

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Third Quarter, 2007 Investment Outlook Update August 1, 2007

“Hedge Fund Guys Gone Wild”

“If you’re going to panic be the first panic” is an old Wall Street adage which has seldom been more true. The most recent “swoon,” “correction,” “panic,” or whatever you want to call it, started July 20th – the day after most major stock market averages had reached all time highs. Whether or not it’s over is pure conjecture. The stock market has had a record long advance without a 10% correction since it put in a double bottom in late 2002/early 2003. The way, however, has been marred by several setbacks of roughly 5-8% during which investors became increasingly flummoxed as the corrections became sharper and scarier. Will this time, actually, be different?

This most recent panic brought together two of the issues MBI has discussed in recent Outlooks – Risk and Hedge Funds. Everyone from Alan Greenspan down has commented on how Risk has been mispriced in the financial markets and how investors were not being adequately compensated for buying lower quality assets. We have commented many times on the out-performance of junk and emerging market debt as well as the under performance of large capitalization blue chip equities. MBI has also written on how the machinations of Hedge Funds distort the markets’ message, which is never very clear to begin with. Hedge Funds and their kissing cousins, private equity are secretive (the press prefers to call them “shadowy”) pools of money that are considered to be sophisticated and which are often heavily leveraged. Some are relatively low risk but most are really gunslingers who need to outperform consistently over increasingly short time frames. Few of them actually hedge their bets. Most use leverage to enhance their returns. But what enhances on their upside, magnifies on the downside.

Unsurprisingly, these two trends are intertwined and came home to roost in July. It seems like years that we’ve been hearing about the housing bubble and how, when it burst, all hell would break loose led by a meltdown in sub-prime lending. Space and common courtesy, keep us from a detailed rant on sub-prime but suffice it to say that too much money was lent to too many people (who it shouldn’t have been lent to in the first place) at terms that were too lenient to begin with. Like virtually everything that Wall Street does, sub-prime was overdone with the usual bad ending. Hedge Funds make it happen faster and with greater intensity.

Sub-prime loans (and their off shoots such as CMOs, CDOs, BFDs, etc.) were sold to these supposedly sophisticated investors who supposedly knew what they were doing. Then, BANG! The game ends. Sub-prime borrowers start to default in increasing numbers. Housing price declines make it worse and a virtuous cycle turns into a viscous one. The “hedges” don’t work, prices collapse, loans (and lines of credit) are called. Panic ensues. In spite of hearing “wolf” cried many times, everyone asks “what happened?”. The doomsters gloat, gallons of ink are spilled writing about it, the politicians rush to ride to the rescue.

Could this time be different? Maybe, a little. Politically, sub-prime will be great theater. There are few problems which politicians can’t make worse, have cost more and take longer to bring to a conclusion by their solutions rather than by leaving it alone. Sub-prime will be no exception. Few politicians can resist the temptation to try to help some blubbering pitiful soul who’s about to loose her home to foreclosure due to Wall Street skullduggery. And few will try. Such issues could help the Democrats in the 2008 elections, thereby increasing the possibility of higher taxes, more regulations, less free trade and a generally less favorable business climate beyond. But those are topics for future Outlooks.

Economic Outlook

The collapse of the sub-prime market will, in all likelihood, make the housing downturn be deeper and last longer. This could put additional downward pressure on consumer spending which has already been weakening. U.S. GDP growth was 3.4% during 2Q and global economic growth remains strong. (2006 was the best year for the global economy ever!) Exports are expanding and business spending has picked up the slack from weaker (but still positive) consumer spending. Congress is opening up the spending taps as it usually does going into an election year. MBI, like the Federal Reserve, expects economic growth “to continue to expand at a moderate pace over coming quarters, supported by solid growth in employment and income and a robust global economy¹.” The sub-prime situation and the resultant freezing up of credit creation adds a wild card to that outlook. Keeping in mind that we have only had two brief shallow recessions in the past 25 years, the sub-prime situation and housing downturn makes a recession more likely but far from a foregone conclusion. A recent NBC/Wall Street Journal poll showed that 68% of Americans believe that we are either already in a recession or will be within the next twelve months. The press coverage of the sub-prime situation and stock market should do little to cheer that mindset, so this could become a self-fulfilling prophecy. But to paraphrase Mark Twain, “Rumors about the economy’s death are exaggerated.”

Interest Rate Outlook

The repricing of risk has been clearly evident in the bond market where quality spreads have widened but are still well below the averages of the last 10 years which includes the narrowest quality spreads ever. Virtually all bond yields, save Treasuries, have risen since the beginning of the third quarter. The normal “flight to quality” has caused Treasury yields to decline and the

¹ Excerpted from the Federal Reserve Press Release of August 7, 2007.

treasury yield curve is back to being somewhat inverted. A positively sloped yield curve would be a good thing and a sign that things might be returning to normal. Whatever that is?

The Fed did not take the Hedgies' bait and lower the Fed funds rate at its most recent meeting. The elimination of the "Greenspan Put" is, in our opinion, a long term-positive for the economy and financial markets. So far the Fed and central banks around the world have injected liquidity into the financial system to temper this liquidity, not credit, crisis. All have emphasized that this is being done on a short term basis. Hopefully, the central banks will drain this liquidity after the storm has passed. We believe that risk does need to be repriced and that the most reckless should be punished for their speculative excesses. The Fed is still more concerned about inflation than recession and with the dollar weak and with the price of gold, silver, and platinum at 20 year highs, the Fed has little reason to cut interest rates merely to bail out overly leveraged Hedge Fund speculators.

We probably missed the extremely small window of opportunity to buy Treasuries that we mentioned at mid year. Unless we see a lot of higher probability of recession, we will steer clear of bonds, especially lower quality bonds, for the foreseeable future.

Stock Market Outlook

Will the latest stock market "panic" just be the latest in a series of 5%-8% quirky corrections? We don't know but we sure hope so. The perma-bears were almost instantaneously comparing this downturn to that of October 1987. OOOOH! Scary! P/Es were 23 and 10 year treasuries were yielding 9% in August of 1987 when that stock market downturn started. At its recent high in July, P/Es were closer to 17 and the 10 year UST yield was just over 5%. Harder, but certainly not impossible, to "crash" from these levels.

The nearly instantaneous snap back in the stock market from its recent swoon reminds us, unfortunately, of the late 1990s when the battle-cry of the Bulls became "Buy Every Dip." That strategy worked until it didn't and we would prefer to see this corrections last a little longer, and maybe go down a little further, but that's just us.

Ironically, MBI sees some positives from this market debacle for the type of stocks in which our clients, and we, are invested. The last two corrections have seen a shift from the earlier leadership of lower quality, smaller capitalization stocks to larger cap, blue chip stocks. As the consumer sector of the economy slows, larger companies with greater exposure to foreign economies should benefit from greater overseas growth. Additionally, continued weakness in the dollar helps earnings (translations) from the foreign operations of multi-nationals. Lastly, that torrent of money that has been pouring into Hedge Funds may slow since Hedge Funds, after all, are risky. Who knew? Since many of the institutions that have been making large, new allocations to alternative investments have been selling large capitalization blue chip stocks to fund these allocations. After all, most institutions owned lots of large cap, blue chips to begin with and, besides, they had been underperforming.

We are increasingly nervous about the consumer sector, especially discretionary spending by lower end consumers. The shivers running through sub-prime could also have more

repercussions for the financial sector and the sectors' recent mini rally may have been more of "a dead cut bounce" than a trend reversal. We are also stand-offish on the energy sector, short term, since there has been lots of speculation by Hedge Funds in the commodity and in the stocks which could unwind if the price of oil continues to weaken and as the "hedgies" look for the next "Mo" (mentum) shift. We still (really) like energy and, to a lesser extent, basic materials for the long term. Consumer non-durables and health care held up pretty well during the "correction," as did the industrials. MBI is working on two lists of potential by candidates. Shorter term we are looking for those companies that have held up best to this silly onslaught. Longer term, we're hoping to find some great companies which have been unreasonably marked down in price by the fire sale going on in Wall Street.

MBI is not sure if this latest summer stock market squal has run its course but for anyone who had gotten bored by low volatility, it certainly has been more interesting recently.

August 13, 2007

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