

Market Commentary

Good Quarter but Amber Light Ahead

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Stock market returns last quarter were stellar, but risks still abound and caution is certainly appropriate. The market rallied in the first half of the second quarter pushing the Dow to record levels. This rally was followed by a pullback characterized by extreme volatility. What produced the strong performance at the beginning of the quarter? What caused the "correction"? What lies ahead?

The market was driven higher in April and early May by stable interest rates, better than expected profit reports from major companies, relatively benign inflation numbers, less dire than expected impact from imploding sub prime mortgages, and perhaps most importantly, speculation based on private equity buyout offers. With the exception of the buyout mania, the other factors are solid reasons for a market advance. We will address our concerns about the impact of the private equity factor in our "what lies ahead" comments.

The causes of the late May early June correction are also pretty clear, namely rising interest rates and signs that the Fed's next move would not be a quick reduction in interest rates. Several Fed officials, and most importantly, Chairman Ben Bernanke, repeatedly expressed concerns about inflation which has trended above the Fed's target range of 1% to 2%.

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What lies ahead? Overall the valuation of the stock market is not really excessive. In early 2000 at the end of the late 1990's market boom the price earnings multiple on the S & P 500 was over 30. Before the recent correction it was only about 18, which is not much higher than the long term average of around 14. Equally

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important, the quality of earnings is much higher today than it was in early 2000 before accounting problems at many companies were cleaned up. Thus stocks are not terribly overvalued and it could be argued that they might be slightly undervalued. This is a positive.

The negatives are interest rates, the impact of speculation due to buyouts promoted by private equity firms, and the potentially huge leveraged transactions undertaken by private equity and hedge funds. These things are related. If interest rates rise, a number of the private equity transactions could lose their financial viability and debt defaults could follow. Hedge funds are probably utilizing substantial leverage to push up their returns. Some of their transactions probably involve speculation on the direction of interest rates. If the market moves against these funds and they are forced to unwind their positions, because of the leverage involved the impact could be substantial. This is not idle speculation. There is reasonable evidence that the recent increase in interest rates is partially rooted in hedging strategies related to mortgage investments by these funds.

Will this produce an economic crisis? That's doubtful since there are reasonable institutional checks and balances and safeguards built into our financial system. On the other hand it could easily exacerbate other problems and cause spikes in interest rates which will in turn impact the stock market.

We think stocks remain a very good long term investment. However there are times, and we think this is one of them, when paying particular attention to the amber light makes sense.

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