

Musings from the Chief Economist

Buy the Dips!

Arthur A. Micheletti, CFA
Chief Economist and
Investment Strategist

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Global equities are going through another rough patch as concerns mount over rising delinquencies in the mortgage market, contagion within some hedge funds and the potential evaporation of liquidity for leveraged buyouts (LBOs). We see these concerns as overblown and view the market downturn as a correction in a bull market. Given good valuations, strong earning fundamentals, contained inflation, low interest rates, stable monetary policy and rising long-term market trends, we believe that the bulls should be given the benefit of the doubt.

Mortgage market risks are contained, not contagious.

Last week, Fed Chairman Ben Bernanke said that losses related to mortgages and mortgage-backed securities could reach \$100 billion. Although some market analysts expect losses of \$250 billion, these estimates are based on a number of aggressive assumptions. Between 2002 and 2006, \$2.3 trillion in subprime loans were made in the U.S. Many of these loans have been refinanced already. Most of the troubled loans were originated in 2005 and 2006 and totaled about \$1 trillion. The \$250 billion loss estimate is based on the

aggressive assumptions that half of these 2005-2006 loans will go into foreclosure and only 50% will be recovered from the sale of the underlying properties. Currently subprime loans that are seriously delinquent or in foreclosure equal 8.2% of outstanding subprime loans and are unlikely to get anywhere near 50%.

Still, the potential subprime mortgage losses are big numbers, and some financial institutions are likely to feel some pain as they increase their loan loss provisions. Fortunately, most financial companies have well diversified portfolios of commercial, consumer, residential, non-residential, domestic and foreign loans. They also have profitable underwriting and trading businesses. In addition, a lot of the bad loans were repackaged and resold so that the risk is spread among numerous investors. Finally, the potential subprime mortgage losses pale in comparison to the size of the U.S. economy (\$13 trillion), the value of the residential real estate market (\$22 trillion) or the change in household net worth over the last five years (\$17 trillion).

Many of the loans made at the height of the froth in the real estate market were high risk loans brought about by lax lending standards and overly creative financial engineering. Now that the

residential real estate party is over, the hangover is beginning, but we believe it's a headache, not a death sentence. We don't see the subprime mortgage losses as leading to a financial crisis, a credit crunch or a recession. Although we expect more losses within the financial sector, the losses should be spread out and well collateralized.

At least one good thing has come out of the subprime mortgage fiasco. Banks have moved to tighten their lending standards and the lending excesses have ended, at least for now. Tighter standards and the removal of speculation from the housing market should be positive for the long-term growth of the economy. Although tighter standards will likely slow or delay the recovery in the housing market, an increase in pent-up demand, falling interest rates, lower home prices, improving affordability and more homebuilder incentives suggest the bottom is in sight or at least can be visualized.

Liquidity for corporate junk is evaporating as investors are becoming more selective.

In recent weeks, losses in the high-yield bond market have caused problems for leveraged hedge funds. Although this is

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bad news for hedge fund managers and individuals invested in those funds, it should not be a major problem for the overall economy. As credit spreads have widened, banks have had problems financing leveraged buyouts. Banks typically offer private equity firms bridge loans to finance takeovers and then repackage these loans to sell them to investors. Unable to find buyers at the right price, many banks are now “stuck” with these loans. Stuck is probably too strong a word, as these banks are being paid handsomely (8%-9%) to hold this debt until market conditions improve.

With \$235 billion of LBO lending to get done and more waiting in the wings, spreads are likely to widen further. However, financing costs have only risen from abnormally low to low.

Despite the widening in credit spreads, they remain relatively low and there is no shortage of available credit. The S&P Speculative Grade Bond Yield Spread has risen about 80 basis points (0.8%) to 360 basis points (3.6%) since mid-June. Over half of the widening has been due to falling U.S. Treasury bond yields. Moreover, yield spreads are only back to where they were late last year. Outside of the junk area, corporate spreads remain tight relative to U.S. Treasuries. The Lehman Brothers Investment-Grade Corporate Bond index's yield is just 100 basis points (1.0%) over Treasuries, up

from about 85 basis points (0.85%) in mid-June but well below its 250 basis point (2.5%) peak at the end of 2002. We see the low spreads as justified due to very healthy corporate balance sheets, strong cash flows and a rising tide of liquidity from overseas.

Some analysts argue that, without LBO activity to reduce the supply of stocks, stock prices will fall. While some LBO transactions will not get done, we do not expect this activity to dry up completely. There is a whole industry of very large buyout firms that are not just going to go away. Banks also have an incentive to facilitate deals, given their lucrative underwriting fees. Some marginal deals probably won't be completed, but, if 50-100 basis points (0.5% to 1.0%) of higher financing cost is enough to sink a deal, it's probably best not done. Although higher costs may lower potential LBO returns from 25% to 15%, LBO transactions are unlikely to go away.

Moreover, LBO activity is not the only factor that has been pushing the stock market forward. Corporate earnings continue to produce positive surprises, and, despite an almost five-year-old bull market, stocks are cheaper today than they were then. S&P 500 stocks are trading at less than 15 times forward twelve-month earnings. If the stock market was being driven by speculation,

P/Es should be rising, not falling. The modest rise in investment grade yields is not enough to suggest that stocks are overvalued. In addition, not all of the U.S. stock market's liquidity has come from LBOs. Foreign central banks and their growing plethora of reserves can provide plenty of liquidity to support merger and acquisition activity. There is no sign that global central banks are reluctant to recycle trade dollars back into the U.S. Twenty-four countries now have government sponsored investment funds that are working to diversify their investment portfolios. U.S. corporate cash flows have also supported share buybacks, dividends and stock prices. As long as cash flows remain healthy as we expect and stocks remain cheap, corporations should continue to buy back stocks. In addition, pension and retirement fund flows should continue to prefer stocks over bonds, given relative valuations.

Continue to overweight global stocks

Although the recent sell-off in stocks has been painful, we see no fundamental reason to reduce our overweight position in global equities. Valuations are attractive, fundamentals remain positive, and the long-term trend of the market is up. In our view, the market decline is an emotional overreaction to factors that are difficult to analyze, making them perfect fodder for news

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headlines and knee jerk investment reactions. Unfortunately, it is difficult to gauge when the negative psychology will abate. However, it is usually best for your investment health not to play into market fears. Market sell-offs like these are often healthy for sustainable bull markets.

The whole purpose of investing is to buy low and sell high. With stocks selling at a discount, an investor's inclination should be to buy. Our strategy will be to see how this sell-off sorts itself out in the short run. If the market can put in a decent bottom or if it becomes extremely oversold, we could switch a little more into stocks from bonds. We might also take some money away from core stocks and reallocate the proceeds to large cap growth or international stocks, which would likely benefit more from a market upturn.

Only if market fundamentals deteriorate or the long-term trend in the market turns down will we likely reduce our allocation to global equities. At that point, our strategy would probably be to sell into rallies rather than to buy dips. If we move to an exit strategy, it will be in an orderly, unemotional fashion.

Although we continue to be optimistic about the market outlook, we will remain flexible in our thinking and true to our disciplines.

Sources: Bailard Research, Bloomberg, Yardeni Research, GaveKal Research.

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Bailard, Inc.
950 Tower Lane, Suite 1900
Foster City, California 94404