

# INVESTMENT COMMENTARY

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## The Markets

Index	Quarter	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	1.98	9.30	16.90	13.77	15.98	6.86
Russell 1000 Growth	4.21	12.68	19.35	12.20	13.84	4.06
Russell 1000 Value	(0.24)	5.97	14.45	15.25	18.07	8.80
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	(0.39)	9.48	17.87	17.34	20.90	10.43
Russell MidCap Growth	2.15	13.35	21.22	17.01	20.39	7.47
Russell MidCap Value	(3.55)	4.83	13.75	17.22	21.02	11.31
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	(3.09)	3.16	12.34	13.36	18.75	7.22
Russell 2000 Growth	0.02	9.35	18.94	14.10	18.70	3.65
Russell 2000 Value	(6.26)	(2.70)	6.09	12.51	18.70	10.07
<u>International Equity</u>						
MSCI World ex US	2.71	14.29	25.85	23.72	24.08	8.30
MSCI World ex US Growth	4.90	17.95	29.01	23.69	22.09	5.95
MSCI World ex US Value	0.52	10.69	22.69	23.71	26.01	10.42
MSCI Emerging Markets (Gross)	14.52	34.85	58.63	41.29	39.11	11.94
<u>Real Estate</u>						
Nareit Equity REITs	2.59	(3.46)	5.68	19.00	21.52	12.19
<u>Domestic Fixed Income</u>						
LB Aggregate	2.85	3.84	5.12	3.86	4.13	5.97

Despite the much publicized market sell-off in late July and early August, financial markets around the world rebounded in September, leaving more markets up than down for the quarter. As is expected in times of credit troubles, smaller companies suffered more than larger companies did. Interestingly, July was the worst month of the quarter while August and September saw positive returns in both the large and small cap markets. During the initial sell-off, the Financial sector was the worst performing sector, but had positive performance in both August and September, along with most other sectors. The exception was the Consumer Discretionary sector, often viewed as the sector most sensitive to economic downturns. Investors, keenly focused on consumer spending and employment, simply lacked the confidence to own companies in this sector.

The Federal Reserve did not disappoint investors, cutting the Fed Funds rate by 50 basis points in September, a relief to many who had purchased bonds in anticipation of such a move. However, the move was so expected that most of the quarter's bond performance was already captured before the action took effect.

The international equity markets continue to perform very well, largely due to a falling U.S. Dollar. With the U.S. economy showing signs of weakness and the Fed lowering interest

**Investment Commentary** is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

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rates, there is little support remaining for the U.S. Dollar. For this reason, international markets continue to appear attractive. Within emerging markets, the BRIC (Brazil, Russia, India and China) countries continue to receive the most support. China gained 42% during the third quarter and is up over 73% on a year to date basis. Brazil and India rose over 20% each while Russia could *only* manage a 9% return for the quarter. Brazil has now averaged over 72% per year over the last five years. China and India have averaged a return of over 48% per year for the last five years.

## The Economy

Given the increased volatility the markets have shown over the past few months, we thought it would be a good time to take a step back and reassess where the markets stand today, and where they might go over the near to intermediate term. As many of you are aware, Larry Thompson & Associates produces our forward-looking capital markets forecast during the first calendar quarter each year. This year, our research indicated that large cap stocks should outperform small cap stocks, and international and emerging markets should outperform domestic markets. All of our research, across all asset classes, is based on economic *fundamentals*. We believe that movements in the financial markets are ultimately tied to fundamentals, however, our economy and our markets do not necessarily move in lockstep with one another. While unforeseen events can certainly have an impact on our economy, our financial markets are much more susceptible to news than our economy. Because of this reality, our firm does not necessarily expect our capital markets forecast to be particularly accurate over very short periods, for example, a single year. Our forecasting record over longer periods has been quite good.

With this said, the forecasts that we developed early this year, have largely been on target. Large-cap stocks have easily outpaced small-cap stocks and international markets continue to dominate domestic markets. For those readers who have not read our **2007 Capital Markets Assumptions**, the basis for our expectation for larger companies to lead their smaller brethren was based primarily on the reality that small companies generally have greater difficulties during economic slowdowns. A secondary factor simply focused on the higher relative valuations for small companies when compared to larger companies.

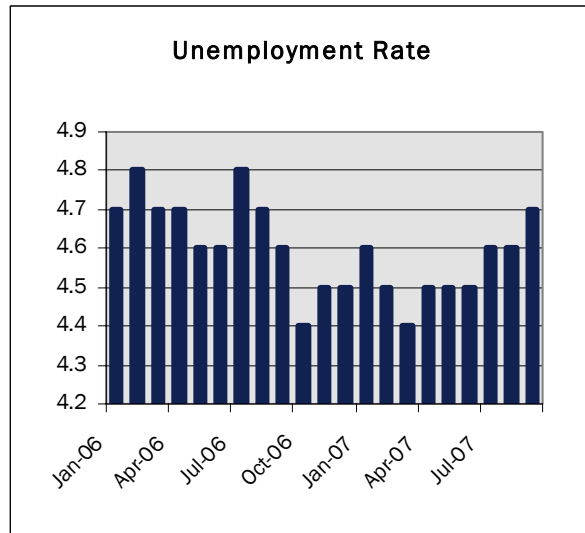
There is no doubt that the credit crisis that we are still experiencing greatly exacerbated the problems for smaller companies. Smaller companies are much more dependent on debt financing, which may explain why they did so well during the “easy money” periods leading up to the bursting of the credit bubble. Today, smaller companies – often being perceived as a greater credit risk – are faced with greater difficulties in borrowing, including higher interest rates.

Perhaps more important than what has happened so far this year is what our financial markets might do going forward. Are we as positive on the equity markets today as we were back in January? Given all of the excitement in our debt markets, are we still sanguine about domestic fixed-income? What about our economy in general?

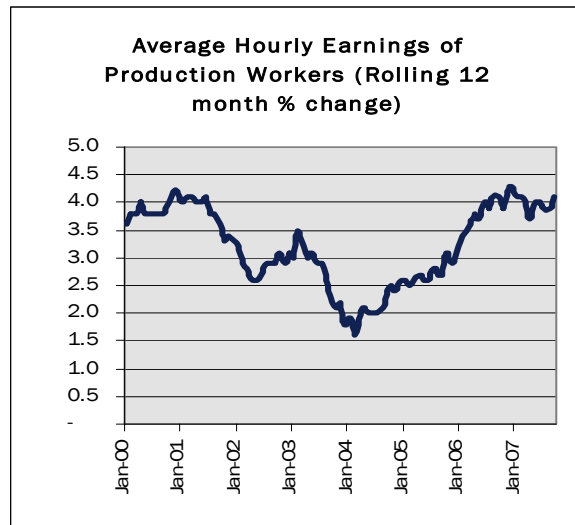
When we create our annual capital markets forecasts, we look at economic and company fundamentals and how attractively priced the financial markets appear given those fundamentals. If you look at today’s major economic indicators, you will see a picture of an economy that could be at the beginning of a period of slow growth.

As our clients and long time *Investment Commentary* readers are probably aware, our firm places a lot of emphasis on the consumer, the largest influencer of our economy. The American consumer has proven to be incredibly resilient, but now seems to be focused on several potential threats – trends in employment (a consumer’s lifeblood), wage growth (more of the same), higher oil prices (again), and some mammoth problems in the housing markets.

We have previously argued that as long as the consumer is employed and seeing decent wage increases, they would continue to spend. Unemployment is still low, although the rate did rise to 4.7% in September, up from 4.4% in March. So far, most of the layoffs have been associated with the mortgage and housing industries. How this number changes over the next few months will offer insight into whether unemployment has spread to other industries.



Wage growth has been improving since the beginning of 2004, although the rate of change seems to be moderating this year. Still, wage growth increased more than 4% over the past year, outpacing inflation. Oil prices are moving higher and into virgin territory, resulting in renewed questions by consumers as to just how painful energy higher prices might be. Interestingly, gasoline prices are *not* close to their highs and gasoline sales actually increased by 2% in September.



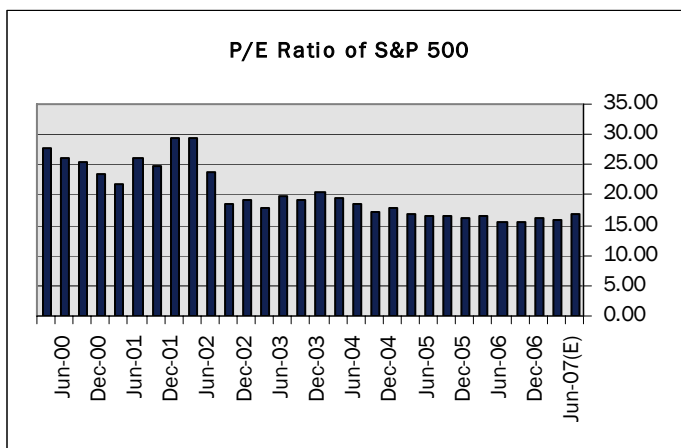
Perhaps the greatest concern of the American consumer today surrounds the problems in the housing markets. There is little good news in the housing world. According to Inside Mortgage Finance, mortgage originations were down 8.8% in the second quarter. Worse yet, the Mortgage Bankers Associations suggested that mortgage originations could be down as much as 36% in the fourth quarter. Characterized as the worst housing slump in 16 years, new home sales have dropped some 18% and the median price of a new home is down almost 3% (from June to August).

Earlier, I stated that there was “little good news in the housing world”, implying that there must be “some” good news. Interestingly, there appears to be little evidence that our housing recession has done much, if anything, to temper consumer spending. Go figure!

At least minor concerns about the direction of employment and wage growth, record oil prices, a nasty housing market and a life size amount of volatility in our financial markets

have collectively shaken consumer confidence. The Conference Board's Consumer Confidence index fell sharply in August and again in September. However, as we have pointed out in earlier writings, consumer "confidence" is not synonymous with consumer "spending". Although there have been hints that the American consumer might be taking a breather, any meaningful slowdown in consumer spending has simply not materialized. There are perhaps two explanations that support consumers' penchant for spending – besides the fact that spending money seems to have become an American tradition.

First, despite the current housing debacle, there are many Americans who have not been *directly* affected by the downturn. The media points to the mortgage and housing industries, which are having big problems indeed. Likewise, there are real problems with those homeowners who have variable rate mortgages awaiting a interest rate reset that may ultimately lead to foreclosure. However, many homeowners have reasonable equity in their homes along with a fixed rate mortgage, possibly carrying a low single digit rate. While they may have wondered if their home may be worth less than it was a few months back, unless they are contemplating a sale, they probably don't give it much more thought. Assuming that they are employed in a non-housing related industry, their lives have not really changed – at least not yet. Add to this, investors continue to see their portfolios increase in value. While the markets have been volatile, most financial markets have performed very well through the first nine months of the year.



How are the markets looking? Essentially, we hold the same views of the financial markets today as we did in January of this year when we began our annual capital markets analysis. Despite the good performance, equity markets still do not appear to be overvalued. At the beginning of this year, the P/E ratio of the S&P 500 was at 16.1. As of September 30, the ratio was at 16.7. The markets have outpaced earning growth this year, but ever so slightly. These values

are only mildly elevated when compared to the very long-term period of 1935 – 2006, when P/Es averaged 15.7. Perhaps more important, current P/Es are still substantially below the twenty-year average, which stands at over 19.

Larger companies should continue to have an easier time than their smaller counterparts will have. This can be attributed to a modest economic slowdown, but more importantly, the greater sensitivity that smaller companies have to the problems in the credit markets.

What could go wrong? Well, the consumer could cut back on his or her "consuming". What might precipitate this? Certainly, the housing virus could spread to more peripheral economic sectors. Energy prices could remain high (or go higher) and persist through the winter. As we know, it is not just the price of oil or gas. Rather, it is the effect that these higher prices have on food, transportation and virtually every other industry group. If oil prices remain high, gasoline prices will no doubt move higher.

Consumer sentiment is already fragile. A small pullback in spending coupled with an increase in energy related expenses at the corporate level could have a negative impact on company earnings. In an attempt to address profitability, corporations could either cut back on wage increases or, worse yet, reduce their workforces. A rise in unemployment would most likely lead to a greater reduction in consumer spending (less employed workers to spend) and the cycle becomes quite vicious.

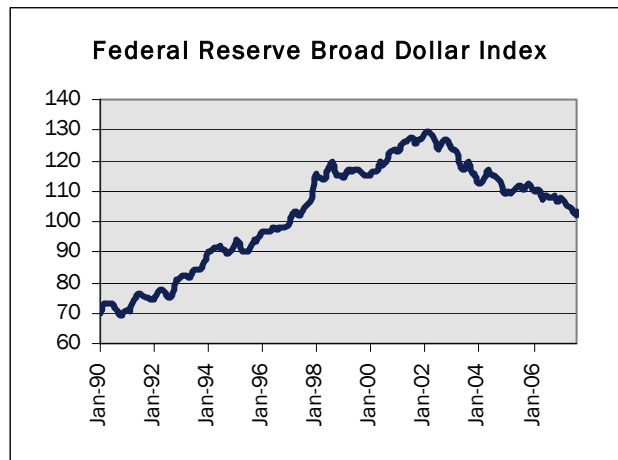
While we acknowledge that the above scenario is a possibility and we remain attentive to this case, we do not believe that it will materialize. Recent spikes in oil prices have been due to new (or renewed) tensions in the Middle East. We believe that oil prices will remain high, but back off their new highs. Consumers will grumble more should gasoline prices move higher, but they will not quit filling their tanks. The housing related industries will continue to count their casualties, but many consumers will escape unscathed. Corporate earnings should moderate, but not enough to spur layoffs. Wage growth is not likely to grow as fast as it has over the past three years, but wage increases should still outpace inflation. Consumer sentiment may remain somewhat low, primarily due to consumers' level of uncertainty. However, it is our belief that the American consumer will continue to spend the almighty Dollar, keeping our economy growing, if at a somewhat slower rate.

Moderate economic growth coupled with financial markets that appear to be reasonably valued from a historical perspective should lend comfort to long-term equity investors. International markets should continue to benefit from a weaker U.S. Dollar (more on this shortly) and outpace domestic equity markets. We continue to be neutral to negative on our domestic debt markets, largely due to the current level of interest rates.

### **Special Report – “The Dollar”**

The second part of this quarter's *Investment Commentary* will analyze the current valuation of the Dollar and its future prospects. There has been much media attention on the weakness of the Dollar. This comes as no surprise to us, as we have been carefully watching the Dollar decline for five years. Because the Dollar has hit record lows against the world's major currencies, there is speculation that the Dollar could begin a long term rising trend. We disagree.

Since early 2002, the U.S. Dollar has been in a steady decline against the world's major currencies. This decline reached new lows during the 3<sup>rd</sup> quarter of 2007, according to the Federal Reserve's Broad Dollar index, a measurement of the Dollar against a basket of foreign currencies. Our clients have benefited greatly from the declining Dollar through their investments in non-U.S. equities and fixed income.



Many factors drive the valuation of the Dollar. These include the level of inflation, the level of interest rates, and the so-called “twin deficits” (the current account deficit and the budget deficit). Macroeconomic theory teaches that the most important factor in currency valuation is the level of inflation, at least over the

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long term. Countries with high inflation levels see higher prices for goods year after year. Therefore, each year, the value of one unit of currency can buy fewer and fewer amounts of goods – a loss of “purchasing power”. Because it now takes more currency to buy the same good, the currency is said to have “weakened”.

For example, suppose a good that costs \$2 and our inflation rate is 10%. That means in one year, this same good will cost \$2.20. Also suppose that the same good can be bought in the UK for £1 today (an exchange rate of \$2/£1) and the UK inflation rate is 5%. Next year, that good should cost £1.05. To prevent arbitrageurs from profiting by buying the good in the cheaper country and selling it in the more pricey country, the \$/£ exchange rate must adjust to keep the cost of the good the same. In this scenario, the value of the \$ must fall to an exchange rate of \$2.10/£1. The \$2.20 priced good for a U.S. consumer would cost £1.05 ( $\$2.20 / (\$2.10/\text{£}1)$ ) to a U.K. consumer. This theory, known as “purchasing power parity” works great in the classroom, but the real world experience has not held true. The U.S. has had very low inflation since 2002, yet its currency has depreciated, contrary to what economic theory suggests.

A second theory of currency valuation states that countries with high levels of interest rates will see their currency decline in value, while countries with low levels of interest rates will see an appreciation in their currency. The theory is that arbitrageurs could borrow in the low interest rate country and invest in a high interest paying country and profit from the spread in rates. To prevent this from occurring, the currency of the low interest rate country should appreciate, making it more costly for the borrower to make their loan payments and eliminating their profit. This is known as “interest rate parity”.

Similar to the inflation story, the economic theory has not worked in the real world. For the past several years, investors have been able to borrow very cheaply in Japanese Yen and invest their Yen in much higher yielding securities around the world, sometimes referred to as the “Yen carry trade.” The Yen should have appreciated to prevent this practice, but it has not. The biggest reason for the theory failing is interference by the Japanese government by selling Yen to keep the exchange rate low, making Japanese exports more attractive to the world. The U.S. has had very low interest rates over the past few years and should have experienced a rise in the value of the Dollar, keeping arbitrageurs from borrowing Dollars and investing elsewhere. It appears that investors have ignored the economic theory of both *purchasing power parity* and *interest rate parity*.

Today, the Federal Reserve and Central Banks around the world have had great success in controlling inflation – so successful that many no longer consider inflation a major long term threat to currency valuation. If inflation is not perceived to be an issue, investors will prefer currencies of countries with the highest yields. This suggests that low interest rate countries such as the U.S. and Japan would see a *depreciation* in their currencies, while higher interest rate countries, such as the U.K. and the E.U. would see currency *appreciations*. Recent interest rate reductions in the U.S. now support a further decline in the U.S. Dollar.

Two other factors that affect the value of the Dollar are the current account deficit and the budget deficit. The current account’s largest component is the level of imports/exports of the country – the trade balance. For many years, the U.S. has been importing more than we have been exporting. This “trade gap” has created the current account deficit. To show how the current account deficit affects the value of the Dollar, consider the following example. When a U.S. consumer purchases an imported good, the Dollars spent to buy that good are sent to the foreign company that created that good. That company sells the Dollars received

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to acquire its home currency. Imports exceeding exports results in more Dollars sold than purchased. Simple supply and demand dynamics result in the Dollar becoming cheaper.

As the Dollar weakens, it should result in an increase in U.S. exports versus imports. In fact, this has happened over the few months – although imports have remained about the same. All else equal, this export / import shift argues for a strengthening Dollar.

The manner in which the budget deficit affects the value of the Dollar is not as straightforward as the affect of the trade imbalance. Currently, our country runs a budget deficit that is between 1% and 2% of our annual GDP. Each year, the government must issue bonds to make up the deficit and pay interest on these bonds. As these interest payments grow larger, they will take up a growing percentage of the budget. Eventually, the government might have to face a choice of either cutting government programs or increasing taxes to pay for this ever-growing interest burden. Cutting government programs means reducing government spending, while raising taxes essentially means reducing the consumers' ability to spend. Either way, the economy would likely weaken. A weaker economy is not as attractive to foreign investors. Likewise, an economic slowdown may also result in lower interest rates. Both of these factors are negative for the Dollar.

In conclusion, although the U.S. Dollar is currently near all-time low valuation levels with many of the world's currencies, there is ample evidence that its value will continue to fall. Lower interest rates, a large albeit improving current account deficit, a large budget deficit and what appears to be a slower economy all argue for a continued decline in the Dollar. Until these trends reverse, there is little argument for a more valuable Dollar.