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Global Asset Management

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Financial markets around the world have been falling in what is now turning out to be the first global economic recession since the world became flat. While the slowdown and credit problem in the U.S. began in the summer of 2007, only in the last few months and with great rapidity have other major industrial countries and the developing world reported significant slowdowns in growth. As late as June, most reports of global business supported continued growth. But it is clear that the systemic banking and housing crisis has morphed into a credit contraction, and now we are experiencing slowing growth around the world.

The heart of this financial crunch starts with the U.S. housing industry and the decline in housing prices. This in turn has undercut the value of financial assets and exposed the global financial systems to losses estimated to be as much as one trillion dollars. It may be more. These losses require the raising of equity and maybe $350 billion has been raised. But this process is getting harder and harder as investors push back. The best indication of that is that the U.S. government had to take over both Fannie Mae and Freddie Mac. They could not independently raise capital. Whatever one thinks philosophically about this, it was necessary and a step toward ultimate resolution.

It appears to us that the larger problems of credit contraction and economic downturn are still underway. Either assets are going to be sold at lower prices in a system of "negative feedbacks" or the central banks and governments of the world will need to step in with their balance sheets and provide significant capital to the system. Certainly the environment is such that we should expect some dramatic and possibly constructive action this winter. A credit contraction is highly deflationary.

Portfolios had been fairly immune to these economic and financial dislocations over the twelve months ending June 30 because of their global orientation. But the emergence of economic weakness in July caused us to scramble to reduce equity exposure to much lower levels. Even so, portfolios have now declined roughly in line with the S&P 500 and the MSCI World. Given the reduced exposure to stocks, if the markets trend lower from here, which we think quite possible, then the portfolios should show resistance. But as long as the economy is sliding and the deleveraging process is underway in the financial system, it is almost inevitable we will see lower prices this winter.

This is a cyclical downturn. It is a sharp and risky one, but cyclical downturns end. For every action there is a reaction. As the global economy deteriorates into the winter, we expect to see policy shifts to expansion by central banks and governments around the world. Many stocks are getting cheap and possess what we think is great eighteen-month appreciation potential. Even so, for the next three to six months, risk seems higher.

As markets and stocks rise out of this crisis, long-term secular global economic themes will once again assert themselves. We have had many financial crises in the past, although the financial aspects of the losses of capital from excessive debt in this cycle are historic and are probably the most severe in the post-WWII era. The developing world will once again be the engine of growth. Demographic trends are hard to deny. Most often the greatest gains are made in the first six to nine months coming out of a low. Therefore, as you might suspect, our attention is shifting and is primarily devoted to identifying the future leadership when the recovery from this bear market arrives. The immediate challenge is to protect capital as much as possible while laying out a framework and plan for capitalizing on that inevitable recovery. Unfortunately we cannot say whether that is weeks or months away. We simply have to let the fundamentals and events play out.

With best regards,

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