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Financial Markets Commentary

3rd Quarter 2007

Summary

October 16, 2007

Stocks came back from a sharp sell-off in late January to post a modest gain for the quarter. The unraveling of the credit markets in the wake of significant losses in the sub-prime mortgage sector led to a panic of sorts, and in the early afternoon of August 16th it looked like the stock market might have a 1987-style meltdown. However, a 370-point recovery by market close helped restore investor confidence, and the trend was already upward before an unexpected 50 basis point rate cut on September 18th erased what was left of the quarterly decline. The market rallied further into the end of the quarter, leaving the US stock market as a whole with a 1.10% gain. We warned investors in the July Quarterly Market Commentary that stocks were not as safe as they seemed at the time. The market's subsequent plunge and ascension illustrates how quickly investors can go from euphoria to despair and back, but it does not change the concerns we have that the economy has certain problems that can't be solved overnight by a Fed rate cut.

That said, stocks continue to benefit from a very strong global economy. Growth is exceptionally strong in emerging markets, most notably in China. Emerging markets returned close to 14% last quarter, dramatically better than the 2.2% from developed international markets (chiefly Europe and Japan). Large companies tend to hold up better during times of economic distress; last quarter was no exception. The S&P 500 gained 2% last quarter, and the 30 stock Dow Jones Industrial Average rose 4.2%. Smaller companies lost 3.1% as measured by the Russell 2000. The sectors of the economy that fared best were those whose output was in demand by foreign companies and investors – technology, energy, and precious metals. Companies catering more to the domestic market – financial services and real estate for example, did far less well.

Bonds benefited from the belief that the domestic economy was weakening. The best category of the bond market was inflation-protected treasuries, which gained 4.5%. Investors were concerned that the Federal Reserve's moves to stimulate the economy would lead to higher inflation. With all of the problem loans coming to light, investors fled to the highest quality bonds. Overall, bonds returned about 3% last quarter. High yield corporate bonds gained less than 0.1% on fears that defaults would rise.

Strategy

We reduced our stock exposure in May and June, so we were prepared for the sell-off in July. Stocks fell enough to approach a buy point on August 16th, but that opportunity lasted less than an hour. As a result, only the most aggressive accounts saw purchases. Despite our much higher cash positions we performed very well relative to the market averages. Our flagship Balanced program gained 2.30% (before fees), compared to 2.38% for the balanced fund benchmark. In other words, we gave up a very small amount of return while substantially reducing downside risk. Ironically since bonds outperformed stocks during the quarter, conservative portfolios performed better than more aggressive ones.

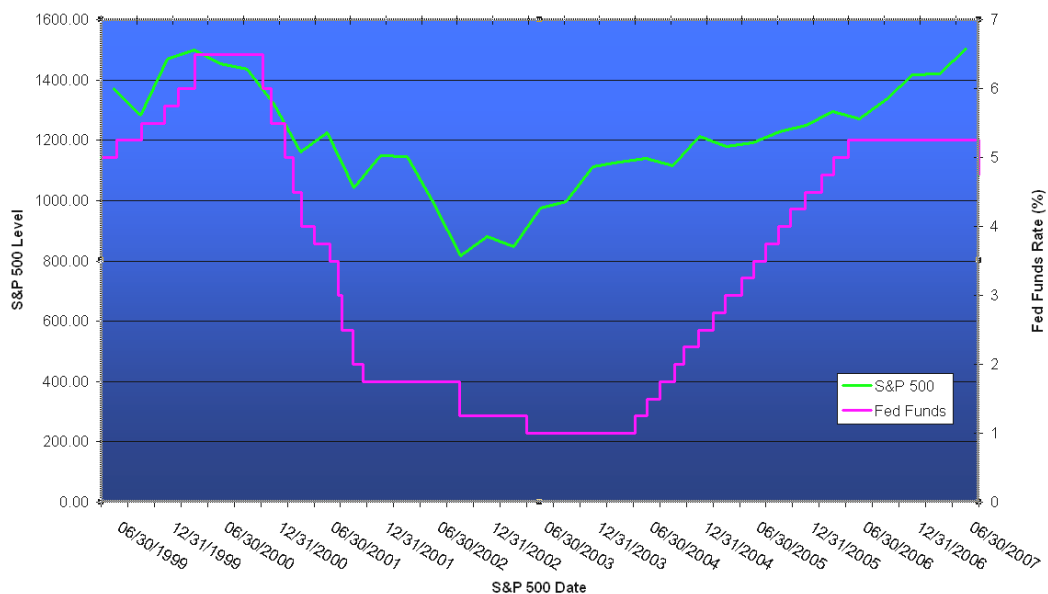
Outlook

If markets were over-sold in mid-August, they are probably over-bought right now. We should expect a more subdued market in the months ahead as the weak housing market impacts sales and profit margins come down. However, corporate balance sheets are as healthy as they have ever been, and this is leading to a high level of stock buybacks. This is an important support under the stock market. In fact, announcements that corporations were buying large amounts of their own stocks were important in reversing market declines both in 1987 and just this summer. It is for that reason that many feel that the downside potential in the market is limited even if it is a long time before the housing market recovers.

Commentary – “The Buck Stops Here”

There is an old story that a very successful broker was retiring and a young broker asked him what his secret was. “IBM”, the man said, “I always recommend IBM”. “But there are a lot more dynamic companies out there” replied the younger man. “That's true, but if I recommend a stock they've never heard of and it goes down, they'll blame me. If IBM goes down, they'll blame IBM”. A great deal of financial advice is like that – calculated to be logically unassailable even if it might be specifically wrong. We are given many justifications for buying, because that is what makes Wall Street money. Sometimes the talking heads on CNBC tell us to buy because profits are rising. This sounds like good advice unless you know that markets often decline during periods of rising profits. Even though corporate earnings rose every year during the 1970s, it still wasn't a good time for investors.

Likewise many say you should buy into the market just because the Federal Reserve is cutting interest rates. However, as the following chart shows, stocks can (and often have) declined when the Federal Reserve is cutting interest rates.



All things being equal, markets do prefer rising profits and falling rates. However, all things are never equal. The present may share some similarities with certain times in the past, but there have never been these exact same circumstances before. The year before a presidential election year has been an up year in the last 17 election cycles. That is a good trend, but it guarantees nothing. In fact, a great deal of money has been lost over the years making leveraged bets on what seemed to be virtual certainties. Essentially, this is what brought down the famous hedge fund Long Term Capital Management in 1998, who made a massive bet that credit spreads would narrow and also hit Bear Stearns and others more recently when they bet that mortgage defaults would never exceed a certain level! The point is there are no indicators or statistics that guarantee success. It is always necessary to do the hard work of analyzing the factors at work, positive and negative, and deciding if the opportunity for gain is worth the risk of loss. No matter what anyone tells you, there is always a risk of loss.

We are not giving advice in the abstract like market commentators do and we can't hide behind their general consensus. They don't have to take responsibility when the market goes against their prognostications. You have entrusted us with your portfolios, and we take that as a serious responsibility. In other words, if things go wrong, you CAN blame us.

Towards that end, there are times when we will pass up a buying opportunity that may ultimately work because we believe that risks are too high at the time. There are certainly times when we will begin to raise cash by selling mutual funds in your accounts before the market peaks. Our ultimate goal is to utilize the cash we have raised to reinvest for you at lower market levels.

As managers we are more comfortable investing when the market is far from the top of its recent trading range, because we know under the right circumstances investors will pay more as they already have.

We prefer to buy when investors are concerned or better yet downright pessimistic, because we know they will come back into the market when conditions seem more certain.

On the other hand, we don't like to invest when investor sentiment is very positive or when prices are at all-time highs. We always like to see potential for improvement, and there usually isn't much potential left when everything is going right and stocks are priced that way. It does little good to buy a stock three weeks before a major market decline if you are a long-term investor. In hindsight I won't even remember that I was up for a while – I'll only know that I bought too high and now it's lower!

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