

MARCH MARKET COMMENTARY

Volatility seems to be the recent theme. Just when it seemed the stock market might have stabilized with a fairly good 4 weeks from late January to late February, bad news around mortgages is picking up again. The market took a tumble in February resulting in the fourth month in a row to post total negative monthly returns, only the 3rd time that has happened in the last 15 years.

The problem continues to grow. Ten months ago (5/17/07), Fed Chairman Ben Bernanke believed problems with subprime mortgages would have a “limited” impact on the overall housing market. Just 4 months ago (11/08/07), Bernanke estimated that the total losses from subprime mortgages could be \$150 billion. In mid-November (11/12/07), a Wall Street real estate analyst projected that losses relating to subprime mortgages could reach \$400 billion. At the end of last month (2/29/08), a new report from another Wall Street firm indicated that total losses that could top \$600 billion (source: USA Today, Financial Times and Investment News).

So, what’s happening? Is there no end to the bottom? How much more money can these companies lose? Well, there’s probably a bit of good news and bad news happening right now. The bad news, while discomfoting, is helping to clear the garbage out of the system. Toward the end of January, the market generally greeted bad news by going up, not down. For obvious reasons, that tends to signal a market bottoming because investors believe the end of the bad news is near.

Unfortunately, the last few weeks have suggested there’s more to come. While it’s still not agreed that we’re in recession and prominent voices still resonate on both sides, it’s probably becoming less relevant because the market has been braced for a recession for quite some time.

We’re seeing another phenomenon that is currently adding to confusion, but could result in some good news down the road. It’s obviously important to remember that most of the losses we’re seeing are not actual realized losses, but restating the value of assets for assessment of capital and coverage ratios. Most of these assets are associated with people’s houses, not stocks. Their value to a large degree is what someone says it is. But, until it’s sold, there is no definitive value.

However, in some cases, the restatement of an asset’s value causes real losses because other assets must be sold or acquired to cover exposures that have increased as the assets that were covering them have had their market value decreased on paper.

Part of the mess in the financial world right now is caused by firms having to adjust the value of their portfolios according to perceived current market values. Just as it sounds, this can be a bit difficult and inexact.

Because the value is changing so fast and hasn’t become any easier to correctly identify, companies are struggling to accurately assess their true value and corresponding capital coverage needs. In addition, many assets appear temporarily undervalued because of the current market dislocation. Of course, this further adds to the need to write down more assets. It’s another example of the liquidity crisis feeding on itself.

There may be some good news in this latest chapter. After being burned badly several times over the past many months, financial firms in general appear to be making very conservative estimates. In the short term, this is more painful because it increases the amount of other assets needed to provide collateral. This has definitely hurt many firms forced to sell assets at heavily discounted prices to meet margin calls.

In the long term, this could provide a source of substantial profit for strong firms. Various firms such as AIG have stated publicly they believe the assets on their books are worth considerably more than the stated value. When these assets are ultimately sold or transferred, the result could be wind-fall profits that ultimately offset much or some of the current losses.

While this may or may not be true, and capturing any undervalue will take a long time, the current stage of unfolding events is a good sign for two reasons. First, the losses should start to slow with more conservative valuations. Second, if the values are indeed stated too low, future profits are now being sown. Even if it takes a long time to fully realize the profits, near term revaluations may reflect more favorable future conditions contributing to return to profitability.

As bad as the news appears, we're encouraged by the fact that the news is coming out and firms appear to be getting an increasingly good understanding of what their problems really are. While this is not ideal, in many ways the current messiness and unstable readjustment is more desirable than last spring's circumstance of a very old bull market, no bad news, and investors lulled into a false sense of security by seemingly endless good news. Currently, the market doesn't react too severely to bad news and even an absence of bad news, much less good news, sends the market higher. While losses and volatility isn't fun, but it's much better than the steady decline of the previous six months. While it may not be the best place to be, we're getting closer to the end and eventual recovery.

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