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Excellence

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KING

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…Already long ago,
from when we sold our vote to no man,
the People have abdicated our duties;
for the People who once upon a time
handed out military command, high civil office,
legions—everything, now
restrains itself and anxiously hopes for just two things:
bread and circuses.…

— JUVENAL, *SATIRE* 10.77-81

Poor Federal Reserve Chairman, Ben Bernanke. He must feel like the head of the cleaning crew that is traipsing behind a multi-year, cross-country circus parade, with the Grand Master, Alan Greenspan, atop the lead elephant, triumphantly marching through the streets, casting bread and party favors to the cheering throngs as the entourage makes its final circle through the Big Apple. Bernanke and his fellow members of the Federal Reserve follow in the wake of the circus animals and the ticker tape, scooping up the animal droppings and pieces of worthless paper cascading downward in the canyons of Wall Street.

Now that former Chairman Greenspan has gone on to the rubber chicken speech circuit, he is free to pontificate about the difficulties the economy is experiencing. Of course, he neglects to tell us about the vacillating environment of interest rates engineered during his 18 years at the Fed. And, most notably, he makes little or no mention of the fact that his Fed lowered the federal funds rate to 1.0%, and, in bewildering fashion, encouraged homeowners to take out variable rate mortgage loans at a time when interest rates were at historical lows. Nor did the Fed attempt to rein in, regulate, or openly discourage the excesses and abuses of the financial markets created by the mushrooming of esoteric financial instruments ginned out by mortgage bankers and Wall Street which were gobbled up by financial institutions around the world, many utilizing leverage to purchase them.

The news of the last few months has endlessly chronicled the downward spiral of the subprime housing fallout. In conjunction with rising oil prices and growing worries of incipient inflation, the steady beat of bleak news has been a major contributor to the downward decline of stock prices. During the same period, the flight to safety in bonds and money market instruments has dragged market interest rates on quality

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credits down to very low levels. Yields on 10-year U.S. Treasuries have dropped from the 4.7% range in October to the 3.6% range in mid-January, while 30-year Treasuries are yielding a meager 4.3%. For equities, the declines from previous highs have been a harsh reminder that excesses inevitably lead to corrections. From the lows of March 2003, U.S. equities had performed very well for over four years. Stock prices at the close of business on January 23 had virtually erased most of the previous years' profits. The stock prices of some companies, especially those in the housing and financial services industry, have dropped to single-digit levels with many declining over 50%. Bankruptcy has thinned the ranks of the more egregious participants in the credit bubble. The survivors find themselves raising capital by selling high cost debt or equity on terms that are highly dilutive to existing shareholders.

As the news about the troubles of the credit and equity markets moved from the business pages to the front page, and unemployment ticked up to 5%, concern is growing that the U.S. has entered, or is about to enter, a recession. The President and Congress, ever ready to please the masses, and never more so than in an election year, are drawing up plans to spread a little butter on the bread of consumers and give business a "break." Never mind that previous attempts to spur the economy with short-term handouts have provided little empirical evidence that such measures achieve their intended objectives. If the U.S. is indeed in or entering a recession, we view the present proposals as a case of too little too late. Such fiscal stimulus, if enacted, will have a limited impact on the economy, and will serve only to make a politician feel good by trumpeting his or her achievements on the stump. In the real world, despite the fear, and in some cases hysteria and panic that have begun to manifest themselves, some other developments are more positive.

With regard to housing, oil prices, corporate and consumer cash levels, a low dollar, and the valuation levels of equities, there are reasons to believe that 2008 will yield more sunshine than the present clouds would indicate. Baron von Rothschild's famous maxim to "buy when the blood is running in the streets" seems apropos today. The subprime contagion has pierced a lot of arteries, and while most financial firms appear to have successfully applied a tourniquet, others have run out of options or continue to search for much needed transfusions of capital.

Yet, while an economic slowdown seems probable, the vein-bulging hysteria of CNBC's Jim Cramer and the call for action in Washington mask a more hopeful set of circumstances.

This is especially the case with housing. The U.S. alone has a greater than $13 trillion economy. The Organisation for Economic Co-operation and Development estimates that subprime losses may reach $200 billion to $300 billion, or about 22% to 33% of the $800 billion in subprime mortgages outstanding. The total amount of U.S. subprime debt is equal to only 1.4% of global stock market capitalization. A loss of $200 to $300 billion would only equal 0.3% to 0.5% of global stock prices. Global stock prices frequently fluctuate daily by percentages greater than these. As bad as the losses have been for specific companies, this is hardly the stuff of a global catastrophe.

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Recent trends belie the worst fears of a mortgage meltdown. Over the past two years, $2 trillion of ARMs have been reset—a figure that is about equal to 25% of all outstanding mortgages, including subprime mortgages. It is true that delinquency and foreclosure rates are up, but they are well below the levels of worst-case fears. Foreclosure rates peaked in August and they have been declining even as more subprime ARMS have been resetting. The losses being taken by banks and other institutions have gone very far in recognizing the credit losses sustained. No doubt there will be more write-downs, but the fourth quarter was not just a kitchen sink quarter, it was a bathtub quarter. By clearing the decks of every skeleton that may still linger in their financial closets, CEOs are positioning their companies to report numbers in the future that are not weighed down by the necessity to again post inordinately high reserves for bad debts. In what may prove to be a positive surprise for some companies, they may actually be establishing reserves that are too high. Should losses not be as high as they estimate, they will be able to write up investments that were previously written down to recoverable amounts that were too low.

Recent reports indicate that new housing starts in December were at an annual pace of 1.006 million, down from an annual rate of 1.173 million in November. That is good news. Housing starts peaked at an annual rate of 2.3 million in January 2006. As builders slow their construction, the underlying demand for housing will have fewer units available for sale. It is often forgotten that the supply of housing is not only absorbed by sales, but by a certain amount of housing stock that is removed from the market every year by demolition, deterioration, fires, floods and other natural disasters. Household formation is fairly predictable based on birth statistics, immigration, and other demographic factors. Usually, household formation runs at 1% per year, a figure that translates into an increase of about 1.1 million new homes formed annually. To meet that demand, another 300,000 units must be added to replace the reduction in housing stock for the factors just cited. Thus, approximately 1.4 million new dwellings are needed to keep pace with normalized demand.

The laws of supply and demand work in housing, and they are coming back into balance. In addition to a slowdown in new construction, sellers are adopting a more realistic position on pricing. The increase in housing prices over the last few years left most sellers with the notion that prices would always go higher. As prices ease, housing becomes more affordable, particularly with mortgage rates at very low levels. As equilibrium is reached at more sustainable levels, housing will no longer be a drag on the economy, but will return as a positive force. At present, markets are assuming a long-term drag on the economy from the downturn in housing.

With the slowdown in construction over the past year, starts are not likely to be as negative a factor for GDP as was the case in 2007. Housing starts would have to fall to under 500,000 units a year to have the same impact on GDP that they did in 2007. Such a rate would be 300,000 units below the lowest reading of the past 50 years. Given normalized population growth and depleting housing stock, levels that low would be economically and politically unsustainable. With supply and demand becoming more balanced, 2008 should witness a gradual return to stability and financial health for a wide spectrum of participants in the housing industry.

In June 2007, $135 billion of mortgage-backed securities were issued. In the wake of the credit squeeze, in November, mortgage-backed security issuance plunged to only $22.4 billion. With lower mortgage rates, new mortgages are being underwritten based on more rational credit requirements, and buyers having some "skin," or equity, in their homes. As confidence returns to the mortgage-backed market, and equilibrium in supply/demand is reached, credit extension and the mortgage-backed market will grow again. It will not reach the dizzying heights attained during the inflated boom, but underlying credits will be much stronger. The return to a more normalized mortgage market in which investors can have confidence will be a major positive for the overall credit markets and market psychology.

As with mortgages, the dynamics of the commodities markets are undergoing some positive corrections as well. While there is no question that global growth has long-range consequences for the demand for industrial and agricultural commodities, in recent months certain markets have been spurred upward by excessive speculation. Nowhere is this more evident than in the oil markets. During 2007, oil exploded from $67 a barrel to $100 a barrel, with the vast majority of the rise coming during the period of August to December. Ten years ago, only about 10% of the trading in the oil markets was attributable to speculators, whereas in recent months it has reached levels approaching 60%. Global economic growth, the excess liquidity sloshing around the globe, heightened geopolitical fears, and a five-year decline in the U.S. dollar have fueled real demand not only by end users but by a host of speculators as well. But energy and industrial commodities appear to be entering a period

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of retrenchment. Talk of an economic recession or slowdown in the U.S. and a stabilizing dollar has begun to tip the scales on energy prices. Since reaching the $100 mark, oil quickly dropped to $88 by mid-January. Many of the same traders who have bid up oil futures have also been shorting the dollar. Now, both sides of these trades may be going against them.

The International Energy Agency reports that high prices have dampened demand. They cut their forecast for worldwide consumption by 500,000 barrels a day in the current quarter, and estimated reduced demand of 300,000 b/d for all of 2008. While demand may slow, production estimates for some areas have increased. A major elephant find was discovered off the coast of Brazil. Russia is forecasting that oil output will increase 5.2% between now and 2010—double its earlier estimate. Canada will become the world's fourth largest producer by 2015. Its National Energy Board forecasts production of 2.8 million b/d within eight years compared to a present 1.6 million b/d. And to the surprise of many, one of the biggest

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increases in production is occurring in Iraq, which has boosted output to 2.2 million b/d, up from a low of 1.5 million b/d only a year ago. Some observers have estimated that in time, Iraq's production could approach 4 to 5 million b/d.

Increasing production around the world and concerns about an economic slowdown have also brought down the price of key industrial commodities, but it is oil which has been the big bugaboo of inflationary pressures over the past several quarters. Energy usage is a major cost input in the production of industrial and consumer finished goods, and a key cost component of transportation and agricultural output. If oil prices continue to moderate and/or fall, it should provide welcome relief to businesses and consumers, and provide the Federal Reserve and other central banks some wiggle room on monetary easing.

The Federal Reserve, having found itself in the midst of a crisis of confidence in the credit markets since last summer, has lowered the federal funds rate and discount rate as well. It has also engaged in some other measures aimed at easing the gridlock in the credit markets, at times acting in concert with other central banks. Yet, critics of Fed Chairman Bernanke claim that he and his fellow FOMC members are behind the curve. Regardless of whether the Fed has exercised the best timing or moved decisively enough, there is no question they will be moving interest rates down at a steady and probably more aggressive pace. We doubt that Bernanke has much sympathy for the speculators and their investment bankers who have birthed the subprime Frankenstein, nor will he lose much sleep at the sight of commodity speculators running for cover. Yet, the Federal Reserve and other central bankers must insure that the banking and financial system remain sound and well capitalized. This they will do. There really is some merit to the argument that some institutions are too big to fail. Collectively, the U.S. financial system is too big for the Fed to let fail. They have already begun to pull out some of their weapons, and they have much more in their arsenal that they are lining up to fire.

The major financial companies of a country are critical to the effective functioning of the whole economy. The financial intermediaries are the keys to the economic system that is based on money. Ben Bernanke is well known for his economic study of the Great Depression of the 1930s. While many point to the Smoot-Hawley tariff bill as an underlying cause of the Depression because it resulted in a major slowdown in world trade, it was a blind Federal Reserve that may have squeezed the lifeblood out of the economy. The Federal Reserve of that era, worried about inflation, reduced the money supply by one-third. Today, Bernanke, who will now be joined by some of the more previously hawkish members of the Fed, will be busily about the task of cleaning up the mess he inherited from the Greenspan era.

Some critics fear the Fed should not lower interest rates because it would cause the dollar to move even lower. With global growth increasingly in question, other central banks which have given lip service to higher rates may be lowering their rates before long as well. Actually, the dollar, which was overvalued during the early part of this decade, has begun to bottom. On a purchasing power parity basis, the dollar is one of the most undervalued currencies on the globe. With some foreign currencies appreciating as much as 40% in 2007 versus the dollar, and the market value of a wide array of U.S. businesses declining by a similar amount, the U.S. must appear like a bargain basement to foreigners, including the rapidly growing sovereign wealth funds. According to Thomson Financial, in 2007, foreign investors purchased $414 billion in

American companies, factories, and other properties through private financing or purchases of publicly traded stock. This figure was up 90% from 2006 and more than double the average of the last decade. During the first two weeks of 2008, foreign investment in American companies of $22.1 billion was announced, more than half of all announced deals. In addition to direct purchases, foreign corporations continue to pour funds into existing plants and facilities. Foreign companies with U.S. operations now employ five million Americans. American factories, those that are domestic as well as foreign owned, are increasingly becoming more cost competitive in international trade. If foreign investors are finding assets in the U.S. attractive, one must wonder why U.S. investors are giving them away at a time when they are going for a song.

In recent years, emerging markets and more mature foreign markets have generally provided investors with attractive returns. Since the beginning of 2005, through November 2007, international mutual funds gathered $381.5 billion, compared to only $5.4 billion for U.S. equity funds, a mere 1.4% compared to the 98.6% flowing into international funds. In recent weeks, unlike the experience for some time, international funds, and especially emerging market funds, are experiencing gut-wrenching declines. Many of the countries in which these funds invest are dependent on oil and other resources for export, or the export of finished consumer goods to the U.S. Any downturn in their exports due to a slowdown in U.S. and global consumer demand will not bode well for their economies and their markets.

Investor pessimism has reached extreme levels. The American Association of Individual Investors publishes a fairly reliable measure of investor sentiment, the percentage of respondents who are bearish versus those who are bullish. In recent days it has reached levels at which the three-week average of bears to bulls was much greater than 200%, a reading rarely reached, and among the most extreme readings in the past 20 years. Such readings have always been a precursor to markets that have rallied more than 20% over the following twelve months. Coupled with this rise in pessimism has been an explosion in the amount of funds investors have placed in money market instruments as they have fled to safety. Recent figures indicate that investors hold approximately $2.7 trillion in money market funds. Will those funds remain parked in safe investments as Fed actions effectively lower the rates on short-term

TOP FOREIGN INVESTORS IN U.S. BY COUNTRY
ANNOUNCED MERGERS AND ACQUISITIONS
(IN BILLIONS)

		2007	2000
1.	Canada	$ 65.6	$ 28.6
2.	Britain	45.8	77.1
3.	Australia	30.1	13.1
4.	Spain	24.2	6.5
5.	Germany	24.2	47.0
6.	United Arab Emirates	17.7	0
7.	Saudi Arabia	12.7	0
8.	Sweden	11.8	2.2
9.	Switzerland	11.2	13.8
10.	The Netherlands	10.8	34.7
11.	France	10.5	28.3
12.	South Korea	10.4	0
13.	Singapore	9.9	1.4
14.	China	9.8	0
15.	Kuwait	9.6	0

SOURCE: THOMSON FINANCIAL

funds at the same time that many stocks yield more than U.S. Treasuries and stocks begin to probe for a bottom?

Insiders and corporations are sending different signals than most individual investors. As prices have fallen, insider purchases of stock, which are now reported on a timelier basis, have accelerated. Corporate insiders are voting with their wallets that their companies are undervalued. Not only are insiders buying, but their corporations are as well. Over the past few years a large number of U.S. corporations have been actively buying back their outstanding stock. In recent months the pace has accelerated. Buybacks have continued to increase quarter after quarter since 2004. The recent flow of funds report for the third quarter was issued in December. It showed that net corporate equity issuance by non-farm, non-financial corporations declined at an $800 billion annualized rate. This rate of net stock reduction was more than 6% of the value of the outstanding stock in the same report. Standard & Poor's estimates the pace of net stock retirement for the S&P 500 at 2.4% a year. Corporations have continued to accumulate capital. The cash holdings of the S&P 500 companies total over $3.0 trillion, almost triple the figure from a decade ago.

In July, the SEC eliminated the short sale plus tick rule, which had been in place since 1934. The plus tick rule required that short sales had to be executed at a price that was an uptick from the previous down price. It appears to have been an ill-conceived and ill-timed rule change. Its elimination is probably contributing to the volatility that has characterized the markets since the change, and it has emboldened short sellers to conduct bear raids on stocks. Eventually, however, shorts must cover their trades, and the tide will turn against these bears. By volume, short sales account for more than 20% of the NYSE volume and 65% of shares held by the public. For a large universe of stocks, the short interest amounts to a significant percentage of the outstanding shares of these companies.

After the recent sell-off, U.S. equities are attractively valued, with the S&P trading at approximately 14x estimated 2008 earnings. Unless earnings collapse, which we do not think is likely, the odds of achieving solid returns are very good. The market is discounting an extremely severe recession, and the yields on bonds are paltry. For the past few years, energy, materials, industrials, and to some degree, technology have been fruitful areas for investment. Financials, healthcare, and consumer discretionary have generally not fared as well. Presently, there is a great deal of fear and pessimism. But value abounds in many businesses. The stocks of these companies will not remain deeply undervalued for an extended period. Many of the former leaders will be facing a new set of problems, including lofty valuations in the face of a slowing economy. Their recent, weak stock price movements may reflect concern that the stage is being set for a new group of leaders.

The housing quagmire has already started to heal. Its costs are being totaled and recorded. Oil and other commodities may be taking a breather. The U.S. dollar is undervalued and a source of export strength. U.S. dollar denominated assets are increasingly attractive. The Federal Reserve and other central banks are mobilizing for growth, not recession. Investors in domestic equities are too pessimistic. Corporate insiders and foreign investors recognize the bargain prices they are being offered. For investors who look beyond the emotional hysteria of today to a long-term time horizon of twelve to twenty-four months, the potential appreciation in many stocks is substantial. Globalization, even with an occasional detour or two, will bring rewards to businesses and consumers around the world. Bread and circuses may corrupt the body politic, but markets will still reward sound stock selection and buying value at the right price.

Roger E. King, CFA
Chairman and President

The year 2008 marks KING's Twenty-Seventh Anniversary. Our professional staff includes investment managers, security analysts, and other specialists qualified to meet the needs of our individual and institutional clients. We are committed to creating wealth for our clients in the long term.

Over the past twenty-seven years, we have successfully navigated through both good and challenging markets by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

Our philosophy focuses on the valuation of businesses and their economic worth as measured through cash flow and not accounting artifice. Our work in equity and balanced accounts, which includes fixed income instruments, helps each type of account. Many excellent fixed income opportunities develop as a result of our research in equities, and vice versa.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

SOURCES FOR THIS ISSUE

The New York Times, Thomson Financial

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