The Correction That Almost Wasn't

Last quarter I let you know that I was becoming concerned about the economy. We discussed the improbability of the elusive "soft landing" and we noted that as of Jan 10th (according to CNBC) oil had fallen to $54.33 a barrel. In fact through the second week of February the market seemed to be on its way to a new all time high. Then on February 26, 2007 after getting unsetting news from China the Dow fell 412 points (at its low it was down 543 points). Before we could recover from that big drop the markets were full of news about the fallout from the sub-prime mortgage crisis. I would like to make a few observations about this "surprise" crisis. We have all witnessed the housing price surge that started in 1999 and seemed to peak towards the end of 2005. As with all markets housing is cyclical and some observers saw signs in the residential market that were similar to the equity markets at the beginning of 2000. Unfortunately for many investors it was only in hindsight. The problems that were concerning everyone were bad practices as we approached the peak of the residential boom. We all saw the signs with no down payment mortgages with interest only payments made to speculators who hoped to flip the house with the least amount of their personal funds placed in the investment. The banks and mortgage companies that made these loans ignored the risks hoping that the real estate market would continue to grow with double-digit returns and even if they had to foreclose on some mortgages appreciation would protect them from their losses. It seems that they were looking for the same unicorn that the soft landing pundits were dreaming of over the last three months. The greed of the mortgage lenders and the greed of the housing speculators were rewarded with losses as the housing market softened. I am always amazed when people are surprised that excess greed is not rewarded by the markets. Speculation is a risky game; if you are not willing to take the risk you should not be in the game. Unfortunately it seems that many major banks and what we might consider high quality lenders took that risk without concern for the consequences. The net result is that it is now likely that for the first time since the 1960's (according to a report on CNBC on April 11, 2007) it is possible that the housing market will show its first nationwide year over year decline in prices.

This fact along with rising commodity prices, as the price of a barrel of oil on April 11 2007 was $62.01 (according to CNBC), which was a 14% rise since Jan 10, does not bode well for the economy. Not only is a soft landing just as much a mythical creature today as it was in January, inflation fears are also creeping into the markets' consciousness. I had hoped that the market decline that started on Feb 26th would let off enough steam to allow the markets to continue to rise respectably; however the markets recovered too quickly and like any good pressure cooker if not enough steam is let off there is still a risk that the pot might just blow its top. To make it simple the risks that I saw in the market earlier this year have not gone away and in fact the risk of a decline and a recession in the US is probably higher now.

Knowing what we know now, what we should do is not much, since we have already been active in addressing the long-term issues. You should remember that we have been hedging your portfolios by adding non-US market centric assets portfolios. Many of you have commodity positions that did well in the first quarter, along with your international positions in both stocks and bonds. This allowed many of your portfolios to out perform both the Dow and S & P 500 indexes for the first quarter.

Our long term strategy has not changed; we expect some softness in the US but we still believe that we are in a global bull market and as long as we can keep risk down and diversification up we can stay on track for your long term goals. Just remember we are investing for the rest of your lives not for the next few weeks and our goal is to take advantage of opportunities when they become available and try to hold the course the rest of the time.

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