

## Market Commentary

### What if No One Wants Your Assets?

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Any way you look at the first quarter of 2008 it was not pretty. Stock markets throughout the world were down, with formerly high flying markets in India and China off about twice as much as the U.S. market. That was small solace for U.S. investors where the Standard & Poor's 500 dropped about 10%. What caused this negative turn and what does it mean for the future?

The main cause seems clear. Lax lending standards and low interest rates which had helped to facilitate an overvalued real estate market came home to roost. The economic ramifications of the real estate price correction were widespread. Financial institutions which held numerous esoteric securities whose value was tied in some way to mortgages faced multi-billion dollar write downs as buyers for those securities effectively went on strike causing market prices to fall necessitating big write downs of the securities. These write downs quickly eroded the capital of financial institutions and other highly leveraged investors, causing them to seek capital infusions, some of which came from sovereign wealth funds.

Consumers who had grown used to using home equity loans to facilitate current consumption no longer were able to do so as prices for their homes fell and mortgages in some cases exceeded the value of the homes. Purchasing power was further eroded by record oil prices, caused in part by a weak dollar which was in turn partially caused by reductions in interest rates intended to offset the real estate related problems. As U.S. consumption slowed, investors feared that the export driven economies of China, India and Japan would also suffer. That caused those markets to fall. This was all a very vicious cycle.

What can be learned from what might be likened to a chain reaction collision in the world's economies, and what does it mean for the future?

First and foremost, real estate is not a sure thing, has cyclical characteristics similar to other investments, and can become just as easily overvalued.

Second, thinly traded, hard to understand and therefore hard to value securities don't always behave as expected. The financial engineering of Wall Street's back rooms can turn into a Main Street debacle.

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Third, the consequences of policy actions intended to address or correct one problem can cause other problems.

Fourth, if you borrow a lot of money to invest, the lender may demand you repay and that demand will rarely be at a time convenient for the borrower.

Fifth, irrational exuberance (to quote Robert Schiller of Yale who really coined the phrase) will as night follows day be followed by irrational pessimism. Both have a tendency to feed on themselves. We saw irrational exuberance in the late 1990's with tech stocks followed by three years of pessimism. Starting in 2003 optimism again bloomed and has now been followed by the pessimism of the last year or so. This phase too will pass.

Financial markets throughout the world are linked together and the U.S. economy remains the world's main economic driver. The notion that investing outside the U.S. as a hedge against the U.S. market has been shown to be not correct.

No one has ever been able to precisely predict changes in the direction of the financial markets (except by accident). We are no smarter than others in that regard. What we do know from years of experience is that markets run in cycles. We believe this cycle also will pass and be followed by another upturn in the markets. We don't know when that will happen, and it won't be heralded by clear signs. It will only be discernible in retrospect. It takes a certain amount of intestinal fortitude to buy when others are selling. However, historically that's the way to make money in any type of market.

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