MV Capital Management E-Update

Economy versus Credit Markets, Round II

November 13, 2007

Every morning we come into the office, switch on the computers and let the guessing game begin. What will be the top-line news for the day? Reports trickle in from the credit markets – another bank is disclosing more bad loan exposure and its CEO is getting ready to "spend more time with the family" and figure out ways to spend that $160 million severance package (perhaps the best way to rescue banks from their subprime woes would be to create a new restructuring fund made up of all those gilt-edged severance packages…). US Treasury yields are at 52 week lows while yields on mortgage loans and bank CDs have barely budged – a sign that credit markets are still dysfunctional.

Yet on other days over the past month the headlines have been dominated by other, seemingly upbeat stories. Technology companies like Google and Apple are reporting great quarterly earnings. US GDP was higher than expected at 3.9% year on year for the 3rd quarter. Productivity is higher, the job market numbers are not terrible, exports are going gangbusters and consumers have not pulled the plug on their discretionary spending budgets.

It seems that the stock market goes up or down on any given day simply on the basis of these morning headlines. Subprime loans – down, tech earnings – up. By "down"" and "up" we don't mean a desultory five points here or ten points there. Back in January this year we had two trading days in which the Dow Jones Industrial Average closed more than 100 points higher or lower than the opening (one down, one up), and the average point spread between the intraday high and low was 165 points. For October the total number of 100 point-plus closes was six (four up, two down) and the average intraday spread was 272 points. So far in November two of the seven trading days to date have been 100 point-plussers, both negative.

This daily face-off between good news and bad is a big part of why –despite all the volatility – the markets really have moved sideways rather than up or down. On July 6 the S&P 500 closed at 1530. On November 6, it closed at 1520 – a modest 0.6% decline for the four month period. When the market trades in a sideways pattern like this – what we call a corridor – the question we always ask is what could cause a breakout on the upside or downside. This is where we get concerned.

For the market to resume the strong upward trend of the eighteen months prior to this summer we think that credit market woes would need to recede into the background while the economy continued to show it can grow at a modest clip with low inflation and decent corporate earnings. In fact that is largely what the market believed back in September, certainly after the Fed's 50 basis points cut that month. Evidence revealed since then, however, indicates that the CW was early in calling an end to the credit/subprime mess. The magnitude of disclosures coming out from Citigroup, Merrill Lynch and others are closer to investors' worst-case scenarios than anything else.

So if the credit markets are going to continue being dysfunctional then it falls to the economy to do the heavy lifting. But the economy seems weaker than the headlines might indicate. The upbeat headline of 3.9% GDP growth yields to the full story that a significant part of that growth came from robust exports, the prime cause of which is the historically weak US dollar. Continuing modest inflation numbers focus on core inflation, thus excluding the very clear and

present fact of $100/barrel oil that is almost certain to translate into ever-higher prices at the pump in a matter of weeks. Strong corporate earnings have been very concentrated in the technology and basic materials sectors, both of which generally derive a large amount of revenues from overseas. Technology stocks though are vulnerable to the prospect of lower consumer spending. In fact it all leads back to consumer spending, that mastodon accounting for 70% of US GDP. We've expressed our view in earlier e-updates that consumer spending is about three trends – household income, household assets and household debt. When these trends reach a negative tipping point consumer spending will decline, and with everything else that's going on there is a reasonable probability that the decline will produce a recession.

At the beginning of this year in our market outlook we presented our view that a recession in the next 12-18 months is a possible outcome but not the most likely outcome. Over the course of the year we have maintained that position, but we have also raised the probability estimate of the recession outcome. Looking at the picture today we still think that anemic growth is a slightly more probable outcome for 2008 than recession – but only slightly. Moreover even a slow growth/low inflation scenario – the fabled "Goldilocks economy" so beloved of commentators in the first quarter this year – does not bode well for a strong 2008 stock market given the realization now that the financial sector's credit woes will – by the banks' on estimates – continue well into 2008.

Seasoned investment managers will say that there are two kinds of years – those when emphasis is on 20% returns and those when the main focus is to not lose money. We think 2008 is going to be more akin to the latter. To protect the downside in a falling market requires use of a full arsenal of asset allocations and specific exposures. The risk to this is that if the market confounds expectations and delivers strong performance then it will be clear that the downside protection came at a cost – the protected portfolio will lag the benchmark. Sometimes, though, that's a risk we have to take. We have not finalized our 2008 exposure and allocation decisions, but we are very serious about them, arguing viewpoints amongst ourselves, challenging and rethinking yet again. We are, after all, stewards of your trust and such responsibility demands nothing less than our fullest attention and commitment.

With warm regards,

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