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Market Commentary

A Review of the Markets and a Look into the Future

Earnings Surprise to the Upside

Human beings, who are almost unique in having the ability to learn from the experience of others, are also remarkable for their apparent disinclination to do so.

- Douglas Adams

Economic Outlook: The Fed's Dilemma

Recent economic data is giving the Fed plenty to think about ahead of its May 9 interest-rate-setting meeting. On one hand, the economy is showing some signs of weakness. Housing starts are down 23 percent from a year ago. Sales of existing homes fell 8.4 percent in March - the steepest one-month slide since 1989. Housing prices are also beating a historic retreat. February's 1.5 percent drop was the largest in almost 15 years.

Consumer confidence in the economy is down. The Conference Board's Consumer Confidence Index fell to 104 in April, the lowest level since last August. And consensus estimates are for real GDP growth to come in at a tepid 1.8 percent annual rate for the first quarter of 2007. All of these things point to a weakening economy that might need an interest rate cut to keep from developing a full-blown recession.

On the other hand, inflation is showing signs of strength. Annual inflation as measured by the Consumer Price Index (CPI) accelerated to a 2.8 percent pace in March, up from 2.1 percent in February. This points to a possible need to raise interest rates to keep inflation contained. Hence the Fed's dilemma - should they lower rates to fight economic stagnation, or raise them to fight inflation? We think the most likely scenario has the Fed holding interest rates steady, waiting until later in the year to see which of these monsters will need to be killed first.

Fortunately, the news is not all bad. Better than expected first quarter corporate earnings have the bulls running loose on Wall Street. Standard & Poors is currently estimating 6.5 percent earnings growth for all of 2007. That expectation may need to be revised upward. An expansion in price-to-earnings multiples represents the best chance for more outsized stock market gains through the year.

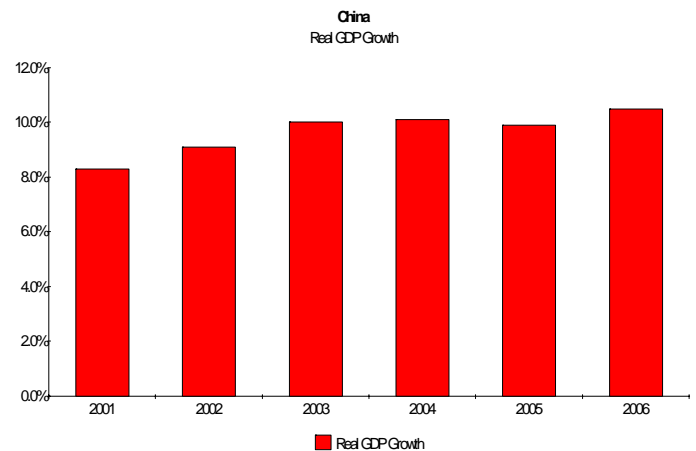
Commodities: China Holds the Key

Commodities made another strong showing in the past three months, prompting *Business Week Online* to ask if commodities have become the "new tech stocks". But unlike tech stocks in the 1990's, the increases are not being driven by hype. Global demand for food, energy and raw materials, particularly from burgeoning Asian economies, are driving this train. Incidentally, there is a spillover effect into the currency markets. Australia and New Zealand, both commodity exporting countries, are seeing significant increases in the value of their currencies.

In the long term, continued growth from emerging economies points to continued strength in commodities. But in the near term, a correction is possible, depending on what happens in China. China's economic growth

accelerated to 11.1 percent in the first quarter of 2007. This was up from an already fevered pace of 10.4 percent in the last quarter of 2006. The expectation, backed up by rhetoric from Chinese officials, is that interest rate increases will be used to slow things down and prevent an overheating situation.

Figure 1. Is China's economy running a fever? (source: www.chinability.com and the CIA Factbook).

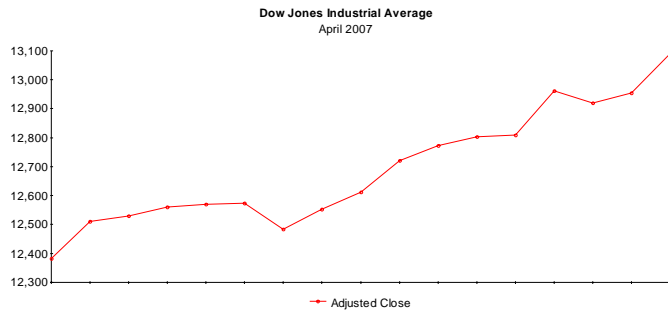


Any slow down in the Chinese economy will likely cause a commensurate slowdown in the commodities market, particularly in commodities such as steel and concrete, used heavily in infrastructure development. Energy and food commodities should feel less of an impact.

Domestic Equities: The Return of the Bulls

Things weren't looking too good in late February and early March. An abrupt decline in the Chinese stock market reminded investors of the risks inherent in emerging markets and precipitated a downswing in our own indices. But since then, stronger than expected earnings have turned anxiety into confidence, and the bulls have stampeded into uncharted territory with the Dow pushing past 13,000 for the first time. Many global markets have rebounded as well.

Figure 2. The Dow breaks the 13,000 barrier (daily closing data through 4-25-2007).



The confidence appears justified. Growth in the American economy continues, albeit at a more modest pace. Growth also continues in emerging capitalist economies such as China and India, which creates investment opportunities for American firms. And the American Association of Individual Investors reports relatively bearish sentiment. In the finest of contrarian ironies, this indicates that there is still money on the sidelines, potential fuel for more gains.

International Equities: More of the Same

For the reasons mentioned above, such as continued global economic growth, international equities remain attractive. This is especially true in the emerging economies of Asia. European equities are also exhibiting solid performance. European economic strength is driving the Euro to record highs against the dollar. This makes the exporting environment more difficult for European firms, but it signals overall strength in the European economies. This strength should provide the basis for additional equity gains in the coming months.

The Size Factor: Big is Looking Beautiful

We continue to favor larger cap stocks. International economic growth is outpacing domestic growth. This situation is likely to continue in the near term. And since larger companies tend to be more integrated into the global economy, they will be able to take better advantage of global growth.

The price-to-earnings (PE) ratio of the Russell 2000 is 20.5. The PE of the Russell 1000 is 16.6. This indicates that the prices of larger stocks have more room to grow versus their earnings.

Dollars and the Interest Rate: A Complex Dance Continues

European interest rates are rising relative to U.S. rates. And the dollar remains historically weak against European currencies. This situation is expected to continue in the coming weeks. The result is less demand for American fixed income securities, thus less demand for dollars to buy them, thus further weakening of the dollar against European currencies.

How long will it go on? Here we come back to the issue of the Federal Reserve's next move. If the U.S. economy grows faster than expected this year, the Fed may raise interest rates to fight inflation. This would strengthen the dollar. If the U.S. economy grows slower than expected, the Fed may cut interest rates. This would exacerbate the dollar's current weakening trend. A middle ground has the Fed holding off on any changes for now, with the dollar remaining somewhat weak. We are anticipating that scenario; nonetheless, we like the hedge that quality U.S. interest rate securities provide against the possibility of weaker than expected U.S. economic numbers.

High yield corporate bond prices have firmed up after some weakness in early March. The outlook is reasonably favorable. But we remain concerned that interest rate differentials versus low risk bonds are at the low end of the range needed to compensate for the added risk. This market calls for a hold-and-see approach for now.

Real Estate: Weaknesses and Strength

According to Green Street Advisors, an independent research and consulting firm specializing in real estate securities, Real Estate Investment Trusts (REITs) are currently richly priced relative to both bonds and big-cap stocks. REITs are corporations that invest in income producing real estate such as apartment complexes and office buildings.

Our analysis supports the view that domestic REITs are not a big bargain right now. The dividend yield on the Equity REIT Index is about 1 percent below the yield on 10 year Treasuries. Historically, the yield on this REIT Index has averaged about 1 percent above.

Nonetheless, REITs remain an important element of our strategy. They provide an important diversification benefit against traditional equities. We see value in Exchange Traded Funds and mutual funds that invest in REITs.

We also like international real estate. We've all heard that old saying about real estate; the three most important things are location, location and location. Well, it turns out that different locations, especially when they are in different countries, experience different swings in the real estate market. So mixing in some international real estate gives us one of the most important things an investment portfolio can have - diversification, diversification and diversification!

Exchange Traded Funds (ETFs): Still a Hot Area

Exchange traded funds (ETFs) continue to play a big role in Green Investment Management's overall asset allocation strategy. ETFs are spreading like wildfire! A year ago there were 201 on the market. Today there are 454. Ninety five have been launched in the first quarter of 2007. There are numerous types to choose from: broad market, real estate, commodities, currencies, fixed income and various sector-specific funds. These offer compelling opportunities and we will continue to pan the ETF market for gold in the months ahead.

The Bottom Line

In the period after Easter, the Christian church enters a season it calls "ordinary time". It is not ordinary as in boring, but in the sense that just the usual business is going on. Easter has come and gone, and Christmas is not yet on the radar.

From an investing standpoint, we might call the current period ordinary time. We do not appear to be upon the peak of a crash or the beginning of a boom. Economic growth continues, but it is moderating. The stock market is reaching record highs, but does not appear overvalued. People may not think of 2007 as an especially momentous period for markets, the way we all think of 1929 or 2000-2001. But things are moving along. It is a time for diversification. It is also a time for careful selection, as there is not any reason to anticipate a surging tide that will lift all boats.

As always there are opportunities and challenges. Green Investment Management will continue to pursue the opportunities and deal with the challenges to help our clients achieve their investment goals. As always, 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. If you have any questions or concerns, please don't hesitate to give us a call.



The views expressed are those of Byron Green as of April 27, 2007, and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.