Strike Two

March 3, 2008

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A written report on the themes driving decisions was last provided on October 2, 2007. The seemingly random publication dates of these infrequent reports have been:

March 2, 2008	Strike Two
October 2, 2007	Strike One
June 27, 2007	Something Will Happen
April 11, 2007	untitled
January 12, 2007	titled simply "2007"
January 1, 2006	titled simply "2006"
March 16, 2004	untitled

It may have been inappropriate to have written just one report during this preceding 8 months of great volatility and stress in the financial markets, but we did provide an unusual 3 reports during the first six months of 2007 in anticipation of what might possibly occur later in that year. The humor is that I still don't have a lot of new comments to add. I do have some though, under the heading of Tactics at the end of these pages, which you may skip to. Otherwise, I'd like to repeat some previous comments which still seem relevant for our discussions.

Financial Markets – Primary Previous Comments

The June 2007 report was used to suggest that certain economic reports being provided by federal government statisticians were likely failing to provide a complete and accurate picture of US inflation, employment and economic growth, and further read as follows:

> *Expect to hear more rumblings of recession through the remainder of the year. The combination of reduced confidence in the economic statistics reported … along with corporate earnings figures that increasingly seem to be assisted through "financial engineering" … the market may increasingly become suspect of the quality and durability of current earnings. I am. The presence of so much leverage in the system provides multiple ways for "fear" to manifest itself. These things don't necessarily go together, and we think that <u>Something Will Happen</u>. So our perspective is this – for now the stock market is likely to make another push to new highs,*

continuing the current momentum. Historically, rallies at this point in the cycle tend to have a weaker breadth of participation… with fewer and fewer sectors and stocks participating. We are losing conviction that the market would be able to hold those new highs and values, so we've expected these rallies in the second quarter and this summer to be used to reduce our exposure to the stock market and "bank some profits." The longer term trends and directions remain close to what we've discussed in the past… (June 27, 2007)

The March 2004 commentary was used to suggest that the United States was approaching a rare occurrence in economic history, an opportunity to contrast the normal shorter-term business cycle with a rare once-in-a-generation long-term credit cycle:

Market economies weave any number of cycles, both short and long. The "normal" business cycle rotating every few years between periods of good economic growth and recession is essentially an earnings and sales/inventory cycle which is income statement oriented. There may be a longer term cycle as well, however, defined by the inclination and capacity to take on debt and extend credit -- which is balance sheet oriented. Income statement cycles are shorter in term, are based on cyclical interruptions in demand, and have the capacity to cause inflation during the upcycle. Balance sheet cycles are longer in term, derive from the general propensity to finance and supply economic infrastructure, and have the capacity to cause deflation during any downcycle. (March 16, 2004)

With that process having begun in the real estate markets, the January 2007 report suggested:

We've certainly seen some cyclical deflation in asset prices like real estate which were fueled by the stunning expansion of financial credit, as discussed last year. Real estate tends to have long cycles, and this is a process which will continue to unwind. … Credit spreads remain very thin, liquidity is overwhelming, and there is very little incentive to invest in low quality paper or junk bonds. Despite this, a tremendous amount of liquidity is being invested directly into such risky positions. … Last, we admit to some nervousness about the financial and banking stocks longer term, and although there have been some breakdowns in the companies most closely tied to real estate finance, this sector will not start to crack until the credit spreads begin to widen. Expect that to happen sometime in 2007. (January 12, 2007)

As more and more of the initial impacts of this hit the news, but with the Dow Jones Industrial Average still over 14,000, the October 2007 commentary further discussed this peak in the cycle:

There is a fundamental problem, and that problem is that we as a market and economy have experienced a massive underpricing of debt. We've made loans with higher probabilities of default, and we've valued those loans too highly. We've collectively as a market taken on too much risk for too little compensation. We've accepted insufficient collateral for such lendings and embedded the presumption that the loans would later be refinanced rather than necessarily later being repaid. This disease does not exist only in those neighborhoods with poorly maintained homes and the single parent trying to give four kids some nicer bedrooms. This disease exists in the boardrooms of many companies, in the leveraged acquisition and private equity funds, in the trading rooms of financial firms, and on the books of civic projects and local and state governments. It is pervasive, it is the manifestation of the psychology of an extended credit cycle, and it is one of the reasons this is a most fascinating period of economic history. (October 2, 2007)

The April 2007 update reinforced our theme for 2007-2008 in US stocks:

Leadership in the market will become thinner with fewer stocks participating over time in the upmoves. Volatility has been low, the VIX volatility index has been quite low relative to history, and we expect this to change over 2007 – resulting in greater dispersion, greater volatility, and some frustration with rates of return for many investors. In this environment, Large Cap should continue it's recent outperformance. (April 11, 2007)

Asset and Commodity Markets – Primary Previous Comments

A favorite report was the January 1, 2006 summary of the major factors driving the investment markets during this decade. This amazing interplay of inflation, deflation, global commodity demand, real estate and extreme debt levels is rather unique in US economic history:

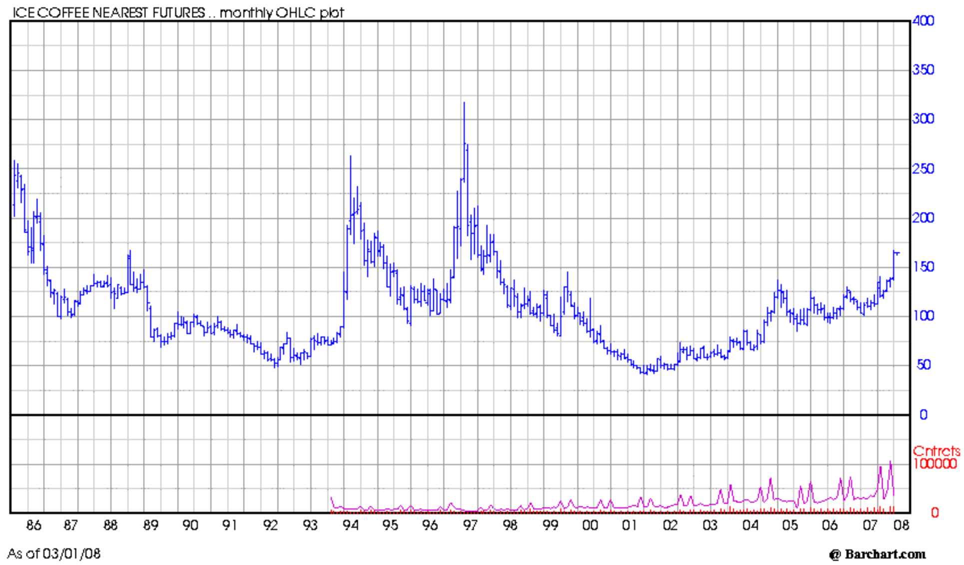
> *The future rate of inflation is one of the most, if not the most, important influences on the future value of both real and financial assets. It is especially interesting right now because we are witnessing in this decade a massive transition in both inflationary and deflationary forces.*
>
> *We have seen, or will see, a unique combination of:*
>
> - *secular domestic deflation in the price of goods sourced from global producers*
> - *cyclical domestic deflation in the costs of labor, intelligence and information*
> - *secular global inflation in the costs of necessities -- energy, water, food*
> - *cyclical global inflation in the costs of economic raw materials such as copper, lumber*
>
> *These four forces are solid. But with both deflation and inflation, impacted differently in a domestic vs global context, occurring over different long-term secular and shorter-term cyclical time periods… it is almost silly to generalize about what the single rate of inflation is. There isn't one. There are many, and they are different, depending upon which item, asset, or context is referenced. Something to think about should Dr. Bernanke pursue a single inflation target as a policy guide.*
>
> *Further, we could see:*
>
> - *cyclical deflation in asset prices fueled by the tremendous expansion of financial credit*
> - *cyclical inflation in asset prices fueled by a possible future declining value of fiat money*
>
> *Candidates to be impacted by these forces, in different ways, include real estate, precious metals, and the continued swings in foreign exchange currency moves.*
>
> *Developing countries such as China and India, and the delicate financial position of the United States at both federal and household levels, are at the root of many of these changes. These forces explain how inflation continues to move out of the many core CPI product items historically measured, and moves into commodity raw material items. It also explains why commodities are increasingly being viewed as an asset class, ably competing with returns from historical asset class decisions between stocks and bonds. This is an important change, and explains how investors can increasingly become frustrated with standardized pie-chart portfolios. (January 1, 2006)*

Our two primary themes for the decade were that the value of the dollar would generally be declining and that oil and gas prices would rise. The dollar broke down in early 2002 and has been in a downtrend ever since, with some interruptions along the way such as in the 2005 and 2006 timeframes. We've not always been successful in taking direct advantage of this decline in the dollar and corresponding rise in gold, our tactics were mistimed on a couple of occasions, but the theme has been correct and it has contributed to our understanding of the investment environment as well as some capital gains.

Oil and gas investments have worked pretty well. It's difficult to remember that crude sold for $17 in 2001, but oil and gas investments have benefited from both the "Hubbert's Peak" supply/demand picture (remember we discussed that terrific book by Princeton professor Deffeyes when published in 2001) and as a "store of value" against the declining dollar. Now, for the 4th quarter 2007, we wrote:

It's been difficult to turn away from our long-term focus on the oil and gas stocks, but we've again taken some gains out of that sector and made some effort to control that exposure. At this point, nothing would surprise me on oil prices … but for the first time in a long time I can see as many scenarios to the downside as to the upside. (October 2, 2007)

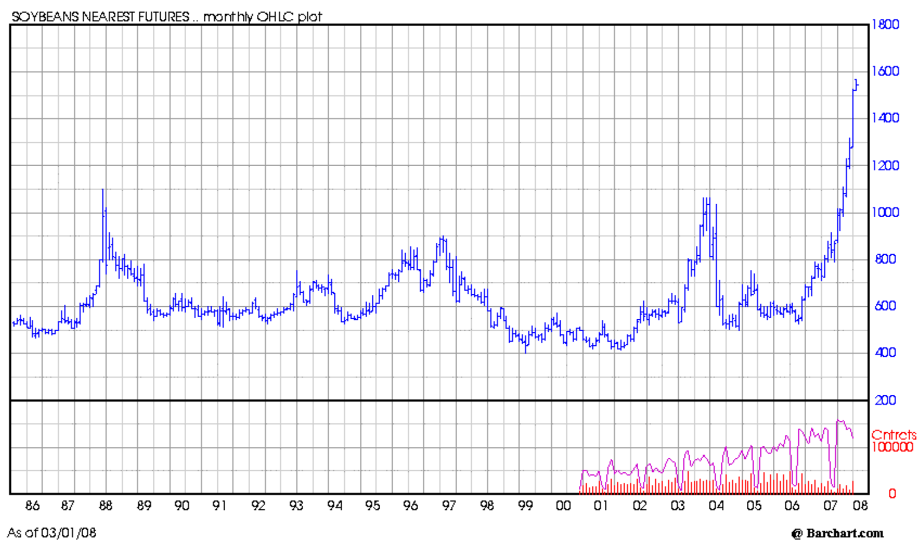
With the other commodity markets, it's just been such an amazing year, I'd like to include a few charts. Our bullish position on coffee dates back to 2003 and still think this bull market is the real deal:



Our comments from January 2007 were:

The cost of food is going up. We expected cattle prices to decline in the first half of last year, and prices dropped roughly 30% by May. From there, prices began to rise and this new uptrend has further to go, as feed costs are rising significantly. Meat will become more expensive. We expected grain prices to begin rising in the second half of last year, and here we go. The price of corn has jumped 50% since the summer, soybeans and wheat are coming along as well. It's not solely ethanol demand that's driving this, though that's certainly a factor, and grains will become still more expensive before this bull market is over. (January 12, 2007)

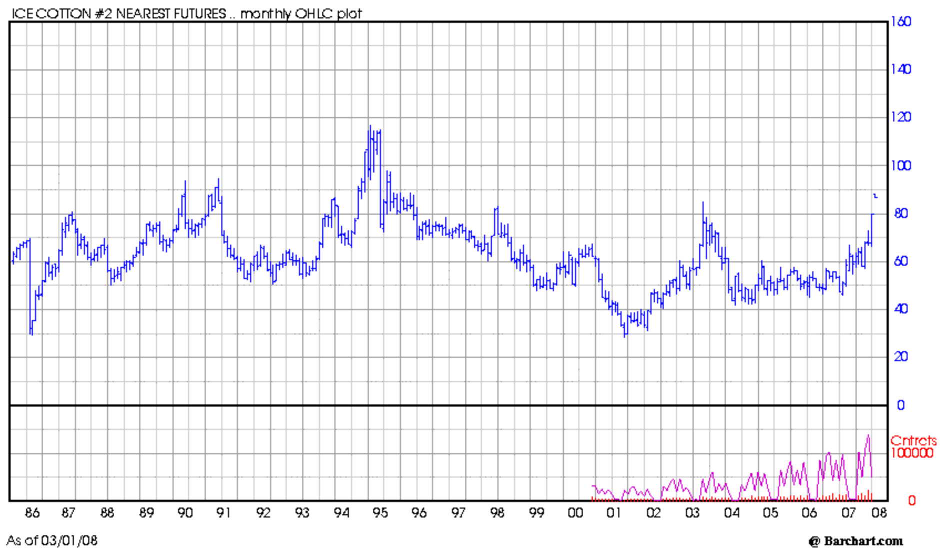
Hard to decide which grain/oilseed market to show, but here is the long term chart of soybeans:



I'm told that in some cases farmers wanting to hedge in current grain prices with forward contracts are finding the grain elevators skeptical of actual delivery and also suffering from the dramatically increased financing needs and unplanned margin calls related to the hedging process. This same process is at play in the gold mining companies that have been shorting the gold market, using hedging strategies designed during less volatile timeperiods. Another market that is heating up is cotton:

Last year we noted that cotton looked like a bull market candidate longer-term although it was still too early in the cyclical processes of that market. The time has come. Rising grain prices naturally diverts some acreage away from cotton and Asian demand remains, so the supply/demand balance for cotton moves into bull market mode this year. (January 12, 2007)

Here's the cotton market, again this is a very long-term 20-year chart for perspective.



As before, our position remains that these cyclical increases in commodity prices are due to supply and demand dynamics not directly influenced by US Federal Reserve policy.

Current Tactics

I've often thought that investment management is best done with limited communication to the client about the possible future tactics that might be taken. Circumstances can change quickly, and are best dealt with by a clear mind unencumbered by previous comments or knowledge that the client is expecting "A" to happen and now you need to do "B" instead. Having said that, here we go:

"Strike One" was the realization that mortgage finance was in trouble and was the first leg in this widening of credit spreads…the interest rate on high quality securities coming down, the interest rate on lower quality securities going up.

"Strike Two" is the realization that housing finance is a symptom of a larger problem, the consumer is struggling, and recession comes into the mainstream media focus. Our comment had been that this has started as "recession by appointment" with the housing and finance industries at the front of the line, clearly in recession. A number of small and mid-sized banks will fail this year. Many retailers and consumer durables companies have now moved into recession as well. There is a long list of retail stores being closed, furniture, women's apparel, Pep Boys, Rite-Aid, home improvement stores – but I would not say that the oil and gas industries are in recession!

If it happens "Strike Three" will move us closer to the end of the credit cycle, triggered if confidence is lost in the broader layers of debt and derivatives, counter-party risks, leveraged funds and so on --

which would ultimately complete the cycle of weak markets and temporarily retard economic progress in most economies. Some elements of this are already occurring, the reality is that these are not three distinct stages along a timeline but rather just my expectation of how the process of repairing balance sheets might develop. So those are some current thoughts on the economy.

Three month T Bill rates have continued to drop considerably. The Federal Reserve typically just follows what has already happened in the short-term money markets and the next meeting is March 18. The US central bank also only has control over high-quality short-term financing, they really have rather limited abilities to influence lower credit qualities and capital markets where the vast majority of business transactions are financed, and of course those credit spreads have widened considerably. We talk as if interest rates are coming down -- perhaps on money market funds and certainly the US Treasury curve. High quality paper, Treasury notes, have not yet seen their lowest interest rate for the year, those bonds can still rise in value further. But most businesses are experiencing considerable increases in the cost of capital, they would love to see their actual interest rate liabilities come down.

There are no bears on gold, silver, and the foreign currencies -- universal agreement that those assets are going to continue rising ever higher. Hmmm. Most of the commodity markets look ripe for a downside correction, and so it will be easy to take profits out of those markets at the slightest hint that a retracement is beginning. In the case of the grains and oilseeds, most all of the immediate bull market is now behind us. In the case of coffee and cotton, any interruption in the bull market right now is just that, an interruption, but we'd expect those bull markets to continue. Cotton can be heavily influenced by global economic growth however, so the corrections there might be more severe either in terms of time or price.

A final comment, we could see the Dow Jones Industrial Average trade well under 12,000 in the next several weeks. Political developments have already contributed to recent declines in the stock market, and more is likely. From that low, a bounce back up could be powerful and well-celebrated on CNBC, but we'd still have to place a significant probability that the market ultimately moves under 11,000 later this year and we will try to comment appropriately along the way.

Regardless, ultimately our goal is to produce profits and participate in many of the better moves available. Portfolio performances have continued to be better than expected, yet we are trying to be very careful with the investments. Please call with any questions, comments, or better ideas!

-Brian