

H.M. Payson & Co.

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RESEARCH NOTES

FEAR ITSELF

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It may strain credibility to suggest that 300 point declines are nothing to worry about. But after close observation and thoughtful consideration over the past fortnight, we are compelled to offer a rational response to the media's hysterical treatment of recent events. *Perspectives* readers will recognize that the current turmoil in the credit markets is a logical outcome of the mispricing of risk premiums that has existed for some time now, although we could not predict exactly how the adjustment would manifest itself. The good news is that our clients have little direct exposure to the losses in the mortgage markets – and in fact may benefit as indiscriminate selling creates opportunities for level-headed investors.

Easy monetary policy, intended to ward off a recession in the aftermath of the “tech wreck,” essentially transferred the equity bubble to the housing market. Artificially low interest rates, combined with the securitization of the mortgage market (the packaging and sale of loans to investors) led to a dangerous relaxation of lending practices. The result is that some people who were not in a position to assume the responsibility of a mortgage in the first place are now defaulting on their loans. The *fear* of widespread defaults has caused turmoil in the markets for the bonds related to these mortgages. In turn, *fears* of the potential economic fallout from tighter lending standards has jolted the stock market.

“Sub-prime” is a relatively small part of the U.S. mortgage market, and actual losses from defaults so far are miniscule in relation to the overall economy. In a recent *New York Times* editorial, economist Ben Stein called for some perspective, citing estimates of \$34 billion in losses, or \$67 billion if things continue to decline and losses double. These figures compare to total estimates of U.S. wealth at \$70 trillion, and a stock market value of \$20 trillion. Recent stock market declines in response to the “crisis” were approximately \$1.1 trillion, or about *30 times* the current losses in the sub-prime market. The media loves to fan the flames when bad news hits the tape, and the current news cycle is no exception.

Investors should keep in mind that – so far - this is a financial market event rather than an economic one. The global economy is undeniably healthy right now. Consumer confidence is strong, unemployment is low, and corporate balance sheets are the

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healthiest in decades. In this quarter's round of earnings releases, fully two thirds of companies in the S&P 500 have beaten expected estimates. Even today, with the housing market correction well underway, the vast majority of economic forecasts call for continued expansion, albeit at a slower pace. There has been significant speculation as to what action the Federal Reserve may take to quell the markets. While we believe market forces should be allowed to work, the consensus is that Chairman Bernanke will do whatever is necessary to avoid a recession.

Our optimistic view notwithstanding, we are cognizant of elevated risks in some sectors of the market, including Financial Services and Consumer Discretionary. For some time now, we have been limiting exposure to banks, whose profitability is pressured by the flat yield curve. Regional banks in particular have relied heavily on the mortgage business as a profit center in recent years, and may now be vulnerable. We have generally avoided the investment banks because of the complexity – and as we have seen, volatility - of their businesses. In Consumer Discretionary we have long avoided the home builders, and have generally favored more defensive issues. Although the valuations on high quality companies such as Home Depot and Harley Davidson appear compelling at this time, we are limiting new commitments to companies that depend on highly discretionary (big ticket) purchases.

In our estimation, the fallout in the credit markets is simply a welcome return to more rational risk premiums. For too long, most sectors of the bond market did not appropriately reflect the risk inherent in the underlying credits. Today, we may actually be seeing an emerging opportunity (particularly in short-to-intermediate investment grade corporate bonds) as spreads widen to compensate investors. As for stocks, our recent focus on larger, high quality issues has served our clients well. We have often alluded to the fact that *prices* fluctuate much more than the long term *value drivers* for stocks (dividends and earnings). We see little risk to these drivers at the moment, and will utilize the current volatility to identify additional opportunities.

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