C|A

CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENTARY

THE PAUSE THAT REFRESHES?

November 2007

Sean McLaughlin
Jessica Diedzic

The Pause That Refreshes?

Massive bank write-downs and accompanying share-price declines during November gave equity investors a taste of the same pain that credit markets have been feeling for several months now. The S&P 500 registered its first correction in several years,[1] returning -10.0% from October 9 through November 26, before bouncing back furiously on November 27 and 28 to register a 4.4% two-day return (the strongest in nearly five years).

We noted in August that there were "other shoes to drop…in the form of nasty surprises at hedge funds, banks, insurance companies, and who knows where else."[2] Perhaps the only surprise about November's sharp plunge was that it was so long in coming.

A Brief Pause, or the Start of a Longer Plunge?

When the market history of 2007 is written, will the recent drop be described as the pause that refreshes, an omen of worse days ahead, or will it merely be forgotten?[3] It is an open question, of course, but the current picture remains worrisome. Three concerns are outlined below. Briefly, these worries include (1) the unhealthy narrowing of the market's gains so far this year; (2) the downturn in shares of financial firms, which often signals a broad market decline; and (3) the stormy outlook for financials (the market's largest sector by far).

No Bench Strength

Market breadth has been declining, and this is not typically healthy. Technical analysis is not our strong suit (we do not know an Elliott wave from a Bollinger band), but common sense and history tell us that when the indices are moving up because of the momentum of just a few big stocks, the environment is not exactly robust. The Russell 3000® Index returned a strong 14.5% in the 12 months ended October 31, 2007, yet two of every five stocks in that broad equity index delivered a negative total return. More stocks lost value than outperformed the index. Just 182 stocks contributed 100% of the index's return, while the remaining 2,200+ stocks were just ballast, netting each other out on a contribution basis.[4]

[1] There are many ways to measure or define a correction, with the most common being a price decline of 10% or more from a recent peak. The Nasdaq Composite and Russell 2000® indices both registered double-digit negative returns in second quarter 2006, but the most recent correction for the S&P 500 was in 2002.
[2] See our August 2007 Market Commentary *Anatomy of a Credit Crunch*.
[3] From a historical perspective, a 10% decline in the S&P 500 is not particularly rare. Ned Davis Research counts 87 declines of 10% or more in the S&P 500 since the beginning of 1928, although they have become less frequent in recent decades.
[4] To calculate this, we multiplied the 12-month total return of each stock in the Russell 3000® Index by the stock's weighting in the index at the beginning of the year to derive each stock's contribution. We then sorted the 3,000 stocks by their contribution, and began totaling those contributions until we reached the index's total return. The remaining stocks in aggregate had a contribution of 0% to the index's return—the positive contributions of some washed out the negative contributions of the rest.

But are indices and markets always top heavy? Yes they are, but the degree of concentration varies. Table A indicates the percentage of stocks in the S&P 500 Index that underperformed the index itself over the prior 52 weeks, while Table B indicates the percentage of index components that lagged the index's return by 10 percentage points or more (Tables C and D illustrate these same two measures of concentration on a rolling basis using the broader Russell 3000® Index rather than the large-capitalization S&P 500, albeit with a shorter time period). On average since 1973, just over half of the S&P 500 component stocks underperformed the index for the prior 52 weeks, and one-third underperformed by 10 percentage points or more. The current level of concentration is greater than it has been for about two-thirds of prior periods dating to 1973.

Prior to the 1973–74 bear market, the 1987 crash, the brief 1990 sell-off, and particularly the Nasdaq peak in March 2000, market concentration was higher than normal.[5] In concentrated markets, typically a small number of momentum-driven stocks carry the market upward, with little help from the rest of the index. Concentration has been rising in recent years, with a shrinking gaggle of giant companies (many of which derive a large percentage of their revenues from overseas and therefore are positioned well in a weak US$ environment) dragging a reluctant index upward. Concentration is now higher than it has been in about seven years, although it certainly remains lower than in 1987, 1990, and much of the late 1990s.

Financial Shares on the Rocks

Financial stocks have a reputation for serving as beacons. When they are in trouble, the theory goes, the economy and the rest of the market often follow. A downturn in financial stocks has often (but certainly not always) been followed by rocky times for the broader markets (Table E), although the history is somewhat limited. In the 12 months prior to the sharp but short-lived Black Monday panic of 1987, financials underperformed by 16 percentage points. Financials again underperformed by nearly 19 percentage points in the year prior to the recession that began in July 1990, a downturn that dealt a brief setback to the stock market (the Russell 1000® returned -14.6% in third quarter 1990). One of the sharpest periods of financials underperformance (by nearly 28 percentage points) came in the 12 months ended February 28, 2000, just as the Nasdaq Composite Index was nearing its peak.

Not all periods of lagging financial stocks have been followed by poor market performance, however. In the late 1970s and early 1980s, for example, high interest rates and particularly an inverted yield curve were not conducive to profitable lending, and share prices showed this. Financials shares underperformed the broader Russell 1000® by more than 16 percentage points in the 12 months leading up to February 29, 1980. The following month, Treasury bill yields at 15% were more than 200 basis points (bps) higher than ten-year Treasury note yields, and the Russell 1000® sold off 11.3% in the month of

[5] As the market started turning down at the beginning of 1973, more than two-thirds of the index's component stocks lagged the S&P's own return, and more than half of the stocks lagged it by 10 percentage points or more, and two years (and a -37.3% S&P 500 return) later, less than 30% of the index's stocks were lagging the index by 10+ percentage points, and more than half were actually leading the index. Over the 52 weeks prior to mid-October of 1987, 62% of S&P 500 component stocks lagged the index, compared to a reading of 48% one year before and 52% one year after the crash.

March. But a rapid disinversion of the yield curve and falling (but still double-digit) inflation cheered the dwindling number of equity investors still active in the market (stocks yielding 5.2% were having a tough time competing with money market yields well into the double digits), and the Russell 1000® ramped up 41.4% in the year through March 31, 1981. Returns following this period were quite volatile (the annualized return of the Russell 1000® was just 4.4% over the two years following February 1980, despite that fabulous early return).

In any case, underperformance by financials has *often* been a harbinger of relatively poor returns for the broad equity market. This is likely even more true today than in previous periods, given the market's and the economy's dependence on the financial sector. Financials are the market's largest sector, they are the mechanism through which Wall Street meets Main Street (primarily in their roles as a provider of credit and secondarily as a manager of assets), and financial stock meltdowns often occur when the real economy is slowing or in turmoil.

Leaning on the Money Machines

At 19% of the broad U.S. market by capitalization, 25% by earnings, and 23% by dividends paid, financials are clearly the driver of the equity markets. And if anything, these statistics probably understate the case; industrial firms such as GE and Ford, retailers, and other nonfinancial firms have sizable financial or consumer-credit divisions.[6] The financial firms that drive our economy are now looking wobbly. Let us look specifically at banks, setting aside insurers and other financial firms. Unlike in 1980, the yield curve is now normally shaped, but that is small consolation for banks, since their borrowing costs are nowhere near T-bill yields: LIBOR is running at 4.89%—95 bps above the 13-week T-bill (compared to a spread of just 29 bps in October 2006)—bond spreads for top-rated banks have more than doubled from their level in early June,[7] and rates on time-deposit accounts need to be high enough to compete with money market fund yields inflated by investors' unwillingness to own asset-backed commercial paper.

In the meantime, bank balance sheets are overloaded with assets and obligations that were supposed to be building blocks of collateralized debt obligations (CDOs) and collateralized loan obligations, and these positions are sucking up capital and constraining further lending. These often low-quality securities cannot be highly levered, and their mark-to-market value has been plummeting. Banks, desperate to neutralize their exposures, are likely shorting AAA-rated subprime asset-backed securities (the primary building blocks of many recent-vintage CDOs) via the ABX and shorting leveraged loans via the LCDX. Heavy short selling of

[6] For more on this, please see our June 2003 Market Commentary *The Financial Sector: A Giant Octopus and Its Tentacles*.
[7] This refers to the Merrill Lynch Index of AA-AAA rated bank bonds with maturities from five to ten years. The option-adjusted spread on this index was 153 bps as of November 15, 2007, compared with 75 bps on June 1, 2007.

these two derivatives pressures their prices further, which may precipitate further asset markdowns (these derivatives are in some cases the best or only price signal for banks to use in valuing their asset-backed securities and loans), which encourages additional bank hedging. This vicious circle is not a recipe for strong earnings.[8]

With 97% of the financial stocks within the S&P 500 having reported their third quarter earnings, the sector looks to have shrunk earnings-per-share by 23.4% relative to third quarter 2006, according to Morgan Stanley. Consensus estimates for fourth quarter show a 24% decline in financials earnings year-over-year, with total calendar 2007 financials earnings expected to shrink 7% over the 2006 total. Pure banks are expected to see calendar 2007 earnings shrink by 20% over 2006, compared with a 9% decline expected for diversified financials relative to last year (the insurance and real estate subsectors, which together represent the remaining third of the financial sector by market capitalization, are expected to grow calendar 2007 earnings by 8% and 17%, respectively).

Earnings expectations for financials have, shall we say, *evolved* in recent weeks, together with the career plans of the top executives at Citigroup, Merrill Lynch, and E*Trade. In the first week of September, analysts pegged calendar 2007 growth at 8%—15 percentage points higher than their current expectation. With financials such a large part of the market, how do these downward revisions impact expectations for the S&P 500 overall? In early September, S&P 500 earnings for calendar 2007 were expected to top calendar 2006 by 8.5%, whereas current expectations are now just 4.6% (nearly 100% of calendar 2007 earnings growth is expected to come from technology, health care, and industrial companies). After four straight years of double-digit earnings growth, earnings contraction in the third quarter of this year and nominal earnings growth for the full year of 4.6% (likely 2% to 3% real) are not encouraging developments in this earnings-driven market where valuations continue to contract. And for third quarter, S&P 500 earnings were expected to be negative for the first time in more than five years.[9]

Are We Overly Pessimistic?

It is quite possible that in a few weeks' or a few months' time, we will look a bit more like Chicken Little than like Cassandra. After all, market breadth appears to be on its way down and has not been mentioned much in the financial press, but it is not anywhere near 1999 levels yet. Financials are underperforming, but not as badly as they did in 1999 and early 2000. And the extent to which subprime mortgage and loan overhangs will cramp banks' style has been discussed at length in many venues.

[8] The *Wall Street Journal* reported on November 30 that Treasury Secretary Paulson was working with mortgage industry participants to cap or freeze interest rates on subprime mortgages. Depending largely on how many borrowers were included and how long the freeze remained in place, this could radically slow the projected growth in subprime default rates, which would likely have a salutary impact on subprime securities and derivatives, even though interest income would be reduced.

[9] For more on peaking earnings, please see our May 2006 Market Commentary *Prospects for U.S. Equities Remain Bleak*.

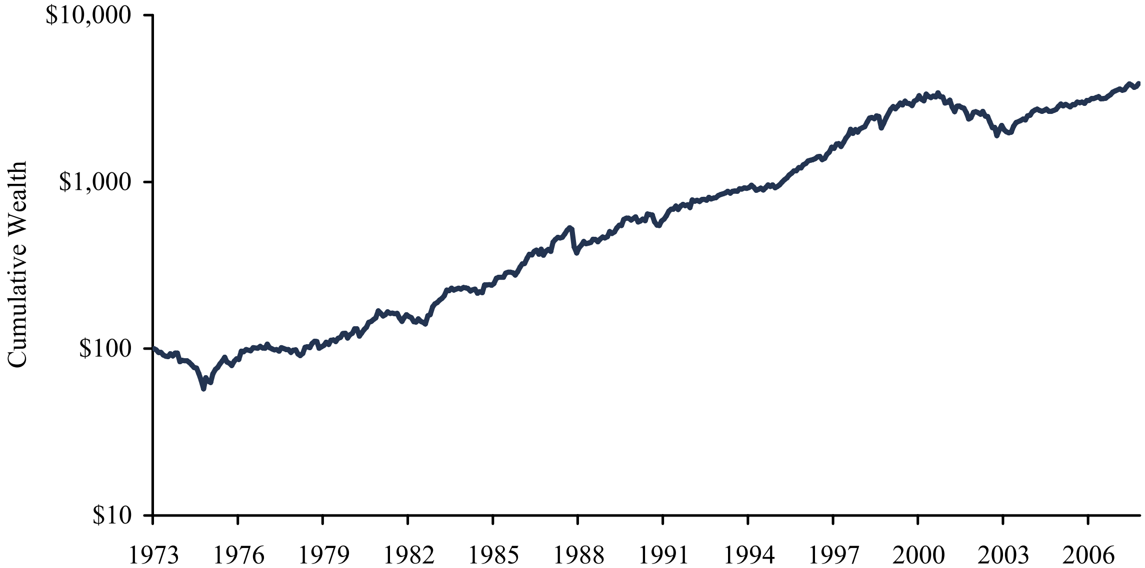
It is possible that these factors are baked in, along with other negatives that have been debated *ad nauseum* (such as the one-two punch to American consumers from housing's negative wealth effect and the declining potential for mortgage equity withdrawal). Investors are aware of these negatives. But were they not also aware in late 2006 that house prices had peaked? And yet they kept building and buying CDOs created from subprime mortgages that could only hold up if house prices appreciated or credit conditions loosened even further.

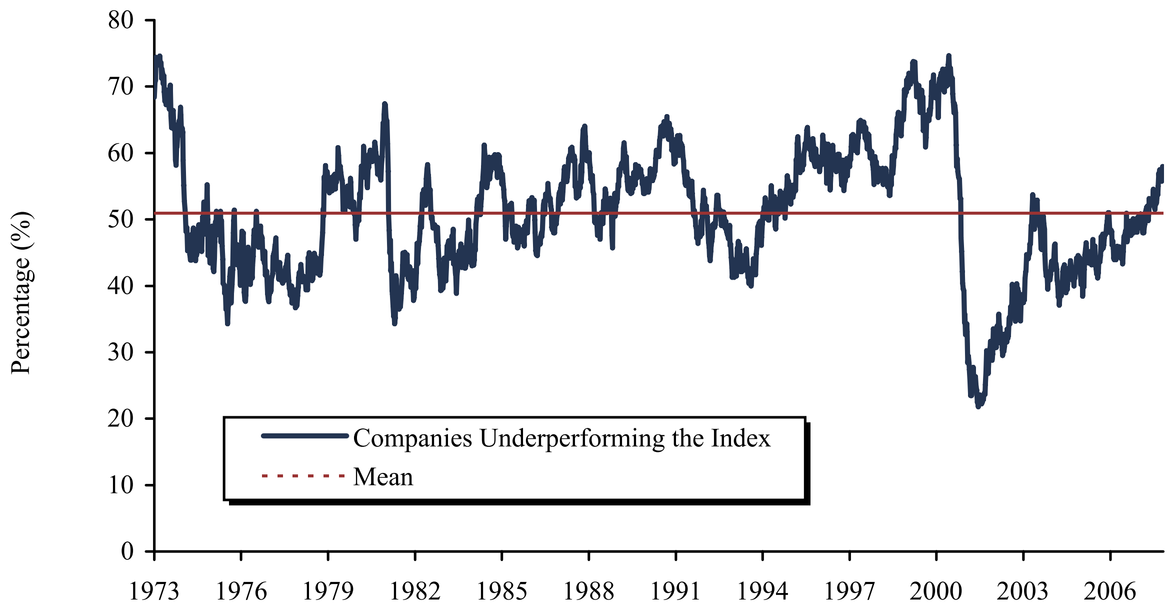
We continue to believe the market remains somewhat overly *optimistic* and that there will likely be tough sledding ahead for the markets. The largest capitalization slice of the U.S. market, and particularly large- and mega-cap growth stocks (which are of higher quality in general than the broad market), have fared much better than the overall market since the credit crunch started in June and July. We have been advocating for some time now that investors emphasize these segments of the U.S. equity market,[10] and we believe that they still are well positioned, both in terms of relative valuations and in terms of defensive posture. We have also suggested finding and funding talented distressed-debt managers who can call down capital when the supply of hot potatoes increases,[11] and if financials really hit the rocks, distressed managers could benefit as refinancing possibilities disappear. It is no stretch to imagine that some of the mid-sized financial firms will eventually be among those whose bonds become fodder for distressed funds.[12]

[10] Please see, for example, Market Commentaries from August 2006, March 2007, and June 2007, respectively: *The Unloved Mega-Caps, It's Getting Late—Risks Are Rising,* and *U.S. Value Stocks Moving Out of the Markdown Aisle.*
[11] Please see our September 2007 Market Commentary *Opportunistic Credit Funds Hoping for Fire-Sale Prices.*
[12] Bridgewater Associates on November 29 highlighted 13 financial companies "at risk of bankruptcy," including Countrywide Financial, the largest mortgage lender in America, whose 3.25% coupon bonds that mature in May are currently yielding more than 30%. Monoline bond insurers, meanwhile, have AAA ratings, yet credit default swaps protecting their outstanding debt issues are currently priced at speculative-grade levels, resulting from their leveraged insurance exposure to securities underlain by subprime mortgage loans.

Table A

PERCENTAGE OF S&P 500 COMPANIES UNDERPERFORMING THE S&P 500 INDEX



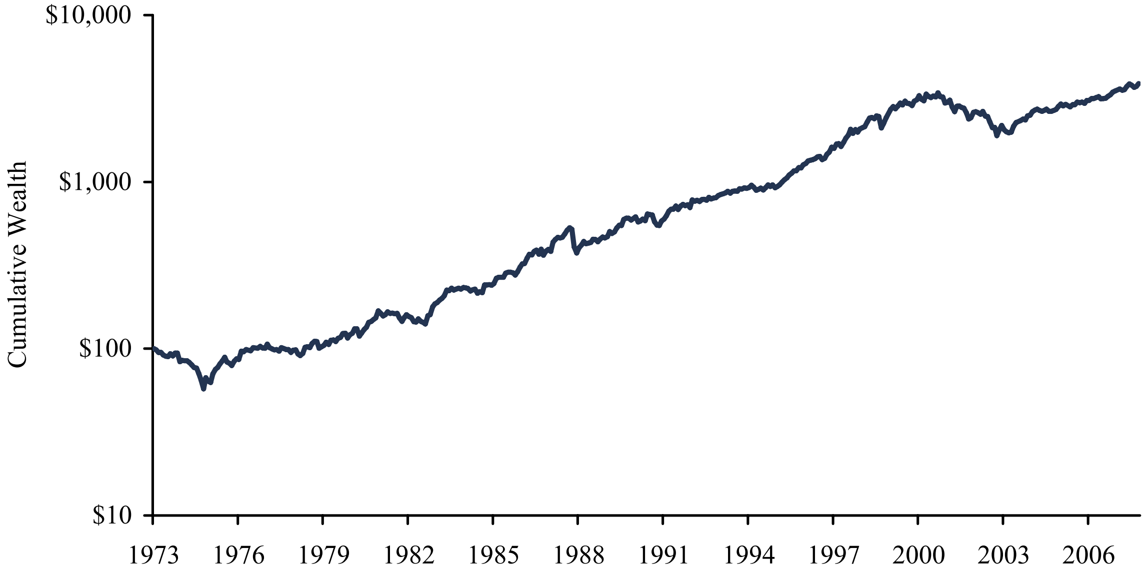


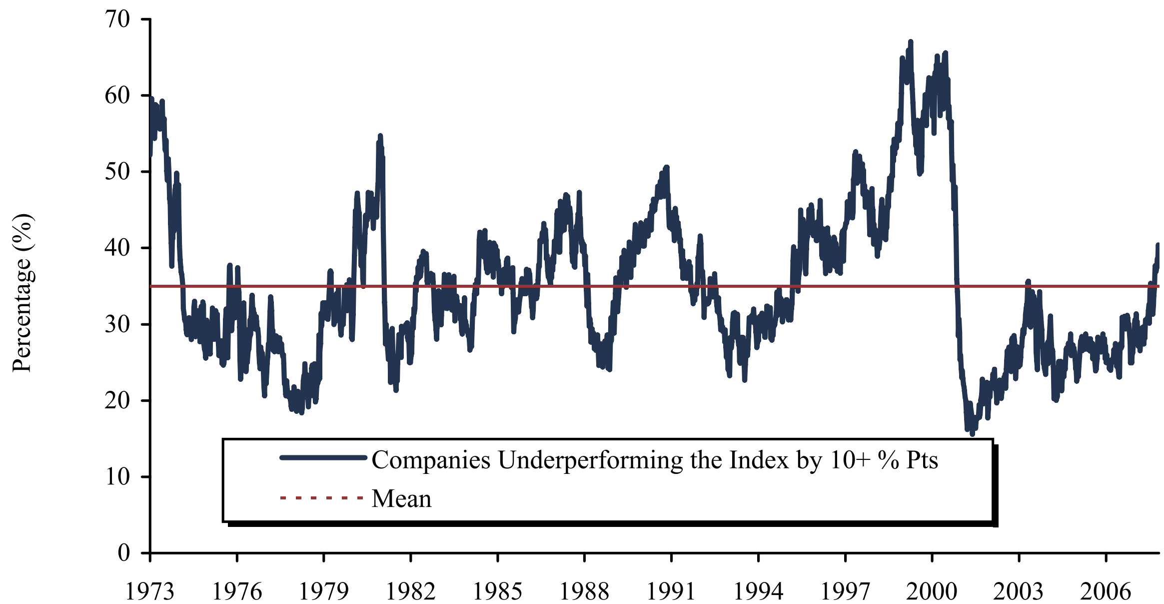
Sources: Ned Davis Research, Inc., Standard and Poor's, and Thomson Datastream.

Notes: Top graph represents monthly data through October 31, 2007, and bottom graph represents weekly data through November 2, 2007. Cumulative wealth shown on a logarithmic scale. The percentage of companies that underperform the S&P 500 Index is calculated on a rolling 52-week total return basis.

Table B

PERCENTAGE OF S&P 500 COMPANIES UNDERPERFORMING THE S&P 500 INDEX BY 10 PERCENTAGE POINTS OR MORE



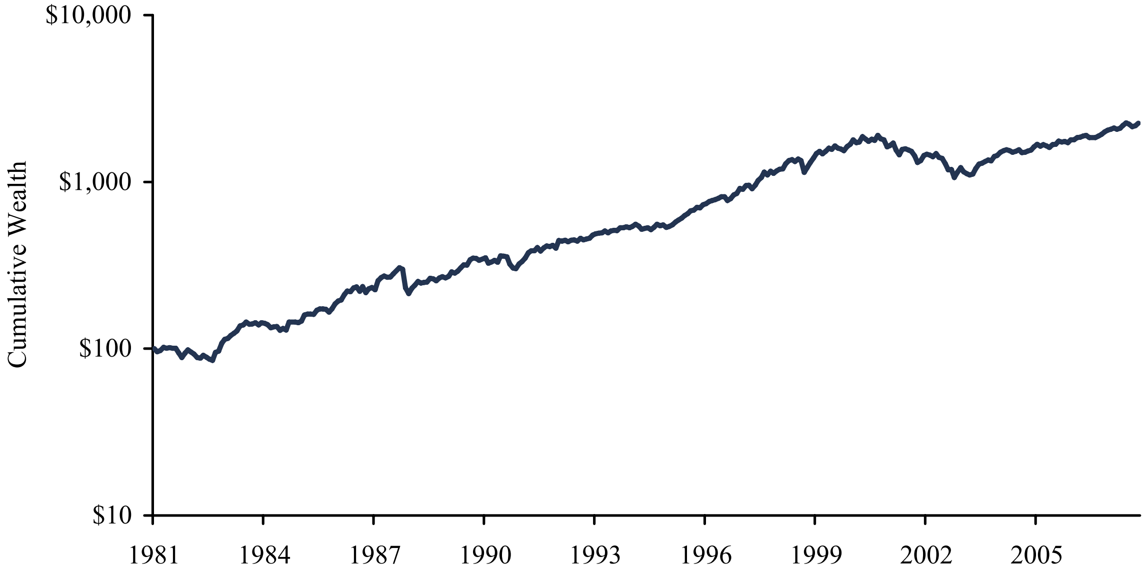


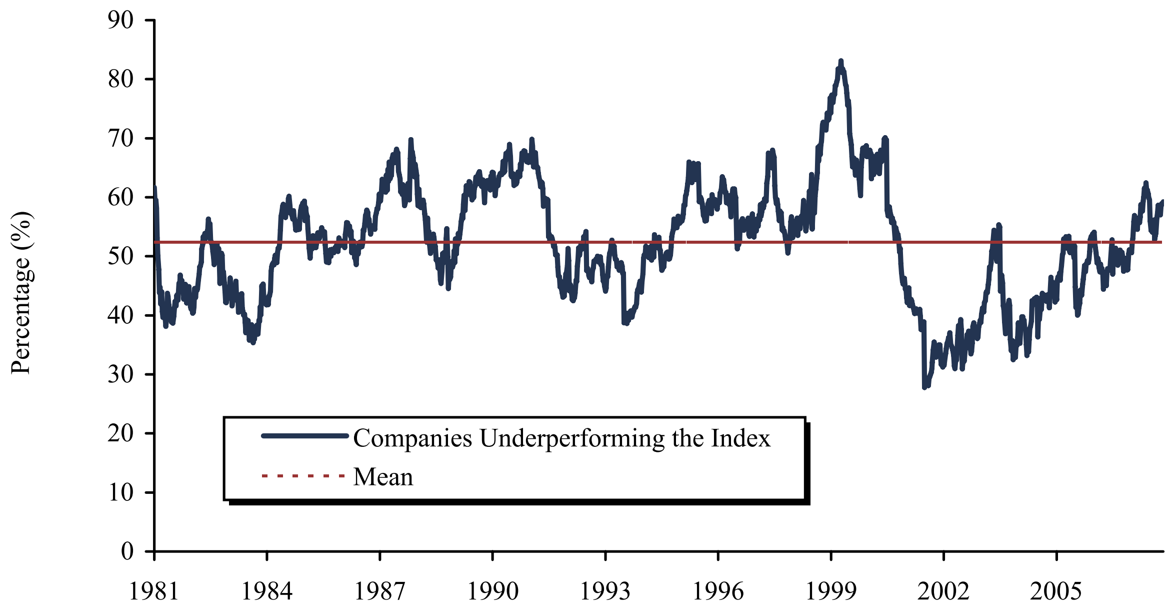
Sources: Ned Davis Research, Inc., Standard and Poor's, and Thomson Datastream.

Notes: Top graph represents monthly data through October 31, 2007, and bottom graph represents weekly data through November 2, 2007. Cumulative wealth shown on a logarithmic scale. The percentage of companies that underperform the S&P 500 Index by 10 percentage points or more is calculated on a rolling 52-week total return basis.

Table C

PERCENTAGE OF RUSSELL 3000® COMPANIES UNDERPERFORMING THE RUSSELL 3000® INDEX



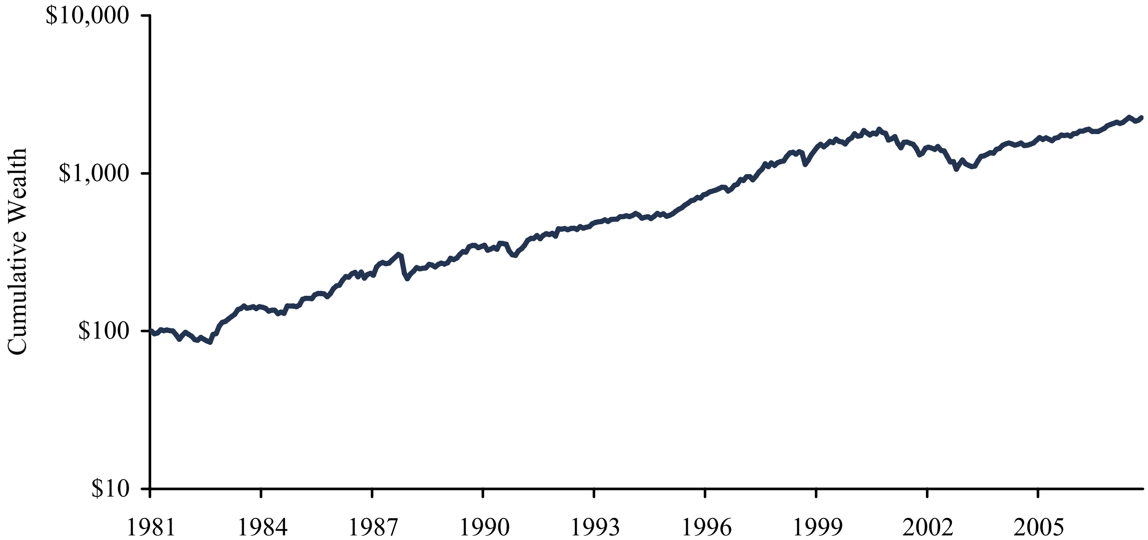


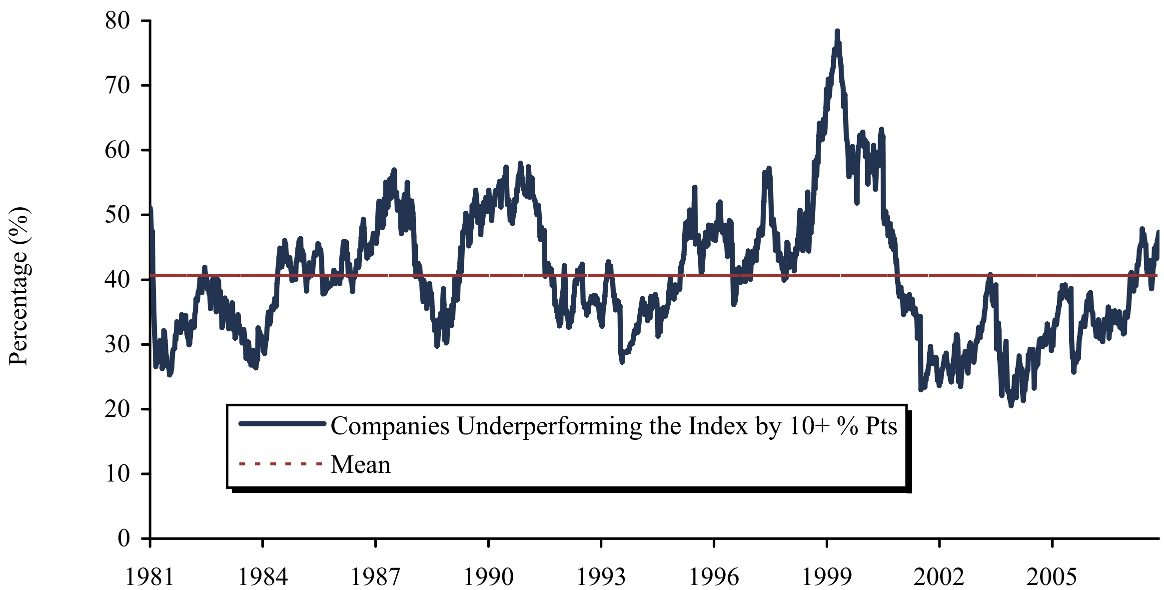
Sources: Frank Russell Company, Ned Davis Research, Inc., and Thomson Datastream.

Notes: Top graph represents monthly data through October 31, 2007, and bottom graph represents weekly data through November 2, 2007. Cumulative wealth shown on a logarithmic scale. The percentage of companies that underperform the Russell 3000® Index is calculated on a rolling 52-week total return basis.

Table D

PERCENTAGE OF RUSSELL 3000® COMPANIES UNDERPERFORMING THE RUSSELL 3000® INDEX BY 10 PERCENTAGE POINTS OR MORE





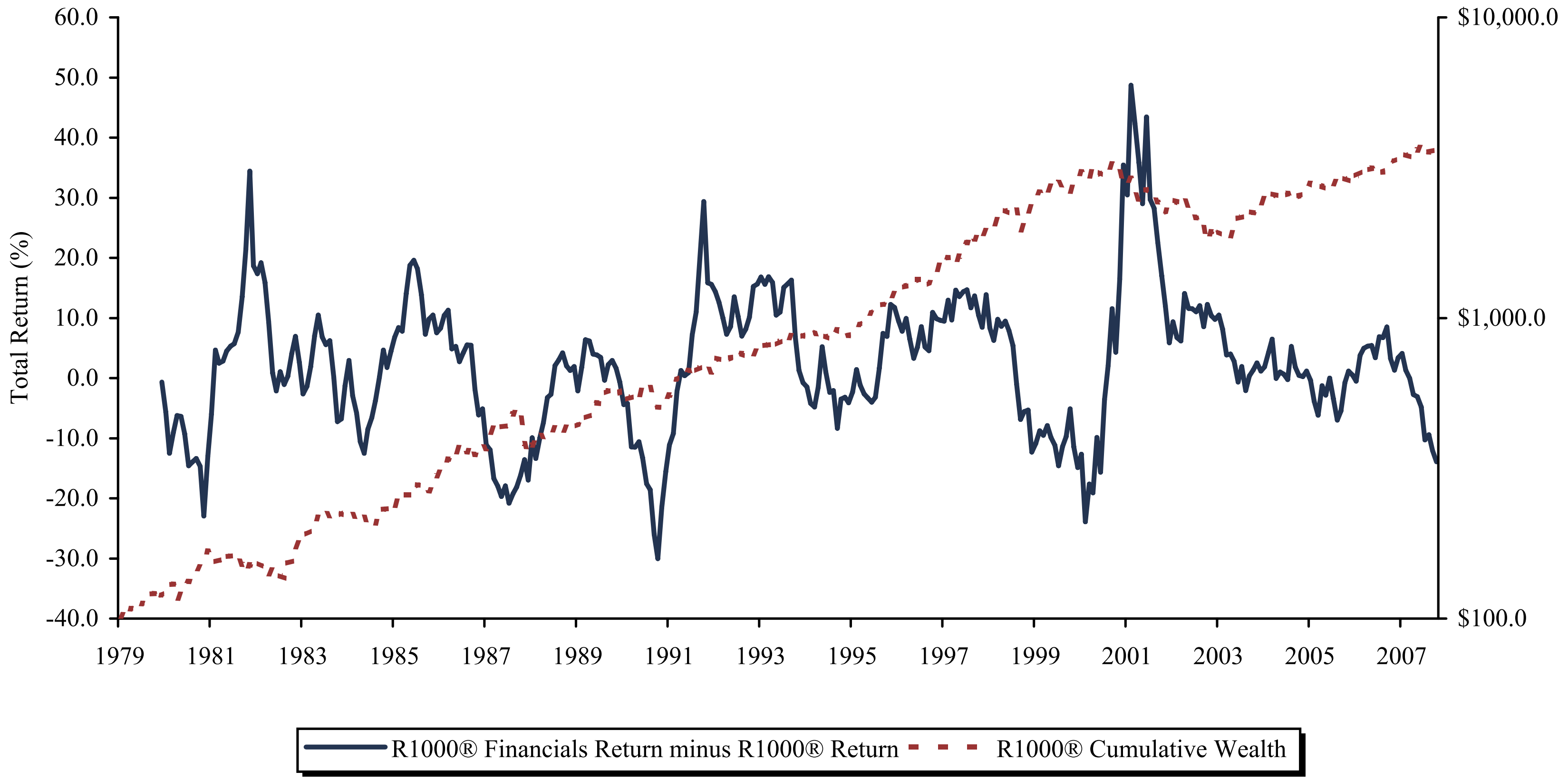
Sources: Frank Russell Company, Ned Davis Research, Inc., and Thomson Datastream.

Notes: Top graph represents monthly data through October 31, 2007, and bottom graph represents weekly data through November 2, 2007. Cumulative wealth shown on a logarithmic scale. The percentage of companies that underperform the Russell 3000® Index by 10 percentage points or more is calculated on a rolling 52-week total return basis.

Table E

12-MONTH ROLLING RETURN OF RUSSELL 1000® FINANCIALS INDEX MINUS RUSSELL 1000® INDEX

January 1, 1979 – October 31, 2007



Sources: FactSet Research Systems and Frank Russell Company.

Notes: Cumulative wealth shown on a logarithmic scale. Data for 2007 are through October 31.