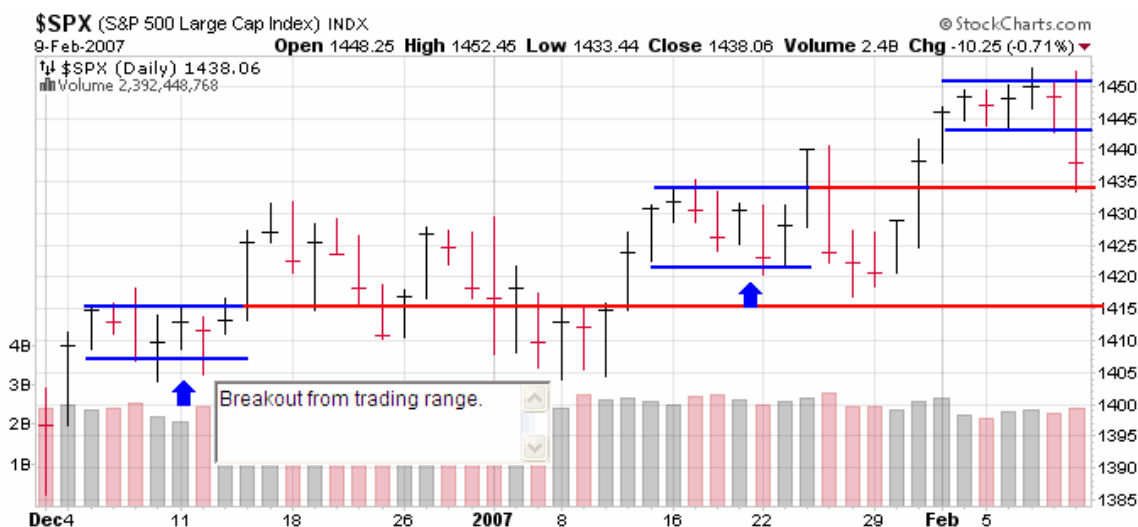


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Bear Essentials

All the major indexes including the Dow Jones Industrial Index, S&P 500, Nasdaq, and the Small Cap Russell 2000 ended the week in negative territory, in spite of upbeat earnings from Cisco and upgrades for the automakers. There was no major change in the market until Friday when rising oil prices and Fed officials' hawkish comments on inflation took the market down. The S&P 500 broke down on Friday after spending the whole week in a tight trading range, closing at 1438. The parallel blue lines in the chart below denote the times over the past couple months when we have had a similar trading range pattern in the S&P 500. This time prices have moved to the downside but extending the lines from the previous resistance areas (shown by the red lines) gives us an idea of the initial areas of support for the index.

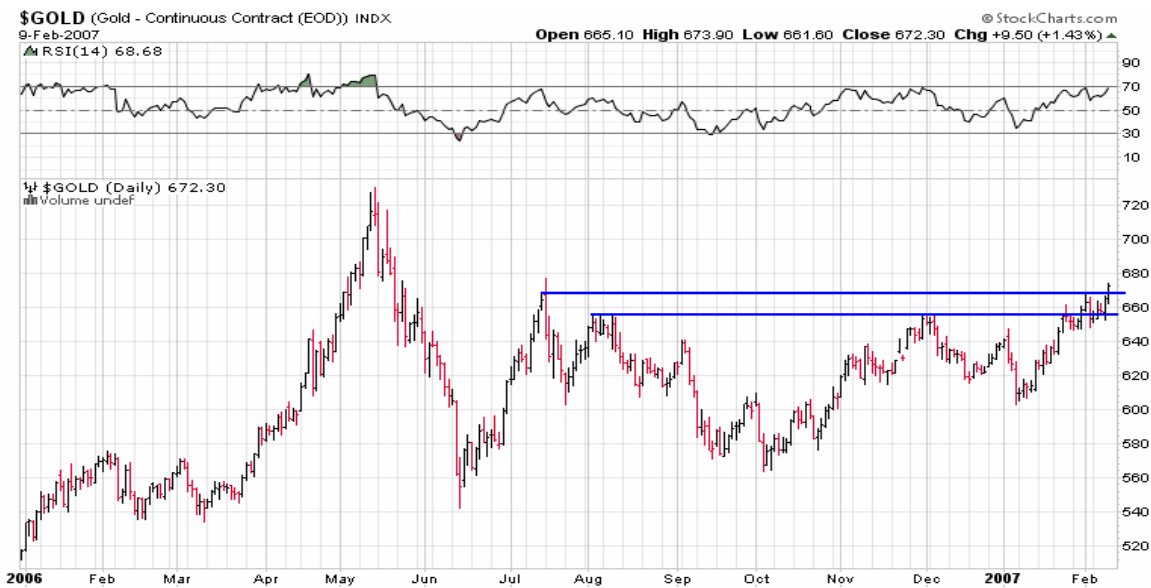


Even though the broad market moved downward, the extent of the money waiting to jump into the market can be gauged by the response to the first-ever hedge fund IPO (initial public offering). Fortress Investment Group (symbol: FIG) closed the day at \$31, up 68% from the IPO price of \$18.50, giving the investment manager a market value of close to \$12 billion. The assets under management at Fortress are just about \$30 billion. It is interesting that despite the generally lackluster returns of the hedge fund industry and high management fees, there is a voracious appetite for a piece of these companies. In this month's *Investment View* we highlighted how hedge fund operations have made the entire market as a whole more vulnerable as it becomes increasingly difficult to ascertain where risk lies.

Even as the risk managers in alternative investments went "over the hedge," ironically, last week we also had a warning from the sub-prime lending market. New Century Financial warned of lower loan production and rising delinquencies. Its shares continued their decline on Friday after dropping 36% on Thursday. New Century specializes in so-called sub-prime loans. These are loans to individuals with questionable credit, and are mostly adjustable rate mortgages (ARMS). As adjustable rate mortgages continue to adjust upward, we can expect more vicious movements in stocks of companies that specialize in that area.

Another factor affecting the market was the comments from a voting member of the Federal Reserve that the “US economy should continue to grow at a sustainable pace and inflation will continue to decline” while leaving open the possibility of further rate increases. As the credit markets absorbed the implications, bond yields moved just slightly lower and the ten-year Treasury yields closed the week at 4.78%, down from 4.82% the week before.

Speaking of inflation let us take a look at the traditional hedge against inflation and declining dollar- gold. After reaching a low of \$542 an ounce last summer, it has quietly crept up and closed last week at \$ 672; up almost 23%. For the first time in 8 months it has closed above the two areas of resistance shown by the blue lines in the chart below. A rise in the precious metal is usually accompanied by growing unease about the prospect of rising inflation, which goes hand-in-hand with a declining dollar.



Next week Fed Chairman Bernanke will testify before Congress about the economy and the direction of monetary policy. The markets are anticipating an uplifting message. And it will compare the message to the barrage of economic releases scheduled for next week, including retail sales, housing starts, the producer price index, and University of Michigan Consumer Sentiment Index. Any negative surprises could be the “bear essentials” in a move down. So far the Fed’s Goldilocks story has been following the script of a not too hot and not too cold economy with moderating inflation. But we must not forget the essential fact that when the bears came home Goldilocks had to flee!

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