

BLUE GRANITE CAPITAL, LLC
INVESTMENT COMMENTARY
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Hello bear market, goodbye Bear Stearns! The relentless selling of financial stocks around the world has wreaked havoc on the equity markets creating a crisis of confidence. The equity markets officially crossed into bear market territory during the first week of July, tumbling 20% from their October 2007 highs. The share price of nearly every financial stock has been pummeled amid speculation and fear from the current credit crisis, recession-like economic conditions and the impact from escalating inflation. The carnage from these related events begs the question who may be next to fail. In fact, IndyMac Bancorp takes that honor becoming one of the largest bank failures in history. Officially taken over by the FDIC on July 11th, this is the first bank failure since the Savings & Loan crisis of the early 1990's. Despite being under federal control, depositors are still lining the streets to withdraw their savings, further adding to tensions and the apprehension of other bank failures. Speculation is widespread concerning the credit worthiness of almost every financial institution, especially the government sponsored mortgage lending enterprises, Fannie Mae and Freddie Mac. The Government has just completed a proposal to increase regulation and financial backing for these mammoth organizations in order to restore confidence and stability to the global monetary system. We are in the midst of probably the greatest credit crunch of our lifetime, and the collapse of these companies would be harmful to an already fragile global environment.

Adding insult to injury, we fill up our cars with \$4 gas (oil hits record \$145 per barrel) and pay more for essential groceries, while our houses and investments are shrinking in value. The consumer, normally the catalyst for economic growth, has less discretionary income for spending due to the impact from higher food and energy prices. In turn, corporate profitability and investor wealth have been declining as the affects of the current economic climate take hold. Record losses within the "tarnished" financial system and associated restrictive lending capability have added to current difficulties. What remains is a smaller pool of capital available for global lending that further inhibits economic growth at a time when it is desperately needed. This vicious cycle of events aptly describes our current dilemma, creating an impasse where viable solutions seem inconceivable. If financial institutions have insufficient capital for lending to housing or corporate expansion, nor the appetite to invest, our economy will meander through tough conditions for a while longer.



Financial institutions around the world are in a predicament and under persistent stress from a confluence of seemingly endless events. Beginning late last summer, the subprime mortgage mess triggered a domino effect that led to trouble in the housing market, and ultimately spread throughout the banking and insurance industries. Circumstances are now further exacerbated by frail economic conditions, high food and energy prices, declining purchasing power and a bear market that has sent stock prices down to levels not seen for years. This “no confidence vote” appears to have no end in sight, and viable solutions to stimulate our teetering economy seem impractical. However, armed with some objectivity and historical evidence, we can see the pendulum has swung too far and the stock market should begin forecasting an economic recovery 6 to 9 months in the future.

While it is difficult to find a silver lining in the current environment, it’s constructive to observe our major problems exist primarily within the financial services industry. Other industries have been hurt by weak economic conditions but nowhere near the intensity felt in banking. Without a doubt, banking and insurance companies will have to make modifications for ill-advised business and investment decisions and the immense scrutiny of their industry. New regulation and structural reform are vital to prevent future systemic abuses and the excessive financial leverage that caused much of this industry freefall. The suffering we feel at the pump, the grocery store and in the declining value of our homes and investments is painful; but the situation is fluid and will surely reverse course. In our opinion, unrealistic trading patterns, excessive short-selling, rising volatility, and so many unprecedented events, set the stage for a market turnaround in the near future.

The performance of the major stock indices during the past 12 months has been quite poor. The S&P 500 Index fell more than 13% during the past year and 8.43% this past June. With equity benchmarks now trading at 2 year lows, there clearly has been no place to hide with the exception of the bond market. Bonds have generated ample returns, insulating investors from the big drop in equities. A significant benefit to our balanced asset allocation strategy has been to mitigate the affects of stock market volatility and offset the decline in stock prices. An encouraging takeaway from these turbulent economic times may be that bear markets and recessions tend to be shorter in duration than bull markets and periods of economic expansion. Therefore, we could anticipate some turnaround in market direction and an improved economic outlook later this year.

Second quarter earnings season has begun in earnest, under the watchful eye of investors everywhere. First indications have been surprising with several banks reporting above expectations even within their mortgage operations. We will closely monitor the company financials and the range of global issues, looking for signs of a market turn.

We hope you are enjoying the summer with your family and friends. Please call us should you have any questions or concerns, and as always, thank you for your support of Blue Granite Capital.

Sincerely,

Scott B. Shubert

