**Global Financial Markets Perspective**
**First Quarter 2008**

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# House of Cards?

This credit debacle is the twelfth crisis in our recent financial markets history. The first financial adversity was First Pennsylvania Bank in 1980, followed by the Penn Square bank failure and Latin American disaster in 1982, the collapse of Continental Illinois in 1984, the Black Monday stock market crash in 1987, the taking down of junk bond king Michael Milken and Drexel Burnham in 1989, the Savings & Loan meltdown of the 1990's, the Mexican Peso crisis in 1995, the Pacific Rim currency and markets crises started by Thailand in 1997, the Russian debt failure, the implosion of Long Term Capital Management in 1998, the Internet bubble burst and finally the collapse of the NASDAQ in 2000.

Every single one of these financial crises had one common characteristic: They all ended. Remember, things are never as good or as bad as they appear when we are actually living through these events. However, experience is our greatest teacher and it has taught us time and time again that every trend and crisis will end. And this lesson applies to both the good and bad ones.

Of course we cannot blithely ignore the 1930s depression fomented by the stock market crash of 1929. Unfortunately a containable event turned into the greatest economic catastrophe of our past generation's lifetime. We have learned from the mistakes of that era—tight money, high tax rates and trade protection. This time the supervisory bodies were quick to lower interest rates, offer a minor tax rebate and refute any thought of raising protectionist barriers. If history is any guide, we won't repeat the mistakes of the past.

Since August of 2007, we have been experiencing a credit crisis ignited by sub-prime loan losses and exacerbated by complex derivative securities. The recent Bear Stearns calamity highlights the fact that something is wrong with the state of modern finance when a firm that survived the Great Depression can't survive what appears to be a mild recession. What went wrong with the "Bear" will be studied for many years to come. One thing is very clear: leverage is a key ingredient in understanding the feast-to-famine mentality in the credit markets over the past period. In other words, just one spark in a dry forest can cause a disaster. Just start with one income flow to meet a mortgage payment, pass through to a securitized product created by Wall Street and sold to institutional investors and then fund the position of the leveraged holder of the mortgage

security with more borrowed funds. But if anything goes wrong with that initial income stream, the pass-through effects to each obligation are amplified in the financial system. In other words, unbridled greed, power and corruption brought down the financial house of cards.

Thankfully, cooler heads have prevailed. During the past two weeks, history-making intervention by the Federal Reserve has staved off a major financial crisis first by providing a unique financing mechanism for commercial banks—the term auction facility—and second opening up the discount window to primary securities dealers who needed liquidity. Early this week Secretary of the Treasury Henry Paulson announced a proposed restructuring of the financial system to avoid future problems. Finalization of such a plan will take time given the current regulatory environment and will be subject to much debate among the players. In the meantime, further financial disruptions cannot be ruled out, but the worst has probably passed.

Our domestic financial crisis has also spread abroad as foreign financial institutions bought into the mortgage packages offered by Wall Street. The Bank of England has been in discussion with other central banks to "ease the strains in financial markets" and the European Central Bank is holding tight on implementing interest rate cuts while providing the liquidity required by euro-zone financial institutions. Other central banks have also provided needed liquidity. This collaborative central bank effort is key to recovery.

Investors are concerned about where we go from here. In January, our view of equity markets was positive for the year as a whole with the first half feeling the pain from continued credit market concerns and the second half benefitting from stronger economic growth and moderating inflation. At the beginning of April, after an extremely volatile and negative first quarter, we have a less sanguine sense of what lies ahead. We are not alone in this conviction. According to a recent report by Standard & Poor's, the U.S. stock market is the most volatile in seventy years! The S&P 500 benchmark for American securities has advanced or declined 1% or more on 28 days this year. That's 53% of the trading sessions. This extreme volatility is a result of investor uncertainty.

In the current market we are also witnessing a buildup in negative data that affects market forecasters' expectations. Suddenly, consensus dictates that recession is upon us even though the requisite two quarters of declining economic activity has failed to show up. Additional pessimistic news is that Wall Street earnings expectations for the year ahead are unrealistically high, and that future growth is likely to be minimal or non-existent. The most recent index of leading economic indicators declined 0.3% -- the fifth decline in the past six months, signaling the U.S. economy is probably in recession. Adding to the

evidence, February industrial production fell 0.5% and the capacity utilization rate dropped to 80.9%. Permits for new home construction fell 7.8%, and the housing industry remains severely depressed. Every data point is interpreted through that lens of negativity and signs that point in different directions are greeted with skepticism or simply ignored.

We think that it is wise to take a conservative view of the economy and future earnings. We also know that the herd is not always or even usually right and that when the consensus is so biased in one direction, opportunities are being overlooked and inefficiencies are being created. One example is the dramatic global market decline in January. Once markets realized that a rogue trader had triggered an enormous forced selling of a $78 billion portfolio of stocks, the markets gradually recovered their losses. Another important point is that stocks and the economy do not necessarily move in sync as the legacy of 1990-91 demonstrates. Equity markets can be discounting mechanisms that incorporate future expectations and we may have seen some of this tendency in late January when the two worst sectors as measured by fundamentals – financial services and consumer discretionary – had the best returns. At the same time, the best sector as measured by fundamentals – technology – had the worst returns! The relentless bad news and multi-billion dollar write-downs in the financial sector may already have been factored into stock prices even though the economic outlook for those companies may still be challenging in the period ahead.

Even if the worst expectations of the economy are borne out, we don't believe that a prolonged steep economic contraction is just around the corner. The last downturn in 2001 was so short-lived that one could barely call it a recession in terms of the pullback in activity – even though it was accompanied by a sharp decline in technology and telecommunications stocks. Seven years later, the NASDAQ index is trading at less than half the peak it reached in March of 2000. The decline in stocks started off a very high valuation base with equities in the S&P 500 and the NASDAQ indices trading at multiples of 26x and 82x, respectively. The 2001 pullback was led by a contraction of business spending, a drawdown of inventories and a painful stock decline from elevated multiples as we survived the Y2K transition with no disasters.

Policies to limit the impact of financial troubles coupled with a short-term fiscal policy bandaid in the form of a tax rebate is a start. However to get the economy back on track we will need a major tax restructuring to improve the competitiveness of U.S. industry. The United States has the second highest corporate tax rate in the world. Corporate America has to compete with the emerging capitalist countries that are growing rapidly and winning the game. Add to this challenge the differing views about making America competitive again – note protectionist issues beginning to dominate Washington speak – and

the presidential candidates have much work to do to address the long-term growth objectives of our country. At least by the end of summer we will have a clearer picture of who are the finalists.

Estimating stock market movements in such as environment will be trickier than ever. Extreme volatility has been uncomfortable to say the least and has affected sleep patterns. History reflects that at stock market highs there is little volatility because the majority believes there is nothing to worry about. Euphoria is the dominant mood. Conversely, fear and volatility is high in the area of a market bottom – as is the case in current financial markets.

Today, corporate balance sheets outside of the home building and financial sectors are as stable and clean as they have ever been with little debt and plenty of cash. Equity multiples are barely nudging 15x. The world is still awash in cash -- from the $3 trillion in sovereign wealth funds of industrialized nations to the savings of billions of consumers to the trillions of dollars of currency reserves of creditor nations such as Japan and China. In theory, capital will seek the best rate of return which means that currently undervalued U.S. assets will benefit from foreign capital.

Unlike most of our Perspective commentaries, we have focused almost entirely on the domestic markets in this issue. We would be remiss if we didn't reconfirm our belief that the global economy continues to boom and to offer proliferating investment opportunities. Even though rising raw materials prices are putting upward pressure on inflation, global demand remains strong which should benefit companies that export goods and services from the United States – a phenomenon that may be sufficient to offset the statistical recession. More importantly for investors is that emerging market economies continue to implement capitalist free market policies and to provide a more transparent investing environment.

The beginning of 2008 has been extremely painful for financial market participants, both in the United States and globally. The sell-off happened rapidly and few companies and investors have escaped unharmed. In this climate of panic and pessimism, the antidote is not optimism but the recognition that sharp corrections are frequently moments of great potential.

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