MV Capital Management E-Update

Of Goldilocks and Gravity

February 27, 2007

"When Wall Street sneezes the world catches cold" is what the market old-timers say. This morning we woke up to the reality of a new world in which a nasty winter flu can blow in from places far away from Wall Street – like the icy wind from the steppes of northern China that blasted us out of our warm beds this morning. While Wall Streeters were asleep last night with visions of Goldilocks dancing in their heads the Shanghai Composite Index plunged 8.8%, its largest drop in ten years and just one day after the index broke through the 3,000 level to reach an all-time high. To make the morning exquisitely worse for the Wall Street bulls the market then served up some unnerving economic data – durable orders down 7.8%, more than twice the expected decline, and Freddie Mac announcing that it would substantially reduce its practice of buying subprime mortgages, that dicey X-factor in the state of the housing market. Equity markets worldwide went into a sharp downturn, while just days ago it seemed commentators were running out of ways to say "conditions are perfect and could not possibly be perfect-er".

What happened? Stepping back a bit from today's turmoil it is actually not all that surprising. In brief: What goes up must come back down. Isaac Newton said it, and the so-called Goldilocks economy is not immune from it. The Dow Jones Industrial Average has traded above its 50-day moving average for 148 consecutive days prior to day. That's the 12th longest run for the Dow since 1900. Yes, 1900, twelve years before the sinking of the Titanic. And this last run has taken place in an environment of stunningly low volatility, as we noted in our last E-update "The Risk Disconnect". We have not had a correction – according to the technical definition of a retreat of at least 10% from the previous high – since 2002. The markets are simply due for a little dose of gravity, and today they got one.

A correction – and let's keep in mind that from today's S&P 500 decline of -3.47% we are still some 6.53% away from having one now – usually is not the result of any one thing but rather a couple of often relatively uncorrelated developments – like China and durable goods, say – that remind investors that the gains they have racked up are only gains on paper, prompting a wave of selling. That is a pretty good assessment here, because there are plenty of profits to lock in. The Russell 3000 Index was up 20.73% from June 14 2006 (the day after the index reached its low for the year) through February 26 2007. Not bad for an eight month return.

So what happens next? The short term is unknowable, we always say. But we have been skeptical of the so-called "perfect economy" for some time now, as indicated in our previous writings, and we don't see much out there to change our perspective. Going back to China, what is interesting about the 8.8% drop is that Hong Kong only fell 1.76% the same day. Why is that of note? The equity markets of Hong Kong and China are joined at the hip, given that China is the single biggest source of economic activity for the vast majority of all listed Hong Kong shares. If something really terrible were brewing in the Ancient Kingdom – a new set of price controls or taxes or some other ham-handed government fiat to exert control over the markets – we'd expect to see Hong Kong bedridden with a fever over 100 when China sneezes. It's more likely that investors pulled their sell buttons *en masse* when the Shanghai index crossed 3,000, just in case. Wiping out all that equity value presents some exciting buying opportunities in what is now the world's second largest economy by purchasing power parity.

We said it at the beginning of this year – 2007 is likely to be one of those years where staying alert at the wheel is more important even than usual. We meant it then and we mean it now.

With warm regards,

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