



## Global Financial Markets Perspective Third Quarter 2007

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### Global Growth Revisited

Investors who had the luxury of vacationing for the entire month of August in a location devoid of news access might have returned thinking that little had taken place while they were away. Fortunately we were afforded three weeks of such luxury but could not take advantage of being away from it all as client concerns prompted our daily visit to the ship's computer lab on our cruise from Athens to Istanbul. Once back in the office in September, we had the opportunity to put the global financial panic in perspective.

Wall Street tends to react to sudden changes in the status quo with apocalyptic rhetoric. The recent carnage in the world of hedge funds is bad, but remember the 1998 Russian crisis that sparked more than a billion dollar decline in famed-investor Julian Robertson's \$21 billion Tiger Fund in just two weeks? That debacle, in turn, was overshadowed by the collapse of Long Term Capital Management, a hedge fund that was bailed out before it would have brought even larger financial institutions down with it. The fact that financial markets survived these past crises is no guarantee that the outcome of the current turbulence will be more benign.

Two breakdowns that took place this summer were the downturn in the housing market and the bursting of the financial bubble that formed around the housing market because of extremely low interest rates, reckless mortgage lending practices and the ability to leverage a home purchase with literally no down payment. These circumstances attracted speculators who saw the opportunity to package these mortgage-backed securities and their derivatives and sell them to unsuspecting investors. Of the two, the second posed an immediate threat to the financial system, given that the leveraged exposure was substantially greater than the actual size of mortgage defaults or outstanding low-credit loans. This looming crisis seems to have been averted by the aggressive action of the Federal Reserve in the middle of September when they reduced the fed funds rate by 50 basis points to 4.75%.

The financial market's exposure to the mortgage crisis is troubling because Wall Street didn't "securitize" loans by slicing and dicing them. These loans were buried in packages of other loans and then bundled with higher credit loans. When mortgage defaults began to rise at the lower end, Wall Street institutions and hedge funds realized that they didn't really know which of these loan derivatives were good and which were bad. The result was that trading in almost anything mortgage-related froze in the middle of July - creating a domino effect. Lenders and mortgage brokers tightened lending standards and banks demanded more collateral. This tightening extended from home loans to credit lines for hedge funds and private equity firms. Getting any kind of a loan went from easy to difficult.

The Fed rate cut seems to have broken that impasse. The effect of the current "re-pricing of risk" on financial institutions is still difficult to gauge because many mortgage-based derivatives don't have a public market and are difficult to fairly value. Much like Franklin Roosevelt's "Banking

Holiday" in early 1933, the temporary pause in August allowed firms to regroup and reassess their policies and controls. For the moment, the wave of panic has been reduced, and the actual damage to financial institutions has been limited.

The effects of the housing bubble bursting are likely to be upsetting but are not likely to have the severe impact that some believe. With the rise in home prices over the past five years (on average about 50%), even a 15% or 20% decline means that many homes are worth substantially more than their purchase price. Analyzing cash-outs over the past few years results in a surprisingly decent picture. Some people may have used their homes as piggy banks, but surveys reveal that nearly half of the money was used to pay off higher-interest debt, such as credit cards. A third was used for home improvements. Less than 20% was used for general consumer purchases. Moreover, housing as a percentage of household net worth is roughly 25% - or \$40 trillion of non-home related net worth for consumers to draw on.

Looked at in another way, this housing crisis has created opportunities for economic growth and greater business activity. Corporations have become a source of deals rather than private equity providers. There have been numerous deals from sovereign wealth funds in the Middle East, with Abu Dhabi, Qatar and Dubai purchasing portions of the NASDAQ exchange and the Carlyle private equity group. These funds have hundreds of billions of dollars at their disposal and have been waiting on the sidelines for the past couple of years while private equity firms dominated the deal market.

The tightening of lending standards may dampen private equity activity, but also may provide an opening for the substantial global liquidity that has been less active in the U.S. market up until now. Moreover, with oil at \$80 per barrel, oil producers have over \$2 billion of petrodollars to invest every day! Saudi Prince Alwaleed bin Talal's investments are valued at around \$50 billion (including significant stakes in both Citigroup and in News Corp.) putting his wealth up there with Warren Buffet. Between a fifth and a quarter of all petrodollars are owned by wealthy individuals. Additionally, the Chinese central bank, with \$1.1 trillion in assets, is the world's fifth largest asset manager and three quarters the size of the hedge fund industry.

This pool of global liquidity has held U.S. long-term interest rates low over the past few years. So it is not surprising that Wall Street investment banks and some mortgage companies took so much risk and are now paying the price. Global interest rates have become compressed, with both short-term and long-term rates as well as corporate and government securities converging around 5%. The result is that many bond managers and money managers who focus on bonds have needed to take oversized risks in order to generate above average returns.

For the most part, this financial disturbance has been a crisis for some parts of the bond market, hedge funds, and Wall Street investment firms - not for equity investors. Equity investors have been rewarded so far this year. The S&P 500 index is up 9.1% and the NASDAQ Composite is up 11.9% - rebounding nicely from the initial fears of an economic downturn. Global equities continued to lead the way with the MSCI World ex U.S. index gaining 14.3% through the end of September. These returns are better than most strategists anticipated for the full year and put the recent housing concern into perspective. Recall that 1997 and 1998 were very good years for investing in the stock market (the S&P 500 was up 33.4% and 28.6% in 1998), perhaps because these crises involved credit and currencies. While the past is no guarantee of the future, we

suspect that equity investors will continue to be rewarded until the middle of 2008 as global growth continues to dominate the investment environment.

More importantly, the knee-jerk sell-off in U.S. equity markets has obscured the fact that earnings growth has been significantly better than Wall Street estimated. At the beginning of the reporting season, consensus expectations were for about 4.2% growth for the quarter. Earnings actually came in up 8% as a result of international sales fueled by the global expansion. Innovative companies continued to benefit from very strong international growth. Nike's recent earnings report is one dramatic sign of the fact – 2% growth in the U.S. market, 17% growth abroad with more than 50% growth in China alone. Global equity markets have been skyrocketing and many U.S.-listed companies such as Nike are benefiting from the same global growth trends. This phenomenon is occurring regardless of the fate of the U.S. housing market or of those U.S. investment firms exposed.

The global growth story remains the dominant theme that is driving domestic equity markets. Global growth is no longer dependent upon the U.S. economy. It has been driving demand for energy, metals, oilfield equipment and services, mining, machinery and shipping – to name a few industries. Over the past five years, the world economy has grown at a 5% annual pace – the strongest expansion phase since 1960. China has been growing at double-digit rates since 2002. India's growth rate has risen to 9% from only 2-3% twenty-five years ago. Russia's growth rate has been boosted to 6-7% on the back of high oil prices and even the African economy will achieve a growth rate of over 6% this year. According to OECD reports, the growth rates of nearly 120 countries will exceed 4% this year.

The globalization process triggered by the end of the Cold War has fostered growth in world trade. According to an article by economist David Hale in the Wall Street Journal, global imports more than tripled between 1990 and 2006 rising to over \$11.6 trillion. Void of trade thirty years ago, China will soon displace the United States and Germany to become the world's leading export nation. Globalization has also encouraged corporations to maximize productivity while restraining wages resulting in record profits. The large rise in profits has buoyed stock market rallies everywhere since 2002. Governments, especially in Eastern Europe, have reduced tax rates on capital that has resulted in investment and productivity growth. The increased mobility of capital across national borders has resulted in an increase in the gross value of global capital flows to 16% of GDP compared to 3-6% during the mid-1990s.

Thanks to the abundance of savings in the world, a by-product of expanding global output, investors will continue to be rewarded by focusing on those countries implementing the same free market ideology that allowed the global economy to take off during the 1990s. Global prosperity and the new global economic equilibrium are sustaining high growth around the world. As bottom-up stock selectors, we believe these market sell-offs offer excellent opportunities to increase positions in companies whose growth prospects are just beginning.

Diane V. Nugent, President  
Victoria Capital Management, Inc.  
4101 Main Street, Suite C  
Hilton Head Island, SC 29926  
Tel: 843-342-3044 x12  
[diane@victoriacapitalus.com](mailto:diane@victoriacapitalus.com)