



Newton's first law of motion states that "an object at rest tends to stay at rest and an object in motion tends to stay in motion with the same speed and in the same direction unless acted upon by an unbalanced force." Isaac Newton should have been a market analyst.

In the capital markets, long-term trends also tend to remain intact until something (an "unbalanced force") actively changes them. Put another way, there is a momentum to most capital markets, and their prevailing trends rarely reverse due to exhaustion (investors losing interest or running out of money). Instead, trend changes in general, and secular trend changes in particular, normally require a powerful catalyst.

For much of the past five years, the global stock and bond markets have benefitted from an almost perfect environment and this environment has sustained a variety of very strong macro-economic and macro-market trends. Interest rates have remained low across the globe, strong productivity improvement has kept profit margins very high, and monetary liquidity has remained at historically high levels. Of equal importance, the past five years has produced a level of global economic growth that was literally unprecedented in terms of both its combined strength and its overall breadth. For the first time in history, only two countries failed to post positive economic growth (Venezuela and Zimbabwe).

Perhaps the most notable and significant impact of this period has been the explosive growth in the emerging markets and the resulting development of a consumer middle class in a wide variety of countries that have historically been overwhelmingly export-oriented (China, India, Korea, Taiwan, Brazil, Russia, etc.). We view this accelerating development of a global middle class that can consume goods from around the world as a seminal event in the development of the global economy. Indeed, we believe that the long-awaited emergence of these developing economies will forever change the rules that have historically governed the global capital markets and economies. Wealth is being created across most of the world as the global economy gets increasingly larger and the gap between developed economies (Western Europe, Britain, Japan, and the U.S.) and developing economies (Brazil, Russia, India, China, etc) gets increasingly smaller.

At present, the momentum and fundamentals behind each of these long-term trends still remain relatively intact. However, for the first time in over five years, investors and analysts alike must now consider a set of variables that, in combination, present a powerful and potentially viable challenge to these prevailing and dominant capital market trends.

It is noteworthy, and a sharp break from history, that the current problems are primarily U.S.-centric. They include the severe bear market in domestic real estate and the related and ongoing implosion in the sub-prime and collateralized debt obligation (CDO) markets, the sharp secular decline in the value of the U.S. dollar, and a gradual but sustained slowing in the U.S. economy.

None of these issues are new, and (thanks to a series of rate cuts by the Federal Reserve) the initial market panic that dominated the global capital markets several months ago has already passed. However, it is important not to confuse the passage of the initial crisis with the resolution of these problems. To the contrary, we suspect that most of these issues will continue to weigh on the U.S. economy and, by correlation, the domestic markets, well into 2008. Indeed, we believe that the re-emergence of these credit-related fears is primarily responsible for the current decline in the global equity markets.

At the heart of the problem is the fairly dramatic bear market in U.S. real estate prices, which is pushing down real estate values (often well below current mortgage values) at the same time that the overall cost of mortgage payments is accelerating higher due to interest rate resets on variable and exotic mortgages. This will be a particular issue over the next two quarters when hundreds of billions of dollars in adjustable mortgages are scheduled to reset. When combined with a slowing domestic economy, worsening consumer sentiment, and a housing environment where average home prices are still too high to be afforded by the average buyer, we expect foreclosures to accelerate and thus dump more and more supply onto the market thus further depressing home prices. Over the past three months, 45 of the 50 states have recorded a jump in foreclosures. Moreover, according to RealtyTrac, third quarter foreclosure filings jumped 30% from second quarter levels, and jumped 100% from year-ago levels. We believe that this trend is likely to get much worse before it gets better.

Equally troubling is the impact of the real estate decline on securitized mortgages (particularly sub-prime) and the so-called "structured products", like collateralized debt obligations (CDOs), that are comprised of this mortgage-related debt. Ever since the implosion of two Bear Stearns hedge funds that invested in CDOs, there has been virtually no liquidity in the markets for CDOs and sub-prime debt. They simply do not trade, which means that they can't be priced (other than by computer models, which are specious at best). There are an estimated 759 trillion dollars of credit derivatives held around the globe, and no one knows if many of these issues are worth 100 cents on the dollar or only pennies on the dollar.

Investors should get some additional clarity on these issues over the coming months due to the newly implemented Financial Accounting Standard #157. This new rule, which becomes effective for all fiscal years starting after November 15th of this year, will make it more difficult for financial institutions to hold these illiquid "Level 3" assets in off-balance sheet accounts, and thus force these institutions to start marking these assets to market (assign to them a value that would be realistically supported by the markets). Until this issue more fully unfolds, we believe that these real estate and securitized mortgage-related issues make the stocks of most financial services companies and virtually all real estate or housing-related companies virtually radio-active. We anticipate massive write-downs that will hurt the profits of many financial services companies for quarters, if not years, to come. Further, even once these liquidity, accounting and valuation issues are resolved, we expect for many financial services companies to spend the next several years fending off investor and home-owner lawsuits related to the sub-prime and CDO crisis.

Another critically-important issue, the falling U.S. Dollar, is actually more of a two-edged sword. On the positive side, it makes American-made goods much more competitive overseas. Over recent months, we have already seen signs that it is starting to shrink the trade deficit, and much of the surprising strength that we saw in the third quarter GDP (Gross Domestic Product) report was attributable to surging exports. On the negative side, a falling dollar both increases the risk that foreigners will sell U.S. financial assets to avoid currency losses and also increases the risk of importing inflation into the domestic economy. The falling dollar also raises the risk of trade protectionism from abroad. The French government has already warned that a continued slide in the value of the dollar could provoke a trade war.



The inflationary implications of a falling dollar are a particular concern to us in light of the many other inflationary influences that currently exist (record oil prices, falling productivity, relatively tight labor markets, etc.). On the other hand, these inflationary influences should be partially offset by the bear market in real estate, which is a very deflationary influence over the long run (although it tends to push up home and apartment rental costs over the short term) and the inexpensive imports that we continue to buy from China and the other emerging markets.



There is little doubt that these dollar and credit market problems are both substantial and long-lasting. The question is whether or not they represent sufficiently “unbalanced forces” to reverse the prevailing market trends. More specifically, are they sufficient to cause an economic recession in the U.S., and are they a sufficiently negative influence to reverse the bull market in global equities?

Unfortunately, in our opinion, it is simply too early to tell how this confluence of events will ultimately resolve itself. However, it is already very evident that this liquidity crisis in asset-backed securities is the biggest challenge to the global economy and the global bull market in equities in over five years, and that the impact of this phenomenon is being further exacerbated by oil prices now hovering around \$100 per barrel.

From our perspective, we believe that the economic expansion and equity bull markets outside of the U.S. are ultimately likely to survive these challenges, albeit with some significant turmoil along the way. However, the outlook for the U.S. economy and equity markets is somewhat cloudier. Indeed, now that the 200-day moving average for both the S&P 500 Index and the Dow Jones Industrial Average have turned lower for the first time in five years (which suggests that the majority of domestic large-cap stocks are already in sustained down-trends), one can make the argument that domestic stocks have already entered into a bearish trend.





While we believe that, at this point, it makes sense to become more defensive as we await further clarification on these issues, we are not yet ready to declare the onset of a bear market in domestic stocks. Instead, we are still inclined to give the domestic stock markets the benefit of the doubt until after we see how they handle the anticipated re-test of the March and/or August lows (illustrated in the 1-year chart of the Standard & Poor's 500 Index).

We view this 1,380 to 1,408 range on the S&P 500 as critically important support, and any breach of this range would likely turn our outlook for domestic stocks decidedly bearish.

Even if these support levels do hold, which would suggest a continuation of the primary up-trend, we would expect for the characteristics of the domestic equity markets to be notably different than what we have seen over the past five years. More specifically, even if a continuing up-trend is confirmed, we expect for market volatility to increase quite dramatically. We would also expect for market breadth to contract quite significantly, and for leadership in the domestic markets to be reduced primarily to stocks of dominant companies in a few select sectors. In other words, in the U.S., we anticipate the emergence of a classic “stock-pickers” market where astute sector and securities selection can allow for returns well above that of the market as a whole.

The bull market in global equities is very old by historical standards, and now faces a variety of very powerful headwinds. Even with that being the case, we must remain mindful of the fact that the world has, in fact, changed in the new millennium, and that the rest of the global economy is now much better able to withstand the impact of problems in the U.S. than it has ever been before in modern history. There is still incredible growth in the world's emerging economies, and there are still generous levels of global monetary liquidity.

It is also noteworthy that, even if we see a modest slowdown in corporate earnings, domestic stocks are relatively inexpensive (currently 14 to 15 times expected forward earnings). Indeed, as U.S. corporate earnings have grown at almost twice the rate of stock price appreciation since the end of the 2000 to 2002 bear market, stocks in general are only one-half as expensive (based on earnings) as they were five years ago. It is also important to keep in mind that equity multiples tend to expand when the Fed is lowering interest rates (which we expect to continue), and that should be a bullish influence on stock prices.



In conclusion, the markets currently face an unusual abundance of both very powerful bullish and very powerful bearish influences. The positive influences include the growth in the emerging markets, the emerging global middle class, abundant global monetary liquidity, reasonable equity valuations, still low interest rates, and a Federal Reserve that is easing monetary policy. The negative influences include the bear market in domestic real estate, the illiquidity in the mortgage and securitized real estate markets, record oil prices, a slowing U.S. economy, and the increasing likelihood of a less business-friendly U.S. legislative environment.

Unfortunately, from our perspective, it is simply too early to tell whether the bullish or bearish influences will prevail in the end. We suspect that the answer will ultimately depend on how long it takes to re-liquify the asset-backed securities markets to the point where the markets can effectively assign value to these securities, and whether or not this re-liquification can be achieved before the current crisis does too much harm to the global economy and to investor confidence. Until these questions can be answered, we believe that the prudent course of action is to become more defensive by increasing portfolio cash allocations, and by emphasizing international equities and the stocks of large domestic exporting companies in the growth portion of portfolio allocations.

The CACH Capital Management Team

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