



# MANCHESTER CAPITAL MANAGEMENT LLC

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## *In this Issue:*

- Market Outlook
- The Surging Demand for Derivatives
- Identity Theft

*The markets have been surprisingly strong in the face of ever more menacing problems.*

## **Market Outlook** *By Ted Cronin, CIO*

The recent rally in the bond market is another indication that our economy is slowing. The wholesale and retail inflation numbers in July pointed to continued low inflation, sparking investors to push the ten-year Treasury yield to a four month low of 4.87%. When bonds become more attractive, their prices increase causing the amount they yield to decline. If the recent trend continues, expect the ten-year notes to fall to 4.5% by next year.

Bond investors were encouraged by slowing employment numbers, a drop in car prices, declining home sales, and flat consumer confidence. The Federal Reserve has stopped, at least temporarily, raising the short term rate after 17 consecutive rate increases. Some of the most respected bond managers have declared an end to the bear market which bonds have been suffering for many years.

Bond yields are some of the most carefully watched numbers as they indicate the cost of money, which effects the profits of corporations, the pocketbooks of consumers, and the purchasing power of home buyers. The housing market has slowed after many years of rapid appreciation, and appears to be correcting its speculative excesses in a long overdue process.

A measure of economic growth, the Gross Domestic Product (GDP), will probably record a rate of 3.7% for the current year, which is close to the historic mean. The Federal Reserve believes that the economy will slow to 3.25% next year and is working hard to steer the economy away from a recession. It could even start lowering interest rates to spur the economy on if it should begin to falter.

I will be surprised if the economy can do better than 2.7% in 2007. But as long as the economy does keep growing and inflation remains moderate, both the bond and stock markets should perform satisfactorily. Investors will react positively to interim economic slowing if it helps restrict inflationary pressures.

Indeed, the markets have been surprisingly strong in the face of ever

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*(Continued from page 1)*

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more menacing problems. Recent events suggest that war could engulf the entire Middle East, from Israel to Iran, combining nuclear weapons with religious radicalism to devastating effect. The evidence of global warming is mounting, as the permafrost shrinks, forests burn, ocean water warms, disease patterns change, and habitats are transformed. No one can correctly calculate the financial impacts of such global events.

Investor reaction to this lack of predictability and loss of control can be to focus on short-term results, undermining the very goals that they are after. It can cause investors to chase their tail in an unending effort to outguess the next threat or new opportunity. Lacking perfect knowledge of the future, investors need to make long-term commitments based on what they do know.

The S&P stock market is up over 4% so far this year, and the current markets are priced fairly by historic standards. I believe the markets offer reasonable opportunities for appreciation through the balance of the year. A recession is unlikely next year. The greater probability is for a scenario of slow growth, moderate inflation, and positive bond and stock performance.

## ***The Surging Demand for Derivatives***

***By Morgan Roberts***

Derivatives are financial contracts that “derive” their value from an underlying asset like stocks, commodities, treasuries, etc. Derivatives involve futures, forwards, swaps, options and an ever-increasing combination thereof. The most straightforward example of a derivative contract is a futures contract. Futures contracts allow you to buy or sell an asset at an agreed-upon price on some specified future date. Futures contracts date back nearly 250 years, originally developed to protect farmers from a drop in their crop prices before harvest. Today, derivatives are principally used to reduce financial risk.

*The use of derivatives has surged in the last five years. It is estimated that financial derivatives in the U.S. currently represent \$110 trillion, up nearly 200% in the last five years.*

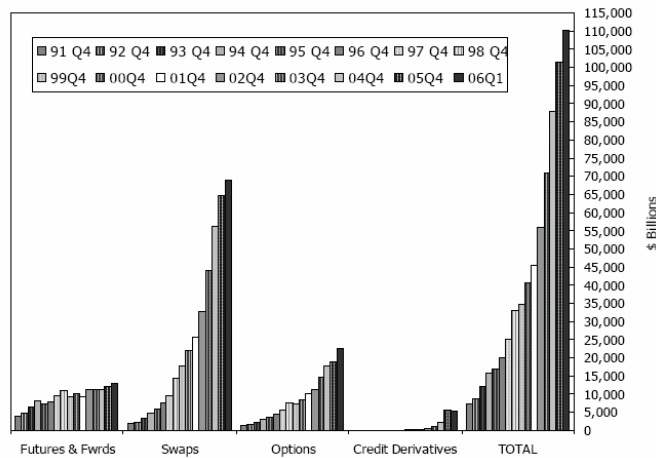
The use of derivatives has surged in the last five years. It is estimated that financial derivatives in the U.S. currently represent \$110 trillion, up nearly 200% in the last five years. The derivatives market has grown so fast in recent years there are concerns that it is overwhelming the regulatory, legal, operations and paper-work handling infrastructure. Some Wall Street experts have even warned of a possible financial catastrophe. So, why has the derivative market grown so fast and what, if any, are the implications to investors?

As you can see in the chart on the following page, most of the growth is coming from credit default swaps. Credit default swaps are derivatives based on underlying fixed income securities such as corporate and government bonds. Credit default swaps allow bond holders to insure their fixed income payments. The buyer pays a premium to the seller to assume the risk of the bond issuer defaulting.

### Derivative Contracts by Product \*

All Commercial Banks

Year ends 1991 - 2005, First Quarter - 2006



*Under present conditions, it can take nearly three months before a bank knows who owes what to whom.*

Swaps are privately negotiated contracts traded on over-the-counter (OTC) markets. The OTC market for credit default swaps has witnessed such rapid growth that there is a large backlog of unconfirmed trades in the market. Under present conditions, it can take nearly three months before a bank knows who owes what to whom. The banks are currently working with the Federal Reserve to implement a “steady state position” which includes a largely electronic marketplace.

Wall Street professionals have warned about the structural deficiencies and potential problems with the burgeoning derivatives market. They point to the misuse of derivatives by speculators and lack of oversight. Derivatives can provide speculators with a powerful tool for creating risk – risk that can be compounded by layers of leverage. These speculators keep their assets outside the U.S. where rules for leverage are circumvented.

In the past, the markets have shown resilience in the face of well-publicized derivative defaults (e.g., Refco, Orange County, etc.) as well as cases of derivatives fraud involving unscrupulous bankers (e.g., Bankers Trust, NatWest Capital, Barings, etc.). So, what about a major financial institution? Are there risks of a derivatives catastrophe at one of America’s leading financial institutions? Tim Geithner, the New York Fed Governor and outspoken critic of the aggressive growth of derivative products, has warned that although they can spread risk for investors they do not eliminate the possibility of a failure of a major financial intermediary.

*After studying the issues, we are not overly concerned about the proliferation of derivatives.*

The derivatives business in the U.S. is concentrated in a small group of very large financial institutions. The top 5 banks represent 96% of the total derivatives contracts, 86% of total revenues and 89% of total current credit exposure. These banks earned a record \$12.4 billion in derivatives activity last year.

\$ in Millions	J.P. Morgan	Citigroup	Bank of America
Average VaR 1Q06	\$94	\$91	\$40
Average VaR 2005	\$88	\$103	\$41
Equity Capital 1Q06	\$108,337	\$114,418	\$129,426
2005 Net Income	\$8,483	\$24,589	\$16,886
1Q06 Avg VaR / Equity	0.09%	0.08%	0.03%
1Q06 Avg VaR / 2005 Net Income	1.11%	0.37%	0.24%

Comptroller of the Currency / Administrator of National Banks: 10K & 10Q SEC Reports

The regulatory body, the Comptroller of the Currency, is not concerned with the growth and concentration of U.S. derivatives activity. They believe very few institutions have the resources, both in personnel and technology, to support the requisite risk management infrastructure. As a result, derivatives activity is appropriately concentrated in those few institutions that have made the resource commitment to operate the business in a safe and sound manner. Further, the Comptroller of the Currency has examiners on site in these large banks to evaluate the credit, market, operational, reputation and compliance risks in the derivatives portfolio on an ongoing basis.\*

After studying the issues, we are not overly concerned about the proliferation of derivatives. We expect, however, that more derivatives will materially increase the volatility when unexpected exogenous events occur. We assure our clients that we have conviction in our investments in order to weather the volatility for our clients.

Please feel free to call me, Morgan Roberts, at (800) 922-6477 if you have any questions or concerns.

\*US Department of the Treasury, OCC's Quarterly Report on Bank Derivatives Activities, 3-31-2006

## ***Identity Theft***

As you may have read or heard in the media recently, identity theft is a major national problem. As many as 7 million people are victim of identity theft each year. These victims often spend hundreds of hours and excessive costs retrieving their identity from thieves. While we do not want to add to this fear, we do think it is important to help you protect your identity.

Here at Manchester Capital we take every step possible to conceal your personal information and shred all personal documents before disposal. We urge you to take similar actions. Additionally, there are several easy steps you can take to protect your identity. These include refusing to share personal information (including social security numbers), reviewing credit reports on an annual or more frequent basis, or even placing a credit 'freeze' on your rating agency files. Please contact us if you would like us to provide additional information or resources on protecting your identity and credit history.

***Please remember it is never too early to discuss year-end tax issues and charitable gifting. Please contact us if there is anything we can do to help.***