"The Moment Of Truth"

Market Commentary – April 2007

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The final reading of growth in Gross Domestic Product (GDP), a measure of the output of the U.S. economy, was 2.5% in the fourth quarter of 2006, revised up from 2.2%. For all of 2006, GDP grew at 3.3%. The consensus estimate of economists surveyed by The Wall Street Journal in early March predicts 2007 first quarter GDP to rise by 2.3% and second quarter GDP to grow 2.4%. These figures indicate that economists in general do not see the U.S. economy sinking into recession, where GDP would actually contract. The Federal Reserve echoes this belief, predicting "moderate" growth for the U.S. economy of around 2% in 2007, while "uncertainties" in the growth rate remain.

The weak housing market will likely continue to weigh on economic growth. New single-family home sales in February fell 3.9% to the lowest level since June 2000. Assuming the current sales pace, inventory of new homes for sale would take 8.1 months to be liquidated, the highest level in 16 years (since January 1991). Inventory of existing homes for sale would take 6.7 months to exhaust. Foreclosures in February, while down slightly from January's record number, were up 12% year-over-year. Many borrowers with weak credit who turned to adjustable-rate mortgages are not prepared when the interest rates adjust higher, thus increasing their payments and triggering the potential for foreclosure. Tighter lending standards are now being implemented, but the damage may already be done.

Futures markets indicate a discrepancy in how Wall Street is interpreting the Federal Reserve's guidance on the direction of short-term interest rates. Fed Chairman Ben Bernanke recently reaffirmed to Congress' Joint Economic Committee that the Fed's bias is toward tightening interest rates. The Fed is concerned that core inflation (factoring out the volatile food and energy sectors) remains "uncomfortably high" and says that its "predominant policy concern remains that inflation will fail to moderate as expected". Still, futures markets are pricing in a 28% probability of the Fed cutting their benchmark Fed Funds rate from 5.25% to 5.0% by July, and a 100% probability of a 0.25% cut by October. Such a discrepancy provides potential fuel to move the markets in the months ahead.

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 17.3. This valuation is not a bubble price, but it is not cheap, either. A higher yielding 10-year Treasury note, which currently stands at 4.65%, would make stock prices relatively expensive.

Technically, the stock market is experiencing a moment of truth. Following the weakness at the end of February, the S&P 500 dipped as low as 1364 intraday on March 14. After that, the index rallied up to 1438, shy of the February high of 1461. From its current level of 1421, the S&P 500 is positioned between support around 1375 and resistance around 1460. Volume on the recent rally was lighter than on the decline earlier in the month, which is bearish. Corrections since early 2003 have been unusually shallow. Investors have become complacent and have grown accustomed to the stock market bailing them out after it dips a bit. It may happen again this time, but one day this method will fail.

We are maintaining our balanced position of stocks and cash in this market environment. Portfolios with covered calls saw several positions called away over the past couple of months. We have replaced these stocks with others that we believe have favorable technical and fundamental factors. Still, we have not lost our discipline of balancing risk and reward by keeping a significant amount of cash on hand. This would allow us to participate in some market upside while also protecting some principal from market risk. Most importantly, cash gives us the ability to buy stocks when they are "on sale".