



Points of Orientation in a difficult Market Environment

Times are very challenging indeed for investors. Bulls and bears both from the professional as well as the media side have been moving in the last weeks more and more to the extreme sides of the scenarios they expect to unfold in the financial markets. This is a sign in itself that must be taken seriously, since it seems that there is no middle ground any longer while adopting a view on either extreme side bears for investors substantially higher risks.

Jeremy Grantham, a value oriented manager of USD150 bn assets, in his latest letter to clients says that we are now seeing the first worldwide bubble in history covering all asset classes. This statement appeals to us since “normal” market mechanism are mostly contradicting. Everything goes up instead of in opposing directions: Interest rates increase(s) – stock markets move up; energy and commodity prices remain at or below record levels – stock markets continue to increase; sub-prime mortgage defaults and subsequent events such as related write-offs at banks leave a mark – still stocks reach higher; the housing industry in the U.S. is hit and potentially leading to a recession in the U.S. – stock markets continue to move up, U.S. economic indicators display a slowdown – still stocks are on the go, etc.

The less positive economic news from the U.S. are offset by good economic news elsewhere. Especially the economies of the EU, Switzerland, China, Malaysia, and more operate at very high levels. Also, corporate earnings worldwide by and large are expected to come in far better than expected just a few months ago.

In the past, stock markets reacted to events that were anticipated in the future. Since the market continue to go up, does this mean that the economic future looks bright?

We believe the following factors drive the markets:

1. Liquidity: There is still easy and plentiful money available. Margin debt volumes at the New York Stock Exchange which is used to buy stocks on partial credit, have never been so high. Also, the wave of merger & acquisitions is largely funded by way of debt and creates a sense of investor euphoria; broad money supply indicators continue to rise all over the world with credit cost and standards still remaining at modest levels;
2. Stock repurchases and privatizations: Lombard Street Research claims that in 2006 6.5% of the market value of the U.S. non-financial stocks was withdrawn from the market. This trend has continued up to today.
3. Investor sentiment: We are told that the M&A wave will continue with banks, mining companies and so on and move from West to East; those investors having had a bearish view feel bad about having missed out the stock market gains in the last weeks and months and may now be catching up; commodities are supposed to have huge upside potential – few, however, refer to a specific time frame; China is a “safe” play, since the Chinese do not want any major disruption before the 2008 Olympics; dire predictions about further fallout of the U.S. mortgage market have abated and lost in importance; a pick-up in inflation is not seriously considered.

How can investors possibly stay out? Have euphoria and fear of missing out led to the recent market peaks, too?

The answer is: Nobody really knows if or when the current benign market environment ends!

Before coming to conclusions, let us review a few of the major **risks** in today's markets:

Inflation: We expect an increase maybe even a pronounced increase due to money supply growth, higher prices in basic goods such as energy and especially in agricultural produce. Previously deflationary forces such as "cheap China" are waning at the same time.

Oil supply: The supply can be disrupted at any time (Nigeria, Venezuela, etc.). The beginning hurricane season may disrupt the gas supply and damage oil refining capacity.

China: Bubble or no bubble? Two years ago the Shanghai Composite stood at 2'000, now at 4'000. Six months ago trading volumes added up to about USD 5 bn / day. On May 10, volumes reached almost USD 50 bn, or about 1'000% increase in 6 months! Every week Chinese open 1 million new bank accounts of which 300'000 trading account per day. Huge numbers of less informed investors enter the market. Insider trading is widespread.

Political arena: When Pakistan's Musharaff falls, fundamentalists may gain power over nuclear arms.

Hard Commodities: The number of (credible) voices anticipating price corrections seems to increase. In most metals, shrinking demand and increasing supplies are expected. Demand may shrink not only due to a weaker U.S. economy but also as a result of tightening credit conditions in China. Predictions are out that copper may fall in the next months by up to 30%, nickel and lead by 50%, and so on. Of course, we know, such scenarios have been predicted before. Fact is that metals have appreciated tremendously and that hedge funds and other metals related products have driven the markets up as much as real demand.

U.S. housing: Most indicators point to a further weakening. April U.S. retail data show that consumer spending is slowing, as did consumer sentiment. The full impact on U.S. consumers may only be seen towards the end of 2007.

Conclusions and Recommendations:

Economic data does not really give reason for concern. This said, other factors may trigger a substantial correction of financial markets. The investor clearly faces a challenging dilemma: To what extent and how best to include the warning signs in investment decisions?

Today, we seem to face a self-sustaining investment environment. In such environment, the value of many or most asset classes may continue to increase to the extent that we see a short exponential phase in the markets before the bubbles burst. The higher the valuations - the steeper the falls! Have you not heard this before and nothing has happened? We admit, yes. The key is mostly timing ... and asset allocation.

How comfortable to you feel with your asset allocation? Do you have enough liquidity to benefit from a correction? Do you know where to invest after the correction? Are you now invested in assets you feel comfortable with to sit a correction out? Do you know at what level you will sell individual assets as prices may continue to go higher? -- And how do you sleep these days? Are you anxious about having left the party too early, or, about when to leave it?

Do you need support in finding the right answers? We at Cottonfield try to support you in gaining your personal view and then advise you on the selection of actual investment opportunities.

Roy Darphin, Partner

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