

Understanding Recent Market Turbulence

By Claire Fletcher

It seems hard to believe that just three months ago, most people had never heard of “sub-prime”, let alone knew what it was. Yet the failure of thousands of low-income Americans to meet the interest payments on their sub-prime mortgages has precipitated one of the biggest crises in financial markets in recent history.

In retrospect, the crisis was inevitable. American families on low incomes were lent money way beyond their means with interest payments that were ratcheted up after the initial “teaser” rate expired.

Sub-prime lending is inherently risky for both lenders and borrowers due to the combination of high interest rates, poor credit history, and murky financial situations often associated with sub-prime applicants.

In the minds of the firms making these loans, all loans are good loans. Their primary goal is to squeeze as many applicants through the system as possible. Once that is done, they package the loans into securities and sell them to traders, who treat the mortgage packages as any other sort of tradable commodity.

Beginning in late 2006, the U.S. sub-prime mortgage industry entered what many observers have begun to refer to as a meltdown. Rising interest rates increased newly-popular variable rate mortgage payments and property values suffered steep declines leaving home owners unable to meet financial commitments and lenders without a means to recuperate losses.

A steep rise in the rate of sub-prime mortgage foreclosures has caused more than two dozen sub-prime mortgage lenders to fail or file for bankruptcy, most prominently New Century Financial Corporation, previously the nation's second biggest sub-prime lender. The failure of these companies has caused stock prices in the \$6.5 trillion mortgage bundled securities market to collapse.

Making matters worse, the packages of debt had been sold on to hundreds of other investors, largely deregulated foreign and domestic hedge funds, who got stuck with the bad loans. Many of those funds, most famously two run by Bear Stearns, went bust as a result of the crisis.

Though nearly all the sub-prime securities out there are in the United States, U.S. mortgages are generally perceived to be among the most rock-solid of investments, so some invariably trickle out to the wider world. Banks worldwide began admitting sizable sub-prime exposure and freezing funds which solidified fears that risk was spreading.

The mass withdrawal of capital from everything from hedge funds to traditional stocks left the system with little cash on hand, hampering the M&A activity and private equity deals that have propelled stock prices worldwide in the past year. Unlike previous stock falls that saw investors moving money from a perceived weak asset to a perceived stronger one, this rout saw them pull their money out and then simply sit on it.

To prevent a wider contagion, central banks the world over stepped in and flooded their respective banking systems with extra cash to ensure banks would be cash-flush enough to maintain normal operations. It marks the first time the American, European, and Japanese central banks have taken such actions together since the aftermath of the September 11, 2001 terrorist attacks.

But the reaction has been surprising. Rather than the markets being calmer, investors have become even more spooked, fearing that the banks have yet to come clean on what the problems

are. To be honest, no one is quite sure who's lost what and this uncertainty is what is causing the volatility to continue.

As we have done during past periods of market turbulence, we want to remind investors to focus on fundamentals and not headlines. Two-thirds of the companies in the Standard & Poor's 500 Stock Index have reported second-quarter earnings that are reasonably above expectations. Earnings are running about 8 percent higher than last year.

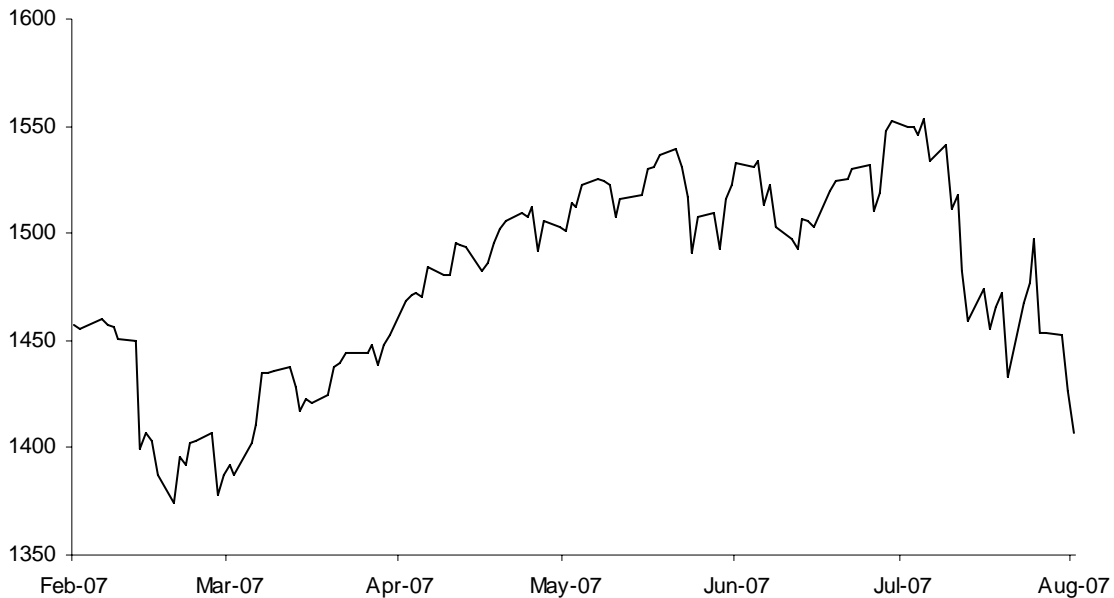
Outside the United States, the gains are even greater. Economies around the world are growing. World trade is spurring global domestic product growth and the major economies of Germany, Japan, and China are accelerating.

Against the background of favourable global economic developments, global financial markets have experienced a sustained rally. The U.S. stock market has been rising steadily over the past several years, with the Dow Jones Industrial Average and the Standard & Poor's 500 Index reaching record highs.

Investors need to remember that periodic corrections are completely normal and in fact healthy for the markets. You should also know that it will happen again, we just don't know when – this is the nature of stock markets. It is this fluctuation that creates risk that allows us patient investors the opportunity to earn superior returns over bonds.

While these sell-offs are indeed painful and can undermine investor confidence, they need to be put into perspective. For example, Figure 1 demonstrates the substantial volatility seen in the stock market over the past six months, with sharp moves in both directions.

Fig 1. S&P 500 Index: Trailing 6 Months as of 15/08/07



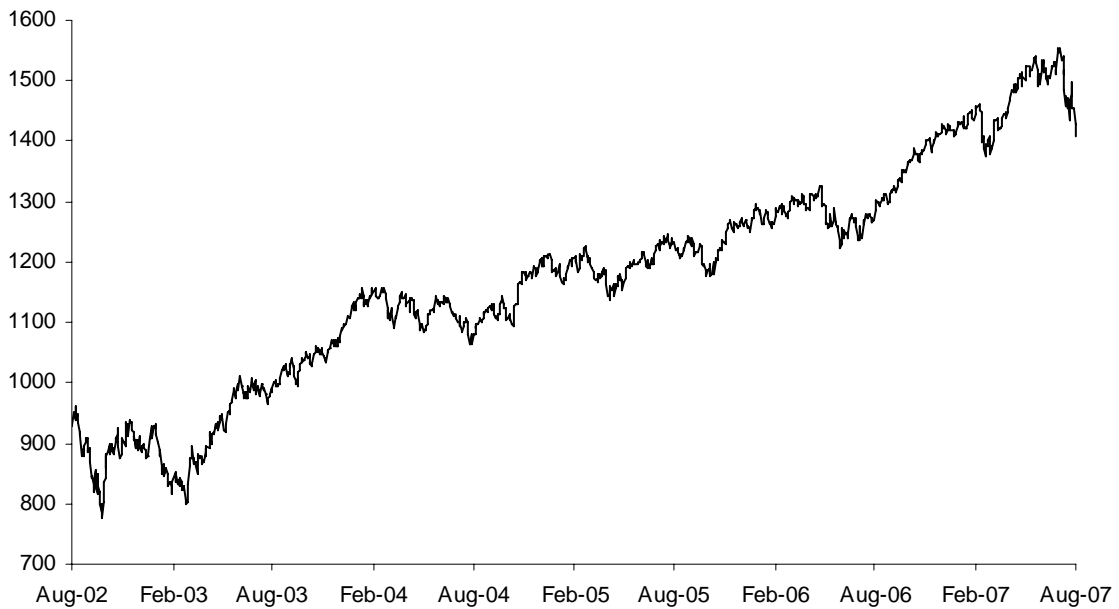
However, this market volatility is much less noticeable when taking a longer point of view, as seen in the S&P 500 Index three-year trailing chart (Figure 2).

Fig 2. S&P 500 Index: Trailing 3 Years as of 15/08/07



From an even longer term vantage point, investors who are able to ride out the short-term market fluctuations have been rewarded with positive stock market returns over the past five years (Figure 3).

Fig 3. S&P 500 Index: Trailing 5 Years as of 15/08/07



The recent fluctuation is normal and to be expected, even welcomed. While we do not necessarily see an extended market downturn at this point, short-term pullbacks that help rein in investor

exuberance and reduce investor complacency can be viewed as a positive from a longer-term point of view.

Volatile times like these are also a good opportunity for investors to check their emotional state. If the stock market's recent ups and downs are keeping you awake at night, it could be a sign that you're uncomfortable with the amount of risk you're taking with your investments.

It is likely that the current crisis in U.S. sub-prime mortgages has further to run. The recent weakness in share markets may yet continue, but this is likely to be just another correction in a still rising trend. When the dust settles we think markets will take solace in corporate fundamentals, which remain very healthy.

While greater market volatility might be with us for a while, we do not advise relying on short-term expectations to structure an investment portfolio. In our view, successful investors begin with the assumption that neither market movements nor the fate of the economy can be accurately predicted with any consistency.

The recent volatility serves to underscore the unpredictability of the markets and reinforces WISE's belief that investors may most effectively pursue their financial goals by maintaining a long-term focus with a diversified portfolio.

This is not the time to panic and drastically alter your allocations or investments. Don't let anyone (including your advisor!) make you second-guess your decision to diversify your portfolio by investing overseas. The purpose of a diversified portfolio is to ride out these types of storms over the long-term; you may take a temporary hit but if you are properly diversified then you still do well in the long-term.

For those of you who may be tempted to ignore everything you've been told and try to time the market, remember that the future is impossible to predict. Warren Buffet once remarked that he couldn't time the market, didn't know anyone who could time the market, and didn't know anyone who knew anyone who could time the market. If the greatest investor of all time can't do it, what makes you think that you can?

My advice is to not panic, simply go on with your daily life and don't waste time worrying about the day to day gyrations of the stock market. It will work itself out in the long run and those who don't panic will emerge the winners.

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