
Strike One

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Our June commentary contrasted a rising stock market, moderating economic momentum, an increased vulnerability to recession, and the explosive growth of weak debt leverage in the system, and determined there were multiple ways for fear to manifest itself and that something would happen.

Something Happened

Wow. I can not easily recall such an immediate loss of liquidity in the consumer mortgage market, in the corporate commercial paper market, and simultaneous panic in the equity and credit markets as was experienced in this third quarter of 2007. Investors rushed into the highest quality paper, the prices of lower quality debt plummeted, and our concerns for banking and financial stocks were not unjustified. Yet as developments progressed, it became increasingly clear that this event was likely just the first swing, that ultimately there will be more to this story, and that this was “strike one.”

As many of you know from our personal discussions over the past month, our thinking evolved into the idea that the future pattern of performance in the stock market would begin to mimic the recent performance in the credit market this year.

To explain that, remember that our theme for 2007 in the credit markets was that credit spreads would widen, to the detriment of lower quality bonds, and that therefore asking questions like “what do you think interest rates will do?” could not be answered without first clarifying the credit quality of the security. Interest rates on lower quality securities can rise at the same time that interest rates on shorter-term high-quality securities can decline, thus widening the credit spread.

It's appeared that this bifurcation between the “haves” and the “have nots” would develop in the stock market as well... and in fact this fits with our 2007 theme for the equity market to become increasingly narrow, volatile, and frustrating with fewer and fewer stocks participating in a thinner big-cap Dow Jones Industrial type of rally (which often occurs towards the end of a price trend). That is our view, that further advances in the U.S. stock market would be choppy and limited to the largest global companies having greater international sales, and to certain domestic companies with the strongest balance sheets in businesses less exposed to possible recession. To the extent that we may have added stocks to portfolios during the recent weakness, one will see that theme in most of the

selections. We expect an increasingly split market, with fewer stocks participating in any market rise, and many stocks lagging significantly. This herding mentality, a pattern of staying with fewer and fewer stocks perceived to be safe and easily traded, is a psychology often associated with the approaching end of a maturing trend. In past market cycles it has been referred to as the "Nifty Fifty" stocks or the "New Era" stocks, and other names. This process has just started, and I don't know whether another "name" for this scenario will develop, but do understand that's the game we are in.

So if this was just "strike one," will there be further strikes, and how much further might the limited advance in the stock market run? I don't know of course, but 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. It is what Treasury Secretary Paulson eloquently and succinctly phrased as a "repricing of risk" but the phenomena does not stop with sub-prime mortgages. We can discuss this more in our personal meetings, but I don't know that we've seen the whole enchilada yet, and I'm concerned it may turn into a full combination plate. Why?

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. It is not limited to the young married couple who thought they could quickly enjoy a home as nice as their parents because of a friendly lender. 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.

Sector Update

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... a squeeze to \$100/barrel, a global demand slowdown to \$65, solving some Iraqi infrastructure problems to provide meaningful new supply during the US election year down to \$60, a temporary leveraged fund liquidation spiking prices down, and so on, but for the first time in a long time I can see as many scenarios to the downside as to the upside.

We've limited our exposure to the banking and financial stocks, realizing we may miss out on some of the buyout activity as those industries increasingly have to consolidate and merge. The medical, pharmaceutical, healthcare industries have looked increasingly attractive this year. With the weak dollar, there will be thoughts surfacing again about the prospects of foreign strategic buyers for some US firms. Some of these transactions can be accomplished, but recent credit market concerns may temper this development.

Having first turned bearish on the dollar back in 2001, somehow that downtrend has become more suspect in our mind. As a result, we really have not made any money or investments designed to benefit from a further weakening dollar or increasing gold price, and suspect that may still be wise in terms of investment. In terms of trading, more nimble and short-term actions, the volatility in that market may be attractive but for purposes of this periodic update, it seems less prudent to now consider long-term investments designed to benefit from current weakness in the dollar. Not to mention that there is an almost universal consensus that the dollar will remain weak, most recently I understand over 90% of traders are bullish towards the euro and bearish towards the dollar.

The other interesting sector we've been commenting on this year has been in agriculture, and the expected strength in the grain markets has been particularly impressive with dramatic and historic highs in the wheat market now. I've traded in those markets for 25 years, and haven't seen anything like the

action in wheat this summer in a long time. These impacts did affect the meat markets as discussed, though a bigger rise in cattle prices would not have surprised me, and I still very much believe you will see moves away from cotton acreage impacting the global cotton market more significantly with higher prices for fiber. I could understand some traders moving from the wheat market to the cotton market at this point. All of this fits in with our general theme of commodity inflation, and again, we do not think it is meaningful to speak of inflation as if it is a single headline number. There is no single inflation rate in this global economy. There are multiple rates, depending on the sector and commodity and market, with both deflationary and inflationary influences complicating the puzzle for U.S. monetary policy.

As for the Fed, the Federal Reserve is reducing interest rates because 1) the credit markets had already reduced interest rates for them so they were simply following the market as usual, and 2) because they'd rather not see Strike Two.

*(Portions of the actual documents prepared for our clients
have been omitted from the website version of this report.)*

-Brian

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