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Market Commentary

A Review of the Markets and a Look into the Future

Sub-Prime Slime is Not so Sublime

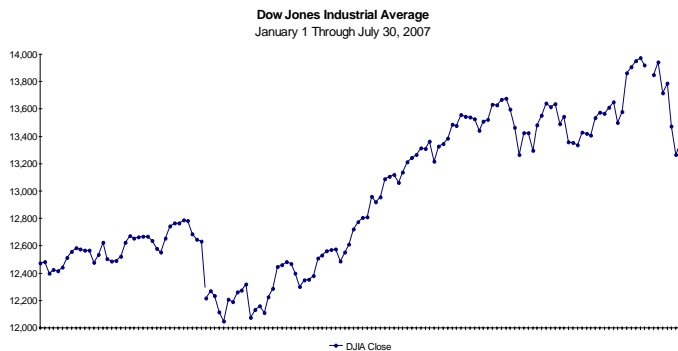
The most treasured asset in investment management is a steady hand at the tiller.
- Robert Arnott

Economic Outlook: A mixed bag

You may recall from the last newsletter that a monster with two ugly heads – weak economic growth and rising inflation – appeared in the first quarter. Fortunately, this menace has made like Elvis and left the building. In the second quarter inflation moderated and the U.S. economy posted a healthy 3.4 percent growth rate. My unofficial tally is that most economists are forecasting growth rates of 2-3 percent for the rest of the year, a modest but sustainable pace.

But the economic news is far from uniformly positive. There has been widening fallout from the woes in the U.S. sub-prime mortgage market, not to mention a continued housing slump, higher gas prices and a sharp stock market decline in late July (*Figure 1*). These factors could pose a danger to consumer confidence if they continue.

Figure 1. The Dow Breaks 14,000 and Retreats



This is significant because most of the second quarter economic growth was driven by an increase in government spending, which rose at a 4.2 percent annual rate. Consumption spending, on the other hand, rose at a more tepid 1.3 percent pace. Continued bad news in the housing and stock markets could turn consumer spending into this economy's Achilles heel.

In the sub-prime market, the bad news keeps coming. Bear Stearns admitted in June that two of its large hedge funds were failing due to sub-prime investments, fueling speculation of more bad news to come.

The result has been a general increase in risk aversion among investors and a significant, though certainly not panicked, flight to the safety of government bonds. This is helping tighten credit conditions in the U.S. and around the world as lenders raise their standards.

All in all, the sub-prime market has grown into an ugly wart on the face of the economy. Nonetheless, we do not expect it will lead to a U.S. recession. Overall, the global economy remains strong and provides a good underpinning for the U.S. economy and its markets.

On July 25th, the International Monetary Fund (IMF) revised upward its forecast for global growth in 2007 to 5.2%, with projections for China, Germany, India and Russia having increased substantially. And the good news about all of the shake-ups and volatility is that they create opportunities as well as perils. Green Investment Management will be combing through those opportunities and developing tactics to benefit our clients.

Stock Market Outlook: Some hiccups, but still strong

On July 19 the Dow Jones posted an all time high, just breaking the 14,000 mark, as shown in Figure 1. Having obtained such lofty heights, investors apparently didn't like the view. In the following days the Dow shed 600 points. The negative factors discussed in the economic outlook above, particularly problems in the sub-prime market, contributed to the fall.

In terms of earnings, expectations are positive. Standard and Poor's forecasts a rise of 7.8% in 2007 over 2006 earnings levels (vs. a rise of 14.7% in 2006 over 2005). For 2008, S&P currently forecasts a 12.6% rise over 2007. The problem is that these estimates may not reflect the most recent news from the sub-prime market.

Poor earnings reports from mortgage lenders and homebuilders precipitated by slumping housing sales (see Figure 2) have also led to anxiety about a possible credit crunch. According to John Mauldin, President of Millenium Wave Advisors, LLC, "Over 40 leveraged buy-out (LBO) deals (i.e., corporate acquisitions) have been pulled in the last two weeks. The biggest investment banks are having to eat the paper on the Chrysler and Boots LBOs, as they cannot find buyers for the paper. In essence, they committed to lend the money and planned to sell the bonds into the market, keeping fat fees and commissions. Now they have to put the loans onto their books."

Fewer LBO's will translate into less demand for stocks in the coming months. In addition, there is an unwinding going on in the yen carry trade – the global phenomenon of investors borrowing yen at low Japanese short-term rates and using the money to invest in high return holdings in other parts of the world. Many of these activities involve sub-prime mortgage markets. The declining value of these investments and a rising yen are depressing returns to the yen carry strategy, and many funds employing this strategy are swooning as the trades are unwound. Topping everything off is the fact that we are entering August, a notoriously down month for the market.

In response to these issues, Green Investment Management, Inc. is altering the composition of our Guardian Allocations and, to a lesser extent, our Opportunity Allocations to reflect a more conservative stance in the near term. However we do not anticipate the development of a true credit crunch or a recession. We believe stocks will regain their footing before the end of the year and resume the upward trend we have seen since October 2002. In the intermediate term we strongly favor stocks over bonds.

More specifically, we are now seeing the pendulum swing toward large cap stocks, which have begun outperforming small caps after years of underperformance. We expect this trend to continue, as large caps tend to benefit more from factors such as strong global economic growth and a decrease in investors' risk appetites.

The pendulum is also swinging from value to growth stocks, and we expect this to continue as U.S. economic growth moderates, causing investors to seek out above market returns in growth opportunities.

Bonds, Interest Rates and Inflation: A little now, more later?

U.S. growth is expected to be modest for the remainder of the year. This should work to moderate any upward pressure on interest rates and inflation in the near-term. Unless something unexpected occurs, no rate adjustments from the Fed are expected through 2007. Ten-year Treasury rates are likely to remain between 4.5% and 5.5% through the remainder of the year.

Some inflationary pressures may result from continued strong global demand and tight capacity in the upcoming year. Looking farther ahead, we could see China's deflationary impact on world prices moderate in the coming years as it faces growth constraints and higher input prices. This could lead to inflationary pressures that the Fed may have to deal with in the years ahead.

Our Current Taxable Fixed-Income Strategy: A double-edged sword

A general lack of risk aversion combined with the use of leverage and financial engineering has helped to keep credit spreads tight and volatility low. As the markets continue adjusting to a more risk averse stance, we should see increasing opportunities to profit from our fixed income strategy.

Yields on lower grade corporate bonds have been rising in recent weeks. This is good news as our current stance in the bond market was designed to minimize the impact of the price declines that are now happening. The resulting lower prices and higher yields are making the corporate bond market more attractive, and we plan to increase our exposure to take advantage of the potential for higher income and capital gains. Improving credit spreads will also offer a favorable sign for equity markets. Our tactics should allow us to take advantage of the situation in both markets as it unfolds.

International Markets and the U.S. Dollar: A case of decreasing returns

A still large federal budget deficit and a large (but shrinking) current account deficit have contributed to a weak U.S. dollar. Relatively slower U.S. economic growth and less favorable interest rate differentials will likely mean more weakening in the near term. This provides continued incentive to invest in foreign equity markets.

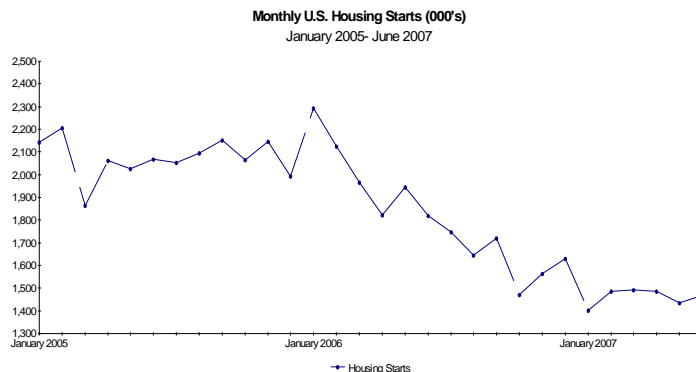
However, the returns to this strategy have been decreasing as out-performance in many foreign markets has eroded valuation differentials vis-à-vis U.S. stocks. Nonetheless, we believe that many opportunities for returns remain, and international holdings provide important diversification benefits, so we will continue to pursue opportunities in foreign markets, though with the expectation of less outsized gains than in recent years.

Real Estate: Still waiting for a bargain

In view of the housing slump (Figure 2), it is no surprise that Real Estate

Investment Trusts (REITs), despite their commercial focus, have not been performing well of late.

Figure 2. U.S. Housing starts (source: U.S. Department of Commerce – Census Bureau)



The good news is that at current prices, domestic equity REITs are trading at a 10 percent discount to their estimated underlying values. Since 1993 the average condition has been prices at an almost 5 percent premium to underlying real estate values.

However, we do not plan to make a run for the bargain basement until yield premiums also indicate that the time is right. We like to see yield premiums of at least 1 percent over 10 year treasuries. Currently REIT yields are at a .6 percent *disadvantage* to treasuries.

Our recent exposure to real estate, beyond that present in the broader basket of stocks represented in our portfolios, has been primarily in the non-U.S. market. We will continue monitoring both the foreign and domestic real estate markets closely in the months ahead for profit opportunities. But regardless of short-term cyclical movements, real estate provides an unparalleled long-term diversification tool in stock and bond portfolios. We particularly like the geographic diversification benefits of foreign real estate holdings, especially in the present environment of a weak U.S. dollar.

The Bottom Line

Anyone who has had a cold can relate to how the economy and financial markets are doing right now. The sub-prime mess is like an infection. Unless it develops into something worse, it will not be enough to take the economy down, but while it lasts it can cause quite a bit of discomfort. The malaise of the sub-prime infection has spread into other parts of the economy, but the economy's fundamentals remain strong enough that it should be able to fight off the effects with a little time.

In the meantime, we can minimize the effects on our own well being by making sure our portfolios are properly "inoculated" against the virus. In addition to this, the market disruptions caused by the sub-prime problems can create unique opportunities to realize above average returns, which we will pursue on behalf of our clients and their financial goals. As always, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. If you have any questions or concerns, please don't hesitate to give us a call. 🐾

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