# MV Capital Management E-Update

**What About the Fundamentals?**

October 5, 2007

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As we write this the stock market has recovered to the previous high points set back on July 19th. As we start the 4th quarter – typically a period of strong seasonal performance – a new conventional wisdom is quickly taking hold. The CW says that the credit crunch is essentially over. We – kind of – know how bad the large banks' post-subprime financial condition is as earnings guidance comes in from Lehman Brothers, Citigroup and the like. Bad yes – but not a runaway disaster. Ben Bernanke came into the bar on September 18th, bought everyone a round and left the tab open. Economic growth in Europe and Asia remains upbeat and our weak dollar supports stronger exports. Portfolio managers, not wanting to underperform their benchmarks, will come piling in as the holiday season approaches. If true, then the correction of the past two months will be nothing more than each other "time-out" since 2003 when the markets have paused, reversed a little and continued on their merry upward surge. Technically we can't even call the July 19 – September 18 period a correction, because the broader markets never closed 10% or more below the prior high water mark.

The CW may be right as far as the rest of 2007 goes. Animal spirits are high on Wall Street and money is flowing in from all corners, institutional and retail alike. It will not unduly surprise us if we see something similar to the 15.79% performance of the S&P 500 in 2006. What concerns us is what happens next. In our opinion the fundamentals make a less than compelling case for extending the party too far into 2008.

What are these fundamentals? In the US about 70% of GDP performance comes from consumer spending. Companies make stuff, we buy stuff and the economy grows. The astounding ability of the American consumer to spend has been the Herculean shoulders upon which the recovery since 2003 has rested. So if consumer spending is the economy's driving force then what drives consumer spending? We see three things: household income, household asset values and household debt. The trend for all three of these factors is negative.

US household incomes have remained relatively flat for years. A couple weeks ago the Bureau of Labor Statistics released data showing that job growth for the previous three months was significantly weaker than earlier estimates had shown. A weak job market will continue to keep a lid on wages. On the other hand record high oil and agricultural prices will not keep any kind of a lid on the prices wage earners pay at the pump and in the supermarket. Anyone who has bought a carton of milk or a packet of tortillas recently will attest to this reality.

Now there is something curious here. Rising prices for gas and food means higher inflation, right? However the inflation measure the Fed and most investors focus on is the so-called core inflation – basically the cost of everything except gas and groceries. Core inflation has been relatively subdued this year and that seems to have given the Fed enough comfort to push through their 50 basis points rate cut in September. That seems at odds with reality. To us a singular focus on core inflation is kind of like a doctor saying to a patient: good news! Apart from that clogged artery restricting blood flow to your heart everything is fine!

The point here is that if household budgets are being stretched to pay for pricier basic staples then there is less cash available in the checking account to buy bathroom fixtures, plasma screen TVs and vacations to Disney World (for anyone with enough job security to actually contemplate taking a vacation in the first place). That's where the other two prongs of consumer spending come into play. As housing prices soared the home equity credit line became a leveraged ATM to facilitate new kitchens, turbo-charged outdoor grills and the like. That period is over for the time being and most of the data coming across our screens do not support the idea that the worst of the housing downturn is over. The problem with using home equity as a leveraged ATM is that when the asset value decreases the liability value – the amount of household debt – increases so it is a negative effect times 2.

As bad as all that sounds, there is a Pollyanna answer to it. Yes – things are bad out there for a lot of folks. But that's not such a big problem because the people who do the lion's share of consumer spending are the ones in the upper strata – the top 15-20% - of income earners. And they by and large seem to be doing just fine. If the top 20% spends more in aggregate than the bottom 80% then it really doesn't matter and things will just keep humming along, right?

The problem with that argument – well there are several problems actually but the main one as it affects stock market performance – is that the consumer-related stocks comprising the largest capitalization weightings on the S&P 500 and the Russell 3000 are those very places where the bottom 80% shops – the Wal-Marts and Targets and Kohls and the like. News coming out of those concerns these days is not rosy – mass retailers are gearing up for what is expected to be a notably weak holiday season this year. In other words – it may be all well and good that a top-decile earner can keep on buying Dolce & Gabbana skirts and Jimmy Choo shoes, but the stock market is likely to be more affected by the fact that consumers in the 40% strata are buying far fewer Daisy Fuentes skirts and Nine West shoes.

From our view in the kayaks we see brief intermittent calm ahead and some rapids further on towards the next bend. How rough it will be after the bend is not clear. What is clear is that it is the right time to be prepared with carefully considered asset allocation strategies and risk-efficient investment exposure. That is job number one on our calendars this fall.

With warm regards,

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