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2007 Investment Outlook: Not So Calm Beneath the Surface “Goldilocks is Dead”

With the U.S. equity market rising over 16% in 2006 and other global equity markets performing even better, what’s not to like? Perhaps it’s human nature or just “our” human nature to find something not quite right with our world. We see several issues to be worried about in the not too distant future.

It begins with the sense that *the stock market is discounting the best case*. Buoyed by a global credit bubble, investors have embraced the “mid-cycle slowdown” theory of a benign slowing of the economy, falling inflation and interest rates and a strong stock market, similar to 1994/95. With an approximate 15% increase in the S&P from its lows, investors have appear to have “banked” a majority of the benefits of a mid-cycle slowdown without confirmation that the risk of a recession has passed. Yet there are significant economic, political and geopolitical differences between today and 1994/95.

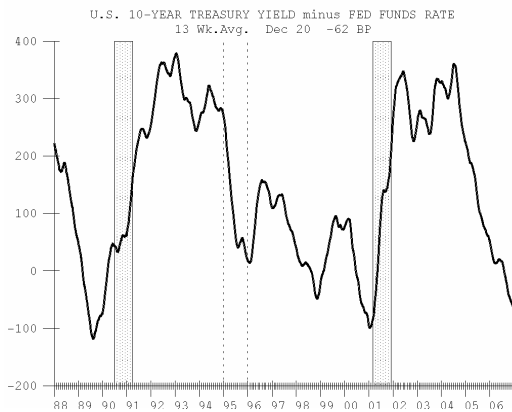
- A. **The global credit or liquidity bubble continues to inflate.** An immense, distorting and potentially destabilizing global credit or liquidity bubble defines the world economy. Its causes are the huge US current account deficit, the staggering foreign exchange reserve accumulation of Asian countries driven primarily by their mercantilist economic policies and complemented by the rise in petrodollars stemming from the significant increase in world energy prices. A revolution in financial “innovation” has been a key enabler of the bubble. According to Independent Strategy, the notional value of outstanding derivatives is 836% of world GDP, while securitized debt is 141% of world GDP. Securitization has led to a de-emphasis or outright abandonment of credit analysis in favor of statistical modeling. The result appears to us to be a systemic mis-pricing of risk as evidenced by the record low spreads in all segments of the credit markets from high yield and emerging market bonds to sub-prime mortgages. These low spreads have led to the boom in Private Equity buyouts as well as the proliferation of exotic mortgage products and the explosive growth in sub-prime lending. The eventual unwinding of this systemic mis-pricing of risk could be catastrophic.

- B. **The US economy: as good as it gets?** Unemployment and interest rates are near multi-decade lows, while corporate profits are at multi-decade highs. Virtually all major US equity indexes (with the exception of the NASDAQ) are at or near record highs. The market appears to have embraced “the mid-cycle slowdown” theory where the economy

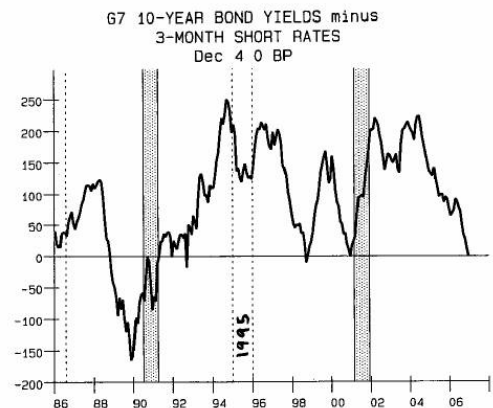
slows just enough to cool inflation, without tipping into recession and the Federal Reserve can stop raising and start cutting interest rates. Investors seem to anticipate a “replay” of 1994/95, when long rates declined 250bps and the S&P soared 40%. This is hardly likely in our view as the key accelerant of recent economic gains, housing, begins a descent of unknown duration.

C. **There are significant differences between the current environment and that of the 1994/95 mid-cycle slowdown.** Since its mid-July lows shortly after the last Fed rate hike, the S&P has appreciated about 15%, while long term interest rates have fallen about 65 basis points (bps)-exactly as “the mid-cycle slowdown” theory would predict. The market has already discounted most of the benefits of a “mid-cycle slowdown”. Yet there are significant economic, political and geopolitical differences between 2006/07 and 1994/95.

1) **Inverted Yield Curve.** The yield curve as measured by the difference between the Fed Funds rate and the 10-yr. T-note is currently inverted by 65 bps and has been inverted by more than 50 bps for 120 days. **(Chart 1)** According to the NY Fed, while the length and depth of inversion are important, the yield curve has inverted before every US recession since 1960, with very few false positives. In 1994/95, the yield curve never inverted. According to the ISI Group, the G7 yield curve defined as the difference between G-7 10-yr.bond yield and 3-month short rates is also an excellent leading indicator of US recessions or serious slowdowns. **(Chart 2)** It is currently flat, exactly where it was heading into the 2001 recession, but above the significant inversion before the 1991 recession. In 1994/95 this spread never came close to flattening or inverting. At its low, the spread was a positive 125bps.



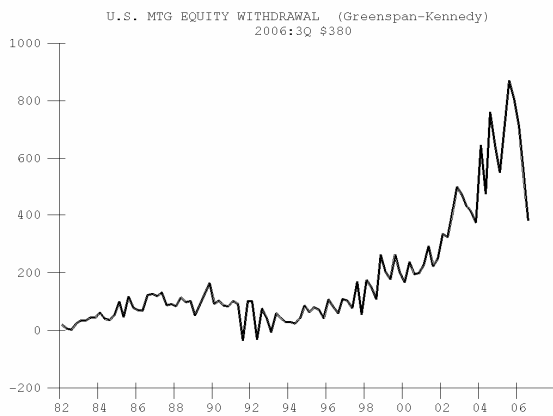
(Chart 1) Source: ISI



(Chart 2) Source: ISI

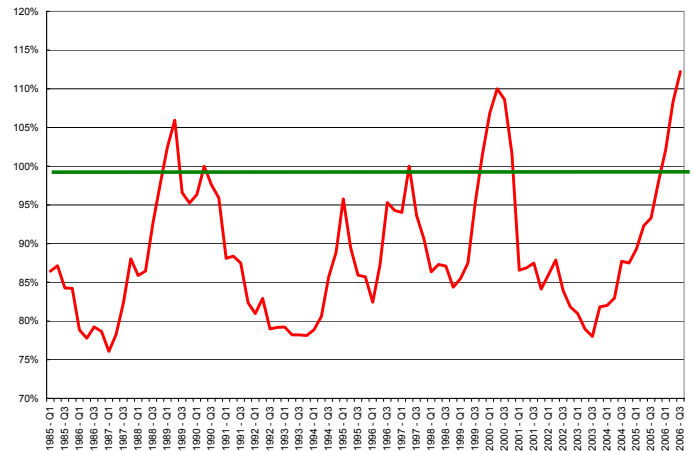
2) **Housing.** The US residential real estate bubble has just popped. The bubble saw unprecedented real house price appreciation, home ownership surge to a record 69% of households and residential investment surpass a record 6% of GDP , all

while housing affordability fell to a multi-decade low. An explosion in exotic mortgages and sub-prime lending helped fuel the bubble and bridge the affordability gap. Despite record low interest rates, mortgage interest payments reached record levels of wages and salaries. Mortgage equity withdrawal (MEW) more than quadrupled to reach a record \$869B or 7.8% of disposable income in Q3 '05 and led to the bizarre situation where consumer spending exceeded disposable personal income for the consumer for three consecutive years. **(Chart 3)** Now the national median home price is declining for the first time in history, while home sales have fallen sharply and inventories of homes for sale have soared. MEW has fallen to \$380B in 3Q '06, while the current median mortgage refinance ratio is greater than 100%, meaning the refi rate is higher than the existing rate. **(Chart 4)** More than \$1.0 trillion in mortgages will face rate re-sets in 2007. Alarmingly, first payment defaults are soaring in the sub-prime mortgage market. In 1994/95, housing was recovering from a long slump that began a half decade before. MEW was increasing from a much lower rate and the refi ratio was less than 100%, putting money in consumer's pockets.



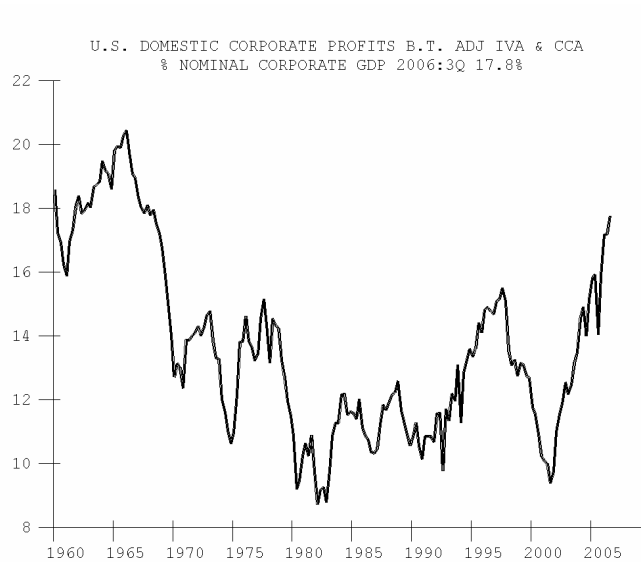
(Chart 3) Source: ISI

Refinancing at a Higher Rate



(Chart 4) Source: B of A Securities

- 3) **Corporate profits.** Corporate profit margins are at multi-decade highs and earnings growth has been strong, while key sectors of the economy are weakening. **(Chart 5)** It is tough to reconcile the consensus forecast for continued strong earnings growth given the already high level of profitability and a slowing economy. In 1994/95 profits grew 10%, while margins were at much lower levels.



(Chart 5) Source: ISI

- 4) **Lower absolute level of interest rates.** In 1994/95, long rates declined 250 basis points. By contrast, long rates peaked at 5.25% this year, well below the lows of 1994/95. It is hard to see a 250 bps decline in long rates today, even with a serious recession. With the current 65bps decline of long rates and 15% increase in the S&P, investors likely have discounted most of the benefits of a mid-cycle slowdown, without confirmation that the risks of a recession have passed.
- 5) **Geopolitics.** The geopolitical situation today is malignant, which is in sharp contrast to the benign post-Cold War peace and prosperity of the mid-1990s. Today, the Middle East is aflame. Iraq is in chaos with our alternatives seemingly reduced to retreat now or retreat later. A defeat in Iraq would be catastrophic. Oil prices would likely spike. It would embolden our enemies and frighten our allies. As Iraq has deteriorated, the Taliban have gone on the offensive in Afghanistan. Pakistan has agreed to a truce in its tribal lands, effectively ending the hunt for Osama Bin Laden and giving free reign to Al Qaeda. Saudi Arabia has announced plans to build a fence along its border with Iraq. Iran, an unintended but major beneficiary of the US invasion of Iraq, has become a hostile, dominant regional power, spreading mayhem in Iraq, Lebanon and Palestine. Most ominously, it is on the verge of becoming a hostile nuclear power and it has picked up support from both China and Russia. In the mid-1990s, Iran and Iraq were both contained and were almost counterweights to each other.

Due to rising energy prices, Russia under Vladimir Putin has re-emerged from the rubble of the Soviet collapse at the end of the Cold War as an aggressive, potentially hostile force. It has no external debt and a quarter of the world's proved natural gas reserves. It supplies nearly half of Europe's natural gas imports. Putin has jailed or killed opponents both inside and outside of Russia and has used natural gas to influence events in now independent, former Soviet states. He has been nicknamed "Gasputin" for his heavy handed energy politics.

Russia, Iran and Venezuela hold significant dollar reserves, are not very friendly with or are hostile to the US and have threatened to diversify their reserves. Iran has just shifted its hard currency budget to Euros. Unlike the Asian mercantilists who have a vested interest in dollar stability, these energy suppliers do not. It is not that far-fetched to imagine these countries acting in concert to provoke a dollar crisis to further their objectives.

China is emerging as a powerful, not always friendly force in world affairs. As a relatively new, but rapidly growing energy importer it will look to extend its influence in the Middle East, likely not always in ways the US would prefer.

- 6) **U.S. Politics.** US politics are almost 180 degrees different today from what they were in 1994/95. Then the Republicans swept into control of both the House and the Senate, stopped the proposed nationalization of the health care industry and set a deregulatory agenda. Today, the Democrats control both houses of the legislature. Their agenda is interventionist and enjoys fairly broad public support. **(Table 1)** Large parts of the economy including healthcare, energy and mortgage lending will likely be affected by new regulations and taxes. Predatory lending prohibitions and mortgage suitability standards will likely exacerbate the current real estate slump. Longer term- free trade, and low dividend, capital gain and personal tax rates will likely be threatened by attempts to lessen income inequality. A withdrawal from Iraq will have grave, long lasting effects on the US as well.

Democrat Agenda

	Strongly Support	Mildly Support
Raising the minimum wage	60	17
Making fed gov't directly responsible for negotiating with drug companies for lower Rx drug prices for Medicare	59	17
Cutting interest rates on student loans	57	19
Continuing to have multiple private companies under contract to Medicare so that they can compete to provide lower prices for Rx drugs as they do now	51	23
Putting pressure on WH to begin to bring some troops home within the next 4-6 mos.	54	14
Eliminating tax cuts for oil companies	47	12
Expanding fed funding for embryonic stem cell research	39	17

(Table 1) Source: ISI

- 7) **Energy.** Today energy prices are in the fifth year of a secular increase, a drain on disposable income that has been cushioned by mortgage equity withdrawal. With the benefit of MEW declining significantly, energy prices could bite harder, even if they are down year over year. In the mid-1990s energy prices were stable at much lower levels.

All in all, we believe the year is setting up for some disappointments. So long as we can identify investment opportunities represented by strong companies with identifiable free cash flow whose management is likely to utilize the free cash to either develop the business through internal capital projects or accretive acquisitions or return its free cash flow through increased dividends, stock buybacks, or deleveraging transactions, we and our clients should weather these gathering storm clouds in a relatively strong fashion.

The catch phrase for 2007 should reflect the homily, “an ounce of prevention is worth a pound of cure” rather than Alfred E. Newman of Mad Magazine famous quotation, “What, me worry?” 2007 will be a lot tougher year on investors than most pundits think.



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