MARKET LETTER
FOURTH QUARTER 2007

Hurricane Hunters BY DEAN DORDEVIC

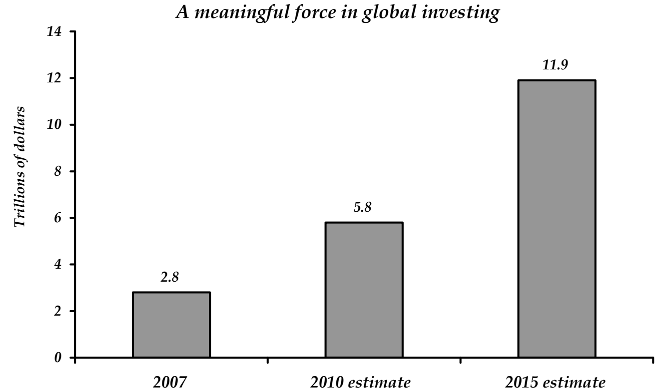
Several months ago, we were asked to characterize the current market environment as it relates to the subprime swirl around us. We offered up a metaphor that has since served as an eerily accurate forecast. We compared the current period to one of those *hurricane hunter* – weather channel TV episodes – whereby those large lumbering aircraft (with very brave folks aboard) routinely fly through the worst of these storms.

The leading edge (market in mid-July) was the worst and most violent. The "eye" was calm, almost peaceful, and usually sunny (market in early fall). Flying through the trailing edge (our current position) while not quite as bad as the initial leading edge experience, is quite harrowing to say the least. We think we're flying through the last of it right now. When we fully exit is anyone's guess, but hopefully more of this subprime mess is behind us than in front of us.

Anyone who has read a newspaper or watched CNBC is well aware of the negatives. To wit: bank stocks have had their biggest decline since the 1990 recession. Consumer confidence is falling, and the Homebuilders Index is at or near a record low. More than 75 percent of Americans say the U.S. economy is getting worse.

With all this bad news, it is somewhat surprising that the broad averages are trading within *10 percent of an all-time high*. We believe that there are several reasons why there is a reasonably firm underlying "bid" for stocks. With bankers on the run, and credit conditions tightening, (to be sure) the U.S. economy is feeling the effects. While this is true in the "real economy," there is another side to the liquidity story that should not be ignored nor underestimated.

Sovereign Wealth Funds
A meaningful force in global investing



Source: Morgan Stanley Research

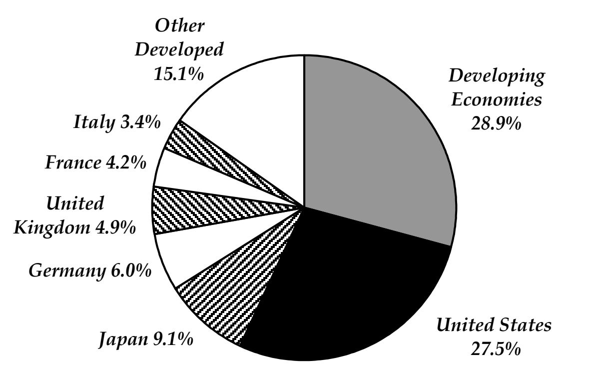
Hedge funds, private equity, sovereign wealth funds ($4 trillion and counting), corporate liquidity, and global money supply growth ... all remain very robust. Despite the extreme volatility of late, investors have not withdrawn from these funds. In fact, these large pools of liquidity have actually expanded. Anecdotal evidence of the cashflow phenomenon occurred late last year when the big box retailer Target Corporation reported quite disappointing quarterly earnings. While this was hardly a surprise, what was indeed a surprise was their announcement that they would repurchase 20 percent of their shares in the open market. Amazing.

The newest and most intriguing pool of global money is oil related. At current per barrel quotes, OPEC nations will earn nearly $700 billion this year. This translates into roughly $5 billion worth of petrodollars to invest *every week*. Citigroup was the most recent beneficiary of this largesse, with the Abu Dhabi Investment Authority becoming one of the largest investors in their company with a $7.5 billion investment. While investors from the Gulf States have historically favored U.S. Treasury debt as investments, the boom in oil prices has encouraged oil producers to set up so-called "sovereign wealth funds." "The oil producing countries simply cannot absorb the amount of wealth they are generating," said J. Robinson West, chairman of PFC Energy. In addition, the explosion in petrodollars has enhanced global liquidity at a time when the foreign currency reserves of export driven economies in Asia are also flush with cash.[1]

In our opinion, the anchor under the global stock market is twofold: (1) the global growth story and (2) abundant liquidity. While the U.S. economy is slowing in large part from the impact of imploding residential real estate (subtracting 1 percent from GDP), the boom in exports (a 1 percent addition to GDP) has *completely offset* the lagged impact of this recession in real estate. In addition, for quite possibly the first time, the U.S. economy is *benefiting from a not insignificant tailwind of global growth and rising prosperity* (principally in the developing world). In fact, in previous cycles, the developing world's economic growth would have *already turned vicious*. In other words, when the U.S. economy softened, in most previous cycles, capital was repatriated and emerging markets virtually collapsed. This has not happened this time. In fact, emerging market economies are (for the most part) self-financing their growth, quite possibly for the first time ever. Bottom line, the developing world collapse that normally accompanies a U.S. slowdown (or recession) doesn't appear to be happening.

While we're quite sure the rest of the world is also slowing, global growth is slowing from rates of growth that are high enough that generalized recession will likely be avoided. At present, there are 120 countries whose growth rates are in excess of 4 percent. Additionally, when taken in the aggregate, emerging market economies have recently *surpassed the U.S. in terms of their share of the global GDP pie*.

The Mix of World GDP 2006



Source: ISI Group

We believe that the equity market will remain very volatile. We also believe that while U.S. GDP growth will slow, a generalized recession will be avoided. Strategically, we have deemphasized those sectors where the fallout from economic weakness is greatest (the consumer, finance, banking), and we have moved capital into those sectors that are the primary beneficiaries of global growth (energy, materials, industrials).

Another way to think about our stance is this: What the developing world *imports they inflate*. What the developing world *exports they deflate*. Our portfolios are geared to profit from that trade, and we envision maintaining our current stance … for now. However, inevitably there will be opportunity were there is now only pain. Stay tuned!

Source:
1. Steven Weisman, "Oil Producers See the World and Buy it Up," *The New York Times*, November 28, 2007.