

Economic Conditions & Market Outlook

Normally, this overview begins by focusing on the major macro-economic issues that have recently driven investment markets and influenced our portfolio decision processes. But current circumstances have been anything but normal and fundamental economic factors have not been the key drivers in recent market moves.

In fact, contrary to the market's extreme volatility of late, economic data has remained rather consistent; with the U.S. economy's growth via gross domestic product continuing to muster on, albeit weakly. This balance has been maintained despite several significantly negative factors, including a prolonged contraction in U.S. housing and a dramatic spike (then drop) in global crude oil prices.

But that is where the good news ends. Aftershocks from the growing credit crisis, as well as unease from recent market gyrations, will likely spill over to disrupt economic stability near term. Congress had the opportunity to proactively address some of the critical issues before conditions worsen. But yesterday the House of Representatives voted down legislation designed to buttress the nation's struggling financial system and help restore a needed level of liquidity and confidence to the investment/credit markets. More on that later but hopefully the markets nose-dive response will encourage lawmakers to readdress the bill later this week.

Stock market movement during all of September has been rather volatile but the latter half of the month has been downright convulsive. Ten of the eleven trading sessions preceding September 29th saw the Dow Jones Industrial Average closing price swings of more than 100 points from the prior day. In six of those sessions, day-to-day closing price swings exceeded 350 points, an extraordinary number. And that does not begin to capture the spastic intra-day market moves in which gainers and losers would often swap leads multiple times.

As noted, this manic market has had little to do with known econometric measures and everything to do with uncertainty and fear inspired by an unprecedented array of bankruptcies, takeovers, and mergers among financial behemoths. The rapidity at which many of the mighty have fallen has prompted a "Who's next?" mentality among rattled investors and surviving institutions alike. The result has been a financial 'fox-holing' of sorts among the survivors that has dried up the daily inter-organization lending and ongoing cash flow needed to keep the wheels of commerce turning.

The severity of this credit crisis has increased exponentially during the past two weeks and heightened anxiety in an already skittery marketplace; resulting in investment market responses have been broad but very tangible. First, the bond markets have essentially ground to a halt due to pervasive nervousness over which issuer may fall next, with even bargain basement sales offers closing out the trading day without a single bid. Second, as mentioned, day-to-day moves in an already overly-volatile stock market have been clearly exacerbated.

The list of financial organizations forced to morph during September is shockingly long, with shareholders and bondholders typically left to bear the loss. One recent weekend alone saw the bankruptcy of the long-lived Lehman Brothers investment firm, the shotgun wedding of brokerage giant Merrill Lynch to Bank of America, and the near collapse of insurance mega-firm American International Group. Earlier in the month, the struggling quasi-public/quasi-private mortgage lending entities of Fannie Mae and Freddie Mac found their identity crisis resolved when the Federal Government took them directly under wing.

Last week saw the nation's largest thrift Washington Mutual seized by regulators and immediately sold to J.P. Morgan, while Morgan Stanley and Goldman Sachs traded their high-flying investment banking pedigrees for the liquidity benefits (and regulatory requirements) offered their commercial banking brethren; a distinction apparently providing little solace to Wachovia Bank as it finds itself being purchased by Citigroup in a hastily structured weekend deal brokered by the FDIC.

Congress can still salvage some form of the bailout package intended to inject sorely needed liquidity into the constricted credit markets, provide a market-making mechanism for complex mortgage-related investments that are currently unmarketable, and ideally begin the lengthy process of restoring calm and confidence in the broader financial marketplace. This bill's approval can't come soon enough.

No single package, government or otherwise, will provide a quick-fix panacea for all the problems currently plaguing markets and investors alike. And undoubtedly, once details of the bailout plan are fully reviewed and evaluated, there will likely be squawking from most every corner regarding inclusions or omissions not to their specific liking. Yet, however imperfect the end result may be, taking action by providing a U.S. Government sponsored financial backstop is an essential step toward stemming a credit crisis of even greater severity and providing a base on which long term corrective solutions can be built.

Detailing all the facets of the rescue plan currently before Congress is beyond the scope of this missive. The key focal points and overriding purpose of the legislation were outlined earlier and the plan's specifics will be dissected by the media in the days to come. Of primary importance is the provision that facilitates the Federal Government's purchase of problematic bundled mortgage securities, providing both a market for these beleaguered assets and much needed liquidity for the financial firms currently holding them.

Contrary to the political posturing being done by some, this is not a 'Main Street' versus 'Wall Street' issue. In truth, the two are inextricably linked. Similarly, U.S. taxpayers will not be simply giving money away. Rather, they will be buying low-priced mortgage-based assets in a credit market that has temporarily seized up. Even when factoring in a worst-case scenario loan default rate, the end result could be a tidy return on the taxpayer's investment. If not, the financial firms benefiting from the proposed rescue plan will eventually have to ante up the difference, in addition to complying with all the other stipulations within the legislation.

Should the Federal Government be in the mortgage business? Perhaps not; although one could argue that with Fannie Mae and Freddie Mac it clearly already is. Should private business expect a government-orchestrated bailout whenever the risk they take turns upside down? Absolutely not; the free-market system necessitates that businesses be allowed to both succeed and fail on their merits.

But this is not a single business at risk, or even a single industry. It is our financial infrastructure in need of support that impacts us all. If capital is the grease that lubricates the wheels of commerce, confidence is the fuel that keeps financial markets running. Right now, that confidence is running near empty. The potential negative consequences of doing nothing are far graver than any missteps that may occur while doing something. When the dust from this crisis clears, there will be plenty of time for blame and accountability.

The easiest targets will be the investment firms who have once more been burnt by their own supposedly sophisticated creations. Credit default swaps, collateralized debt obligations, and various other interrelated derivative arrangements have added intensity to the subprime meltdown. Like a financial Frankenstein, these complex investments have taken on a life of their own and contributed to the destruction of their creators.

Also high on the list of scorn are the supposed captains of industry, corporate C.E.O.s and their board members, who had neither the fortitude nor foresight to prevent their companies from sinking. And while their organizations' demise may have dragged down the fortunes of employees and investors alike, they personally often remained not just afloat, but also enriched, for their ineptitude.

However, greed, leverage, and incompetence have not been the province of Wall Street alone in creating this gargantuan mess. Far from it. Banks and credit issuers of all varieties shoulder their share of the guilt by promoting personal leverage beyond all reasonable standards of prudence. So do financial markets regulators for clearly not understanding the complexities of what it was they were supposed to be regulating.

Politicians deserve culpability for mandating increased lending to sub-prime borrowers and pressuring lending organizations to fund deals that should never have been made in the first place. Securities ratings agencies also deserve special mention since they apparently had nary a clue as to the underlying risk of the investments on which they placed their imprimatur. They have maintained their ignominious track record of routinely pronouncing the financial 'patients' being monitored as unhealthy long after they are dead.

Last, but certainly not least, in this list of those contributing to this current crisis via the exercise of greed, leverage, and incompetence is the individual borrower. Yes, at the risk of being politically incorrect, the very ones being collectively cast as the woeful, unknowing ‘victim’ deserve recognition as well. While there were indeed many unfortunates who were preyed upon by unscrupulous lenders deserving of a public flogging, just as many individuals fully understood the risk they were taking by borrowing more than they could ever afford via a variable rate mortgage and betting on ever-increasing real estate valuations to fund future refinancing.

Comparing what similar homes sold for in nearby neighborhoods, towns, etc. became a national pastime. And when real estate prices did rise, inflating personal net worth, many viewed the concept of leaving home-equity within the home as being rather blasé. Far better to use your house as a four-walled ATM from which to fund vacations, vehicles, and the like. Unfortunately, for many the proverbial chickens have come home to roost.

Our Tactical Investment Stance

Roof Advisory Group’s disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client’s specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- After remaining at a ***minimum equity*** allocation for most of the month, we quickly dropped our target portfolio weightings to a ***below minimum equity*** level in an attempt to preserve client capital. It was anticipated this ***temporary fallback position*** might be necessary and was planned for well in advance. Action was initiated ***early yesterday afternoon*** when rejection of the proposed bailout package became imminent.

We are already transitioning back to the prior target levels in some stocks, given the rapid bounce in today’s market. A full return to the previous ***minimum equity*** position will occur as soon as deemed prudent. However, forthcoming political decisions will enhance market uncertainty and ***buying will be selective*** and ***focus on value***, but the latter becomes an ***increasingly challenging*** proposition in this whipsaw market.

- ***Diversification remains a priority*** in all firm’s portfolios, with that strategy again demonstrating value in these unstable market conditions. While the firm does not make significant sector bets, we do look to add value by slightly overweighting areas in favor, while underweighting those that are not. In our opinion, ***avoiding untimely sectors and poor performing stocks*** is essential to long-term growth and risk control.

Our sector exposure at present includes a ***slight overweighting in Energy, Basic Materials, and Financial*** stocks, with the latter sector previously being notably underweighted. Specific sector weightings will vary based on the target portfolio investment policy in use.

- Positions in stocks with significantly ***lowered or at-risk earnings expectations were pared*** mid-month. So were individual equities ***deemed most vulnerable to negative moves*** in the current quixotic market.

- ***International and global equity exposure*** has again been ***proportionally reduced*** as part of the overall reduction in equity allocation. This has ***faired no better*** than domestic U.S. market exposure for most of the year and has lagged even more as the U.S. dollar regains some strength.

- ***Short-term fixed income*** investment levels will be ***temporarily higher than normal*** due to the tactical shift in equity allocation. Money market funds used by the firm have been ***reviewed at the holding level***, with changes made if needed. All bonds with potential sub-prime lending concerns were eliminated last year. In response to the surprise defaults mentioned earlier, we have aggressively attempted to further reduce fixed income positions in targeted banks/brokerages. The firm will be look to maintain a ***competitive aggregate yield*** in the bond portion of portfolios but the current overriding priority is ***preserving safety and liquidity***.

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