Institutional Investment Research, LLC

## Newsletter Beginning Q4 2007, October 1, 2007

**Prepared by Daniel R. Shore, Chief Research Analyst, Publisher, and CEO**

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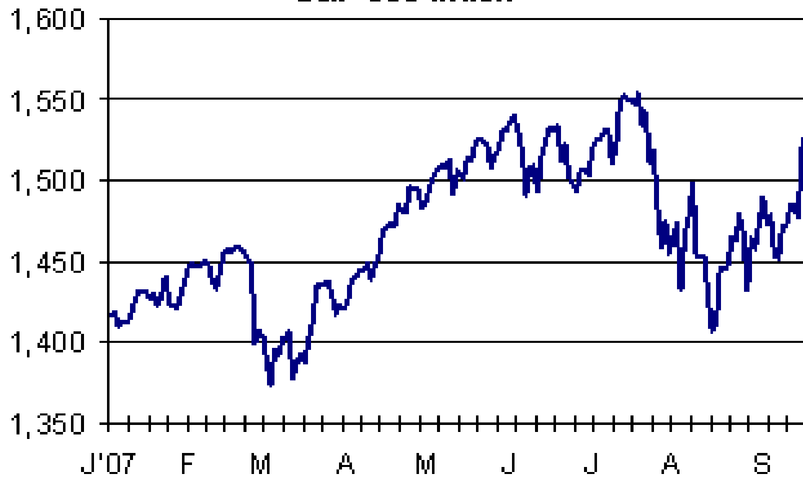
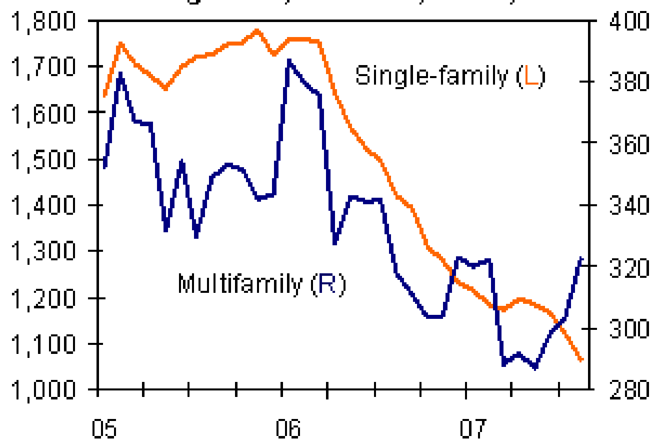
**Introduction and Contents:**

The third quarter of 2007 was certainly a roller coaster ride for global markets. As we have been predicting since January, the re-pricing of risk in the credit markets finally arrived with a vengeance. After a strong first half of the year, global markets began selling off in late July and early August as a number of hedge funds, mortgage companies, and banks announced stunning losses associated with sub-prime and alt-a mortgage portfolios. As the residential real estate market in the US continues to weaken, mortgage defaults and foreclosures are hitting record highs. This in turn is creating a re-assessment and re-pricing of risk in the mortgage and asset backed securities debt markets. This mortgage related turmoil has also created major liquidity problems in the commercial paper and leveraged buyout debt markets as investors in high yield corporate debt also started re-pricing risk. As we have predicted in each of our prior newsletters, the re-pricing of risk in the global credit markets has significantly increased the yield spread between treasuries and high yield debt. This yield spread increase sent a shock wave through the global financial system because the increase in yield spread caused the value of high yield debt to decrease significantly. This sudden drop in debt value caused a number of mortgage firms and hedge funds to go bankrupt and even precipitated an old fashioned run on a bank in the UK. To contain the credit crisis, central banks around the world injected funds into the banking system and on September 18th the US Federal Reserve cut its Fed Funds Rate by one half percent to add more liquidity. Before this Fed rate cut, the S&P500 lost approximately 8% of its value and global markets lost approximately 10%. Since the rate cut, the US and global markets have regained back most of their losses to close just above where they were at the end of June. However, our research leads us to believe that there is still more trouble ahead. We believe there is a 40% chance of a recession in the US economy within the next 12 months. Banks and mortgage companies are yet to reveal the full extent of their problems and the housing market is still trying to find a bottom. Sub-prime mortgage interest rate resets will actually peak sometime in mid-2008. When these mortgage rates reset it will trigger an increase in defaults and foreclosures. Falling housing prices and an oversupply of inventory will make it very difficult for homeowners in default to sell their homes. Furthermore, homeowners are no longer able to extract as much equity out of their homes through mortgage equity loans and lines of credit. This mortgage equity withdrawal was a major driver of increased consumer spending during the housing boom.




Source: Moody's Economy.com.




Source: Moody's Economy.com.

Because of the elevated risk of recession and lower corporate earnings in the US economy, we will make some adjustments in our portfolios to take a more defensive posture going into the 4th quarter. Fortunately, year to date through this market turmoil our Model Portfolios have performed well and are still beating their respective benchmarks with less volatility. Our Conservative, Moderate, and Aggressive Model Portfolios are up 7.63%, 9.03%, and 10.24% respectively year to date. The diversification in all of our portfolios has allowed them to outperform the S&P500 through this market turmoil with considerably less risk and volatility.

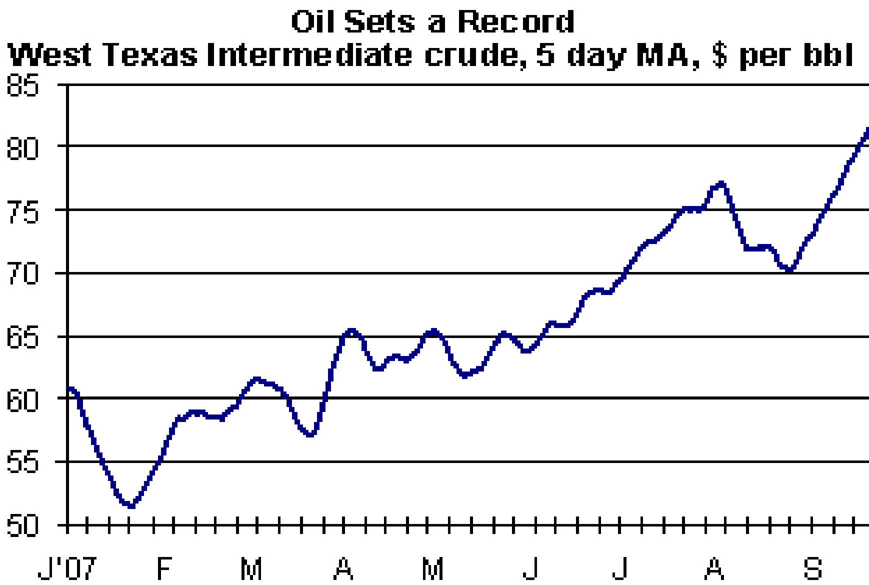
## Global Economic Overview and Outlook:

Prior to the recent credit crisis the OECD (Organization for Economic Co-operation and Development) was forecasting GDP growth in the US to be 2.1% for calendar 2007 and 2.5% for 2008. The OECD is now in the process of revising downward these Real GDP growth forecasts to 1.9% for calendar 2007 and 2.1 % for 2008. As mentioned earlier, the risk of recession in the US is now much higher. Moody's Economy.com forecasts the risk of recession to be 40% and a recent statement by former Fed Chairman Alan Greenspan puts the odds at 50%. So far central banks around the world have injected liquidity into the financial system quickly to stabilize the crisis. We believe that the crisis is far from over and therefore more rate cuts and central bank action will be required. Up until the credit/mortgage crisis hit, US stock market valuations did not look to be overvalued. However, now that the credit market has seized up and the yield curve has become steeper, these valuations could look much worse if corporate earnings fall due to weaker than expected economic activity and higher borrowing costs. We continue to tilt our portfolio stock weightings toward international stock sectors because of this potential US economic weakness. Going forward we will also be reducing our exposure to the US market by exiting our allocations to small and mid-cap US stocks. If we do fall into recession, large companies will tend to weather the storm better than small and mid-sized firms. One indicator we like to look at is the outlook that shipping firms like FedEx offer with their earnings guidance. FedEx recently issued a statement that they see deteriorating economic activity in the US economy and expect this weakness to continue into next year. Because of this information and many other leading indicators we are watching, we believe the next year or so will be a time for caution. As we stated in the last newsletter, we still believe that growth in the Eurozone, Asian, and Latin American geographies will keep the overall global economy expanding at a rate close to 3%. We are revising up our 2007 forecast for international economies to the following: Euro zone growth 2.8%, Asia 4.4%, and Latin America 5.4% in real GDP terms. Even after impressive appreciation so far year to date, many of these international markets are still selling at attractive valuations. The Eurozone's economy is still growing faster than the US economy, yet Eurozone stock markets still have P/E ratios and price to cash flow ratios that are less than those of the S&P 500. In the Asia Pacific region we continue to favor the MSCI Australian stock index and Asia except for Japan. Japan is still growing slower than the rest of the world and has an overvalued stock market P/E of 25. While China's economy is reported by its government to be growing at a blistering 11% pace, we still believe the Chinese stock market is in a bubble and may not sustain its incredible boom much longer. The Chinese market is up over 100% so far in 2007 with an aggregate P/E of over 45. While some may think we are missing an opportunity in China, we can't recommend an allocation to China when its valuation is so high. Stock market speculation in China and other emerging markets is driving this emerging market bubble to its inevitable conclusion. We want to be out of the Chinese and Emerging Market bubble before the bubble bursts. Our Asian portfolio allocations have very little Chinese Market exposure at this time.

## Oil:

As we have predicted all year, crude oil continues to price well north of $60 closing at $81.66 per barrel at the end of Q3. Iran continues to thumb its nose at the international community and forge ahead with its nuclear ambitions. Also, the war in Iraq continues to descend into sectarian civil war. Therefore, we continue to believe that the risks are tilted toward prices being higher and staying above $60 per barrel during 2007. Our allocation to natural resources in our portfolios has

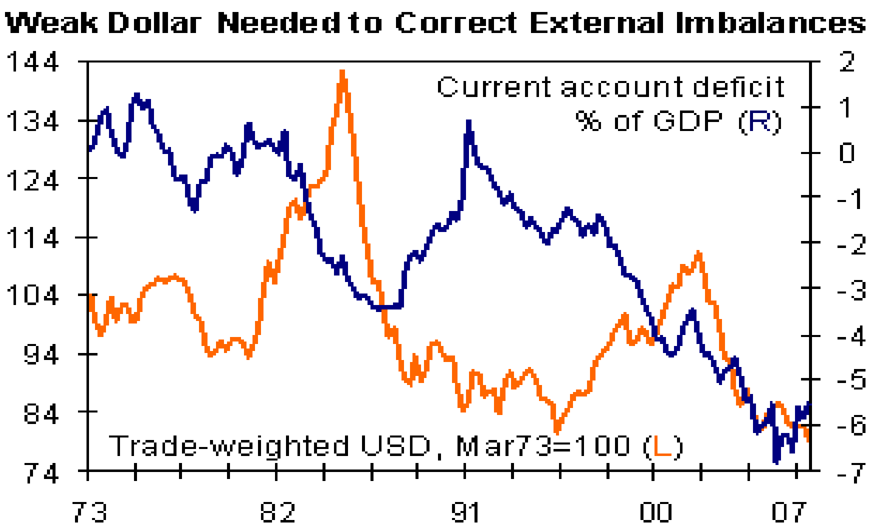
benefited nicely from high oil and energy prices. Another factor supporting the high price of oil and other commodities is the continuing decline of the US dollar relative to other currencies.




Source: Moody's Economy.com.

**US Dollar in Decline:**

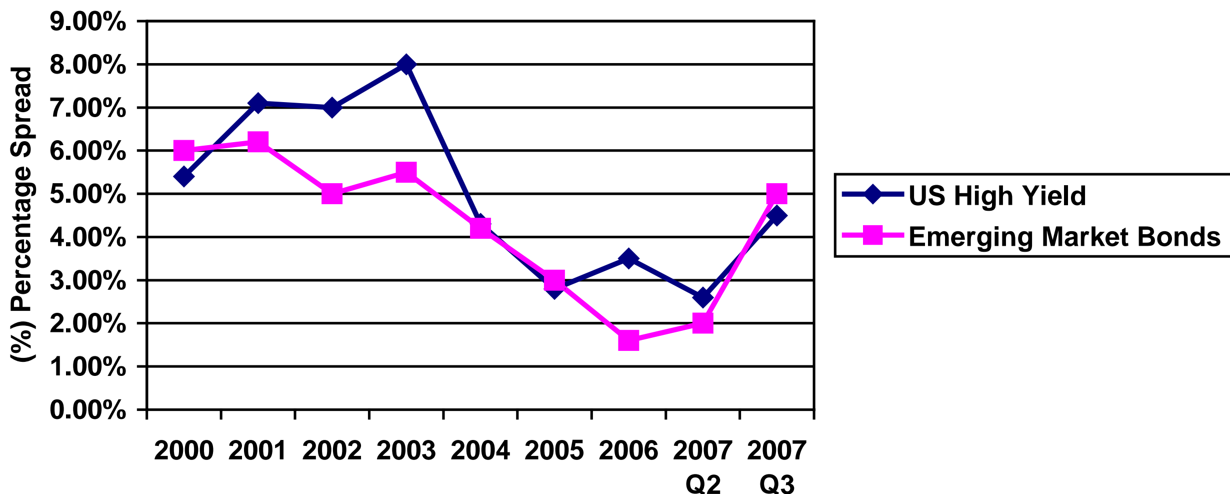
As discussed in our previous newsletters, the US Dollar continues to lose its value relative to other currencies with the US Dollar Index losing 7.17% year to date as reported in the Wall Street Journal. Dollar weakness and global demand for commodities is causing price increases in most commodity sectors. So far year to date, gold is up 16.9% after being up just 4% at the end of the first quarter. Rate cuts by the US Federal Reserve, like the most recent half point cut on September 18th, will most likely cause the dollar to weaken further as it decreases the yield advantage of the dollar relative to foreign yields.



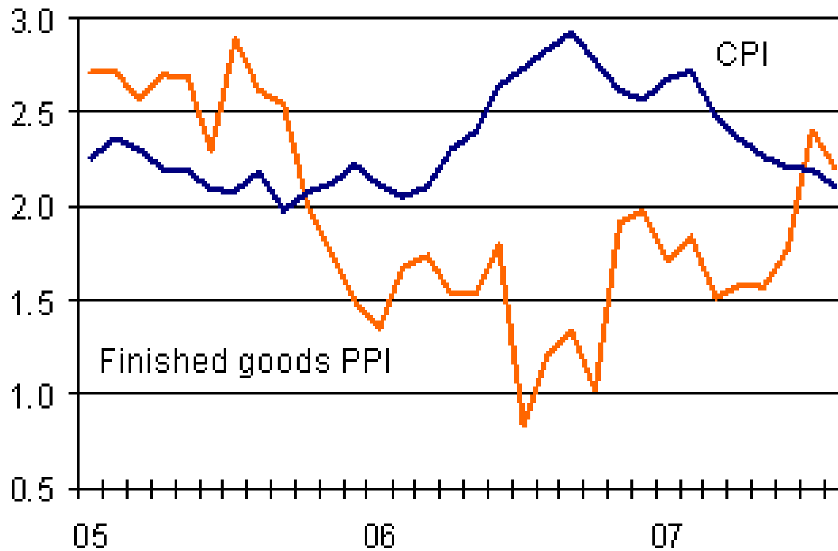

Source: Moody's Economy.com.

**Global Credit Crunch and Inflation Outlook:**

The global credit bubble that we have been talking about has finally turned into the global credit crunch. As we discussed in the Q2 newsletter, the lowest interest rates in a generation, liquidity created by derivatives, deficit spending worldwide, poor mortgage and corporate lending standards, along with a global housing boom caused a bubble in credit and debt issuance. This bubble is now officially deflating as debt markets re-price risk and the financial sector starts dealing with credit defaults and foreclosures. Credit spreads are finally starting to widen back to more historical levels as credit risk gets priced more accurately. The chart below shows the yield spread between high yield debt and US treasuries.




Regarding consumer price (cpi) inflation, our research position has not changed significantly since the last newsletter. We still believe global GDP growth will be close to 3.2% in 2008. Global money supply growth is leveling off and we have inflation in the world's major economies comfortably below 3%: US= 2.2%, Eurozone= 1.9%, Australia 2.5%, Canada 2%, UK=2.5%, Japan=0%. Therefore inflation should stay calm unless we see an unexpected spike in global GDP growth. Many economists are discussing the possible inflationary effects of the central bank actions and the US Federal Reserve's recent rate cut. As discussed earlier, these central bank actions were taken to stabilize the global credit markets in the wake of the recent credit market turmoil. While we do believe that more rate cuts are coming and these cuts do have the potential to cause increased inflation, it is more likely that rate cut induced inflation will be offset by deflating housing prices and credit valuations. Our benign consumer price inflation forecast is not at odds with our investment allocation to commodities because the price increases in commodities are driven more by dollar devaluation as opposed to consumer price inflation.



Source: Moody's Economy.com.

**The Alphareturns Model Portfolios:**

The table below details the current portfolio allocations in the Alphareturns portfolios. We will briefly touch on the rationale behind the various asset class choices:

**Metals and Mining Stocks:** While we still like gold as an investment commodity, we want to diversify into more commodity coverage including steel, aluminum, enriched uranium, copper, titanium, and other metals. The stocks of companies engaged in mining these metals are selling at attractive valuations that give investors a potentially higher return. We believe the declining US dollar and global GDP growth in the 3% range will continue to favor companies involved in mining precious and industrial metals. To participate in this sector we are recommending the SPDR exchange traded fund (symbol XME) which tracks the S&P Metals and Mining index. Additionally, this quarter we are recommending an allocation to the specific gold mining ETF symbol GDX. As we decrease our allocations to the small and mid-cap sectors of the US stock market we will move a portion of this money into the GDX gold miners ETF as a hedge against further US stock market weakness and/or volatility.

**US Value Stocks:** Even though one of our key investment principles is the historical performance benefit of owning small/mid cap stocks vs large caps, at this time large cap value stocks are more attractive than small-cap and mid-cap value. This is a rather rare situation in the market and it may persist for another year or so. Therefore, we are temporarily departing from one of our key investment principles regarding the benefit of small and mid cap stock investing until these sectors become fairly valued and safe again. The Vanguard Large Cap Value (symbol VTV) ETF is our only allocation at this time to the US market. We are reducing our VTV allocation and moving a portion of this to the EPP Asia Pacific ex-Japan ETF to further increase our international exposure.

**Foreign Value Stocks:** International Value stocks still look attractive from a valuation standpoint. These foreign value stocks will also gain from the falling dollar trend. European, Australian, and Asian ex-Japan (excluding Japan) stock markets look especially attractive due to lower price to earnings ratios and higher yields than US stocks. Europe, Asia, and Australia are also enjoying stronger GDP growth than the US this year. Their strong growth is forecasted to continue through 2008. We are invested in this sector with four exchange traded funds: Ishares MSCI EAFE Value Index (symbol EFV), Ishares S&P Europe 350 Index (symbol IEV), Ishares MSCI Australia Index (symbol EWA), and Ishares MSCI Pacific ex-Japan (symbol EPP).

**Foreign Small Cap Stocks:** With the overheated stock market situation in many of the emerging markets, we are making an overvalued call on emerging market stocks and avoiding emerging markets. Valuations now look attractive for foreign small/mid cap dividend paying stocks in developed markets. Our allocation in this sector is fulfilled with the Wisdom Tree Investments (symbol DLS) foreign small cap dividend exchange traded fund.

**Fixed Income:** As forecasted in our previous newsletters, the credit crunch and re-pricing of risk in the credit markets is resulting in a steeper yield curve. Therefore we are still recommending all of our fixed income to be allocated in Short Term 1 to 3 Year Duration US Treasuries. We forecast short-term rates to fall as US GDP growth slows in 2007. The I-shares 1 to 3 year Treasury Bond exchange traded fund (symbol SHY) is our allocation vehicle for fixed income at this time. If your brokerage firm has a money market account yielding close to 5%, you may want to put your fixed income allocation into a money market account instead of the SHY exchange traded fund.

**Natural Resources:** We are standing firm on our allocation to the natural resources sector because we believe the falling US dollar, reasonable global GDP growth, and energy supply issues will continue to favor companies involved in the natural resource sector. Energy companies involved in oil, refining, and natural gas are especially attractive. To achieve a broad diversification in this sector we are recommending an allocation to the Ishares S&P GSSI Natural Resources Index exchange traded fund (symbol IGE).

**Alphareturns Model Portfolio Allocations For Q4 Calendar 2007:**

| Symbol | Asset Class | Conservative Risk<br>1-3 year horizon | Moderate Risk<br>4-7 year horizon | Aggressive Risk<br>7+ year horizon |
|---|---|---|---|---|
| **XME** | **Metals and Mining Stock ETF** | 5% | 4% | 3% |
| **VTV** | **US Large Value Stock ETF** | 10% | 15% | 20% |
| **GDX** | **Gold Mining Stock ETF** | 3% | 7% | 9% |
| **EFV** | **International Value Stock ETF** | 12% | 17% | 22% |
| **EPP** | **Asia Pacific ex-Japan Stock ETF** | 4% | 8% | 9% |
| **DLS** | **Wisdom Tree Int'l Small Cap Dividend Stock ETF** | 3% | 5% | 7% |
| **IEV** | **European Stock ETF** | 5% | 6% | 7% |
| **EWA** | **Australian Stock ETF** | 3% | 4% | 5% |
| **IGE** | **GCSI Natural Resources ETF** | 5% | 4% | 3% |
| **SHY** | **1 to 3 year US Treasury ETF** | 50% | 30% | 15% |

## Q3 2007 Performance Discussion:

During the third quarter of 2007 our model portfolios slightly under performed their benchmarks (see table below). During Q307, our Conservative Portfolio returned 1.50% vs its benchmark of 1.78%, our Moderate Portfolio gained 1.42% vs its benchmark of 1.64%, and the Aggressive Portfolio gained 1.28% vs a benchmark gain of 1.53%. After the September 18th Fed rate cut, the S&P500 staged a remarkable rally. As discussed earlier we believe international markets are poised to rally as well and eclipse the gains in US markets. Our heavy allocation to international stocks impeded our performance a bit last quarter but we believe we will be rewarded for this allocation going forward.

Year to date, our portfolios are still outperforming their respective benchmarks by a wide margin. The Conservative Model Portfolio has returned 7.63% YTD vs its benchmark of 5.71%, the Moderate Model Portfolio has returned 9.03% YTD vs its benchmark of 6.88%, and the Aggressive Model Portfolio has returned 10.24% YTD vs its benchmark of 7.76% (see performance table below for details). So far year to date, our portfolios are averaging approximately one half the volatility of the S&P500 when calculated on a quarterly standard deviation basis.

| Model Portfolios → | Conservative Risk (1 to 3 year horizon) | Moderate Risk (4 to 7 year horizon) | Aggressive Risk (7+ year horizon) |
|---|---|---|---|
| Q1 2007 | 2.47% | 2.80% | 3.07% |
| Q2 2007 | 3.49% | 4.57% | 5.60% |
| Q3 2007 | 1.50% | 1.42% | 1.28% |
| YTD 2007 **ending 9/28/07** | 7.63% | 9.03% | 10.24% |
| Benchmarks → | 50% Stock S&P500, 50% Bonds L.A.B.* | 70% Stock S&P500, 30% Bonds L.A.B.* | 85% Stock S&P500, 15% Bonds L.A.B.* |
| Q1 2007 | 1.01% | 0.87% | 0.77% |
| Q2 2007 | 2.83% | 4.25% | 5.32% |
| Q3 2007 | 1.78% | 1.64% | 1.53% |
| YTD 2007 **ending 9/28/07** | 5.71% | 6.88% | 7.76% |

*Note: Bond portion of the benchmark is based upon the Lehman Aggregate Bond Index L.A.B.

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