

# Fireworks Spark Markets in July

## Market Summary

July 2007

July was volatile with U.S. markets both breaking records and tumbling during subsequent trading days. On July 19<sup>th</sup>, the

Dow surpassed 14,000 for the first time ever, yet on the 27<sup>th</sup> markets had their worst day since February 27<sup>th</sup> of this year, and the Dow closed down 311 points.

	July	YTD	1 Yr	3 Yrs	5 Yrs
<b>Domestic Equities/Fixed</b>					
S&P 500	(3.1)	3.6	16.1	11.8	11.8
Russell 2000	(6.8)	(0.8)	12.1	13.4	16.0
Russell 1000 Growth	(1.6)	6.5	19.5	10.3	10.2
Russell 1000 Value	(4.6)	1.3	13.5	14.7	14.5
Dow Jones Wilshire REIT	(7.9)	(13.4)	0.6	19.1	18.6
Lehman Aggregate Bond	0.8	1.8	5.6	3.9	4.4
<b>International Equities</b>					
MSCI EAFE	(1.5)	9.1	23.9	23.0	19.9
S&P/Citigroup EMI-EPAC	0.0	12.4	33.1	29.4	26.9
MSCI Emerging Markets	5.3	23.8	50.5	41.5	33.7
<b>Alternative Assets</b>					
GS Natural Resources	0.2	19.6	20.2	29.2	25.6
DJ AIG Commodity	2.1	6.6	1.8	9.8	15.0
HFR Fund of Funds	0.5	8.4	15.2	10.8	9.2

U.S. equities ended the month down, led by small-caps and value stocks. The Russell 2000 and Russell 1000 Value ended July down 6.8% and 4.6%, respectively. Large-caps fared better in the July heat as did Growth equities, ending the month -3.1% and -1.6%, respectively. REITs have continued to lose value since February 2007 and year to date are 13.4% lower.

Global stocks weathered the downturn better than their U.S. counterparts, with the MSCI EAFE ending the month down 1.5%. Emerging markets were the best performers in July, earning a positive 5.3%. Emerging market stocks are also the best performer for the YTD, and trailing 1, 3, and 5 year periods.

Returns for alternative assets have been positive for July and superior to domestic stock returns. The DJ-AIG Commodity index returned 2.1%, and the HFR Fund of Fund index returned 0.5% due in part to higher oil prices.

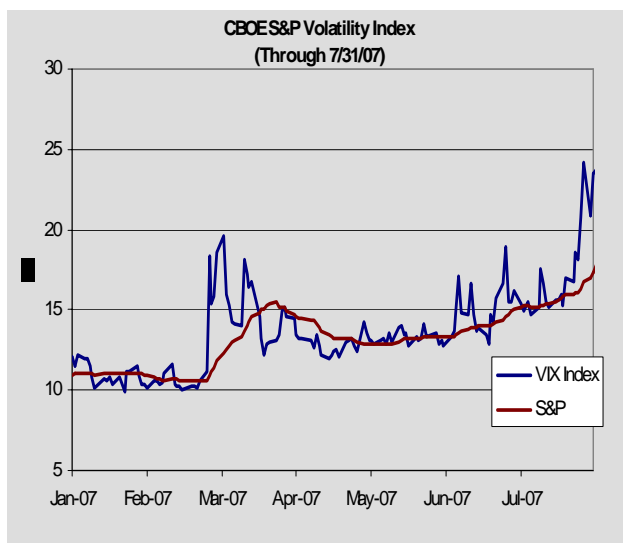
Three large contributors to the tumultuous month were the meltdown in the subprime mortgage market, increased market uncertainty (as measured by the VIX Index) and the widening of credit spreads on corporate bonds and loans.

The subprime mortgage sector continued to crumble during the month of July. The rise in delinquencies and defaults forced dozens of subprime lenders out of business. At the end of the month, American Home Mortgage Investment Corporation, the nation's 10<sup>th</sup> largest mortgage lender, became entwined in the subprime turmoil and had to reduce its payroll by more than 400 employees.

American Home specializes in prime and near-prime loans, but has made loans that allow borrowers to produce little documentation of income or assets. Organized as a REIT, American Home recently held a 2.5% share of the U.S. mortgage market. On July 27<sup>th</sup>, American stated it would not pay a promised \$0.70 dividend because the money may be required to fund operations. Moreover, it had already been receiving and paying "very significant" margin calls in prior weeks and was unable to borrow on its credit facilities and fund its lending operations. American Home's stock price fell 39% in premarket trading from \$10.47 at close on July 27<sup>th</sup> to \$6.39 on July 30<sup>th</sup>. In August, the company shut its doors, and its stock traded at less than a \$1. The American Home situation illustrates that the subprime meltdown affects not just small mortgage lenders, but big players as well.

With the subprime frenzy in full swing adding fuel to the fire, it is no surprise that volatility abounded in the market. U.S. stocks broke records, reaching just above 14,000 during the month, while also incurring one of the largest losses in five years. The VIX Index, often referred to as the "fear gauge," rose to a four year high of 24.17 on July 27<sup>th</sup> indicating that the next 30 days are expected to be action packed.

When the VIX index rises, it indicates a higher degree of uncertainty in the markets. The index average since 1990 is 19. Historically the index has come within 2 points of reaching 50 three times in the past ten years. On October 8, 1998, when Russia defaulted on its debt and losses spread globally, after September 11, 2001, and after the collapse of Enron Corporation in July of 2002. Although we are certainly nowhere near the realm of those events now, it is important to be cognizant of the higher temperature readings on the VIX Index.



Widening credit spreads were arguably the leading cause of the market's retreat. The option-adjusted credit spread on the Lehman High Yield index spiked from 2.92% to 4.13%. Private equity deals accounted for 39% of the announced mergers and acquisitions so far this year, according to data from Thomson Financial. With the sharp rise in the cost of debt, buyout firms will struggle to justify the high valuation multiples they were willing to pay for public companies. Even at higher spreads, financing will be harder to come by. Several banks are stuck with LBO debt that they have been unable to sell to investors, which will make them less willing to take such exposure in the future. During July, Bill Gross, manager of PIMCO's \$103.1 billion Total Return Bond Fund, commented that fewer leveraged buyouts along

with the subprime crisis could knock 5% to 10% off the stock market.

On another front, debt funded stock repurchases will also be slowing if the cost of borrowing rises too much. Roughly \$320 billion of share buybacks have been announced so far this year, close to last year's total of \$365 billion. However, there is evidence this momentum is dwindling. In July, Expedia Inc. stopped a planned buyback because it could not borrow enough at acceptable terms. Furthermore, Moody's downgraded Home Depot because of the debt it incurred to assist in paying for a \$22.5 billion buyback.

The sharp increase in the VIX index suggests that we're in for much higher market volatility over the near term. What remains to be seen is whether this is a brief periods of turbulence, similar to May/June 2006 and in the sell-off in late February / early March this year. The sharp rise in credit spreads makes this period more worrisome. Cheap credit has been a significant driver of the market over the last few years, and its removal suggests more downside risk.



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