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## **Financial Markets Update      August 31, 2007**

**Global stock markets have been struggling in recent weeks. The Dow Jones and S&P 500 stock indices made all-time highs on July 19, but have declined more than 7% since then. The Dow, for instance, has fallen to a level it first hit on April 25<sup>th</sup>. For international stocks the decline is 9.2% (back to the level of March 28) and small stocks are off 10.2% (which has wiped out all its gains back to November 10, 2006). As stock market declines go historically, this is hardly worth noting. Nevertheless, there has been concern recently that the markets would be heading significantly lower. We don't believe that is going to happen, but neither are we ready to buy just yet.**

**The cause of the stock market decline was first due to the losses in sub-prime mortgages and related debt instruments suffered by certain financial services companies and hedge funds. These losses resulted from the sales of other securities (primarily stocks) in order to raise cash to meeting margin calls and redemption requests due to the original sub-prime mortgages. In recent days these concerns have grown regarding a general weakening in the economy caused by a slowdown in consumer spending due to rising home foreclosures and lower real estate values. Many in the financial media have made the case that the home mortgage sector represents just 6% of the U.S. economy, so the impact should be fairly small. This misses the point that consumer spending is almost 70% of the U.S. economy, so even a 3% decline in consumer spending would turn negative an economy that was previously growing at 2%. Adjustable rate mortgages are going to continue to be reset at higher rates for more than two years, so the situation is unlikely to improve in the near term.**

**As you know, we have been concerned since May that stocks prices had risen beyond economic fundamentals. We raised a significant amount of cash in all portfolios with the idea that we could earn approximately 4.7% in the money market while waiting for a cheaper entry point. We were especially concerned with the valuations of highly appreciated sectors like real estate, emerging markets, and small company stocks, so we cut back those positions more decisively. Our decision to do so was timely. The stock decline was especially steep in the small company and real estate sectors.**

**We are not yet ready to begin buying back into those positions as yet; we believe the market has not yet fully discounted the economic effects of the weak housing market. Stocks had risen 11% as of July 19<sup>th</sup> on top of a gain of almost 16% last year so a seven percent decline hardly makes them cheap. We expect markets to remain choppy over the next few months. In addition to sell-offs there will be brief rallies that carry the markets up 200-300 Dow points. Our concern is the big picture. We are not ready to be more fully committed to the market until either it is priced to reflect the difficulties in the housing market or until those issues are resolved.**

**Eric C. Graber, President & Mark A. Carlton, CFA**