

Investors around the world have experienced an up-tick in volatility over the past five months. A large number of culprits have been responsible for this weakness. These include slower US and global growth, sub-prime losses continuing to mount, credit markets freezing up, institutional forced selling, fraudulent trading, and the collapse of Bear Sterns.

Since the market peak in October of 2007, we have witnessed a downturn much larger than most first expected. The S&P 500, a market benchmark that tracks the performance of 500 of the largest US companies, fell some 17 % from its peak to trough. The losses were not contained to the US markets. The MSCI world index, a stock market index consisting of securities in 23 countries, saw a decrease of over 16 %. After reaching an intraday low on Jan 22nd the market rallied back, only to falter and test the previous lows almost a month later. Previous rally attempts have failed as well. Encouragingly, the market has so far held its most recent low and has rallied.

There are several reasons the recent rally has held. The most notable reason has been the encouraging actions by the Fed and Government to address some of the problems plaguing the market. You may note, in our first quarter market update, we were concerned the Fed had fallen behind the curve, and suggested they should begin aggressively cutting rates. During the first quarter, the Fed cut rates by 200 basis points.

In addition, there have been numerous liquidity boosting actions implemented by the Fed and other major central banks. The Fed intervention in the Bear Sterns bailout and its taking in of mortgage-backed securities, have also been key to the recent rally. These actions demonstrated that the Fed is not willing to let the major banks fail. Since then we have seen more banks raising capital, which has been very encouraging. While we still maintain caution, it is beginning to feel as if the worst of the credit crunch might be behind us.

“Is this the Bottom?”

This has been the dominate question. We have witnessed some positives of late, but there continues to be many issues of concern. The debate between bulls and bears rages on and both sides can site plenty of evidence to support their cases. Those that are optimistic on the market believe the problems are cyclical in nature and the larger economic backdrop remains supportive. We tend to side more with this optimistic outlook. While we remain cautious about the credit crisis, we maintain this shakeout of share prices is similar and comparable to the saving and loan crisis of the early 1990s.

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Let us take a closer look at the similarities and differences between the two. Both the S&L crisis and the recent credit crunch were caused by deflation in real estate values. In the 1990s it was commercial real estate values that were decreasing. Currently, we see the deflation in residential markets.

In 1991, bad debt in the banking system approximated \$125 billion, or 3% of GDP; presently sub-prime related bad loans are estimated at approximately \$400-450 billion, or 2.5% of GDP. Both crises were rooted in devaluation of real estate, and the total damage is also comparable.

However, not every situation is exactly alike, and this time is no different. In 1990, the downturn in real estate was a global problem, and most of the world was in a real estate meltdown. Japan, Asia, and Europe all saw major crashes in property prices. Today we do not see a global real estate downturn as most of the deflation is limited to the US.

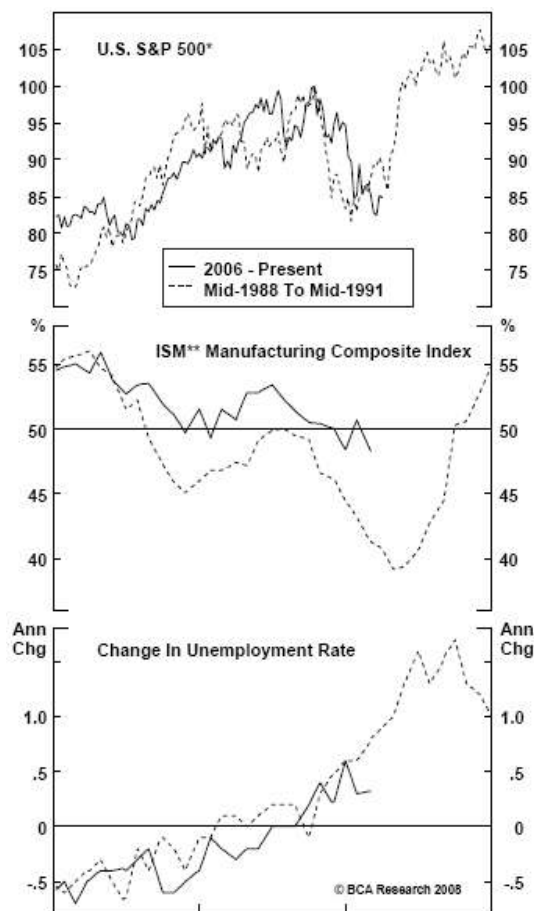
Furthermore, at the time of the S&L crisis, inflation was more of an issue with a core rate of approximately 6% in the US. At present, we have inflation rates at historic lows which allow the Fed to pump liquidity into the financial systems.

Currently, global growth in general is very strong with emerging markets, in particular, continuing to boom. In the early 1990s the backdrop of global growth was very different. Japan was in debt deflation and Europe remained in chaos as a result of the German reunification. China was dealing with the aftermath of the Tiananmen Square incident and its economy was facing hyper inflation.

This cites only some of the differences and similarities between the two crises. We examine these to get a sense of where we may be in the current crisis and how it is likely to evolve. If we are right in our assumption that this crisis is comparable to the S&L debacle, we would expect both the US economy and financial markets to make similar adjustments.

The chart to the right highlights the adjustment paths for both scenarios, which illustrates that they have followed the same peak to trough declines in terms of time and magnitude. Based on this comparison, it is possible that the equity market has already seen the worst.

During the S&L crisis, the S&P 500 began its rally in October of 1990, five months before the economy reached its recessionary lows as measured by unemployment and manufacturing activity. If history is a guide, the US economy will likely remain weak in the coming months, reflecting the deflationary impact of the housing decline and the credit crunch. However, this should not prevent a sustainable rally in stocks.



* Series rebased to 100 at the peak.
** Institute for Supply Management.

While comparing characteristics of the S&L and the Credit Crisis appears to support a rally in stocks, there are additional signs that suggest we may have reached a bottom. Since the post-war period, we have witnessed unprecedented policy reflation. Since falling behind the curve at the onslaught of this credit crunch, the Fed has cut rates by 3% in the span of seven months, and they are likely not done.

Many other central banks in the world have also increased their roles by actively injecting liquidity into the system. Moreover, the US government reduced excess capital requirements for Fannie Mae and Freddie Mac, the biggest buyers of American home mortgage, which is predicted to lead to an infusion of \$200-\$300 billion of liquidity into the mortgage market. These are just a few examples of stimuli that have been created whose impact will last for months to come.

As a result of this stimulation we are seeing a liquidity boom developing across the world. This excess liquidity has to go somewhere and history shows that it usually precedes the first phase of a new bull market in stocks and a rebound in economic activity. These developments manifest that monetary and fiscal policy are having an impact on the world economy and financial markets. While we understand that many risks remain, the probability of a sustained meltdown is decreasing.

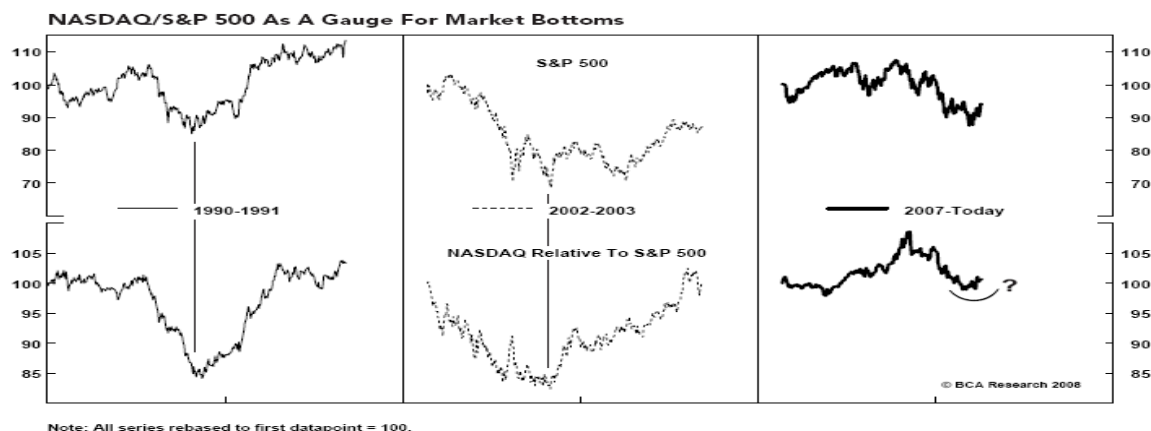
Presently we believe that we are still in the bottoming process but that we have more than likely seen the worst of the credit crisis. This call of a market bottoming is not without risk, and we still face many. There is always great uncertainty, accompanied by many erratic moves, preceding a turning point in stocks.

In addition to the positives on the monetary and fiscal front, there are additional signs that a bottom may be forming. One of these is the relationship between the S&P 500 and the NASDAQ. The chart at the top of the next page, shows that historically, the end of a bear market is concurrent with the NASDAQ outperforming the S&P 500 as NASDAQ stocks tend to be more sensitive to fluctuations in the business cycle than companies in the S&P 500. Another present indicator is the ratio of bullish to bearish advisors, last seen at this extreme in 2002. Furthermore, corporate insiders have stopped selling stocks. In sum these developments support our view that the cyclical bear market is in its latter stages.

Going forward, we are maintaining a cautiously optimistic approach. Our portfolios largest holdings remain in cash, due to continued risks and volatility, but we are on the lookout for buying opportunities. Investing is about taking calculated risks, and the big question going forward is whether the risk/reward profile has improved enough for investors to take on more of a growth stance. We believe there is more risk to the upside than the downside at this point.



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Fixed Income

The credit crunch brought about a large flight to quality, as investors left credit sensitive sectors of the bond market, along with equities, and moved into US Treasuries as a safe harbor. This has led to US Treasuries being highly overvalued with yields at historic lows. But there are areas in fixed income we see as being undervalued.

The first of these is the municipal bond market. Because interest on muni-bonds is tax free, they typically yield less than comparable treasuries. But over the past few months they actually have higher yields than treasuries across the yield curve. Longer term yields are usually around 92% of long term treasuries, but that ratio has increased to over 120%. This is more than a 4 standard deviation move, which is truly historic. We are overweighting the highly rated muni-bonds and continue to look for buys to add to our fixed income portfolios.

Muni-bonds are not the only area of the bond market that is showing good value. Investment grade corporate bonds are also at historically attractive levels. At the end of March corporate bond spreads were over 300 basis points above Treasuries. While they have come down slightly, they remain much higher than average. Corporate bonds historically average about 125 basis points above Treasuries, these current levels are over 4 standard deviations from this average. While we remain cautious for the near term due to expectations of slower growth, we are seeing value in the highly rated, shorter maturity corporate bonds.

In summary, while the past quarter was extremely volatile, we remind investors to maintain an intermediate to long term perspective. You should not be deterred from focusing on your goals by short term market events, particularly as many signs are indicating we might have reached a bottom.

We sincerely thank you for your continued patronage and support!

With kindest regards,

The Regatta Research Team

Disclosure

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