

Markets Warm Up In August

Market Summary

August 2007

According to the Stock Trader's Almanac, harvesting crops made August the best performing month for the stock market from

1901 to 1951. Now that less than 2% of our economy is involved with farming, August has become the worst month for the S&P 500 in the last 18 years. Based on recent history, this month's 1.5% gain in the S&P 500 should be cheered by investors.

	August	YTD	1 Yr	3 Yrs	5 Yrs
Domestic Equities/Fixed					
S&P 500	1.5	5.2	15.1	12.2	12.0
Russell 2000	2.3	1.4	11.4	14.5	16.6
Russell 1000 Growth	1.6	8.2	17.7	11.0	10.5
Russell 1000 Value	1.1	2.5	12.9	14.6	14.5
Dow Jones Wilshire REIT	5.9	(8.2)	1.9	17.9	20.0
Lehman Aggregate Bond	1.2	3.1	5.3	3.7	4.3
International Equities					
MSCI EAFE	(1.6)	7.4	18.7	22.2	19.5
S&P/Citigroup EMI-EPAC	(3.6)	8.3	24.1	27.5	26.2
MSCI Emerging Markets	(2.1)	21.1	43.6	38.6	32.7
Alternative Assets					
GS Natural Resources	(1.0)	18.4	23.4	29.3	25.0
DJ AIG Commodity	(3.6)	2.8	1.8	9.1	13.2
HFR Fund of Funds	(2.1)	6.1	11.8	10.0	8.7

Despite the Volatility Index (or "VIX") remaining above 20 for the entire month of August, U.S. equities ended the month higher, led by small-cap and growth stocks. The Russell 2000 and Russell 1000 Growth indices ended August higher by 2.3% and 1.6%, respectively. After losing value since February 2007, REITs posted strong returns for the month, gaining 5.9%. A decline in interest rates during August helped bonds gain 1.2%, as well.

International stocks did not fare as well as their U.S. counterparts, with the MSCI EAFE ending the month down 1.6%. International small cap equities were the worst performers in August, declining by 3.6%. Emerging market equities fell by 2.1% during August, but are the best performing asset class for the YTD, and trailing 1, 3, and 5 year periods.

Returns for alternative assets did not fare well in August, with the DJ-AIG Commodity index

declining by 3.5%, and the HFR Fund of Fund index declining by 2.1%. Natural resource equities also declined by 1.0% during August. The decline in hedge funds is discussed in further detail below.

The U.S. equity markets during August began the month with a small rally, sold off sharply in mid-month, then strongly rallied into the end of the month to close on a positive note. This type of volatility is indicative of the current market environment we have witnessed during the summer of 2007. Several themes have permeated through this volatile summer, including the meltdown in the subprime mortgage market, unwinding of the yen carry trade, and in August, a renewed sense of investor optimism from Federal Reserve Chairman, Ben Bernanke.

The effects of the subprime mortgage sector continued to influence the credit markets during August. Evidence began to mount this month that contagion effects from the subprime mess are spilling over into seemingly unrelated equity strategies. Some highly levered hedge funds were forced to liquidate positions at fire-sale prices to meet the more stringent margin requirements now required by prime brokers. This, in turn, caused the most widely held stocks by hedge funds to tumble, which had a very large effect on those hedge funds employing quantitative strategies. This is one more case showing how seemingly un-correlated strategies can become correlated during periods of market upheaval.

In August, investors continued to unwind the yen carry trade, a market event that began in mid-June. At the close of July, the yen was trading at 118.60 to the dollar. By the close of August, the yen had strengthened against the dollar by 2.4%, to close the month at 115.78. This is further evidence that investors are taking speculative risk off the table, and reducing liquidity in the global markets as a result.

Due to deteriorations in the credit market caused by the subprime fallout, the Federal Open Market Committee (or “Fed”) approved a 50 basis point reduction in the primary credit rate, or “discount window lending rate”, to 5.75%. The main difference between the discount window lending rate and the more popular Federal Funds rate is that the discount window represents direct borrowing from the Federal Reserve, while the Fed Funds rate is the rate at which banks lend to each other. The discount window is meant to be a lender of last resort to depository institutions that cannot obtain liquidity in the market at reasonable prices. Since this is not the primary way the Fed adds liquidity into the economy, the effects of this reduction may not be wide-felt. This move, however, did placate investor uncertainty and helped bolster confidence in the liquidity system.

Stocks rallied globally on the news of the reduction in the discount window lending rate, as investors now speculate that the Fed will cut the federal funds rate at their next meeting on September 18th. Fed Funds futures, a good indicator of investor sentiment regarding the Fed’s policy changes, are fully pricing a certain a 25 basis point reduction, and a very high probability of a 50 basis point reduction. It is obviously difficult to speculate on what the Fed will ultimately decide, but should the Fed only cut by 25 basis points (or not at all), investors may be disappointed. Volatility seems likely continue into the foreseeable future.

In light of the recent market turbulence, we believe our clients are appropriately balanced between short-term risk exposure and long-term growth. Over the last few years, most of our clients have reduced exposure to public equities in favor of exposure in alternative assets. Despite recent troubles, absolute return funds have provided our desired level of portfolio protection. Within our public equity allocations, we believe our portfolio tilts towards large cap growth and quality stocks (at the expense of small cap and value stocks) will continue to add value. These tilts have reduced exposure to cyclical and financial sectors and increased

exposure to the global growth story *vis à vis* large, multinational corporations. In international markets we continue to recommend trimming exposure to small cap and emerging market stocks.

The silver lining to the recent volatility and uncertainty in the markets is that if the markets continue to pull back and if credit conditions deteriorate further, new opportunities to profit will be created. As these themes continue to unfold, it is paramount to preserve capital and only take risk when it will be well rewarded.



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