

2007 – 2008 Epilogue and Prologue

2007 was a year divided into two parts. The first half rewarded risk, the second half punished it. At the beginning of the year there seemed to be endless liquidity to finance ever bolder and more leveraged private equity transactions. At the end of the year liquidity had virtually disappeared from the markets as major financial institutions went in desperate search for cash and private equity deals unraveled. The collapse of the structured finance market, which encouraged speculation under the radar screen of rating agencies' investment grade blessings, resulted in massive central bank intervention on a scale rarely seen.

The developed countries of the world started to experience relative softness in economic growth towards the end of last year. This trend will probably continue into at least the first half of 2008. Countries which witnessed the greatest speculation in real estate and which have high levels of consumer indebtedness, such as the U.S, U.K., Ireland, and Spain, will experience the most dramatic effects of a necessary return to more sober times.

The U.S. has already lived through a dramatic correction in the housing market. For example, housing starts declined by nearly 50% in less than two years, without witnessing a severe economic downturn. The American consumer, who is apparently born to shop, has soldiered on and not materially changed his spending habits. It is unlikely that we shall witness a further deterioration in housing anywhere close to the proportions we have already experienced. If the American consumer has not cut down drastically on his spending habits with all of the negative headlines of the last few months it does not seem likely that he will do so in the foreseeable future. What we may see, however, is a prolonged period of stagnant growth where consumers, and society in general, will try to live more within their means. Spending power will be constrained by high energy and food costs, less availability of credit, and more job uncertainty.

Individual European economies will probably continue to see considerable disparities in performance. Strong export focused economies, such as Germany, will likely outperform economies which are heavily finance and/or housing dependent, such as those in the U.K., Spain and Ireland,. European consumers will in general also be constrained in their spending patterns by concerns similar to those found in the U.S. High costs of basic necessities and tighter borrowing conditions will act as a brake on stronger consumer spending. Employment uncertainty should, however, be less of a problem in Europe than in the U.S.

The business sector both in the U.S. and Europe has been, and will continue to be, in relatively good financial condition. As Alan Greenspan recently pointed out, corporate balance sheets are unusually strong and companies are generating healthy cash flows. Many companies took advantage of earlier low borrowing rates and locked in long term financing at attractive rates.

Equity markets remained relatively buoyant even during the difficult second half of 2007. Credit markets, on the other hand, experienced a significant correction in last year's second semester. Credit spreads for high yield bonds more than doubled during this period. Bank loans in the institutional market suffered an unprecedented six standard deviation move in July 2007. The credit markets have already discounted a modest economic recession in 2008.

We believe that a combination of central bank monetary stimulation and politically-motivated fiscal stimulation will prevent a slide into severe recession. We may, however, experience a period of sub-par economic growth and above-par inflation, that is a period of moderate stagflation. We continue to believe that our high yield portfolios will most likely generate returns in the range of 6% to 8% in 2008.