



THE REARVIEW MIRROR

In 2007, it paid to avoid assets that had been bid up by leverage.

As investment advisers, we can never predict future market conditions, but we can generally see when trends have become overextended. Our over-arching objective is to examine global economic developments and intelligently position our clients to benefit from them.

Voices of reason have long warned about the highly levered state of the U.S. economy. We highlighted these concerns in past newsletters, but couldn't forecast exactly when, where, or how the credit bubble would deflate. The ugly realities of NINJA (No Income, No Job or Assets) loans and overextended consumers surfaced this year, punishing investors and creditors who incorrectly assumed that housing prices would always go up.

Concerned about the abundance of easy credit, we reduced our clients' direct exposure to the U.S. mortgage market and related sectors across both fixed income and equity positions during the past two years. We concurrently repositioned portfolios to benefit from **global growth** rather than **U.S. growth**, reflecting our belief that emerging-market economies will drive economic activity and global supply and demand dynamics over the foreseeable future.

We made these changes because we believe it is important to stay clear of investments marked by deteriorating trends and valuation concerns and to know that we cannot pick the top. We won't always get it right, but we put a lot of work into judiciously taking on risks with good payoffs and avoiding those without.

As investment advisers, we don't need to solve the world's problems. We just need to try to navigate the risks as best we can and to seek opportunities where there is a strong case for higher prices over time. This focus on risk control is critical to growing portfolios. This past year reminded many investors of what happens when one brazenly buys what is popular or "working." It also reminded many that no tree, however impressive, ever grows to the sky. ■

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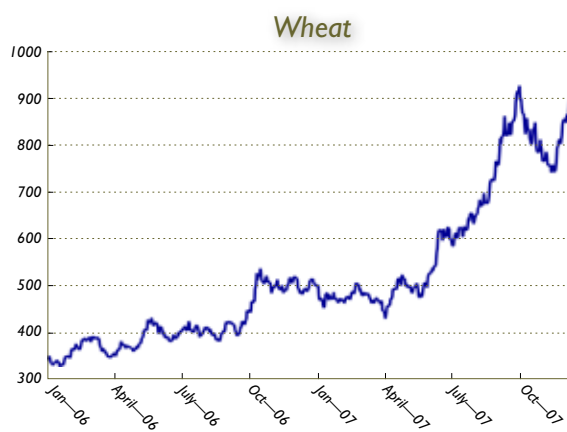
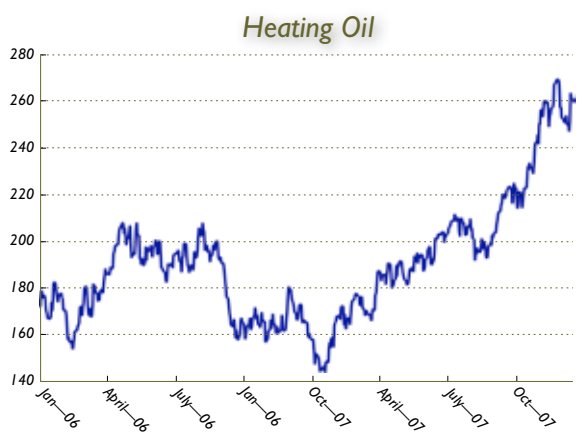
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THE ROAD AHEAD

We begin with a retrospective:

Price Movements: 2006 – 2007



Source: Bloomberg

The U.S. economy currently is being re-liquified through lower rates and liquidity injections at a time when the U.S. dollar has declined precipitously vis-à-vis all major currencies. MZM (Money Zero Maturity: a proxy for money supply) growth is up 24.3% on a year-over-year basis through this past August.¹ This re-liquification is the Fed's strategy to stave off a shutdown in the credit markets following a period of reckless lending.

In our view, re-liquifying the system may be highly inflationary because a disproportionate share of these additional dollars will likely go to basic goods that are already in tight supply. Indeed, we are seeing substantial increases in the prices of raw food, energy, and metals across the board. With labor supplies remaining tight globally—brought on by a long-term decline in the birth

rate and robust global economic development—significant wage increases are likely to follow. This possibility has yet to be reflected in the bond market because inflation statistics exclude these factors and heavily weigh U.S. real estate.

The reason most observers are discounting inflation is that between 1980 and 2000 the U.S. Federal Reserve witnessed the best possible environment: disinflation from increasing abundance of all commodities (including labor), robust U.S. economic growth from a less draconian tax policy, productivity gains, and increased world peace (as symbolized by the fall of the Berlin Wall). As such, the Fed could ease credit whenever the economy softened and inflation remained benign. Likewise, world economic policy was set by the G7 and the U.S. dominated the agenda.

Those days are over.

¹ Source: Federal Reserve Bank of St. Louis, Oct. 11, 2007

Until now, a great deal of the world's savings was exported to the U.S. where much of it was squandered in loans to residential real estate speculators. It was inevitable for domestic real estate to suffer, particularly in light of the levels to which prices were bid up. Needless to say, many foreign bank lenders didn't appreciate being left holding the bag. As a result, foreign investors are now less willing to underwrite U.S. assets, especially because of the weak dollar; this ultimately makes the current credit challenges more difficult to resolve. The Fed's view is that given the choice of either multiple U.S. bank failures or broad-based inflation, inflation is the lesser evil. This problem, they feel, can be addressed in the future.

Looking towards 2008, two interwoven themes will likely direct global market activity. First, virtually all commodities are becoming scarce—there hasn't yet been a concrete supply response to recent price increases. Second, emerging-market economies continue to prosper because of labor outsourcing from the developed world. This growth puts relentless demand on energy, metals, and agricultural products because these resources are all required for improved standards of living as these economies evolve.

It seems clear to us that global consumers will now have to pay for the previous decades' lack of investment in capacity for commodity production. This payment will come in the form of higher prices and a bigger share of income.

But here's the good news...

In our view, there are three factors that will prevent a severe bear market and deep recession in the U.S.:

- 1. Inventories are already lean, so no major adjustment will be forthcoming.*
- 2. The labor market will likely remain tight.*
- 3. Given the weak dollar, we don't anticipate that corporate revenues will collapse.*

While these give us cause for optimism, a lingering concern is what increasing cost pressures will do to general corporate profits in the U.S. It is for this reason that we prefer to invest in the **price-makers**—companies that have assets that are in high demand and whose prices are set by global supply-demand characteristics—instead of the **price-takers**—companies whose margins are dependent upon a disinflationary environment.

As we've said before, we're not trying to leap tall buildings in a single bound; we just want our clients to benefit from the most discernible trends and to own investments with the best available risk/return trade-offs. Our approach of designing strategic, global, value-oriented portfolios is the best way of maximizing our clients' chances of generating solid returns and avoiding a permanent loss of capital. We feel confident that our team, our investment strategy, and our firm's philosophy position us to deliver superior results for our clients. We hope you feel the same. ■

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THE LIGHTER SIDE

VOLATILE MARKETS CAN BE TRYING, but they are great inspiration for financial cartoons. For example, *Grant's Interest Rate Observer*—one of the investment publications we read—features a witty cartoon on each edition's front page. *Barron's* and *The New Yorker* also have comedic geniuses on staff. This smart humor serves as a refreshing palate cleanser to detailed financial notes from companies' 10Ks and minutes from the most recent Fed meeting that we generally consume.

Below are two of our favorite cartoons from this year. If you are interested in seeing more, you can visit www.grantspub.com/cartoon/ or www.cartoonbank.com. ■



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