THE DANA VIEWPOINT

WOO HOO

August 1, 2007
Dow: 13,293

That was a wild ride last week, and we don't mean the "Simpsons Movie." The stock market as measured by the Dow Jones Industrial average reached 14,000 in mid-July and at the end of July was down about 5%. The broader S&P 500 Index has declined about 6% over the same period. So what is behind this sudden down-drift? Wall Street has a new term for any market declines, and it is called "re-pricing risk." It is widely assumed that liquidity (cash and assets) drives the markets. Unfortunately many took to including credit availability in that assumption. The strong economic growth since 2002 coupled with low interest rates pushed lenders to issue shaky mortgages to even shakier buyers (sub-prime loans) thus stimulating a housing boom. As with any boom, prices go to excess and need to be "re-priced." We are on the downside of that boom currently. Enter leverage. Leverage is a wonderful thing when the market is going your way, however, when it turns, it can create an over reaction among investors. The initial correction in housing was being absorbed in the market place until the failure of two Bear Stearns funds that were backed in part by these sub-prime loans. Bear Stearns raised about $1.5 billion and then borrowed enough to buy $12 billion of these securities. Then the defaults hit. Initial estimates were that losses in these two funds would be 10-15%, however, that was just the tip of the iceberg and losses now are expected to be much higher, rendering these funds virtually worthless.

Now we get to the credit availability part of the liquidity equation. Lenders have drastically reduced new mortgage loans by raising interest rates and tightening lending requirements. More importantly for the stock market, the tightened credit restriction will slow down the leveraged buyouts (LBOs) that have been a major driving force behind the bull market. Companies that are or were planning to buy back shares of their own stock (to increase earnings per share) may be constrained by the new credit restrictions.

How will this impact the bond market? There is definitely a flight to quality as investors are buying government bonds and pushing rates across once again under 5%. Another way to view this flight to quality is to look at the spread between 10 year treasury bonds and junk bonds. In 2003 when investor optimism was still low that spread was eight percentage points. As confidence in the economy and the market increased that spread narrowed to less than three percentage points in May of this year.

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The recent sub-prime scare has increased that spread to four percentage points. The long-term average for this spread is 4.5 points. The market is a wonderful self-correcting mechanism.

How about the stock market then? When we have a decline of 300 points in the Dow, it sounds huge but is only about 2%. So far in total, the Dow has declined about 5% from its peak. The broader S&P 500 has shed about 6%. Normally we could expect a "dead cat" bounce from here and some further testing of these interim lows. We have not had a 10% correction in the stock market since the bull began his run in 2003. That's over four years and the bull needs a rest before continuing his run. If the market were to decline 10%, it would take the Dow to 11,200. Somehow we do not think that will happen. We expect the market to continue a consolidation phase where some stocks will make new lows, while others will be forming a solid foundation for the next advance. The same can be said for industry groups. Housing activity is still in a downturn and may not rebound until next year. Consumer spending slowed to a 1.3% rate in the second quarter down from a 3.7% rate in the first. Don't ever count the consumer out, however, as this slowdown may be temporary with the holiday season fast approaching. The Gross Domestic Product came in at a 3.4% annual rate for the second quarter, up from 0.6% in the first. The core consumer price index rose at a 1.4% annual rate in the second quarter, a four year low.

Unemployment remains a low 4.6%. Healthy demand abroad has sent exports surging and the trade deficit declining. Government spending and non-residential construction continue to be strong. All in all, a good backdrop for economic growth. The markets will acknowledge this in their own time, and it is still a good time to own common stocks.

Random thought for August:

"In the business world, the rearview mirror is always clearer than the windshield".

Warren Buffett

Michael L. Dana
Chairman of the Board

James W. Ivey
President

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