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ASSET MANAGEMENT GROUP

GOLDILOCKS HAS A COLD

The market's retreat in recent days has provoked concern that its performance may be signaling an oncoming recession and a bear market. Reality, however, challenges such a pessimistic forecast.

The leading market averages (S&P 500, DJIA, Russell 2000, etc.) are down less than 5% from their highs of less than a week ago. A modest decline of such magnitude traditionally has been considered a typical correction in a continuing bull market. Coming on the heels of a gain of nearly 20 percent over the past 12 months, a period of consolidation should be viewed as a healthy development that typically washes out some of the advance's accumulated excesses, thus reducing risk. This is evident in the fact that in recent weeks key indices have become overextended and are trading above their 30-, 60-, and 90-day moving averages. Respites are normal events in long market cycles, having occurred several times during the lengthy bull markets of the 1980s and 1990s.

The housing sector aside, the U.S. economy is in good shape. The excesses and imbalances that trigger a recession are essentially absent. While the consumer has turned somewhat cautious due to the negative wealth effect on housing values, this restraint is largely offset by strong employment, with at least 1.6 million jobs estimated to be created this year and an increase in hourly wages of 4.6%. In addition, a strong flow of tax revenues continues to support government spending, while business outlays for plant and equipment are being stimulated by vigorous export demand, elevated capacity utilization and a drive to protect profit margins.

On the housing front, a problem exists, although it is being greatly exaggerated by media hype, widespread confusion and the constant ringing of the alarm bells. The key issue is whether our financial system is sufficiently healthy to withstand the damage from a weak housing sector and a consequent deterioration in credit quality. In this regard, we rely on history for guidance. The savings and loan debacle of 1990-92 ultimately cost $400 billion, nearly half of which was paid by Washington. However, the direct exposure of financial intermediaries, notably lenders, was considerably greater than at present since collateralized debt obligations were not then in fashion.

In the current situation, most of the credit risk has been transferred to speculators, either individuals or institutions. The financial intermediaries who financed underlying loans and questionable mortgages will, no doubt, take some hits. The magnitude of these residual write-offs, however, is not likely to directly compromise the nation's financial system. As to the size of such exposure, it should be noted that the technology/telecom debacle of 2000-2002 is estimated to have erased $3 trillion in wealth, a figure that certainly far exceeds any damage that the problems in the housing sector will incur. The indirect fallout from more cautious credit markets may give rise to greater discipline and more conservative valuation metrics for LBOs and private equity transactions but should not halt such deals. This is apparent in the demonstrably lower premiums paid for recent acquisitions than was the case in past cycles.

In brief, it is reasonable to assume that patience will be as important as the cost of writing off bad loans in dealing with the consequences of the housing problem. In the meantime, economic growth has already been significantly reduced, thus recognizing the impact of the drag from the housing sector. Preliminary second quarter GDP carried considerable evidence that the consumer has already turned cautious.

For the stock market, the ongoing uncertainty has had a restraining influence. It would be a stretch to forecast anything more than a mid-cycle correction with appreciation consistently trailing the growth in profits; interest rates moving within a moderate range; corporate balance sheets boasting more than adequate liquidity despite aggressive share repurchases; dividends rising at least in line with the increase in earnings; and high quality megacap companies trading significantly below the market's P/E. More relevant is that, interest rates considered, the leading indices are priced at their lowest valuation levels in more than 20 years.

Unlike the market of the late 1990s when most investors widely assumed that nothing could go wrong, the current mindset is that we are facing intractable problems that may evolve into a worst-case scenario. In our opinion, the weight of evidence contradicts such a dire assessment. In fact, we expect the stock market to end 2007 comfortably above yesterday's close.

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