



## Global Financial Markets Perspective First Quarter 2007

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### “Ironing Out” the Financial Wrinkles

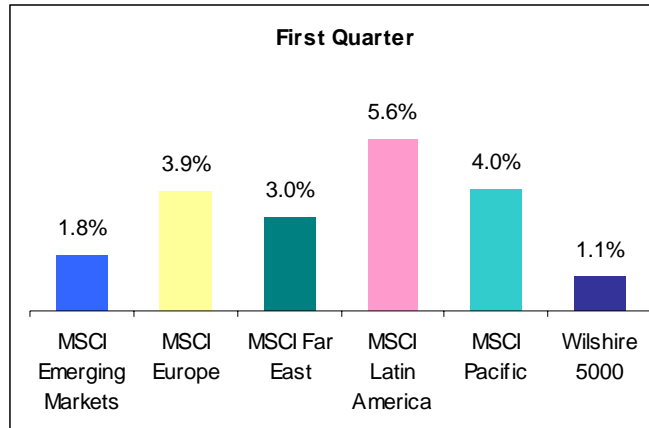
Investors tend to get mesmerized by short-term swings to the downside in equity markets. The first such decline this year occurred in late February. The day after a weeklong Chinese New Year holiday break, the domestic Shanghai and Shenzhen A share markets reached historic highs. However, sentiment turned extremely bearish the next day and stocks had their worst single day in ten years, with the Shanghai and Shenzhen indexes down by more than 9%. In the following month, the Dow Jones Industrial Average fell from a record high of 12,846 to a low of 11,926 – a decline of 7.2%. The S&P 500 index fell from 1,461 to 1,363 – a decline of 6.7%. Five years ago few American investors knew about these stock exchanges. Today many professional investors blame this one-day drop for sparking worldwide equity market declines. While the media was quick to highlight the risks of equity investing, investors focused on the long-term knowing that such short-term wrinkles are normal.

When taking a long-term view, one that is a necessary precondition to being a stock market investor as opposed to a stock market trader, history is replete with examples of these wrinkles. One study recently enumerated market declines of meaningful proportions while putting such declines into perspective. From 1947 through 2006, the Dow Jones Industrial Average has risen 6,933%, an outstanding demonstration of the effects of compounding but also an endorsement of free-market profit opportunities. With this type of performance record, how could any reasonable long-term investor fear the downside? Well, this same time period was marked by a number of alarming declines. There were 64 corrections of 10% or more and 15 corrections of 20% or more. Those sizeable declines turned many bulls into bears and encouraged investments in less volatile securities, ones that also had substantially lower return potential.

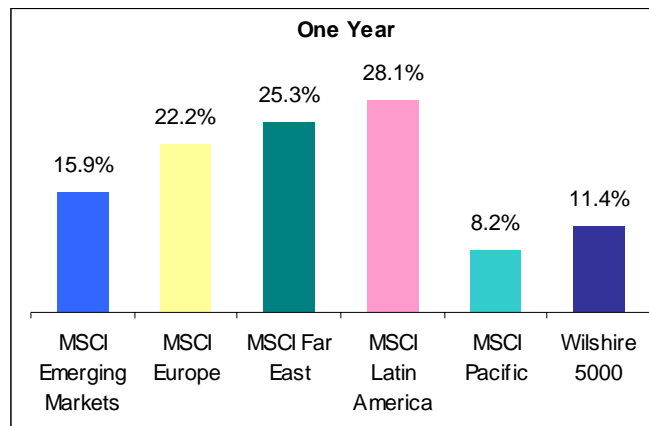
So where might a 10% or 20% correction take us in today’s markets? The close of the DJIA on April 4<sup>th</sup> was 12,530. A 10% correction would take the market down 1,253 points and a 20% correction would lower the Dow by 2,506 points to a level of just about 10,000. We are not anticipating such a “correction” anytime soon and have some confidence that the recent wrinkle may push off any moderate correction within this historical context. Investors should be aware that such corrections do occur within this long-term trend and that “ironing out” the wrinkles takes time.

Despite the short-term decline experienced in the first quarter, equity markets behaved reasonably. The chart on the following page provides a summary of global equity market returns for the first three months of this year.

Foreign equity markets continued to lead with Latin America returning nearly 6% while U.S. equities as measured by the Wilshire 5000 index rose slightly more than 1%.



Investors who choose U.S. markets would prefer to look at weak first quarter statistics as evidence that the markets consolidated the gain in stock prices from a low point in July of 2006. Even though one-year statistics for U.S. stocks equaled the long-term average gain of around 11% (see exhibit below), the quarter to quarter rates of return were quite volatile. The first quarter of 2006 saw a gain of 4.6% for the S&P 500 index. Then, after the double whammy of higher oil prices and rising interest rates, the S&P 500 index dipped to a low of 1,225 in July of 2006 but then rallied to a high of 1,462 by February 20<sup>th</sup> of this year – a gain of 16%.



The rally seemed to be triggered by the combination of a change in Federal Reserve policy to stop raising interest rates and a decline in the price of oil. As long as the Fed senses that inflation is moderate and the economy is not too strong, they will maintain the current Fed funds target interest rate of 5.25%. From our perspective, the outlook for reasonable growth and low inflation suggests that the Fed will not make any overt change in interest rate policy for the foreseeable future.

In looking at the volatile equity performance during the last twelve months, but experiencing one-year returns that appear normal, investors must realize that short-term volatility shouldn't disturb a viable long-term strategy. The historical performance record allows investors to take a step back and put these short-term wrinkles into perspective.

For investors who try to anticipate either upswings or downswings in stock markets, we suggest such a skill is temporary and that few, if any, professionals or novices can master. More likely than not, the ones that guess it right at any point in time seldom repeat their success. As one of our old colleagues in this business once said: “Do you ask someone who has won the lottery how he picked the numbers?” In other words, we are all subject to the emotional aspect of stock market investing and at key turning points many investors are charged with either greed or fear. By sticking with a long-term strategy and leaning against the wind, a few investors can iron out their investment wrinkles.

## **Energy and the Economy**

A perspective on global financial markets is incomplete without taking into account the single economic factor that can have critical implications for global growth and inflation – energy and the price of oil. We have seen how surging oil prices have driven stock prices down and subsequent price declines have given impetus to market rallies. Each time there is an “event” like the recent seizing of British hostages by Iran, the energy market reacts quickly as any interruption in oil supplies from major producers such as Iran push oil prices higher.

Knowledgeable energy industry forecasters have predicted oil prices above \$100 per barrel if there is a disruption of oil flows from the Mideast. Such a price surge would undoubtedly trigger the 10-20% stock market decline that we discussed earlier. But what is the likelihood of such an interruption?

As time passes, the impact of such a disruption dissipates because the high price of oil has been triggering many responses that will inevitably lower the cost of oil. These reactions can be characterized as one or more of the following: conservation, innovation, substitution or new sources of supply.

When the price of oil began rising a couple of years ago, we failed to track the acceleration in spending on these sources of increased energy supply. As readers of the Wall Street Journal or regular viewers of CNBC or FOX news know, there has been an enormous proliferation of new sources of supply. There are billions of dollars being expended to find and produce alternatives to oil. Since most of these solutions take time to develop and bring to market, the current high price of oil remains somewhat sticky but, as each new development emerges contributing to lower oil demand, the price will undoubtedly fall. There is also a need to do something about the risks of global warming that will provide bilateral support to alternative energy source development. For investors in financial markets, the risks appear short-term. The opportunities opening up for investments in producers of alternative energy solutions are growing.

The other good news is that falling oil prices will have an important effect on lowering inflation, given oil’s important role throughout the global economy. In the United States, the economy has grown at a below-average rate for three consecutive quarters through the end of last year. This slow economic growth reduces the risk of future inflation.

History shows that the risk of inflation increases as the economy strengthens and decreases as the economy weakens. When the economy is strong, the demand for materials and labor to produce

goods and services goes up. Eventually, companies can increase prices because they are paying more for these inputs. Alternatively, when the economy is weak, the demand for materials and labor usually goes down.

This relationship between economic growth and inflation does not mean inflation always goes up when the economy is strong or goes down when the economy is weak. More than a year ago when the housing market was strong and the economy was growing at an above-average rate, the Federal Reserve was raising short-term interest rates to reduce a potential inflationary environment. Today, the housing market is in recession while the rest of the economy is not. But, when the economy is growing at a below-average rate there is always a risk the weakness could spread and the whole economy could fall into recession. The key to relating these variables is productivity. Rising productivity can offset the pressures on prices when demand increases.

As investors, we try to anticipate when inflation risk is changing. Economic growth is just one variable in making this determination. The economy does not always fall into a recession just because of probabilities. Recessions are always caused by something. Currently, there is no indication of any major regulatory or fiscal changes to be implemented anytime soon. And even though Alan Greenspan suggests that there is a risk of recession because we haven't had one in a long time, we haven't been hit by a meteor in a long time either.

Even though the probability of recession increased modestly over the past four months, we are confident that the nexus of high corporate profits, rising jobs, higher incomes, continue productivity growth and solid retail sales will undermine the pessimistic view that sub-prime contagion will pull the rest of the economy down.

## Conclusions

The U.S. economy appears to have grown at a sub-par rate during the first quarter of 2007 – the fourth consecutive quarter of below-average growth. This fact illustrates that the rate hikes from mid-2004 through mid-2006 have dampened economic growth as the central bank intended. However, core inflation is now below the Federal Reserve's comfort zone meaning that monetary policy may reflect an easing of inflationary concerns. History suggests that the full impact of a series of rate hikes can take more than a year to affect the economy. Consequently, the pace of economic activity could remain subdued well into the second half of this year. On the other hand, growing exports plus a weaker dollar are having a buoyant effect on economic growth.

Asia excluding Japan and Australasia – grew at its fastest pace in 11 years in 2006. The Asian Development Bank has penciled in more modest growth of 7.6 to 7.7% for this year and next. Growth appears to be on a sounder footing compared to the late Nineties as Asian central banks have accumulated vast foreign exchange reserves (\$2.3 trillion) to cushion against future crises. Moreover, growth in China and India will continue to expand by double-digits -- outpacing the majority of G7 economic growth over the next few years.

We really don't want to bore you by beating a "dead" horse (see our Financial Market Perspective "The Asian Miracle" dated April 18, 2006), but last week China announced that the economy grew at a faster-than-expected 11.1% rate year-on-year in the first quarter. Core

inflation came in at 1% proving that strong economic growth is not inflationary especially when productivity is soaring. Analysts fear that China, which once helped to lower global prices, could start exporting inflation. In our view, that event is still a way off – the spike in March data was almost wholly due to food – but pressures are building. Wages are growing at an annual rate of 15% and, while excess manufacturing capacity remains, it has a less benign impact now that services command a bigger slice of the economy. Asset inflation, as evidenced by bubbles in real estate and equities, is rampant. Yet such price increases are coming off low levels not unlike industrial America in the post War 1940s. We are not so concerned when wage inflation takes the average workers pay up from \$200 per month to \$230.

Having unleashed a market-oriented economy, Beijing is having a harder time tempering growth with administrative measures. Calls to cool lending have not stopped factories and plants from proliferating. The increases in local banks' reserve ratios did not prevent the industry making new loans of \$180 billion in the first quarter -- almost half the total for all of 2006. And the bite-sized rises in interest rates have clearly failed to curtail stock market frenzy. The Shanghai domestic-equity market, despite falling 9 per cent one day in February, is up 27% since the start of 2007 and retail investors are opening trading accounts at a record pace. Add to this situation the fact that Beijing has taken exchange competition to new levels by ordering all but the biggest issuers to spurn listing on the Hong Kong exchange and stay home. Chinese regulators clearly have an interest in promoting the home markets. Together the country's two domestic currency A-share markets recently overtook Hong Kong in terms of market capitalization.

China isn't the only miracle economic story to be told but one that reflects a rising global phenomenon—the embrace of capitalism, free markets and low tax rates. After years, if not decades of America's commitment to build capitalism around the world, our work is now bearing fruit—although many politicians and media elite have no clue about our success. The ramifications of this success could stay with America as long as government doesn't hamper our ability to compete on a global basis. For investors, new opportunities will continue to emerge around the world no matter the impact of misdirected economic policies in the U.S.

Financial market volatility is never pleasant. Long-term investors must remember that every so often equity markets experience a few wrinkles. A rebound in inflation could quickly undermine today's financial market bullishness. The threat of rising tax rates after the Bush tax cuts expire are clearly a threat to our competitive position. The threat of protectionism could add another layer of risk to the outlook by blocking competition in U.S. markets from less expensive overseas goods and services. Ironically, globalization is supposed to be disinflationary – not inflationary as we are witnessing today. Perhaps there is a wrinkle in this process too!

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