Courier Capital Corporation

Market Review & Update

FALL 2007

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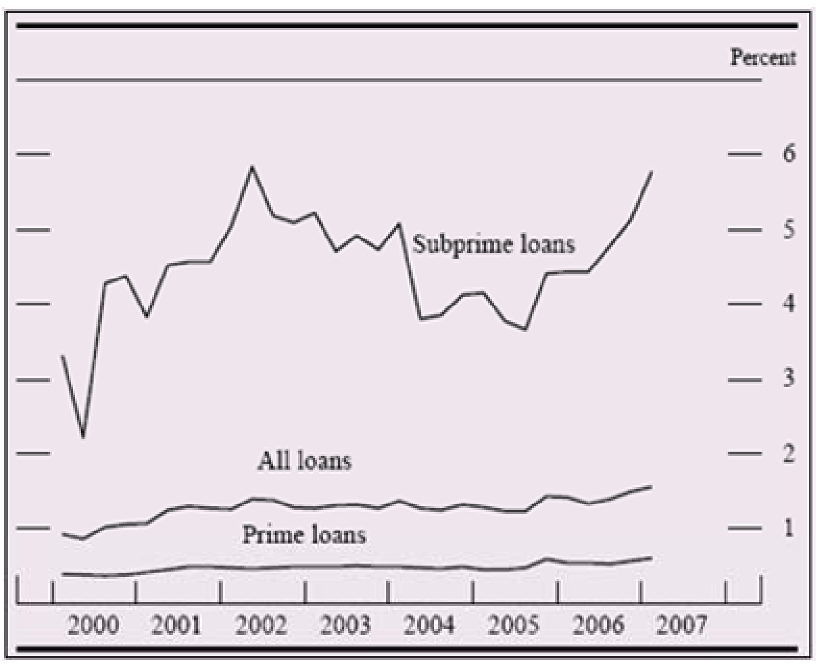
If you were fortunate enough to leave town on June 30th, and vacationed until September 30th in a remote country with little or no access to news you would probably note "Gee! The market didn't budge an inch this entire quarter…". And, you know, that's probably the proper perspective to take, because as we know, budge it did, yet does it at all matter?! We now find ourselves right back in the very same place we began, but after living through a 10% correction, beginning near the end of July and ending as did the 3rd Quarter.

In the world of market psychology, the 3rd Quarter could easily be termed a psychodrama. Triggered by a combination of the sub-prime mortgage headlines and hyperbole, coupled with initial doubt that the Fed would be willing to come to the rescue of innocents, the market tumbled about 1500 points in 3 weeks, only to rise the equivalent in the succeeding month. The Fed, in some ways, was both the architect of the decline and of the rebound.

Under Alan Greenspan, the Fed watched the real estate bubble build on the foundation of the low interest rates that many now feel the Fed left too low, for too long. This cheap source of funds allowed real estate speculation to occur for an extended period of time. The inevitable mortgage defaults we are now witnessing and declines in property values from bubble levels are the understandable punishment a free market doles. Buy too much or pay too much, then the market will remind you that you were foolish. An important point to note is that these defaults are primarily concentrated in the sub-prime category of mortgage loans. Creditworthy borrowers, known as prime loans in the mortgage industry, continue to maintain a low delinquency rate. (Figure 1.) According to Moody's Economy.com, homeowners owing approximately $32 billion in sub-prime adjustable-rate mortgages (ARMS) began paying higher monthly payments as their interest rates reset this month. This is the highest monthly amount of sub-prime ARMS that will be re-setting during this housing cycle. By December of this year, the monthly figure is projected to drop to $25 billion, and will have fallen to $3.6 billion by December of 2008 largely due to lenders ending the availability of these mortgage products for borrowers with poor credit histories.

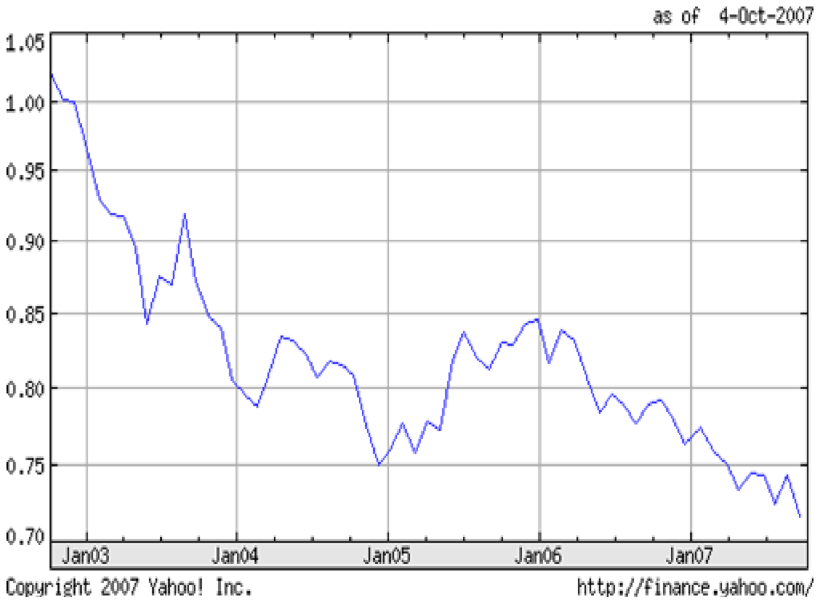
Figure 1. Delinquency rates on residential mortgages



Before the Fed acted this quarter, you may have heard the term "moral hazard" being bandied about. This is what they were pointing at. If the Fed were to step in and save people and lenders that bought too much, got too aggressive and speculative, then they should be punished by the market for their avarice and fail. The moral hazard was to decide to save those that deserved punishment. Milton Friedman, the economic hero of free markets who we sadly lost this year, would remind us that it is the market's job to take care of such miscreants.

So, the Fed did not act. Like humans always do, they began to resent the Fed for not acting! Go figure… Part of the reason for the resentment was that the explosions that were punishing the greedy were beginning to exert collateral damage on innocent investors, businesses and economies. Credit desks closed for business causing many innocent businesses to be want of short term financing used to fund day to day operations, which in many cases, began to slow. The dominoes began to tip…and to the rescue comes the Fed. Bernanke allowed the discount

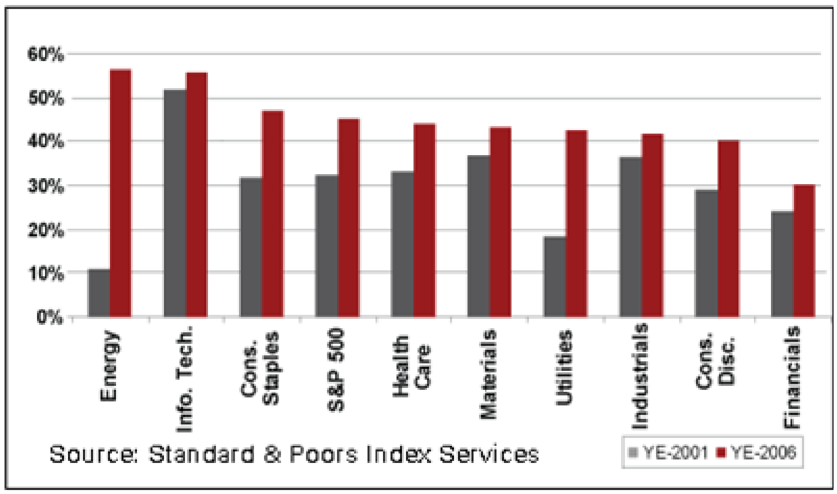
Figure 2. Dollar has fallen steadily vs. the Euro



window to begin to lend more, at lower standards than usual and then made a bold move, lowering the Fed Funds rate by a full 50 basis points, double what the market was anticipating. That, coupled with various countries injecting massive liquidity into the global marketplace and order began to restore. Business began to return to normal and the market rose the 1500 points it had lost. And so, for the 3rd quarter, absolutely nothing happened, nothing simply happened in such a dramatic way that only drammamine would aid the vertigo.

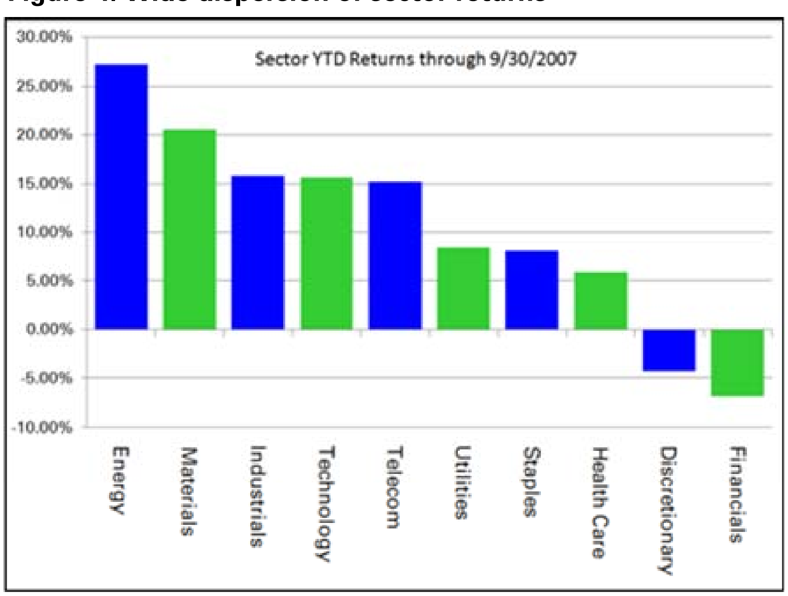
It would seem (you never really know until much later…) as though the Fed did an admirable job, lowering both the discount rate and the Fed funds rate aggressively. What do lower interest rates accomplish? Well, the big impact is on the dollar. Currencies basically achieve their relative valuation by the attractive/unattractive opportunity to earn a risk free rate of return. With several central banks around the world raising their short term rates, and the US lowering theirs, the dollar falls to reestablish the equilibrium of return. (Figure 2.) This is very bad for travelers overseas as they encounter the occasional $70 martini, but, very good for those US companies that do most of their business overseas. Valuations of these large multinational companies have been quite favorable for some time. This gives plenty of room for market values to increase as earnings from foreign sources continue to grow at an above average pace. Many of the larger multinational companies in the S&P 500 now do a majority of their business abroad. (Figure 3.) In fact, according to Merrill Lynch, seven years ago Coca Cola earned 62% of its sales overseas and that figure is now 71%. Over that same time frame, 3M's overseas sales have risen from 52% to 61% of total sales, and Intel's overseas sales have gone from 57% to 85% of total sales. Due to some of these factors, profit growth could again surprise analysts and investors. As of September 30th, only 50 companies in the S&P 500 had issued profit warnings compared with 98 companies this time last year. In the past when warnings were light, profit growth tends to surprise to the upside.

Figure 3. Percent of foreign sales by industry sector in S&P 500



A lower dollar essentially puts a sale price on all US goods. Picture China needing new power plants, they have three possible vendors: Matsushita in Japan; Siemens in Germany; and GE in the US. The dollar level basically places a 20% off sign on all GE products. The market establishes a new clarity in vendor sourcing and the US companies do a land-office business in foreign markets. This will aid in offsetting some of the economic weakness occurring at the hand of the aforementioned real estate driven weakness. Additionally, lower interest rates hurt traditional savers and help equity investors, allowing valuations to increase.

Figure 4. Wide dispersion of sector returns



The dispersion of returns between the various sectors of the S&P 500 has definitely made this a most challenging environment for managers to outperform benchmarks. (Figure 4.) In that light we feel truly fortunate to continue a period of excellent returns, based primarily on fortunate stock selection.

This market's fuel over the past five years has been strong global growth driving strong earnings trends. Federal Reserve Bank action now seems supportive, and the persistence of these trends will be the key to how results manifest in the latter half of 2008 and beyond.

We'll talk to you soon…