

Upside Down

The financial markets meet Alice in Wonderland

By Paul Woods

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In the second quarter of 2007, signs of the approaching apocalypse began to appear. Congress appeared determined to reward every illegal immigrant that participated in the first successful invasion of the U.S., Paris Hilton dominated the headlines, and honeybees began to die mysteriously. My hunch is the death of the honeybees was a mass suicide because of the first two news items, but that hasn't yet been officially confirmed.

Things were mostly turned upside down in the bond market in the second quarter. A weaker economy is supposed to produce higher bond prices. Instead, economic growth slowed dramatically and the bond market responded with higher interest rates. Like they say, this wouldn't be any fun if it was too easy. As conventional wisdom went out the window, bond market gurus became road kill and some large fixed income hedge funds began to implode by the end of the quarter.

In the stock market, everyone knows that higher interest rates usually produce lower stock prices and value stocks are usually a better investment than growth stocks. The Alice in Wonderland theme was maintained as the equity market responded to higher interest rates with a rally that saw growth leave value in its dust. About the only piece of conventional wisdom left standing was "sell in May and go away" as the equity market finished the quarter with a decline in June.

In the second quarter in stocks, big was good, value was bad, and REITs were ugly. For reference, here's the stock market segment scorecard for the second quarter.

	<u>Symbol</u>	<u>3/30/07</u>	<u>6/29/07</u>	<u>% Change</u>
All Cap Growth	RUAZG	2,205.70	2,350.28	6.56%
All Cap	RUAZ	829.05	873.19	5.32%

All Cap Value	RUAZV	3,136.77	3,265.40	4.10%
Small Cap. Growth	RUTZG	2,458.23	2,619.67	6.57%
Large Cap. Growth	RUIZG	558.59	595.22	6.56%
MidCap Growth	RUMZG	917.19	977.15	6.54%
Large Cap. MidCap	RUIZ	775.97	818.18	5.44%
Large Cap. Value	RUMZ	1,030.48	1,081.55	4.96%
Small Cap.	RUIZV	823.02	858.51	4.31%
MidCap Value	RUTZ	800.71	833.70	4.12%
Microcap	RUMZV	1,192.94	1,230.60	3.16%
Small Cap. Value	IWC	58.81	60.50	2.87%
REITs	RUTZV	4,399.22	4,481.73	1.88%
	RMZ	1,118.95	1,002.06	-10.45%

Source: Thomson One Financial, Thomson Baseline

Within these market segments, the top performers were energy and other resource companies, technology, and industrial companies. Investors apparently concluded that higher energy prices would hurt consumer spending and higher interest rates would be a negative for financial companies. These industries, along with health care, underperformed just about every stock market index. Here's the stock market index and industry group scorecard for the second quarter of 2007:

	<u>Symbol</u>	<u>3/30/07</u>	<u>6/29/07</u>	<u>% Change</u>
Dow Industrials	INDU	12,354.35	13,408.62	8.53%
Nasdaq Composite	COMPQ	2,421.64	2,603.23	7.50%
S&P 500 Index	SPX	1,420.86	1,503.35	5.81%
Russell 3000	RUAZ	829.05	873.19	5.32%
Energy	SPENS	463.37	529.71	14.32%
Technology	SPHTI	352.33	388.15	10.17%
Clean Energy	ECO	197.43	216.96	9.89%
Capital Goods	IXI	356.78	390.87	9.55%
Basic Industries	SPIN	324.52	354.50	9.24%
Commercial Services	SICSS	193.65	208.99	7.92%
Transportation	TRAN	4,810.70	5,098.88	5.99%
Health Care	HCX	391.16	409.02	4.57%
Consumer	SPCCS	299.93	310.21	3.43%

Services				
Consumer				
Staples	SPCNS	272.68	278.44	2.11%
Biotech	BTK	764.18	777.49	1.74%
Financials	SPFN	478.27	485.53	1.52%
Utilities	SPUT	202.34	200.10	-1.10%
REITs	RMZ	1,118.95	1,002.06	-10.45%

Source: Thomson One Financial, Thomson Baseline

In a forecast we'd like to forget, we expected the Federal Reserve to begin a cycle of interest rate cuts this summer to fix a yield curve that was inverted (short term interest rates were higher than long term interest rates). However, the bond market got tired of waiting for the Federal Reserve to overcome bureaucratic inertia and fixed the problem on its own, as you can see.

<u>Current Yield</u>	<u>3/30/07</u>	<u>6/29/07</u>	<u>% Change</u>
90 day Treasury Bills	5.04%	4.82%	-4.37%
5 Year Treasury Notes	4.54%	4.92%	8.37%
10 Year Treasury Notes	4.65%	5.03%	8.17%

Source: Bloomberg LP

In our industry, the euphemism for too much money loaned to folks with too little property and a history of not paying loans back is the sub prime market. By adding a little lipstick to these loans, dressing them up, and putting them in a nice package, they become marketable as Collateralized Debt Obligations. As bond yields have been close to historic lows in the last few years, the higher yield of these instruments appealed to some investors willing to ignore the risk side of the equation.

In the second quarter of 2007, the inevitable began to happen and the result was a CDO cloud hanging over the head of many hedge funds, major institutions, and brokers. In some cases, hedge fund losses approached 20%. Once the cream of the crap was liquidated, creditors were left with collateral that became the equivalent of toxic waste. As worries this might have to be liquidated for pennies on the dollar rippled through the bond market, interest rates went higher. By the way, we've always believed in taking risk in stocks, not bonds, so our clients have no exposure in this area.

Meanwhile inflation remains above the Federal Reserve comfort zone and interest rates continue to rise in Europe, which will cause the dollar to head south unless the same happens here. All this has more than offset slowing economic growth and produced higher interest rates during the second quarter. Currently, we expect the Fed to remain steady and not make a move in either direction. The pull back in bond prices and increases in bond yields particularly in the Federal Agency market and Treasury market allowed us to buy some cheaper bonds with higher yield for our clients in the second quarter. We continue to emphasize quality, liquidity, and intermediate maturities.

Economic growth slowed from over 3% to under 2% in the last three months as problems in the housing market and lackluster consumer spending began to take a toll. We still don't see a downturn, but expect growth to remain unexciting for a few more quarters until recent increases in money supply growth begin to stimulate the economy in time for the next election.

Given what's happened to conventional wisdom so far this year, we're a little reluctant to climb too far out on a limb with our forecasts. What we can say is the stock market is still undervalued relative to interest rates, but less so than it was a quarter ago. The combination of higher stock prices and higher bond yields now has the equity market about 12% undervalued, according to our model. However, stocks still look like the only game in town as problems in the mortgage market will probably keep a lid on real estate prices, and fixed income yields haven't gone up enough to make bonds a compelling alternative. We expect the combination of rising earnings and undervalued stocks to produce a higher return in the equity market by the end of the year.

Please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul

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