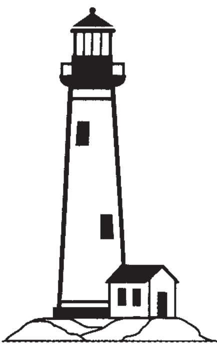


Lighthouse Beacon

A Guide in the 21st Century

Volume 9, Number 5 | Quarterly Review | October 2007

Lighthouse Investment Commentary

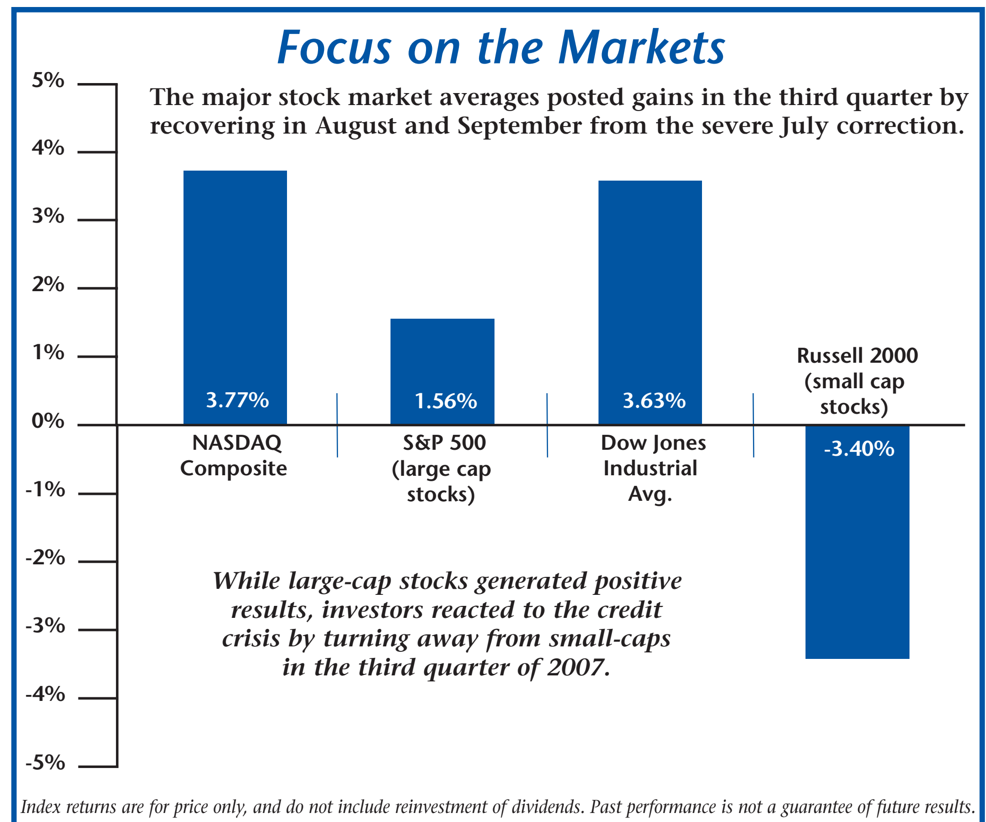
The Fed Spoke . . . The Market Listened

The nation's central banker –The Federal Reserve Board– appeared to inject confidence as well as liquidity into the markets on September 18. That's when the Fed took the bold move of reducing both the federal funds rate and the discount rate by one-half of a percentage point.

While some rate cut had been widely anticipated (and hoped for), the size of the cut was more than a little surprising. The reaction was immediate that day, as the three major market indexes produced their largest point gains in five years and then kept rising the following day. Foreign markets also reacted positively, and major banks followed the Fed's lead by cutting their prime lending rate –also by a half-point.

The actions appeared to have limited the potential fallout from the subprime mortgage debacle and the housing industry slump –which was beginning to have negative effects on consumer and business confidence. The greatest fear was that the housing-related credit crisis might become contagious, lead to greater tightening of money available for lending and act as a major drag on the general economy. However, the Fed's firm actions –which included the first fed funds rate cut in four years– sent a strong signal that the central bank stands ready to do what it needs to do to restore confidence and ensure continuing economic growth. The moves should lead to reductions in interest rates on all types of loans to businesses and consumers, including mortgages, equity lines of credit, auto loans, and credit card charges. Although the Fed's actions are less likely to reverse the housing slump –which will have to run its course– it may soften the jolt from the bottoming process.

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.

We believe the Fed made the correct move. The twin rate cuts should be a sign that the board is ready and willing to be flexible and to act decisively when necessary.

As has been the norm these days, however, there are those who will always take a negative view of events. It should not surprise anyone to hear more gloom-and-doom regarding inflationary risks, political motivations and the oft-heard lament that "things are really a lot worse than they appear." Let's not forget that housing comprises a relatively small portion of gross domestic product and other areas of the economy have been able to maintain their growth patterns nicely. An excellent example is in U.S. exports to foreign nations –our products continue to be in strong demand in fast-growing foreign markets. And, don't forget that consumers –big potential beneficiaries of the Fed's actions– account for two-thirds of the economy.

You may remember that in last quarter's newsletter, we suggested a 5-to-10% correction in the market was possible at any time. Little did we know that just such a correction would come so soon and that the market would begin to recover so quickly. After reaching new all-time highs in July, the Dow Jones

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Industrial Average went into a correction of 10%, only to reverse direction quickly –on news that the Fed unexpectedly had lowered the discount rate. The Dow then went into a tumultuous period to rise and then fall again several times during August and September before the Fed acted again on September 18.

This past quarter's market volatility did provide further evidence against the folly of trying to time the stock market. It all happened so quickly as part of the continuing fallout from the subprime mortgage debacle and the housing slump. These related events have been felt in financial markets throughout the world, affecting banks, hedge funds and institutional investors. The great fear was that it would eventually lead to a global recession by choking off liquidity in financial markets throughout the world, drying up money for funds for loans of all types.

The media exacerbated the situation with a constant flow of "gloom and doom" stories forecasting credit crises and even recession. Then came the Fed's September 18th move, and the backdrop for investing changed again.

Before the Fed's action, we were beginning to see that lending of all types was becoming more restrictive. Banks and investors were becoming more worried about what kinds of credit problems their borrowers might be exposed to, even if they didn't have any direct exposure to subprime mortgages. The Federal Reserve Board injected liquidity into the markets in two different ways: by cutting the fed funds rate and by cutting the discount rate. The fed funds rate is the target rate that the Fed sets for banks to lend to other banks. It usually is the cheapest source of overnight money for banks. By lowering that rate, the Fed was making it easier for banks to borrow and easier for the borrowing banks to make a profit when they turned around and lent out that borrowed money at higher rates in the economy. The discount rate typically is higher than the fed funds rate. It is the rate the Fed charges for its loans to banks. While banks obviously would prefer to borrow money at the lower fed funds rate, there may be times when they still have trouble getting those loans. That's when they can turn to the Fed and borrow at the discount rate and then put that money to work in the economy. So, the Fed's action eased the flow of money into the economy both through bank-to-bank loans (the fed funds rate) and Federal Reserve-to bank loans (the discount rate). As it did so, the Fed was increasing the potential profit margin that banks earn when they lend money out to consumers and to businesses.

Stock market investors recognized this easing of liquidity, and the major market indexes again started moving up –first dramatically, then in a more normalized pattern.

The lesson is clear. As difficult as it is, we must continue to try not to dwell on short-term events. We need to be focusing on economic and business fundamentals and our long-term goals. Just remember: after all the turmoil and market volatility, the major stock indexes produced positive results for the third quarter.

Lighthouse Guides

Q: Why have my corporate bonds and preferreds declined in price over the past several months, even though interest rates have not risen?

A: The most basic rule in fixed income investing is that bonds and preferred securities typically move inversely to the direction of interest rates. When interest rates rise, the prices of securities decline. When rates go down, prices go up. Let's say you have a bound that is yielding 5%. Then, the market interest rate rises to 6%. Your bond's price reacts by declining to the point that its payout becomes 6% of the current price. The income being produced hasn't changed, but the current market value of the security has changed.

That's pretty simple. Except in the real world, it isn't quite that simple. Bond prices also reflect the difference in yields between bonds of different credit qualities. We call those differences the "spread." The spread refers to the differential between the yield of a non-Treasury bond –such as a mortgage-backed security or a corporate bond– and the yield of a Treasury. The idea is that the spread reflects the extra income an investor receives to compensate for the added credit risk of the non-Treasury security. For example, we might have a situation in which a 10-year Treasury yielded 5%, a AAA-rated corporate bond yielded 5.3%, an A-rated preferred might yield 6%, and a low quality, high-yield bond might have a yield in the 8-9% range.

During periods of market turmoil, the "spreads" of different sectors might change as demand increases for Treasuries and demand decreases for "spread" products. Treasury prices would tend to rise and their yields decline in this "flight to quality," as investors prefer to be invested in the least-risky, highest-quality security. Conversely, the prices of the spread products would go down and their yields would rise –resulting in a change in spread relationships.

None of this affects the income being produced by any particular security. In the case of high quality corporate bonds and preferred securities, a change in spreads does not really indicate a risk of default, although that risk may exist for some lower-quality, higher yielding bonds. The "spread," however, does indicate stress in the fixed-income markets, whether real or apparent. While spreads of some securities recently widened –and their prices declined– due to credit concerns, it is likely that many of these securities will recover in value when tensions in the market subside and spreads start to tighten again.

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