

Global Contagion

Market Summary

March 2007

The first quarter of 2007 was a bumpy ride for global markets and one that tugged at investors' emotions. The year began with slow steady growth in the major indices with the S&P 500 returning 1.5%, MSCI EAFE posting 0.7%, and the Lehman Aggregate Bond index flat at the end of January. The end of February caught investors by surprise with nearly all major domestic and international indices losing between 2-4% on February 27th. The choppy waters continued the rest of the quarter fueled with continued media reports adding to investors' fears. Recent volatility has been blamed on everything from a correction in the Chinese market, the unwinding of the yen carry trade (borrowing yen at low interest rates to invest in riskier assets), worries over the fallout in the U.S. subprime mortgage market, concerns over economic growth, or a combination thereof. Regardless of the cause, the lessons learned from the ride in the market were short-lived and seemed to have done little to curb investors' risk appetites. By the end of March, most markets were near or above their February 26th levels. Despite growing uncertainty, investors' risk tolerance does not seem to have waned much. Most major indices finished the first quarter in positive territory, with U.S. equities trailing the pack once again.

Index Returns @ 03/31/07	MTD	YTD	1 Year
Wilshire 5000	1.1	1.4	11.3
S&P 500	1.1	0.6	11.8
Russell 2000	1.1	1.9	5.9
MSCI EAFE	2.5	4.1	20.2
S&P/Citigroup EMI-EPAC	3.9	6.6	23.9
MSCI Emerging Markets	4.0	2.3	20.7
Lehman Aggregate	0.0	1.5	6.6
Dow-Jones Wilshire REIT	-2.6	3.7	21.8
DJ-AIG Commodity Index	1.0	4.6	9.4
GS Natural Resources	3.2	5.2	-9.4

A lesson continually reinforced by market downturns is the interrelatedness of global markets. When risk aversion rises, there are usually few places to hide in global markets. It is apparent, that now more than ever, global economic events have far reaching effects on the

world market players. Today, investors around the globe are required to process and analyze the effects of global economic, political, and even social events and their effects on markets. Global investor sentiment will likely become an increasing driver of volatility. All of this begs the question, "how well is the U.S. positioned globally?" The answer increasingly hinges on the view of how foreign investors perceive the U.S. economy and its markets as opposed to domestic investors' perception on the U.S.

For years now, economists have issued severe warnings about the growing current account deficit and the looming economic effects on the U.S. economy, which will no doubt have global repercussions. To date the warnings have largely been ignored and the growing deficit has had no apparent negative ramifications on U.S. and global markets (with the exception of a sharp decline in the value of the dollar). That said, it is naïve to assume the imbalance can continue to grow without consequences. The magnitude and duration of the impact are unknown. The U.S. current account deficit increased to an estimated record of \$856.7 billion in 2006 or 6.5% of GDP. Looking at the individual components of the current account, it comes as no surprise that the balance of goods is the primary driver of the current deficit which will continue to grow as U.S. consumers continue to look to emerging countries for cheaper goods. The U.S. is a net exporter of services, which is also no surprise as we have moved from an industrial to a service economy. To offset the current account deficit, the US must attract a steady stream of cash from foreign investors. Making matters worse, U.S. investors continue to seek investment opportunities abroad, which must also be offset by foreign inflows. The result was an estimated inflow of \$1.5 trillion of foreign investments in 2006. These inflows essentially fund our consumption and investment. The U.S. must then service the debt to foreign investors. The balance on income shifted to a deficit for the first time ever in 2006 as income payments increased more than receipts. None of this is new news to economists

or investors and like many events over time does not pose a huge threat in and of itself. The U.S. market and economy has usually proven to the rest of the world to be a safe and prosperous investment opportunity and continues to attract foreign capital. However, it is worrisome that inflows are coming increasingly from foreign central banks, rather than profit-motivated investors. One long-term concern is the seemingly inevitable time when emerging

market countries decide to consume and invest their income on foreign trade internally, rather than plow it back into the U.S. This could have a negative impact on the U.S.

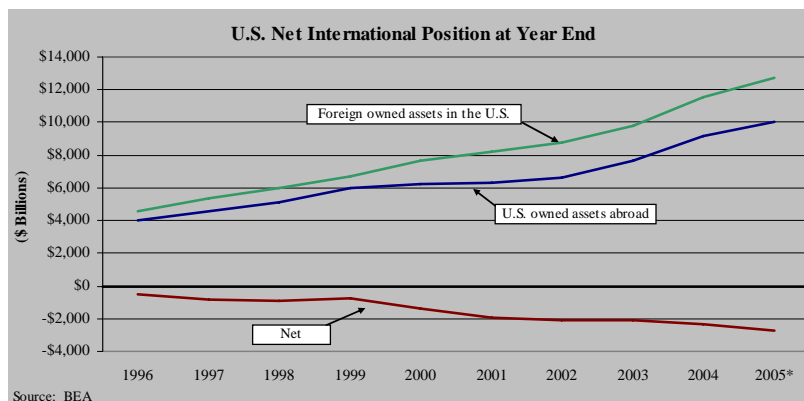
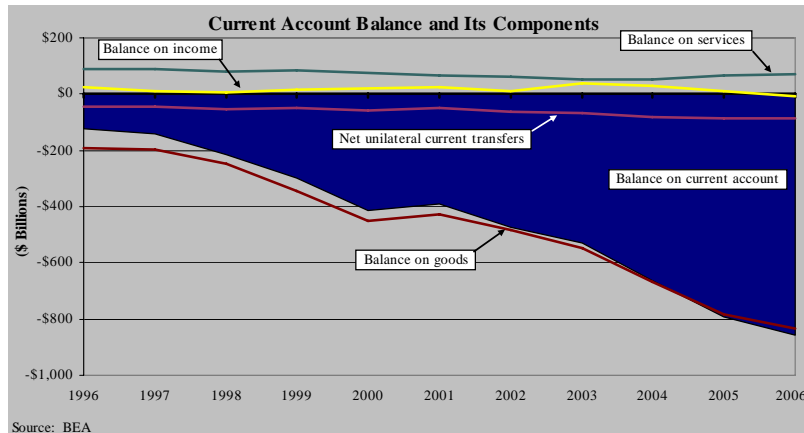
economy by forcing real interest rates upward. China and other foreign governments have hinted recently at diversifying their reserves. A scenario in which unwanted U.S. dollars pile up in foreign hands, combined with a falling dollar value, higher inflation in the U.S., and/or some unforeseen catastrophic event could prove to be the tipping point. Besides the growing current account deficit, other significant domestic economic challenges are knocking at the door including an aging population, rising healthcare costs, and underfunded Social Security and Medicare programs to name a few.

The probable scenario is not a hard landing or even a crash of the U.S. economy but rather a long and slow decline of relative wealth to the point where economic prosperity is shared more

evenly on a global level. It is without question that international trade is crucial for global prosperity and to raise the living standards of the emerging world, but policy makers must be mindful of the imbalances that it has created. The imbalances must be corrected eventually. It

is naïve to assume that because the U.S. current account deficit seems to have had little negative effects thus far, that there is no cause for concern. Doubtful is not the same as an impossibility. After all, the objective of risk management is not to prepare for the normal likely events, but rather to position for the unforeseen infrequent events. Certainly there is no better time to maintain a well diversified

portfolio to include global and real assets (real estate and natural resources) in an attempt to provide protection against a probable continued fall in the U.S. dollar, higher expected inflation, and any consequences from an ever rising deficit.



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