Portfolio Insight

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Global equity markets fell sharply in the first quarter of 2008 as investors responded to continued evidence of a credit contagion spreading through the financial system. As measured by the S&P 500 Index, U.S. equities were off 9.5% for the three months ended March 31, 2008, their worst quarterly performance since 3Q 2002. European markets declined more than 10%, and emerging markets like India and China dropped 23% and 34%, respectively.

Declines in U.S. equity indices over the past six months have been largely influenced by massive dislocations in the financial sector. These problems stem largely from the significant expansion of debt over the past two decades, and the reasons for the increase in leverage are many. Boiling it down to basic supply and demand, there has been an almost constant and ever-increasing supply of cheap money, the response to which has been an equal willingness to borrow and take risk.

Borrowing and lending practices as applied to the private sector have been imprudent, even reckless. Easy money has fueled speculation in real estate, commodities and financial assets. And it has funded live-for-today consumption. Should-be renters leveraged themselves to buy a first home (which many could not afford). Others simply wanted to move up, to buy property for investment, or to extract equity for consumption. In the financial world, the rise and impact of private hedge funds has been meteoric, resulting in big increases in leveraged commodity and financial asset positions. The lenders to all these risk takers—banks, mortgage companies, brokers, pension funds, mutual funds, and other holders of large pools of capital, both domestic and foreign—were looking for fees or for yields well above those obtainable from risk-free U.S. Treasuries. All of this debt created tenuous and unstable conditions for the financial markets. When economic conditions put stress on the weakest or most leveraged borrowers, the previous virtuous cycle of rising asset prices and debt levels reversed and became a vicious cycle of declining asset prices and repayment demands; or in many cases illiquidity or insolvency.

Federal Reserve Response

The Federal Reserve has since stepped in with unprecedented actions, among them saving Bear Stearns from imminent bankruptcy and providing additional liquidity to the U.S. financial system. The Fed cut interest rates a total of 2% during the quarter, and its actions appear to have averted what could have been a much deeper and broader financial crisis. The credit market problems probably reached a crescendo in March with the Fed-engineered sale of Bear Stearns to JPMorganChase. However, one of the most significant and lingering effects of actions taken to date will be reduced future lending by most commercial and investment banks. The process of returning to more manageable levels of debt on the books of both borrowers and lenders is likely to be measured in years. This will serve as a drag on economic recovery in the United States and will have at least some spillover impact globally. At the same time, the Fed recognizes that the threat of inflation remains and has indicated it is reluctant to drive rates too low.

Our last *Portfolio Insight* pointed out the four main causes of this market decline. The first two causes, the credit market crisis and a weak dollar, are here and now. The third, a recession, has not been declared, but a significant slowing in the economy has already occurred.

The fourth cause, inflation, is also clearly evidenced in commodity prices but not yet in U.S. labor costs. However, rising labor and food costs in developing countries are increasing the risk of global inflation.

Weak U.S. dollar could actually provide a boost to the economy…

The U.S. dollar, as indicated by its accelerated decline since last August, has been a victim of the credit crisis and the Fed's easing policy. This is a double-edged sword for domestic investors, consumers, and businesses. While it is true that the weak U.S. dollar caused some investors to flee dollar-denominated assets in favor of those of appreciating currencies, a weaker currency also results in higher earnings reported by U.S. multinational companies. To be sure, the decline in the dollar has exacerbated the rise in prices of commodities traded in dollars. It has also raised the cost of imports and increased the prospects for inflation longer-term in the U.S. However, the positive effects of a weak dollar are the increased exports from the U.S. and an influx of foreign tourists. Both of these are having a positive effect on our economy and our balance of trade.

Shorter term impact aside, a weak dollar might ultimately lead to a reversal of U.S. job losses to other countries. According to a recent KPMG study, the U.S. is now a cheaper place to do business than many other developed countries like Britain, France and other European nations. The most recent Duke University/CFO magazine Global Business Outlook Survey indicates that 50% of Europe's CFOs and 60% of Asia's CFOs believe the dollar's devaluation is permanent. As a result they are compelled to hedge their global manufacturing costs by moving some of it to the U.S. The U.S. worker, who has been hurt the most over the past few decades from jobs outsourcing, may now find an improving job market as global companies look to the U.S. skilled labor force. This should be a shot in the arm for the U.S. economy.

How Chilton Capital Management's portfolios are positioned

In early March we watched with interest an interview between former GE CEO Jack Welch and an economist. Welch was adamant that most companies do not have the ability to raise prices and yet they are watching their margins get squeezed by rising commodity costs. The economist asked Welch what a company should do in such an environment to grow their earnings. He responded by saying they must try to create products which are differentiated from others and thus have pricing power. In our opinion, Welch could not have said it better. Why? Our investment process has *always* focused on finding companies which have differentiated products and unique competitive advantages. These characteristics, when combined, often provide a degree of pricing power. We believe companies fitting this description will be among the leaders in the next few years as their earnings growth is likely to outpace the overall market.

Notwithstanding periodic buying panics, we believe the U.S. market may be early in a bottoming phase, rather than in a sustained, explosive price recovery. Having money invested in U.S. equities has generally been rewarding for investors who recognize that bear markets happen but who have the temperament to stay in the market when times are difficult, such as now. During times of financial stress, markets have always been quick to sell higher growth companies and rotate into more defensive shares such as utilities and consumer staples. When the stresses abate, markets rotate back into higher growth companies with their improved valuations. We expect the same thing this market cycle.

As for those who would abandon the U.S. for foreign markets, we think the fact that many of the international markets have experienced big declines over the past months is proof that most economies and markets are connected. Fund flows to "hot" emerging markets like China and India soared in 2007, even after several years of increase. Although the main culprits in the global selloff so far have been housing and the American and European derivative and fixed income markets, Chinese and Indian equity markets have actually performed worse this year than markets that are closer to the epicenter of the problems.

We continue to believe that 2008 will bring a period of slowing economic growth in the U.S. as the credit crisis works its way through the economy and impacts personal consumption. Despite this weak economic backdrop, we are finding opportunities to add companies to client portfolios that have the ability to grow earnings faster than the market. And we still believe that U.S. multinationals provide the most cost-effective exposure to the growth occurring in developing countries. Generally speaking, we remain largely invested in companies with conservative balance sheets—high levels of cash and low or no debt. Interestingly, U.S. corporations are probably among the least leveraged asset classes available today for investment. As long-term investors, we see compelling values emerging for businesses currently discounted as the financial storm cuts valuation levels to multi-year lows.