

# First Quarter 2007 Commentary

After climbing to new highs in the early weeks of the year, US stock market benchmarks plunged nearly 6% between February 20th and March 5th. A sharp drop in foreign stock markets and escalating problems in the US subprime mortgage market caused investors to reassess their appetite for risk. The rapid sell-offs could also be the result of larger potential problems such as the tightening of international liquidity as global interest rates rise; the end to the carry-trade; and the spreading of subprime woes to other areas of the lending market leading to an adverse impact on consumer spending and economic growth. However, as foreign markets rallied and the subprime debacle failed to spawn a financial “contagion,” stock market investors regained confidence. By the end of March, markets recovered to their beginning-of-the-year levels, masking the quarter’s roller coaster ride for investors. For the first three months of 2007, the Standard & Poor’s 500 Index edged-up +0.64% while the Russell 1000 Growth Index returned +1.19%. We doubt that the aforementioned concerns plaguing investors have been assuaged by the short two-week market correction and that a more extended period of consolidation is needed to adequately price-in additional economic and market risk.

Domestic economic growth has slowed over the past four quarters with housing the major liability. While it is still too early to call a bottom to residential construction, tight labor markets and strong payroll employment and income data do not portend recession. While consensus GDP forecasts have been pared for the first half as a result of waning capital investments and the prolonged slump in housing and automobiles, continued weakness should convince most that the Fed is done tightening. Consumer spending in the US is holding up, supported by continued gains in jobs and incomes. However, the headwinds created by the US housing recession are likely to persist well into 2008. According to a study reported in *The Economist*, 60% of all adjustable-rate mortgages made since 2004 will be reset to payments that will be 25% higher or more; a fifth of these mortgages will reset 50% higher. Eighteen percent of mortgages taken out in 2006 and a quarter of all adjustable-rate mortgages due to reset in 2008 now have negative equity. In addition, the collapse of the subprime mortgage market could further depress home prices by reducing housing demand and increasing supply. The failure of several subprime lenders and the tightening of credit standards reduce the number of potential homebuyers while housing supply is increased as borrowers unable to afford reset mortgage payments are forced to sell and foreclosed properties come back on the market. Thus, the reverse side of the prior boom emerges with the marginal buyer becoming the marginal seller, depressing prices and signaling an extended period of housing stagnation.

Although the Federal Reserve acknowledges that housing weakness could spillover to the broad economy, its “dovish” March statement reiterates their primary concern is stubbornly high inflation. A rise in long-term inflation (and more critical for the Fed, a rise in long-term inflation expectations) requires accelerating wage gains. Five years of solid job growth have produced a tight US labor market, especially for skilled workers. As a result, wage gains have accelerated. So far, rising wages have been more than offset by productivity gains, allowing US businesses to improve profitability without raising prices. However, annual productivity growth in the US was just 1.4% in last year’s fourth quarter, down from a 4% peak registered in early 2004. Declining productivity gains could squeeze corporate profits already under pressure from higher borrowing and raw materials costs, putting pressure on companies to raise prices. Since productivity and labor force growth establish how fast the economy can grow without fueling inflation, slower growth in productivity increases inflation risks and makes the Federal Reserve more reluctant to lower interest rates.

# First Quarter 2007 Commentary ~ Continued

A recently released Fed study links the productivity acceleration of the late 1990s to corporate investments in technology. The Fed may be concerned that the decline in US productivity could be the result of the drought in corporate capital spending that followed the 2001 bust in technology investment. Indeed, in his March testimony to Congress, Federal Reserve Chairman Ben Bernanke noted recent weakness in US business spending on equipment and software and expressed his concern that “the magnitude of the slowdown has been somewhat greater than would be expected given the normal evolution of the business cycle.” Finally, stubbornly high inflation combined with sluggish economic growth could further weaken the US dollar’s foreign exchange rate. A weak dollar makes US imports more expensive, creating even more inflation pressures. Adding it all up, inflation pressures may persist and delay the move to lower rates to hasten healing in the housing market to late in the year.

With corporate profit growth decelerating, further gains in stock prices are more dependent on higher price-to-earnings ratios. Stock valuations are very sensitive to interest rates and, by implication, inflation expectations. Interest rates and stock valuations are inversely correlated, that is, higher rates beget lower valuations and lower rates beget higher valuations. Consequently, the best outcome for the stock market would be an economy that slows just enough to create slack in the labor and raw materials markets (i.e., higher unemployment and lower commodity prices) without slipping into recession. This would allow the Federal Reserve to lower interest rates and stimulate growth without raising inflation, achieving an economic “soft landing.” This scenario remains the most likely outcome and the most positive environment for financial markets.

The global economy appears in good shape with solid growth coming from major developed economies which have interest rates somewhat lower than the U.S. With domestic economic and profit growth showing fatigue, large-cap growth companies which sport significant foreign profit exposure should perform well in a trendless market punctuated by increased volatility and a diminished appetite for risk. With the level of corporate earnings high and interest rates still historically low, the market’s price/earnings valuation does not appear to be a significant headwind. What is needed is a catalyst for growth which should be forthcoming from the Fed later in the year.