DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

MONDAY
August 13, 2007
www.djcOregon.com

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Grim markets suggest music may have stopped

Citigroup's CEO is still dancing, but many have left the floor

SUMMING IT UP

William Rutherford

With the equity markets suffering an agonizing summer sell-off, the question is: Has the music stopped? Many on Wall Street think so, but not all. Charles Prince, CEO of Citigroup, told the Financial Times last month that, "as long as the music is playing, you've got to get up and dance." But he was not rattled by the "sharp" pullback in the markets.

In the week ending July 27, the Dow dropped 226 points, then 311, punctuated by a 208 point loss on Friday. The Standard & Poor's 500-stock index suffered its worst week in five years; the Dow, its worst since 2003.

Just days earlier the Dow had hit an all-time high, but that day on KPAM radio I said we were due for a 10 percent correction. We have not reached that number yet, but we've made a good effort. For the week, the S&P was down 5.15 percent and the Dow was down 4.41 percent. All in all, it was a week we would like to forget.

In addition, the slump in real estate continues. The president of Countrywide Financial, the largest home mortgage lender in the nation, said on a conference call that the market was the worst "since the Great Depression." Meanwhile, American Home Mortgage closed offices nationwide and laid off 7,000 people because of margin calls from financial institutions.

The market break, of course, was caused by subprime worries. The failure of two mortgage-backed funds operated by Bear Stearns and the failure of several hedge funds rattled the credit markets and sent the equity market into a tailspin. At the same time, market volatility, which had been low, jumped, and a flight to quality followed, causing bond yields on the 10-year treasury to drop to the 5.80 range, down from 6.30 just days before.

Perhaps this was not all bad news, as it gave the Federal Reserve some more wiggle room. For some time the Fed has expressed concern that the markets are not properly pricing risk, and while earnings were up 10 percent on the year, the markets were up at an annualized 12 percent rate. It appears the markets were due for a correction in any event.

It appears the economy will grow at a slower pace, about 2 percent. We will need to look for growth outside the United States. Large, multinational companies should be the primary beneficiary of this trend.

Add in the exuberance in the buy-out markets and one can see the markets were ripe for correction. But was it a correction or the beginning of something bigger? To put it in perspective, it was nothing like the 1987 market crash, in which the markets fell more than 20 percent in less than 8 hours.

Where do we go from here? Was this event merely a re-rating of risk or the beginning of a credit crunch? Where just weeks before pundits were forecasting the beginning of a new growth cycle, now others are talking about a slow-motion train wreck.

We have to look first to corporate profits, and the strength of the economy, because it is from the profits that the economy will grow, jobs will be created, consumer spending (70 percent of the economy) will increase and capital spending will grow.

Corporate profits in the second quarter of the year were better than expected, but that is now history. Looking forward we have a decline in construction, high energy prices and a weak jobs report. The consumer will feel less wealthy as the housing and equity markets decline. Mall traffic is already down 5 percent year-on-year, so it appears the economy is weakening, not strengthening.

Furthermore, the uproar in the capital markets will make borrowing more expensive and perhaps harder to do. The re-rating of credit risk, while painful, will not be without consequences.

These are not good indicators for growth. It appears the economy will grow at a slower pace than in the second quarter, more in line with its average of the last several quarters, about 2 percent. We will need to look for growth outside the United States, where economies are strong. Large, multinational companies should be the primary beneficiary of this trend.

The Fed faces a different set of issues than what it confronted

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just a few weeks ago. A slowing economy and more realistic risk evaluation must be good news for the Fed. A slowing economy could mean less inflationary pressure and thus, should we need some help in the capital markets, the Fed is well-positioned to provide it. During the long-term credit management crisis, the Fed stepped in to aid the markets with a combination of arm-twisting, liquidity and lower interest rates. Even though the bond markets seized up, a greater crisis was averted. It can do this again if necessary. This would not be a bailout but rather a reasonable response to a dysfunctional market. It does mean the Fed may not hold interest rates steady for the rest of the year.

Only time will tell what's to come, but the Dow Jones industrial average is a good barometer of the economy, as it aggregates information about financial markets and the economy. It is an important signal not only to investors but also to the general public.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar for its three- and five-year returns. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact Rutherford at 888-755-6546 or on the Web at www.rutherfordinvestment.com.