"Treading Carefully"

Market Commentary – June 2007

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Growth of the U.S. economy, as measured by Gross Domestic Product (GDP), was revised down from 1.3% to 0.6% in the first quarter of 2007. This is the weakest reading since the fourth quarter of 2002, when the economy was coming out of recession. Weighing heavily on GDP growth were the trade deficit, a reduction in business inventories, and the weak housing market. Boosting GDP, however, was the consumer. Consumer spending, which represents approximately 70% of all economic activity in the U.S., was revised up from 3.8% to 4.4%. Robust corporate earnings have kept the job market strong, with unemployment at only 4.5%. As long as people feel their jobs are secure, they seem to keep spending. Many economists believe that first quarter GDP will be the low point for the year. The National Association for Business Economics predicts GDP growth of 2.3% in the second quarter of 2007.

The Federal Reserve is confident that the economy will continue to expand, but they expressed "considerable uncertainty" that inflation will cool. At its meeting on May 9, the Fed kept its benchmark Fed Funds rate steady at 5.25% for the seventh consecutive time. Futures markets are betting that this will continue, assessing only a 22% probability that the Fed will make a 25 basis point cut by December. The risks to the economy due to a weaker housing market have "diminished slightly", according to the Fed. "The predominant policy concern remains the risk that inflation will fail to moderate as expected", they added. Core inflation, which factors out the volatile food and energy sectors, was 2.2% in the first quarter of 2007, just above the Fed's comfort level of 2%. While Fed Chairman Ben Bernanke does not believe the U.S. economy will slide into recession during 2007, former Chairman Alan Greenspan has put the odds at one in three.

In addition to citing the risk of recession in the U.S., Greenspan is also concerned that Chinese stocks may undergo a "dramatic contraction". The Shanghai Composite shot up 130% in 2006, and has rocketed higher by another 50% so far in 2007. While China's economy is booming, with GDP growing faster than 10% per year, the strong performance of stocks has generated speculation that the upward momentum in stock prices will continue. China's stock market is dominated by retail investors rather than institutions, which dominate U.S. markets. Anxious to get in on the action, Chinese investors have reportedly been opening about 250,000 brokerage accounts a day. Stock markets worldwide sold off when the Shanghai Composite Index plummeted by nearly 9% on February 27, but gave a more muted reaction when Shanghai dropped 6.5% on May 30. Should a Chinese stock market crash cause a sell-off in global markets, we would view it as an opportunity to buy well-diversified large cap companies in the U.S. that are temporarily on sale.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.4, slightly higher than 18.3 a month ago. With a P/E of 18.4, the earnings yield (E/P) is 5.4%. The yield on the 10-year Treasury note has crept higher over the past couple of months to 4.9%. The 10-year Treasury is an important variable in our formula to value stocks. The higher the yield, the lower the fair value for stocks. If the 10-year Treasury continues to march higher, especially if it gets above the headline-grabbing 5% level, the stock market could stumble.

There is quite a bit of hype baked into the stock market right now, suggesting that investors be careful. Our market breadth indicator has been weakening since the end of April, but it has been clinging on to positive territory. Market risk has us cautious about committing new capital with mutual funds. For individual stocks, the best opportunities we have found are in the financial sector (banks, insurance companies, and Real Estate Investment Trusts). Still, we are mindful that the stock market has not had a 10% correction since the cyclical bull market began in March 2003. Our cash position will give us a degree of protection when volatility eventually returns to the market.