

Dragon Breath

Market Summary

February 2007

Before the 27th, February had the look of a solid, quiet month. The Dow was fresh off record highs and Punxsutawney Phil had predicted an early spring. Suddenly, a rapid sell off of the Chinese equity market started a downturn that rippled through markets around the world. US investors saw

the S&P500 lose 3.5%, the largest one day loss in almost four years. There was plenty of pain to go around, Brazil, Mexico, and Argentina each saw their indexes tumble

over 5%. The rumors of a possible capital gains tax by the Chinese government contributed to the fall its market, and apparently sparked losses in other markets. However, it's hard to believe the decline in the Chinese market, which has arguably been in the midst of a speculative bubble, justifies the decline in other markets.

The well documented problems in the subprime market have been a concern over last few months. For last few years, lending institutions have been fairly liberal in their lending standards. As interest rates have risen and home prices stalled, the apparent wisdom of relaxed standards for interest only mortgages, adjustable rate mortgages and other exotic loan packages has waned. The real fear behind the subprime market is that an increase in defaults would worsen the

reduction in home prices and cause an economy-wide credit crunch.

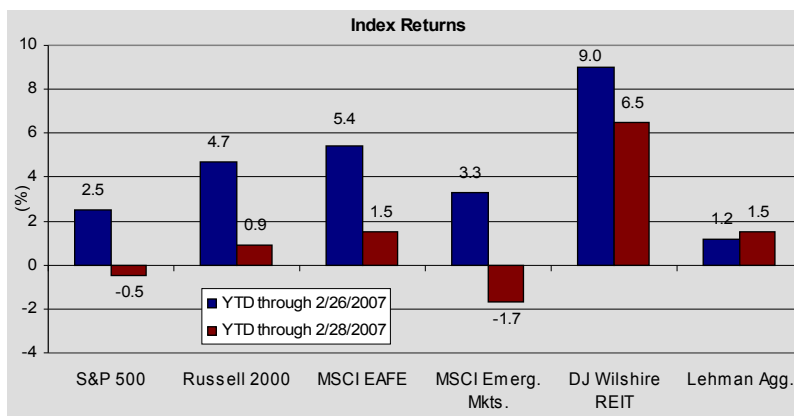
The currency markets may have also had a hand in the fray. Analysts have been saying that the yen carry trade (borrowing yen at low interest rates to invest in riskier assets) was large enough to feed on itself and drag other markets down if it was forced to start unwinding. The yen spiked 2% on the 27th, and was perhaps a sign some of the positions

financed by the carry trade were forced to liquidate their holdings during the downturn.

Other contributors to the downturn included Alan Greenspan's February 26th

comment that a recession may be "possible," (he later clarified his statement, saying that a recession was "not probable,") Bad economic news contributed as well. Durable goods were down 7.8%. We would not have expected any of these weaknesses to have a serious impact alone, but their convergence, sparked by the fall in China, seemed to have resulted in investors suddenly paying attention to risks in the economy and world markets that had apparently been ignored. As we have pointed out in the past, risk premiums on global assets are remarkably thin. A little more fear, regardless of the cause, can have an outsized impact, especially when markets are as frothy and investors as complacent as they are today.

For the month, REITs led the charge in losses. The Dow Jones Wilshire REIT index was down 2.2% for the month. However, the index is still up 6.5% for the year and was the number one performing asset class in 2006.



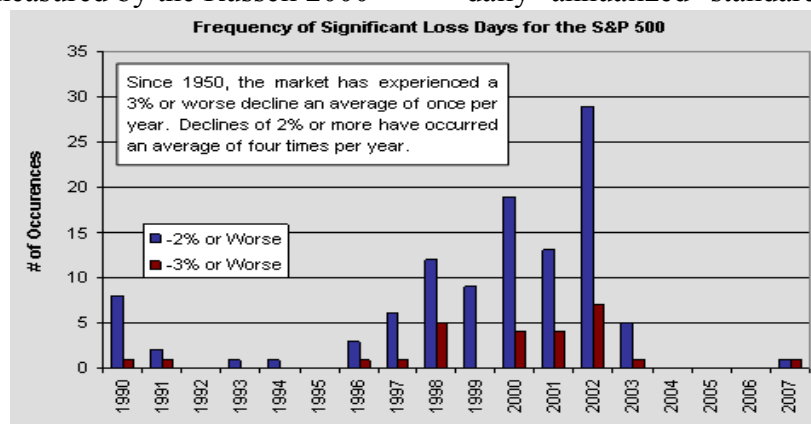
Domestic equity markets were down for the month as well. The S&P 500 index lost 2% for the month and its return for the year slipped to -0.5%. Growth and value stocks experienced mixed results. Large cap value slightly outperformed large cap growth, measured by the Russell 1000 Value index and the Russell 1000 Growth index, with respective returns of -1.6% and -1.9%, while small cap growth fared modestly better than small cap value, measured by the Russell 2000 Value index and the Russell 2000 Growth index, with respective returns of -0.3% and -1.2%. Growth is up over value in both the large and small assets classes year to date, and we are anticipating that it will outperform value stocks over the next few years.

Despite the worldwide nature of the downturn, international equity markets continued to outperform domestic equity markets. International small cap led the way with a 1.4% return for February. Its 2.6% year to date return led both major domestic and international asset classes. The MSCI EAFE was up 0.8%. The MSCI Emerging Markets index was only negative performer of the bunch losing 0.6%. Over each of the last one, three, and five year periods, international equities have handily outperformed their domestic counterparts and likewise rewarded portfolios weighted toward international markets.

Alternative asset returns were up for the month. Helped by a \$4.49 rebound in oil

prices, the DJ-AIG commodity index gained 3.4%. The HFR Fund of Funds index was positive for the fourth consecutive month, gaining 1.0%

Given how low volatility has been recently, the steep decline in equity markets on the 27th caught investors by surprise. The market had made a fairly steady march upward since the second quarter of 2006. Before the 27th, the daily annualized standard deviation of the



S&P 500 was running at 7% over the last three months, less than half the historical average. Remarkably, the loss was the first decline of more than 2% in nearly four

years (950 trading days to be exact). It was the longest stretch in between 2% declines on record. The lack of volatility recently is a stark contrast to the abnormally high volatility experienced early in this decade. In 2002 alone, the S&P 500 declined by 2% or more 29 times and by 3% or more 7 times. It's impossible to say whether the pullback in February was a blip or a sign of things to come. Regardless, investors should be cautious in this world of low risk premiums.

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