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Market Commentary

A Review of the Markets and a Look into the Future

A Data Dependent Summer

"We are not retreating - we are advancing in another direction."

General Douglas MacArthur

In my previous newsletter, I described the investment climate as "Partly Sunny with Increasing Cloudiness". While I do not generally speak about the investment markets in meteorological terms, my forecast actually turned out to be quite accurate. Investors and policymakers have been struggling for the last few weeks with economic data suggesting growth may be slowing, while inflation is accelerating – a troublesome combination. If this is not challenging enough for the markets, new changes in the geopolitical landscape are certainly clouding the picture further. The recent outbreak of war between Israel and the Hezbollah in Lebanon and worries about a wider involvement by Iran and Syria have been added to pre-existing concerns surrounding Iran and North Korea's nuclear desires. Furthermore, recent successful terrorist bombings in India and a failed attempt in Canada remind us that terrorism is alive and well.

So, where does that leave the markets? Fortunately, an anticipated slowing of economic growth around the world should help to reduce inflationary pressures, arguably the market's most pressing concern. Regarding the geopolitical tensions mentioned above, these types of events are often fleeting in their influence on the markets. Of course their affects could be more significant if the conflicts broaden or major disruptions to trade or oil supplies occur. The bottom line is that the outlook for the markets and the economy in the near-term are very much data and geopolitically dependent. We will be watching closely for signs of whether our new forward looking Federal Reserve Chairman can orchestrate the much needed economic slowdown without tipping the scales too far. We will also monitor the Middle East closely with the hope that tensions will eventually ease without causing any serious disruptions.

Data recently released reveal signs the economy is slowing. The Commerce Department announced that the U.S. economy grew at an annual rate of 2.5 percent last quarter, less than half the pace of the prior three months. Consumer spending also rose at an annual rate of 2.5 percent, as a slowdown in the housing market and sharply higher energy prices clearly took their toll on consumer spending. In addition, employment growth has been slowing as well. About the only area of the economy that is holding up well is exports.

An indication that economic weakness is likely to continue for a few more months is reflected in the fact that the Treasury yield curve is once again inverted. This means short-term Treasury bill rates are higher than longer-term rates, somewhat of an aberration. This uncommon event has historically been associated with a significant slowing of economic activity in the ensuing months. Given this environment, it is very likely that earnings forecasted for



"Your mother called to remind you to diversify."

future quarters are going to be too high. To the extent this proves to be true, equity markets may go through an adjustment period until the new earnings realities are accepted. The good news is that valuations are generally good, and corporations have been demonstrating their active willingness to use their healthy balance sheets to accelerate share buybacks or purchase other attractive companies in the face of lower stock prices. This serves to give the stock market a firm underpinning of support.

As we begin to approach fall, the prospects are good for the investing environment to improve, concurrent with an end to Fed tightening and an easing of inflationary pressures. To the extent the economy proves to be weaker than currently expected, it may ultimately require a Fed interest rate easing to get the economy and stock market back on track.

Investing Themes Going Forward

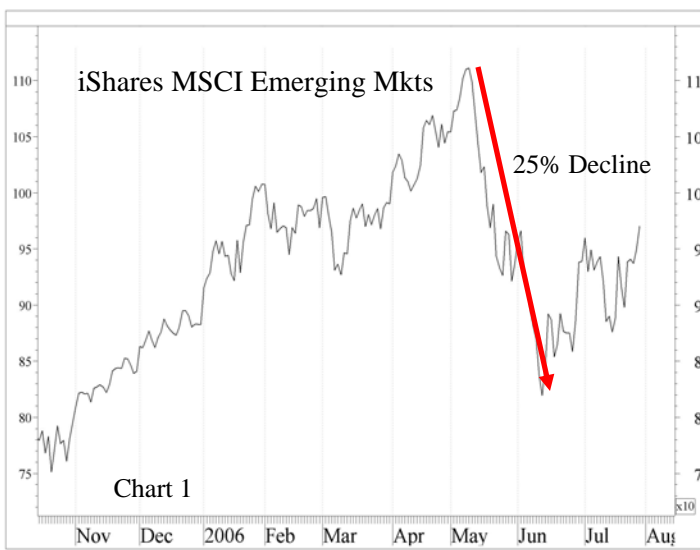
Easy money, strong economic growth and the increasing willingness of investors to take on more risk has fueled the performance of aggressive asset classes since the bear market bottom in 2002. The recent May to June sell-off in the global markets may reflect a change from these trends. During the decline, small cap stocks, commodities and emerging market securities were some of the hardest hit. Many of the securities that had performed the best in recent years were indiscriminately dumped by investors and replaced with more conservative positions. Investors' actions reflected an increased caution about the slowing economic environment, somewhat of a risk reassessment. Foreign emerging market equities especially reflected this "hunker down" mentality as they declined about 25% in one month (see Chart 1 below), a much more severe drubbing than their more conservative foreign developed market counterparts.

The environment we have evolved into recently is almost a mirror image of the previous one, characterized by slowing growth, decreasing liquidity and investors' increasing aversion to risk. Going forward, this theme will probably continue for a bit longer. Mid-cycle economic slowdowns, such as this appears to be, are confusing and disruptive to financial markets. Once it is clear the Fed has navigated a slow-down without tipping the economy into recession, a more predictable and rewarding environment should ensue. In the meantime, less cyclical, large-cap stocks will likely outperform small-cap stocks. The performance of foreign developed equity markets may exceed the returns of foreign emerging market equities and commodity based investments may soften as commodity demands moderate.

Bond Outlook

A slowing economy coupled with rising interest rates should result in the gradual pick-up of the default rates from speculative grade corporate debt in the coming months. Any increase would begin from a historically low base, yet would tend to cause credit spreads to rise as investors demand more yield for the added credit risk they accept in corporate bonds over Treasuries. Standard and Poor expects default rates in speculative grade debt to rise from 1.7% in June of this year to 4% by year-end 2007. Going forward, a scenario such as this should favor high quality debt, such as Treasuries, over more speculative grade issues. The good news is that slowing growth rates generally result in lower interest rates, an exceptional environment for Treasuries.

In closing, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. 🐾



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