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ESTABLISHED 1854

RESEARCH NOTES

RISK COMES HOME TO ROOST **FEBRUARY 28, 2007**

Since 2002 we have been in a bull market for riskier assets, and in the market for risk, generally. This rally in the appetite for risk was manifested by record narrow yield spreads on junk bonds, exuberant multiples for small stocks, very low capitalization rates (yields) on commercial real estate and, among other things, a very strong performance by emerging market equity and debt.

As markets do, this bull market in risk went farther than most people thought it would and much farther than we felt was justified by the underlying fundamentals. Indeed, the market in risk reached "bubble" proportions - until yesterday.

Liquidity is what drives markets in the short-term. The world has been awash in capital due to the rapid growth of money supply in this country, which we exported around the world in the form of our large trade and current account deficits. However, we saw the much publicized problems in the sub-prime mortgage market over the last several weeks as the “canary in the coal mine”, a sign that problems might be developing at the fringes of the more speculative markets for credit - and that liquidity might be starting to dry up in markets in which we would not expect to see much liquidity in the first place.

Recent comments by former Federal Reserve chairman Greenspan about the possibility of a recession in the near future, combined with a dodgy durable goods report for January and a sharp sell off in the highly inflated market for Chinese stocks served as catalysts to bring the bull market for risk to a dramatic finale yesterday. However, the bubble may only have begun to deflate. Valuations in many markets may need to adjust significantly to bring relative values back in line to more reasonable levels of return per level of risk.

It's important to note that China's total stock market capitalization is an insignificant percent of the world's total equity capitalization. However, China’s economy, growing four to five times faster than the average developed country, has emerged as a driver of global economic growth - and the fear of a possible slowdown in the region helped fuel the global retreat in equity prices.

Higher quality assets in both the bond and stock markets performed better than riskier assets yesterday. Indeed, the Russell 2000, a proxy for small stocks, suffered its worst percentage decline since late 2002. Today, we have seen a significant follow through in large, high-quality equities which out-performed small stocks again by approximately 1%. This certainly does not constitute a long-term trend, but given the vociferousness of yesterday's selling accompanied by large volume, we believe the turn may have finally arrived.

Yesterday was definitely a wake-up call for investors. We may have been early in quietly reducing the risk in our portfolios over the last several years, but we believe our patience and discipline will once again be rewarded with strong relative performance. The equity and bond markets could see more normal levels of volatility ahead, which could imply a rocky ride for the riskiest, less-liquid asset classes such as real estate, small stocks and emerging market debt and equity.

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