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Volume 16, Issue 4

November 12, 2007

## Market Commentary

A Review of the Markets and a Look into the Future

### Uncertainties Create Opportunities

*The further backward you can look, the farther forward you are likely to see.*  
- Winston Churchill

#### Economic Outlook: The Fed Steps Up

The U.S. economy continues to offer up a mixed bag of both positive and negative data to confuse the markets. Nonetheless, Fed Chairman Ben Bernanke proved that he is serious about taking a stand against the threat to the macro-economy posed by the ongoing sub-prime credit fallout. At an October 31 meeting the Federal Open Market Committee (FOMC) lowered the fed funds rate, despite unexpectedly strong third quarter GDP growth of 3.9%. This is good news for investors. It shows that Dr. Bernanke is not overly stingy with rate cuts in response to financial market problems, even in the face of robust GDP numbers.

Nonetheless, the Fed made it clear that the preemptive phase of rate cuts was over, and that more cuts would require clear signs of a weaker economy. Since then we have seen a favorable October jobs report, an unexpected rise in factory orders and strong third quarter productivity gains. Despite these positive signs, Bernanke gave somewhat downbeat testimony to the Joint Economic Committee of Congress on November 8, noting that the Fed expects economic growth to "slow noticeably" in the fourth quarter as a result of the credit slump, remaining sluggish until well into 2008. Recent negative data that has reinforced this view includes falling consumer confidence, historically high oil prices and a historically low dollar. Bernanke made it clear, however, that the Fed is expecting slower growth, not a recession.

Assuming that the slowdown happens, it will likely be a matter of the sub-prime credit problem impacting aggregate demand through consumer spending. That the sub-prime fallout continues is indisputable. Bank of America, Citibank, JP Morgan and Wachovia are among the banks that continue to announce financial problems and write-downs. The CEO of Merrill Lynch and Citigroup have both resigned as a result of the debacle.

According to Dr. Bernanke, "Delinquencies on these (sub-prime) mortgages are likely to rise further in coming quarters as a sizable number of recent-vintage sub prime loans experience their first interest-rate resets." He also voiced concern about costlier energy and an eroding dollar, which have helped push consumer confidence down to its lowest level since the aftermath of Hurricane Katrina.

All of this points to a future weakening in consumer spending, which accounts for two thirds of total demand in the economy and which has been the chief driver of economic growth in recent years.

As a result of all of this, many economists have lowered their forecast for fourth quarter economic growth to around 1.5%. In some respects, this outlook for weaker growth with rising commodity prices brings to mind the "stagflation" of the 1970's, when the U.S. faced a combination of high inflation and shrinking output that confounded economic theory. During this time the stock market went nowhere.

While such memories are disquieting, it is important to understand that the world has changed significantly since the 1970's. Central banks are much more aware of

how to deal with inflation. Inflation is also less of a threat due to Americans having vast access to low cost imported goods from growing economies such as India and China. The growth in economies such as these, in fact, is a large driver of world commodity prices. This has led some to say that the situation of the 1970's has been reversed. Instead of supply-side changes in oil prices driving the world economy (as was the case then), the world economy is now driving oil prices on the demand side. There is much truth in this, although there is still reason to be concerned about potential supply-side impacts on oil prices if political problems in the Middle East worsen.

The continued weakness in the U.S. dollar is another cause for concern. Since early last year the trade-weighted dollar has declined in value by about 15%. This factor adds complexity to any decisions the FOMC may want to make regarding lowering interest rates to support the economy. Lower interest rates would reinforce the dollar's weakness, leading to higher import prices and possibly higher inflation. However, a significantly weaker dollar is not in the best interest of most other countries, especially those who send their products to the U.S. At some point, leading governments would likely coordinate efforts to stem the dollar's decline if necessary.

#### Stock Market: Still Uncertain, but Light in the Distance

What does all of the economic uncertainty mean for the stock market? By predicting slower growth, but no recession, and hinting at a more neutral stance going forward from its recent rate cut, the Fed has set a definite expectation in the markets. If economic data surprises on the downside, the markets may perceive that the Fed has underestimated the current risks and acted too slowly. So stocks may be very sensitive to economic data in the coming weeks.

For this reason, we anticipate continuing volatility for the stock market in the fourth quarter. We anticipate downward pressure in financial and mortgage related sectors as write-downs continue and home prices fall further. Existing home inventories are at a 10.5 month supply level, with 3.4 months being normal. Together these make for a ratio that is at a twenty-year high. We are emphasizing reduced exposure through the end of the year.

On the plus side, the Fed has displayed its readiness to provide liquidity support to the stock and credit markets as recently as November 4<sup>th</sup>, when it injected \$41 billion into the banking system following Citibank's announcement of huge write-downs to their sub-prime debt exposure. There is also more clarity to the entire sub-prime situation than was the case in August. With the banking group down more than 20% from its 52 week high, we may see some bargains beginning to appear in the not-too-distant future.

Regarding the broader market, as of this writing most indices are struggling just below their 200 day moving averages - a potential sign that the short-to-intermediate trend of the market may be changing. The coming days should paint a clearer picture. Continued low interest rates and an FOMC that stays responsive to future market seizures that may occur is key to the underlying support of the market.

As opposed to the August sell-off, the current market weakness is not reflected nearly as much in risky assets, such as emerging market equities, cyclical equities and high-yield debt. This is a good sign that the market is not anticipating broad cyclical weakness. Additionally, money supply growth, as measured by money zero maturity (MZM), is up 12% year-over-year, which should provide ample liquidity to the market.

Ten-year Treasury bond yields have declined from 5.3% in mid-June to 4.2% today, reflecting a trend seen in many industrialized countries. If these long bond yields decline further or even just hold, it could be a positive sign for both domestic and international stocks.

Seasonality is also working in favor of stocks. There is a tendency for equities to experience higher returns around the turn of the year. According to the Stock Trader's Almanac, November commonly ushers in the best performing six months of the year for the stock market. Another positive sign is found in current valuation levels. The S&P 500 is selling for just 14.5 times next year's earnings forecasts and 16.3 times the last 12 months earnings. These multiples are attractive considering the low interest rate environment we are in.

In conclusion, while there are still problems in the stock market, due largely to the sub-prime fallout, in such times of crisis are the best opportunities eventually found.

### Bonds: A Flight to Quality

Investor worries about the state of credit markets and the overall economy has increased demand for low-risk U.S. government bonds. A third quarter auction of \$5 billion in new 30-year treasuries exceeded expectations, finding strength from both foreign and domestic bidders.

Bonds in general could be strong price performers in the near term if interest rates and yields continue to decline as part of a slower growth scenario. High grade bonds look especially valuable in this scenario, as uncertainty can create a flight-to-quality effect.

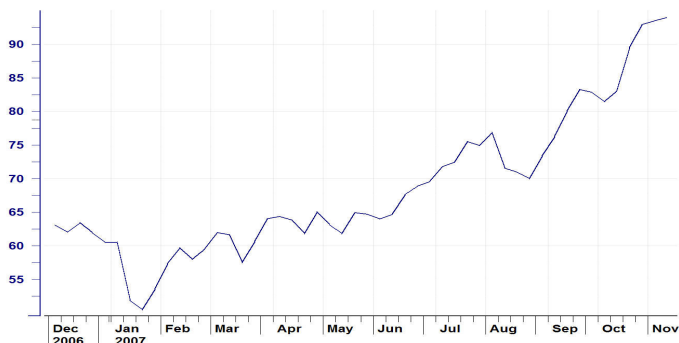
This picture bears watching especially closely, not only for the opportunities bonds present as a safe harbor in which to wait out economic uncertainty, but because the lower yields will eventually reach a point where they provide support to drive stock market gains.

### Commodities: Perception vs. Reality

A recent run-up in the oil market has driven crude prices into record territory near \$100 per barrel (see Figure 1). There are reasons to believe this run-up may now be running on fumes and could beat a retreat if tensions in the Middle East were to lessen. While some of the run-up has come from global demand growth, some has also come not from supply and demand realities but from speculation regarding possible supply disruptions if the situation between Iran and the U.S. deteriorates further.

To the degree that actual economic growth has been responsible, a forecasted slowdown in U.S. growth in the fourth quarter may also take the edge off of recent gains. A declining dollar has also played a role in the oil run-up, and a stabilizing dollar is another scenario under which oil will lose upward momentum. Finally, Saudi Arabia has stated that OPEC will discuss a supply increase at the November 16-17 meeting as a response to the high current price levels.

Figure 1. Spot crude oil prices

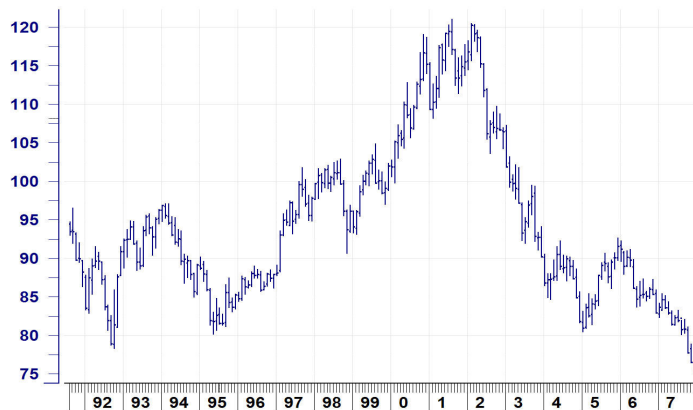


The wider commodities markets paint a similar picture. While there have been strong price gains recently, they appear to be losing some momentum.

### The Dollar: A Bottom in Sight?

The rapidly falling value of the dollar (see Figure 2) reflects an anticipation of further U.S. economic weakness as well as lower U.S. interest rates relative to its trading partners.

Figure 2. The U.S. Dollar Index (USDIX)



The decline has brought both good news and bad news to the American economy. On the good side, the dollar's decline has helped shrink the trade deficit to its lowest level in almost two and a half years. On the bad side, imports have become more expensive to Americans.

One of the most disturbing factors of the decline is that no one is quite sure where the bottom may be. Talk of multi-lateral intervention to reverse the trend has begun, though such a move is still considered unlikely at this stage of the game. Still, the possibility of intervention can itself act as a market assurance that a solid bottom does exist. In the meantime, the best hedge against the trend is a portfolio that holds a diversified selection of commodities.

### The Bottom Line

Watching the economy and markets in recent weeks has been like seeing a Polaroid picture coming into focus. While uncertainty is certainly still with us, a general view of the impact of the sub-prime credit crunch and the extent of its fall-out is developing. Slowing economic growth and market volatility through the end of the year appear likely, with the bond markets offering opportunities for safe harbor to a well constructed portfolio.

Avoidance of a full-blown recession and a 2008 resumption of stock market growth appear likely, given recent Federal Reserve actions and statements. Nonetheless, as is always the case with the economy and markets, no one's crystal ball is crystal-clear, and we will be watching the situation closely in order to respond quickly to any changes in outlook. 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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