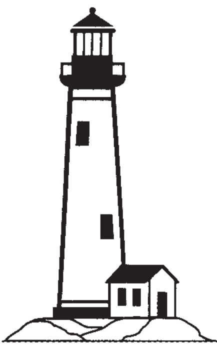

Lighthouse Beacon

A Guide in the 21st Century

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Lighthouse Investment Commentary

Despite Market Volatility, Fundamentals Remain Sound

Investors in equities may not have made much money in the first quarter of 2007, but they received a lot of excitement for their money. Stock markets around the world took investors on a wild ride, reversing direction repeatedly –and sometimes dramatically--before finishing the period very close to where they started.

Let's retrace the journey. Continuing the rally that began in mid-2006, stocks around the world began 2007 by moving higher. In the United States, the Dow Jones Industrial Average hit its all-time high. But on February 27th, the markets' upward trajectory came to an abrupt halt when warning signals flashed. First, China's Shanghai index plummeted by 9% in a single day, initiating a global sell-off that spread from Asia through Europe and eventually to the United States in less than 24 hours.

At the time, almost everyone had an explanation for the sudden reversal in the markets. However, now that the smoke has lifted, two key factors appear responsible for the burst of volatility:

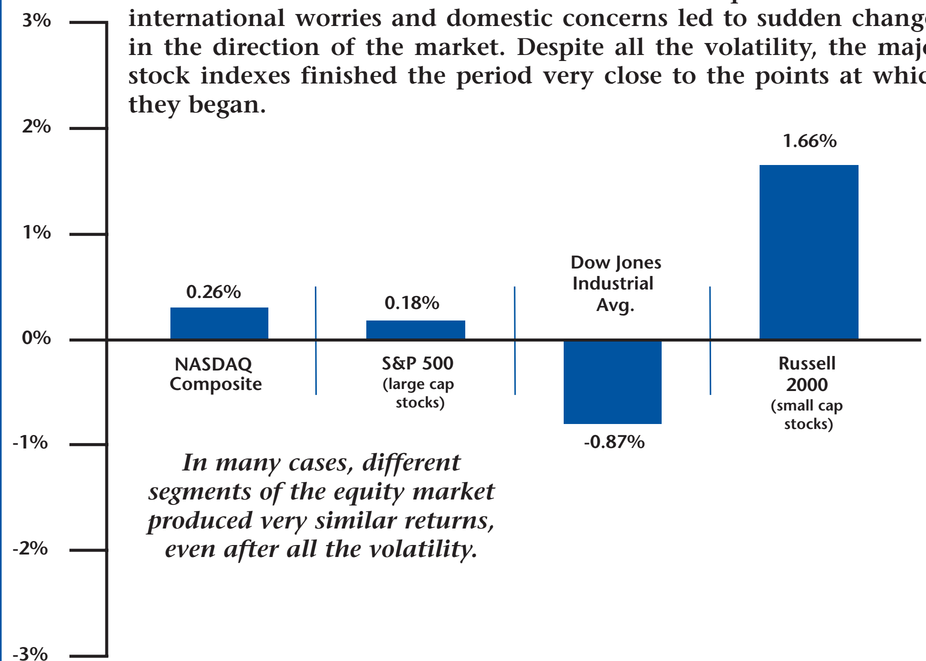
- Rumors had spread that the Chinese government was planning to place restrictions on the Shanghai market to ease some speculative excesses;
- The quoted comments of former U.S. Federal Reserve Chairman Alan Greenspan, in a speech to Hong Kong business leaders, that a recession in the United States in 2007 was "possible."

Greenspan's remarks actually may have caused the greatest psychological damage to investors in the global markets, as many look to the United States as the dominant driver of the world economy. (Greenspan later qualified his comments to say that while he did acknowledge a recession was "possible" he did not believe it was "probable." Moreover his successor, Ben Bernanke, stipulated that he did not foresee a recession this year.)

The result of all this was a frenzy of stock-selling that was exacerbated by a glitch in electronic trading systems in the U.S. The selling continued for several days. From the spectators' seats, some media commentators added energy to the downward movement of stock prices by suggesting that the markets were in a "meltdown" of historic proportions. By the time the immediate carnage was over, the Dow Jones Industrial Average was down about 5%, but the Dow index –as well as the Shanghai index—recovered virtually all February's losses by mid-March --when the next bout of volatility hit.

This second, and less severe, drop in the markets was precipitated by widening fears that problems in the U.S. housing market might spread to other parts

Focus on the Markets



Index returns are for price only, and do not include reinvestment of dividends. Past performance is not a guarantee of future results.

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of the economy. The catalysts for these fears were a report that mortgage delinquencies had risen and a succession of disclosures about problems in the subprime mortgage business. These concerns, though, soon appeared to be overblown and anxieties abated.

The sudden fluctuations in market trends like those we witnessed in the first quarter of 2007 can be unnerving. Unfortunately, they have become an almost normal part of investment life. Every so often, emotion enters the market –temporarily crowding out the facts and overriding rational deliberation. Over time, these events just seem to underscore the old adage that the market climbs a wall of worry. In March alone, the worries surfaced over rising oil prices, increasing tensions in Iran and the slowdown in the U.S. housing market. However, by the end of the month, stock prices were about even with the levels of early January.

Investors clearly were on edge by the end of the first quarter. Adding to the understandable unease in the markets was the fact that there was plenty of contradictory information available to justify either pessimism or optimism about the direction of the markets going forward. Nevertheless, we think several factors should be kept in mind as we look out toward the rest of 2007:

1. The economy continues to grow, albeit at a slower expansion rate than a year ago, when problems in the housing market had yet to surface;
2. Corporation profits and stock dividends continue to increase;
3. Inflation is contained;
4. Interest rates are not at burdensome levels;
5. Stock valuations remain reasonable by historical standards. Heavy merger-and-acquisition activity and private equity buyouts give testimony that seasoned investors see plenty of value in current stock prices.

In short, we don't have the necessary ingredients for either a prolonged bear market or a recession.

There also is another major factor that should reassure us: new Fed Chairman Bernanke. He does not want a recession, nor does he want an implosion in the housing market to cause growth to slow significantly. If the deceleration of economic growth were to intensify, Bernanke has the motive, means and opportunity to stop any slide and stimulate renewed economic growth by cutting short-term interest rates quickly. It is abundantly clear that the next move by Bernanke and the Federal Reserve is much more likely to be a cut in interest rates than a hike.

Meanwhile, our message is simple: *Keep focused on your long-term investment goals. Own stocks with positive growth potential. Own high-quality fixed-income securities. Don't be surprised by the occasional bump in the road and don't let emotions cloud your judgment.*

Lighthouse Guides

Q: How much of a serious threat does the subprime mortgage market pose to the general economy?

A: Limited, although the current slow-down in the housing market will reduce growth in the U.S. in 2007.

The owners of any bad debt arising from the subprime mortgage lenders are more likely to be hedge funds or mutual funds, rather than the local financial institution in local communities, many of which were so vulnerable during the savings and loan crisis of the 1980s.

Many of the mortgage issuers are divisions of large financial institutions which, while they may take a hit on their earnings for a quarter or two, can withstand the pain. To be sure, there will be bankruptcies among some of the more thinly capitalized mortgage issuers who may be forced to take back delinquent loans. But the damage will not be widespread.

At about 10% of the overall mortgage market, subprime loans represent a relatively small –but not insignificant— part of the home lending universe. And, many of the troubled subprime loans most likely can be renegotiated to terms more favorable to the beleaguered borrowers. Financial institutions, whether banks or other lenders, do not want to own residential property if they can find any way of avoiding it.

Unfortunately, some financially strapped families will be hurt by the crisis and even lose their homes. And, the housing market may not recover quickly, which may bring challenges to those who had planned to sell their homes in the next year.

If history is a guide –and it usually is—the housing market eventually will stabilize and home prices will begin rising again, consistent with the laws of supply and demand. But the next round of price increases almost certainly will not be as dramatic as those we saw in 2004 and 2005.

In the meantime, look for minimal damage to the overall economy.

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