



Sublime to Sub-prime

Dealing with market fluctuations and volatility

September 2007

It was only a few weeks back, in late July, when the CNBC talking heads were chattering about record highs in the Dow. Second quarter corporate earnings were solid, interest rates & unemployment were low, the economy was purring on 8 cylinders – yes, nothing but blue skies and Palomino Ponies. What a difference a few weeks makes. We've learned what "sub-prime lending" is but don't yet know its effects. We've heard that mortgage/real estate markets are in foreclosure, "hedge fund" is now a punch line, consumers are pad locking their wallets and the dreaded "R" word, *Recession*, is now being whispered. Seemingly gentle, upward marching markets have now become ripe with violent, intra day swings. Did the domestic economy really just tank in just over 30 days? Did an economic quantum shift just take place or is perception disconnecting from reality? The truth is likely somewhere in between.

The current sub-prime concerns may certainly be more than a hiccup – perhaps a full blown contagion with far reaching financial tentacles. Or maybe not. History reflects numerous events that lead to panicked markets: World wars, terrorist attacks, currency meltdowns, economic recessions, etc. A review of market movements during these times suggests there is a certain amount of over-reaction to bad news. Financial markets are very resilient, mirroring our US economy. Necessary pullbacks and corrections occur to allow markets to realign with reality. Otherwise, collapses like 1987 and 2000-2002 become higher probability.

We remain cautiously optimistic, both because of history lessons and also due to a couple of economic conditions. 1) We as the investor public are fairly heavy in cash, and 2) The Federal Reserve will likely be an economic white knight. Let's examine both.

1. Having excess cash is extra ammunition during market corrections. The big question is how you decide to use it. Do you look for opportunities or do you freeze up in fear? Can you effectively separate market emotions from its fundamentals? Do you adhere to your investment time horizon and asset allocation or do you deviate due to market gyrations? Volatility should be embraced not scorned. It provides short term windows to buy low (and sell higher).
2. The Federal Reserve already cut its Discount Rate on August 17th. This was symbolic in nature. However, it is widely believed that the Fed will cut the Federal Funds Rate September 18th .25-.50%. If so, consider since 1945 there have been 11 initial rate reductions. During those periods, the S&P posted an average gain of 19% 12 months after the first cut and rose 10 of the 11 times (2001 was the lone exception).¹ Now, there is no guarantee that history will repeat itself but we do think the Fed cutting rates will instill confidence and some kind of floor under the economy & market.

What's the downside? September and October are historically spooky market months. Annual market bottoms are statistically made during these months. If this cycle repeats we hope to cautiously take advantage. We don't consider this market timing, rather just being opportunistic. The credit crunch will continue to claim more casualties but will also provide additional market share to the financially sound survivors – i.e. Bank of America, Wells Fargo², Citigroup, American Express.

Predicting the future is futile but preparing for it is prudent. If the current market turbulence has your stomach in knots, give us a call. We can help you revisit your financial objectives, provide guidance and lend a sympathetic ear. In the meantime, best to avoid anything, mortgage loans or otherwise, that is sub-prime.

Fiscal Fitness is a publication of Houlihan Asset Management, LLC for the benefit of its clients and friends.
Houlihan Asset Management. Practical Advice. Prudent Investments.

¹ S & P Outlook 2007

² In the interest of full disclosure, my wife, Michelle, works for Wells Fargo Mortgage.