Rutherford Investment Management, LLC
10300 SW Greenburg Rd. Suite 115
Portland, OR 97223

Phone: (503) 452-1210

www.rutherfordinvestment.com

Quarterly Newsletter
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Volatility returns to markets

The third quarter of 2007 saw volatility return to the markets. Since the crash of 2000-2001, the markets had returned to a period of more normal volatility with the VIX (Volatility Index) in the ten to sixteen range. With the onset of the sub prime lending problems and the almost complete disruption of the credit markets, the volatility index rose over 30, to levels not seen in five years, and stocks suffered.

First alluded to in the column I write for The Daily Journal of Commerce in June of 2007, “The ghost of Greenspan past”, the sub prime debacle rattled the credit markets around the globe. Two banks were taken over in Germany, and the British government was forced to guarantee all deposits in all the banks in the country. Citigroup wrote off $6 Billion in connection with the problem; Deutsche Bank $6.09 Billion and UBS a half a Billion. Merrill Lynch posted a $5 Billion loss for the quarter and Washington Mutual warned. Many more write offs are expected.

American credit markets are returning to normal, but across Europe there are still problems and the European Central Bank has been forced to act as the lender of last resort as recently as last week. Russian markets are still in disarray. Presumably these markets will get back to normal with a lot of help from their central banks.

A cloud was cast over the U.S. housing market as well as some of the more inflated European markets. This cast a pall over the equity markets, but bonds rallied in a “flight to quality.”

Each central bank rode to the rescue as volatility soared and equities sunk. A ½% rate cut by the Fed in mid September punctuated how difficult things had become. Fed Chairman Bernanke, in a move that caught the markets by surprise, took decisive and pre-emptive action. The goal was to contain the problems to the financial markets, and not let them spill over to the general economy. Consumer stocks fell under pressure, and then rallied as investors became more optimistic about a solution. We do not know yet if the Fed was successful, but the action was bold and welcomed. The markets soared and have been in a general upward trajectory since. By staying with our discipline, we were able to have one of our better quarters, salvaging what shaped up to be real problems.

While we do not know the full effect of the Fed rate cuts, we do know the Fed is paying attention, a welcome relief from the past administration (You know who I mean). As you look forward to the next Fed meeting, the Fed faces difficult choices. On the one hand, the Fed faces a real threat of inflation. Commodity prices are up world wide. Grain stocks in the U.S. have increased into record territory with wheat nearing $10.00 a bushel. Feed stocks are soaring because of our misguided ethanol policy which is now finding its own limitations as it turns out to be hard to distribute the stuff. Bankruptcies will ensue. The rising price of grain means a rising price of protein and food stuffs generally. The effect will soon be at a grocery store near you. In the meantime oil is about $80.00 per barrel. Officially inflation is about 2%, but few believe that.

On the other hand, the Fed faces a slowdown if the housing problems spill over into the economy. There is a rising fear of recession, but I do not see that occurring.

In the meantime, we try to keep the portfolio defensive, while still open to growth. We have jettisoned most of our consumer discretionary stocks and financial stocks. Although this is the best quarter of the year for discretionary spending, we have been wary. So too financials, until they have to go thru a confessional period; then we might find some interesting. We maintain a strong weighting in the health care sector and have increased our position in both technology and international investments where we expect to get the most of our gains. Our stocks which are part of the global infrastructure build-out, food, and energy should be good performers going forward.

William D. Rutherford, President
Rutherford Investment Management LLC.