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## MARKET COMMENTARY

April, 2008

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During the first quarter of 2008, the S&P 500 declined by 9.9% as markets ran into a buzz saw of an accelerating financial crisis, a steepening housing downturn and slowing domestic economy, a weakening dollar, and rising global commodity prices. In our January 2008 commentary we cautioned, “buckle up, it may be a rough ride.” The first quarter was indeed that, from start to finish, as momentous financial deleveraging and newfound aversion to risk created a maelstrom for consumers, investors, central bankers, and governments alike. Yet, as the quarter came to a close some signs began to emerge of a healthier, better capitalized financial system while the equity market itself demonstrated an underlying resiliency.

### *The Great Deleveraging*

March 2008 marked the fifth consecutive down month for the S&P 500, the longest such losing streak since 1990. It was also a quarter marked by extraordinary financial turmoil, probably the worst we have seen in the past 25 years. Companies caught with too much leverage, too much risk, and too many illiquid investments lost access to short term credit and collapsed as major financial institutions sought to deleverage their balance sheets and reduce risk. Thornburg Mortgage, an underwriter of purportedly only the highest quality jumbo mortgages fell victim to margin calls. Carlyle Capital, a hedge fund controlled by a private equity firm of longstanding good reputation, saw its portfolio of fairly ordinary mortgage-backed fixed income investments suddenly collapse under the weight of a leverage ratio of greater than 30 to 1. As housing related securities continued to decline,

Bank of America strode into the mayhem, agreeing to acquire hemorrhaging mortgage origination giant, Countrywide Financial, in a hastily arranged marriage. Along the way, Societe General, one of the oldest banks in France, “discovered” a historic \$5bn euro trading loss apparently run up and concealed by a low-level “rogue” employee. Then Bear Stearns, the prestigious eighty-five year old investment banking firm with 11,000 employees, disappeared over one weekend- its remnants merged into rival JP Morgan for roughly the value of the firm’s Manhattan real estate. While successive rounds of write-offs were taking place across Wall Street and the global financial system, perhaps the poster child for all the subprime carnage became Swiss based UBS, the largest money manager in the world. Its Chairman abruptly resigned following the announcement of yet *another* write off, this time a \$19bn sub prime based loss, a \$12bn quarterly operating loss and an emergency \$15bn capital raising effort. Remarkably though, and to the surprise of many media pundits and doomsayers, the U.S. stock market and underlying economy withstood these sustained blows and remained standing to answer the bell for the next quarter.

### *The Fed Comes to the Rescue*

There are two principle reasons that our staggered credit markets were able to maintain their footing. First, in no uncertain terms, the Federal Reserve and US Treasury weighed in by providing further access to its significant resources which helped to unlock frozen credit markets and to shore up key institutional balance sheets under threat from the onslaught of

panicked deleveraging, short selling, and even rumors of an old fashioned run on the bank. Once the Fed realized the extent of the issues at hand, they acted decisively to lower interest rates, provide liquidity injections and relax lending criteria. It even facilitated a historic Wall Street merger, whose failure conceivably could have risked a domino style collapse of the global financial system. There were three interest rate reductions in the quarter; the Fed funds target rate was cut in half from 4.5% to 2.25% through three successive cuts, which included an unscheduled cut made after the long weekend following the “SocGen” trading loss. There were several liquidity injections for institutions facilitated through the Term Auction Facility (TAF), a lending facility for banks that allows them to exchange various assets with the Federal Reserve for temporary liquidity. This was meaningfully broadened (in terms of both qualifying assets and term duration) and, for the first time in history, extended to primary broker dealers under the Term Securities Lending Facility (TSLF). Finally, it is clear the “invisible hand” of government was working overtime and weekends. The Fed played a prominent role in the whirlwind long weekend disposition of Bear Stearns, and took the highly unusual step of sharing in the credit risk involved in JPMorgan’s acquisition. This not only facilitated the merger, but prevented Bear Stearns from defaulting on its massive counter-party obligations which extended throughout the global financial system.

### ***Global Capital Comes to the Rescue***

The second reason credit markets were able to withstand so many blows was the ready availability of capital replenishment. We are in a world awash in capital seeking opportunities. Other stronger financial competitors, private equity, and international investors and sovereign wealth funds, have all participated in this recapitalization and investment process. While capital pools are not unlimited and new capital comes at a dilutive cost to existing holders, the ability to remain in the game, to simply be a survivor, cannot be dismissed. The survivors should prosper in the next up cycle. We think it is import to note that those who propped up Citibank in the early 1990’s still have about a 6x

gain on their investment despite the recent collapse of its stock price.

While this is not the end of the deleveraging in the credit markets, perhaps the first quarter of 2008 has put the worst and most disruptive phase behind us. Importantly, it was the quarter that marked the full deployment of the US Government’s significant resources into the battle. There will undoubtedly be more credit market problems from here, but the Federal Reserve by its actions has taken a financial meltdown off the table and the crisis phase is over. Finally, never forget that our banking and finance system is the fundamental building block of capitalism. Banks are a regulated industry for a reason: there can be no American economic success without strong credit markets and a viable financial system. When it came to righting the financial ship, Mr. Bernanke and the Fed understood there was never any choice in the matter.

### ***The Industrialization of the Developing World and the Pursuit of More***

We often talk of the tale of two markets. While the global financial markets are in turmoil, the natural resources and industrial infrastructure markets continue to prosper. As noted, oil and commodity prices have continued to climb as the dollar weakens and demand in the developing world grows. While the US is struggling to produce positive GDP growth in 2008, the BRICs (Brazil, Russia, India, China) and Greater Asia are charging ahead with solid economic growth driven by a surge in infrastructure projects against the backdrop of ongoing urbanization and rising standards of living. This transformation is fueling what has been called the world’s greatest infrastructure and natural resources boom.

From roadways to railroads, to resource exploration and refining, to office space, consumer distribution and housing, developing world infrastructure spending is increasingly decoupling the global economy from the US. Global resources and industry are challenged as these developing economies grow and seek to provide a rising standard of living for their teaming throng. As we debate our carbon

footprint, the throng, which is a significant multiple of our American population (North America, Western Europe and Japan represent only about 14% of the world's population with no collective growth) demands more. More food, more energy, more commodities, more technology, more money, more jewelry, more amenities, more expectations, more stuff. For companies and industries that participate in this great endeavor there will be significant opportunities for growth and profit.

Certainly this infrastructure and natural resources boom is not without peril. As investors we should understand that the global "pursuit of more" will highlight the reality of global scarcities and be a driver of inflation. As natural resource values continue to rise, countries that once exported commodities are forced to hold them for their own internal demand, further exacerbating shortages and price squeezes. Geopolitical risk is another important byproduct of this global shift as resource rich but politically unstable countries flex their newfound muscles. The trend of accelerating industrialization in the developing world may create structural shifts and risks that we have not had to worry about for generations. Rising agricultural and energy

prices will test the ability of governments to maintain growth and stability. At the most basic level, our formerly very reliable food supply is already stressed in ways we haven't seen for years.

**Conclusion**

Industrialization and rising standards of living in the developing world are long term trends, and despite their inherent challenges, should provide significant opportunities for years to come. We continue to overweight basic industrial, infrastructure, energy and natural resource companies that benefit from both the weak dollar trend and growing global demand. In this vein we are also paying more attention to the materials and agricultural sectors. In addition, we are searching to find opportunities in the smoldering ashes of the financial sector. We have found tarnished and discarded jewels in the past in such deeply out of favor industries, and they have often turned out to be some of the very best performers.

**Market Balance Sheet**

POSITIVE	NEUTRAL	NEGATIVE
Interest Rates	Inflation	Geopolitical Stability
Economic Growth/Industrial Production	Dollar	Energy Prices
Fiscal Policy	Employment	Regulatory Environment
Valuation	Free Trade Protectionism	Economic Growth/Consumer Spending
Profit Growth/Margins	Budget Deficit	
Productivity		
Demographics		
Liquidity (Monetary Growth)		

**POSITIVE**

Interest Rates

Interest rates are low and very favorable to equity valuations. Over the span of the last six months the Fed has aggressively moved to lower the fed funds rate from 5.25% to 2.25%. Inflation expectations remain a concern but should moderate with a slowing economy. We believe the bulk of rate cuts are now behind us, although the Fed could cut rates once or twice more depending on the severity of the housing downturn.

Economic Growth	<p>GDP should remain positive, barely, at around 1% for the next few quarters. We see the odds of a domestic recession as having increased in recent months, but the combination of a weak dollar boosting U.S. exports and a strong global economy should be enough to keep us out of recession. We look for growth to begin to reaccelerate late in 2008.</p> <ul style="list-style-type: none"> <li>➤ Profits and corporate liquidity remain strong outside the housing related and financial sectors : <ul style="list-style-type: none"> <li>1) increased business investment and higher employment.</li> <li>2) strong dividend growth and share repurchase.</li> </ul> </li> <li>➤ The housing downturn and the slowdown in domestic economic growth has been accompanied by an increase in defaults in the highest risk mortgage lending area called sub prime loans. There continue to be losses associated with defaults, foreclosures and asset write-downs, and spill over into the consumer segment of the U.S. economy. We believe certain sectors, however, such as natural resources, materials, and infrastructure related industrials are particularly well positioned for continued growth.</li> <li>➤ As we have previously noted, the longer term economic growth driver has shifted from the consumer to capital spending and industrial production, and toward innovation, small business, and more entrepreneurial activity.</li> </ul>
Fiscal Policy	<p>Taxes on dividends and capital gains at lowest levels in over 60 years. Two year extension of the tax cuts on dividends and capital gains through 2010 would likely be threatened by a new administration. The 2008 tax rebate and fiscal stimulus package will provide some support to the economy and to the consumer in the second half of the year.</p>
Valuation	<p>Very reasonable at about 15.5 times estimated 2008 S&amp;P 500 operating earnings. Moreover, stocks are significantly cheaper than bonds, where the bellwether 10 year U.S. Treasury currently yields about 3.5%, and is thus valued at roughly 28 times “earnings” (its coupon).</p>
Profit Growth/ Margins	<p>Corporate profits are forecast to be down modestly over the next two quarters due to losses in the financial sector, but ex financials, corporate profits are actually forecast to be up 10% in the first half. Profit margins continue at very high levels aided by ongoing gains in productivity, but are under pressure from both a rise in raw material costs and a slower consumer.</p>
Productivity	<p>Continues to drive profit growth and keeps the U.S. economy the most competitive in the world; has moderated somewhat but should reaccelerate due to lower employment growth and a weaker dollar boosting U.S. manufacturing competitiveness.</p>
Demographics	<p>Baby boomers in the sweet spot of wealth and investing cycle, hungry for growth and income.</p>
Liquidity (Monetary Growth)	<p>Money growth is accelerating in the U.S. and global liquidity is very strong. Global broad money (e.g. MZM) is robust, growing at better than 10% on a year over year basis according to ISI Group.</p>

**NEUTRAL**

Inflation	<p>Cyclical inflationary pressures are significant across global commodities and basic resources from agricultural products to energy and metals. We still believe the recent pick up in inflation will prove temporary, as the global economy exerts relentless pressure on prices. In particular, China and developing Asia remain the dragon slayer of inflation, exerting downward pressure on U.S. wages and manufacturing. Low global bond yields and a relatively flat yield curve with the 10 year treasury still well below 4% in the U.S. also indicate inflation is contained.</p>
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Dollar	The weaker dollar helps U.S. multinationals and exports, but our trade deficit, though improving, remains stubbornly high despite the competitive advantages of a lower dollar. It is also worth noting that about 30% of our trade deficit is due to imported oil (net energy imports are currently running at an annual rate above \$300 billion). This represents a structural deficit, which has exploded in the last couple of years due to the declining dollar and doubling of global oil prices. It should also be noted that the weakness of the U.S. dollar is ultimately an inflationary force, and significant further declines could be damaging to the U.S. economy and restrict our monetary options.
Employment	After a record 55 consecutive months of job growth the employment market has weakened. The 5.1% overall unemployment rate is relatively low by historical standards, but likely to increase over the next few months due to continued housing related fall out. Overall employment is forecast to be essentially flat year over year.
Free Trade/ Protectionism	Free trade and free market oriented reforms were given a boost by recent election results in South Korea, France, Canada and Mexico.
Budget Deficit	Currently running at less than 1.5% of GDP, but likely to increase in the second half of the year due to the tax rebates, fiscal stimulus\housing relief package, and lower federal tax receipts. We would like to see more spending restraint. Bigger issue is the persistent growth of medical care costs and the long term liability of retirement in our aging society.

### **NEGATIVE**

Geopolitical Stability	Iraq is improving but political progress is still lagging our success in reducing sectarian violence. The global terrorist threat will be with us for some time as will the issue of a nuclear Iran. Although event risk remains significant, investors are becoming more accustomed to dealing with terrorism, scandals and unforeseen events.
Energy Prices	Oil prices remain elevated and ended the quarter at \$105/bbl, roughly \$10 above where it started the year. Domestic natural gas prices rose sharply to average around \$8.50/mcf in the quarter and closed at \$9.35/mcf, up more than 20%. While there remains a geopolitical risk premium in the price of oil, without a significant global economic slowdown, it is difficult to make a convincing case for a sustained drop in energy prices. Additionally, in order to be economically viable, most non conventional hydro carbons (e.g. Canadian Tar sands, ultra deep water, coal to liquids, biofuels) need a sustained price of about \$70 per barrel of oil or higher.
Regulatory Environment	Recent changes in Congress and the Presidential election raise the possibility for increased regulation and tax policy changes for certain industries, as well as for individual tax rate