"Euphoria"

Market Commentary – May 2007

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Gross Domestic Product (GDP), a measure of the output of the U.S. economy, grew only 1.3% in the first quarter of 2007. This is down from the 2006 fourth quarter reading of 2.5%, and the slowest rate of growth since the first quarter of 2003. Residential investment fell an annualized 17%, which cut GDP by a full percentage point. On a brighter note, consumer spending, which accounts for about 70% of economic activity, grew 3.8% in the first quarter. The 17 consecutive 25 basis point interest rate hikes between 2004 and 2006 are setting in, cooling economic growth. Economists in general believe that the first quarter GDP reading should be the worst for this year.

Corporate earnings are coming in better than expected in the first quarter, although expectations were low going into the quarter. It appears that the first quarter of 2007 will snap a streak of 14 consecutive quarters of double-digit earnings growth. As of April 1, analysts expected earnings of S&P 500 firms to grow by 3.4% in the first quarter. With 277 of the S&P 500 firms reporting earnings already, S&P 500 earnings are now expected to grow by 7.1%. Analysts expect second quarter earnings to grow by only 3.4% before picking up later in the year.

A chronic problem in the United States is worsening with regards to the funding of Social Security and Medicare. In recent decades, total federal tax revenue has averaged 18.3% of GDP. In 2006, Social Security was 4.2% of GDP and Medicare was 3.1% of GDP for a total of 7.3% of GDP, or 40% of federal tax revenue. By 2030, the U.S. government forecasts Social Security at 6.2% of GDP and Medicare at 6.5% of GDP for a total of 12.7% of GDP, or about 70% of federal tax revenue. Nearly all federal tax revenue would be consumed by taking care of retirees. According to Treasury Secretary Henry Paulson, this would "threaten America's future prosperity". It is important to keep this brewing storm in mind and consider how it would affect your savings, living, and investment dollars.

The euphoria of Merger & Acquisition (M&A) activity continues to keep a floor under stock prices. Private-equity buyers seem willing to pay top dollar to acquire companies these days. Even the potential of future bids for companies has been propelling stock prices higher. Credit is very easy right now, so leveraged buyouts are becoming frequent. With the passing of each week, financial pundits seem giddy to welcome another "Merger Monday", where companies agree over the weekend to be acquired. The emotion associated with merger mania is an eerie reminder of 1987, when hostile takeovers and leveraged buyouts were factors that drove the U.S. stock market higher. By October, the stock market crashed, falling more than 20% in one day. If today's Federal Reserve decides to attack inflation and hike short-term interest rates despite slowing economic growth, the stock market could be in for a wild ride.

Technical factors of the market are mildly bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 is 18.3, up from 17.3 a month ago. Stocks have become much more expensive over the past month. With a P/E of 18.3, the earnings yield (E/P) is 5.5%. The 10-year Treasury note is hovering at 4.7%, which historically is quite low. It is curious that the stock market seems satisfied with earning only an extra 0.8% over the 10-year Treasury while accepting stock market risk.

The stock market still has not had a 10% correction since the cyclical bull market began in March 2003, the second-longest winning streak on record. Significant pullbacks are healthy, as they allow stocks to regain strength and push even higher. Growing uncertainty about corporate earnings and the strength of the U.S. economy could be catalysts for a correction, as would an exogenous event. What we do know is that it is more difficult to find undervalued stocks these days. There are some good opportunities in the financial sector, but we need to be selective. Our balanced approach toward risk and reward is important to hitting the curve balls that we expect the market to throw us in the future.