

C *Economic & Market* Commentary

A Shot Across the Bow

During the quarter, investors in major global stock markets reacted to a sudden realization that some investments were risky. This realization caused a sharp and broad sell-off in shares of publicly traded companies around the globe. Due to the sharp run-up in share prices since late last summer, the drop felt worse than usual. However a long-term view shows that this correction was only one of nine that we have experienced in the last four years, and, very likely, one of many more we will experience in the coming years. While it was the sharpest decline in the last four years, it was similar to the percentage drop experienced in May 2006. This shot across the bow is yet another warning to investors that earning a rate of return greater than the Treasury Bill rate entails risk and is subject to short-term set backs.

An investment strategy is designed to manage, not eliminate, risk in a portfolio. Generally, if the stock market drops, the value of a portfolio of well-diversified stocks will also drop. Conversely, if the stock market rises, the value of a portfolio of well-diversified stocks will also rise. The make-up of the portfolio determines to what degree market changes are captured by the portfolio and how it will react to a given set of economic realities. The speed and magnitude of stock market advances and declines can be astounding and make it more and more difficult to implement meaningful short-term trading strategies. The growing number of hedge fund closures or failures is a testament to this reality.

Despite the number of failures and the lackluster risk-adjusted returns of hedge funds, their growing influence has accentuated price movements as they rush to enter or exit an investment to exploit an opportunity. In this environment, it is difficult, at best, to successfully predict the timing and flow of money in and out of certain investments. Many professionals and individuals will attempt to do so, however, with varying degrees of success. Stellar's investment strategy uses methodical adjustments to chart a steady, long-term course through the ever-changing markets.

The current view, as reported by the venerable Blue Chip Consensus, calls for slowing economic growth. The extent of that slowing seems to be based upon each economist's view of the wider effects of a rapidly deteriorating housing market on the overall economy. Even in the midst of allergy season, this is nothing to sneeze at: the home building industry impacts many aspects of local economies around the country.

The immediate economic concern is a sharp reduction of consumption that has been financed by home equity loans. Fresh off a period where real estate investors could put very little money down and expect to withdraw its appreciation, or "flip" the property for a gain to fuel spending, they now face the opposite situation. The real estate market has stalled, and in many parts of the country has reversed course. Without appreciation, the ability to "flip" properties and spend the resulting appreciation is drastically

reduced and, to add insult to injury, the expense of financing these stagnant investments has increased due to variable rate mortgage interest resets. At industry conferences in the last few months, we have found many “Wall Street” firms to be quite positive on the real estate markets and housing related industries. Frankly, we do not share their optimism, as the inventory of land and homes held by homebuilders could choke a horse and many individual real estate investors are feeling the same kind of pressure. Tighter lending standards and reduced profit expectations have further reduced demand, putting further pressure on real estate values.

The level of borrowing permitted in real estate deals has been as high as 90 to 100 percent of the property’s value, leaving very little equity. Even a slight decline in value can put the real estate investor in a position of owing more than the property is worth. Such an investor may have to go through a prolonged period of “negative cash flow” (spending principal or spending future gains) while waiting for real estate values to turn, or let the lender foreclose on the property that was held as collateral. Add in problems associated with “sub-prime debt” making it harder to obtain financing, and you have something along the lines of a perfect storm.

Looking ahead, if the spillover effects from the real estate market reversal do not get out of hand, and inflation remains in check, valuations on equities remain attractive. When you combine the recent quarter’s earnings reports with February’s market correction, current valuation levels, as measured by the P/E ratio, are almost back down to last summer’s attractive levels. Serving as a counterbalance to the positive outlook on valuation, the mounting uncertainties about economic growth and additional turmoil in the Middle East will likely keep the markets choppy until some of the current uncertainties are resolved.

The same uncertainties that have reined in the stock market have kept a lid on longer-term interest rates, keeping bond prices steady. As uncertainties come out of the market, we would expect to see better opportunities to extend bond maturities, capturing higher yields in the future.

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