Second Quarter 2007 Commentary
Private Equity, Leverage, & Liquidity

The second quarter began with the markets continuing their upward assault on the record books. And while we achieved new records across the major indices, it was done with a fair amount of volatility, as well as other issues.

There are three large forces currently driving the markets and the global economy.

First, ***there is an economic market cycle***, secondly, ***there is the China and oil factor***, and thirdly, ***there is leverage***. We are entering the late part of the economic cycle when inflation begins trending up, and the tradeoff between inflation and growth becomes more acute, and central banks (worldwide) tighten monetary policy.

One thing that is different is ***China and India have essentially doubled the world's labor supply***. This has had the effect of producing deflationary pressure that has necessitated the creation of much more liquidity to prevent labor deflation. That's allowed the business cycle to go on longer. Business cycles end when inflation emerges and central banks have to tighten monetary policy.

The economy is made of three main components: labor, raw materials or commodities, and capital. When you lower the price of one (ie: labor) it exerts an upward pressure on the other two. Despite pockets of inflation, we have not had a high level of general inflation because of all the production that is taking place. But the China factor and the large wave of liquidity have resulted in 100% of the countries in the world showing economic growth.

The fixed currency exchange rate with China has created a system in which to keep the exchange rate in balance, the Chinese have to buy U.S. dollar-denominated assets (principally bonds). We've seen their reserves go up as we have been lent a lot of the money. ***That leads to debt and leverage***.

There has been a great leveraging up in the classic form of debt. But there's been a lot of leverage in financial assets as well because of all the liquidity in the hands of institutional investors all around the world. As such, ***the booms we are seeing in asset values, the art market and high-priced real estate are occurring as a result of a lot of money coming from foreign investors and passing through the hands of investment managers who are bidding up risky investments and using their fees to buy up luxury goods.***

The investment managers' dilemma is getting money invested in a prudent manner and this has resulted in a big shrinking of risk premiums. Anything that has an interest rate higher than another interest rate is probably going to be bought. Most people are not worried about price volatility, so, therefore, yield is the more important factor. Whatever has the highest yield gets bought against short positions of that which has the lowest yield. Also, when volatility goes down, investors believe they can have larger positions with the same amount of risk and therefore has resulted in much more leveraging up.

Traditionally, an "AAA" rated bond would have to pay less in interest costs than say a similar maturity bond that is only rated "BBB". In recent months, lower credit bonds (defined as BB+ and below) have traded at a smaller risk premium (compared to US Treasuries) than ever before in history. Over the past 20 years, this margin averaged 5.42 percentage points. Earlier this month, it touched down at a record 2.63 percentage points. This means that ***high risk borrowers are paying less than ever (about 8%) to borrow money.***

This tight credit spread is not limited to just the US. Today the debt of countries like Colombia trades at less than two percentage points above US Treasuries, compared to 10 percentage points just five years ago.

<u>Financial leveraging has been going on at a rate and an intensity that is unprecedented</u>. Consider the pricing of private-equity-fund investments. Now private companies are actually selling at higher multiples than public companies because of the demand for capital. Even more ominously, some of these private equity firms are going public and there'll be even more pressure to maximize assets under management to enhance how they look when they are re-issued as public securities.

<u>Money is available today in quantities, prices and terms never before seen in the past 100 plus years in the US financial markets.</u>

<u>This is giving investment managers tremendous temptation to borrow more money than ever before on bets that have a lower and lower margin of safety.</u>

Given this mix of issues, what is the risk of a U.S. recession? There is plenty of money providing liquidity. There has been an adjustment in housing, but that does not mean the average individuals income level is going to drop much because of it. As previously stated, ***<u>100% of the countries in the world are growing</u>***. Americans are focused on the housing market. While that's meaningful, there has not been a collapse of incomes *and* a collapse of household cash flows.

Everybody is flush with liquidity and it would be shocking to me if the sub-prime problem essentially spread and sank the economy. Recession isn't a risk until we get later in the cycle and we start to see an emergence of concerns and a desire to tighten monetary policy, which will happen simultaneously probably around the time of the presidential elections.

<u>We generally have bets on wider credit spreads and we have bets on interest rates rising, not declining</u>.

<u>Liquidity will tighten, credit spreads will widen, risk premiums will increase</u>. It will be accompanied by ***<u>the U.S. dollar going down and other currencies rising</u>***.

Hedge funds and private-equity firms today are like the dot-coms in 2000: Ask for money and you'll get it. They are bidding up the prices of virtually everything. In fact, several of our favorite investments have been bought out this year. While that has improved short term investment performance, it makes the long term more difficult. The amount of money flowing is almost out of control, and it's making everything overvalued.

We heard one manager describe the current situation in the following manner: There are 11,000 planes in the sky and only 100 good pilots -- an accident is bound to happen. Just like the dot-com bust, the winners and losers will be sorted out but the technological advances won't stop.

Please call or stop by with questions.

Sincerely yours,

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™