Bear Stearns Emergency Funding	\$1.6 billion	0
Equity as of 6/30/07	<i>approx. \$90 million</i>	0

Source: Lotsoff Capital Management/WJSJ 7/27/07

