

INSIDE BUSINESS

Volume 13 | Number 42 |

www.insidebiz.com

OCTOBER 15 - 21, 2007 | \$1.00

3rd quarter challenging for investors, economists

Scholars disagree on who coined the expression, "May you live in interesting times," but the third quarter of 2007 certainly qualified as an interesting time, especially for investors and economists.

In our last column, published July 16, we predicted credit derivatives posed a genuine threat to investors and outlined the changes we were making to client portfolios. However, we had no idea the problem would begin raising its head that same day.

Before the third quarter ended, portions of the credit markets simply shut down. Stock markets plunged, central banks pumped in many billions of dollars around the world, and short-term interest rates dropped in the U.S. However, by the quarter's end, the stock markets had largely returned to their previous highs this year, and the credit market relaxed.

To recap the stock markets, the statistics look remarkably good on the surface. The Dow rose 3.6 percent in the third quarter and is up 11.5 percent so far this year. The broader-based S&P 500 rose only 1.6 percent in the third quarter but is up 7.6 percent this year. The tech-heavy Nasdaq rose 3.8 percent in the third quarter and 11.8 percent this year.

What could be wrong? Two things!

Credit derivatives top all concerns

First, some observers trace the problem of the third-quarter credit crisis to the subprime mortgage market, ignoring the market for credit derivatives. Currently, it is difficult to discuss one without the other. The markets assumed all subprime mortgages were bad, when only 14 percent were delinquent. More importantly are the billions of dollars in adjustable-rate mortgages that will increase their interest rate over the next two years, to the tune of about \$800 billion (see graph). It is a reasonable assumption that the default rate will increase, and the markets will react as they did this time.

This situation also affects home values, which are dropping in most markets. In August, new home sales fell another 8.3 percent, to the lowest rate in seven years. This makes consumers feel less wealthy, and they can be expected to spend less in the coming quarters. Since consumers are the most important part of our economy, accounting for two-thirds of all spending in country and 20 percent worldwide, investors should factor this into their strategy.

Reflecting this consumer slowdown is the most recent U.S.

Commerce Department release of retail sales. Although the most recent report shows a 0.3 percent increase, it becomes a decrease if the promotion-driven surge in auto sales is stripped out, as well as the decrease in gas prices at the pump.

None of this is good news.

We feel this messy economic picture is wrongly attributed to the subprime issue. It is really a reflection of the problem with credit derivatives, particularly the lack of transparency or information about them.

There are many useful derivatives that protect investors, but Warren Buffett described the credit derivatives as "weapons of mass destruction." According to The Wall Street Journal, "Credit markets also are dancing to the tune of these derivatives."

The most commonly watched set of indices of the subprime-related derivatives is the ABX. One dropped 35 percent as the credit crisis began in July, but has now regained about 30 percent. In other words, the appetite for risk remains too strong as the loss has almost been fully recovered.

The Fed accommodated this reversal with its aggressive rate cutting, but even more rate cuts will not address the problem of 2 million people losing their homes in the next few years. Too much is expected of the Fed, and flooding the markets with liquidity is akin to using a shotgun when a rifle would do. A legislative solution will be necessary, but will it be timely?

The silver lining in the summer

credit crisis is that investors in the many derivatives unrelated to the subprime market may be more careful now, allowing the rapid growth in derivatives to slow enough to be managed. Hopefully this has been a wake-up call.

A weakening dollar

The second thing that worries us is the continued fall of the dollar. We were enthusiastic when the dollar began falling in 2002. However, enough is enough.

Generally, the dollar is down 8 percent this year. The depreciation is even worse against other countries, e.g., 14 percent against the Canadian dollar, 11 percent against the Norwegian krone, 10 percent against the Indian rupee. Unfortunately, it is only down 3.8 percent against the Chinese yuan, where we still need more depreciation – a lot more.

A weak dollar is not a "bad" thing. Yes, it's more expensive for Americans who travel abroad, but a weak dollar also increases our exports because foreigners can then afford more of our products. For example, the 15 percent increase in our farm exports is directly attributable to the weak dollar.

On the flip side, the weak dollar makes the cost of imports higher, which can "import inflation." We are clearly seeing that in the price of imported commodities, which continue to set record highs. In 2004, storied investor Jim Rogers wrote *Hot Commodities*, saying that the bull market in commodities began in 1998, averaging 17 years per cycle. He argued commodity prices would rise because of the cycle and because of the growth of the emerging markets unleashed by globalization. Now, in addition,

a weak dollar further drives up the prices of imports to the U.S.

The dollar will remain weak as long as we run a huge trade deficit that floods the world with depreciating dollars, and we maintain low interest rates compared to other nations. While the increasing cost of imports will slowly lessen the trade deficit, it will be just that, slow.

The strong jobs report for September makes it unlikely the Fed will further reduce rates, which should slow the continued decline of the dollar.

How we're managing it

Traditionally, investment advisers see the world in terms of where we are in the business cycle. Our firm looks for continued smooth skating, but with periodic patches of thin ice and chilling dips when the market behaves violently, like it did this summer.

We continue reducing portfolio exposure to mid-cap and small-cap stocks, and prefer large-cap stocks now. Forty-five percent of revenue of the companies in the S&P 500 is from international sales, which benefits from a falling dollar.

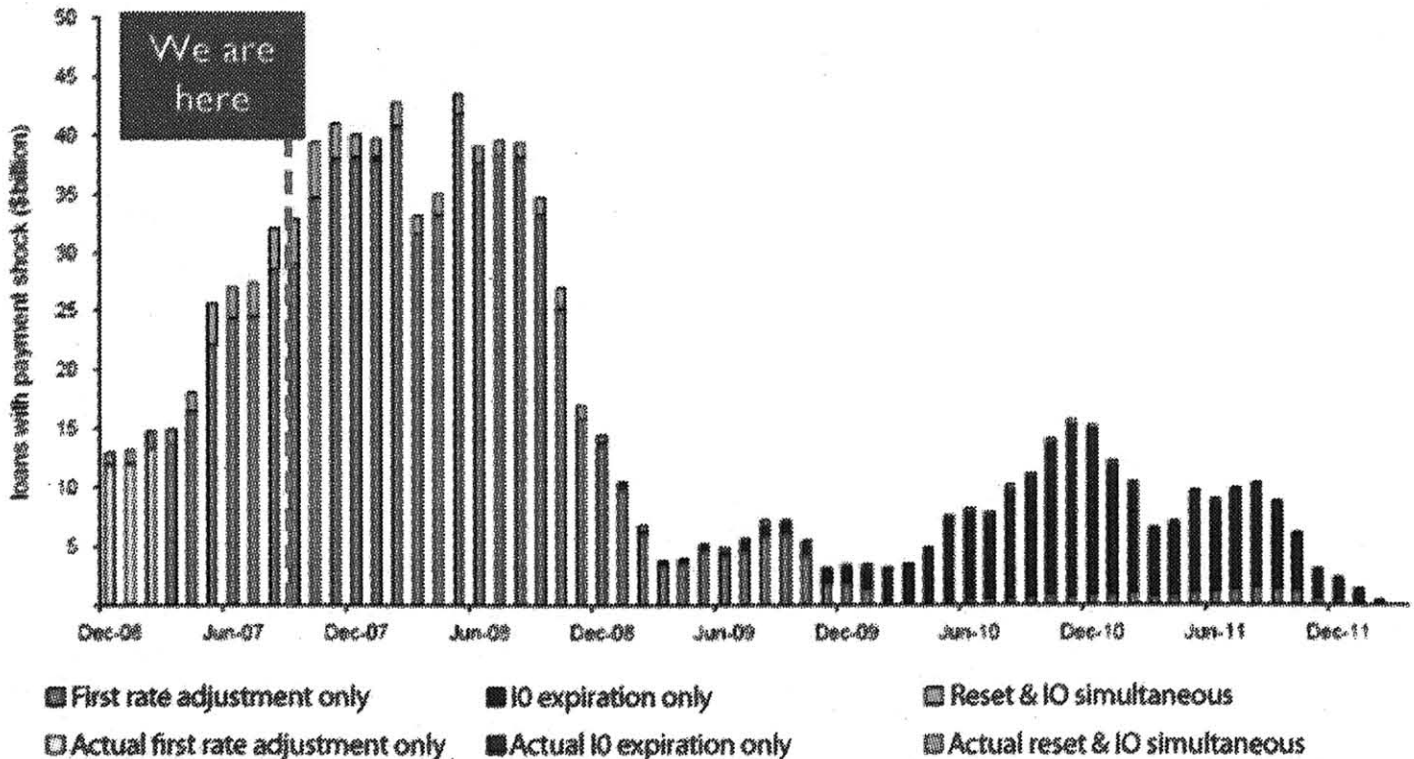
We still like technology, commodities and international stocks, both developed and emerging. REITs are badly beat up now, but we look forward to going back next year. Cash may be boring, but a nice place to be when the economic outlook is so murky.

Our original S&P 500 prediction for year-end still remains unchanged at 1575, which now seems quite modest, since the fourth quarter has been positive each year for the last nine years. Let's just hope it is not as "interesting" as the third quarter!



Jim Flinchum, a CFP practitioner as well as a certified investment management analyst, is the managing principal of Bay Capital Advisors, an investment advisory firm with offices in Washington, D.C., and Virginia Beach. He can be reached at www.baycapitaladvice.com.

~\$800 Billion of sub-prime mortgages to reset



Source: Deutsche Bank and Rockwater Municipal Advisors, L.L.C.