

2nd Quarter 2007

THE MARKET AND THE ECONOMY

The stock market keeps going up. The Dow and the S&P 500 are back or above their peaks in 2000. The NASDAQ has a way to go. Energy continues to be the leading sector as we have been saying it would for four years now. International stocks continue to perform better than domestic stocks due to the global economy.

**James W. Paulsen, Ph.D., Chief Investment Strategist
Wells Capital Management
(from his newsletter)**

Has Housing Bottomed???

We think it has! Most activity indicators for housing (new and existing home sales, housing starts, permits, homebuilders surveys, homebuilder stock prices and the level of residential construction spending) have been oscillating close to the same levels (perhaps slightly less) for the last six to nine months. Moreover, several leading indicators (lumber futures prices, affordability indexes and new mortgage purchase and refinancing application indexes) have risen above their respective cycle lows in recent months. Even if housing activity has not yet reached a final bottom, its “rate of descent” has clearly slowed. This is more important for the economic outlook. A mildly declining (i.e., a still weak) housing industry over the next year is not that concerning. If real residential spending continues to decline modestly in the next year, big deal! Continued health in consumption and renewed evidence of strength from the business sector, manufacturing and international trade should be more than sufficient to offset any further erosion in the housing industry. Moreover, the broader environment surrounding the housing industry remains positive. Even though housing has collapsed, nonresidential construction is robust, jobs continue to be created, the unemployment rate is low, economic liquidity remains abnormally pronounced, interest rates remain relatively low, consumption growth remains remarkably strong, corporate profits are still rising and the stock market is still advancing. This does not describe an environment conducive to a continued housing bust. The “housing issue” is not about whether housing has bottomed, nor whether housing is about to recover. Indeed we expect housing activity to remain subdued for some time. Rather, the real issue is whether the housing “collapse” has ended. We are increasingly convinced it has. Should this prove correct, the focus and underlying momentum in the economy should soon move away from the housing industry.

Has Core Inflation Peaked???

Core consumer inflation appears dormant. Its annual rate peaked last Fall at 2.9 percent and has subsequently declined to 2.2 percent, only slightly above the Fed’s stated comfort zone. Core measures at the wholesale level have also diminished and even wage inflation recently peaked. Despite its seemingly benign nature, the risk of a reacceleration in core inflation remains elevated. The U.S. labor

unemployment rate is too low and the factory utilization rate too high to be comfortable about inflationary trends. Global real GDP growth is expected to remain close to 5 percent in the next couple years—too fast for a recovery now in its sixth year! Within the U.S., since real GDP growth has reaccelerated, inflationary pressures in the nearly fully-employed resource markets could become more pronounced in the second half of this year. The U.S. dollar has fallen steadily since its peak in 2002 producing a chronic rise in commodity prices throughout this recovery. Within the last month, the S&P GSCI non-energy commodity price index has posted yet another new cycle high! Lowest stage pricing pressures, therefore, remain evident in the economy. The real inflationary impact of a prolonged period of U.S. dollar weakness may just now be starting to emerge—improvement in the U.S. trade deficit. Improved international trade flows should intensify cost-push pressures in the increasingly tight U.S. resource markets. Finally, this recovery has been dominated by abnormally rapid and persistent liquidity trends.

“Too many dollars chasing too few goods” should not make anyone comfortable about inflation. Ultimately, “excess liquidity” needs to be purged. How will this be accomplished? The most likely resolution is probably faster inflation. Rapid global growth, accelerating domestic growth, tight domestic resource markets, a chronically weak dollar, forthcoming U.S. trade improvements, unrelenting advances in commodity prices, persistent excess liquidity and an interest rate structure which is still near a four-decade low! Hardly an environment which inspires confidence that inflation has peaked!

Everybody is Looking for a Crisis!!!!

Since long-term bond yields have risen above 5 percent, “crisis watch” has gone on full alert! For sometime there has been an intense search by the media for a potential blowup among the current cast of roughly 10,000 hedge funds. Recently, they finally found two with problems! And these two supposedly portray a broad-based, systemic risk for the economy. The subprime crisis is also getting renewed emphasis. So is the CDO market, junk bond yield spreads and the “bubble” in China’s stock market! The current “crisis mode” also seems increasingly sensitive to terror news. With the current mentality so focused on hunting for a crisis, it would not be surprising to see a revival in the Yen carry forward trade crisis, the dollar dumping crisis or maybe even a dusting off of the bird flu pandemic!

We think a financial crisis, while always possible, is unlikely. Currently, there is little “policy stress” in the system. Interest rates at only about 5 percent still represent some of the lowest yields in the last four decades! Liquidity growth remains remarkably ample as most money supplies about the globe have been accelerating in the last year. Fiscal stimulus remains robust. Continued U.S. dollar weakness remains stimulative to overall U.S. economic growth. The yield curve has again turned positively-sloped.

Where is the policy stress normally associated with a financial crisis?

Also contrasting with the past, most debt is no longer held in the banking system! Historically, financial crises would shut down the financial industry and therefore the credit creation system. Today, since much of the debt is held outside the banking industry (by pension funds, foundation & endowments and private portfolios) a crisis might hurt pension balances but would not likely shut down credit availability as it has in the past.

Most importantly, any concentrated financial risks that do exist today are more broadly dispersed and diversified about the globe than ever before. There are more globally diversified sources of liquidity today which could help alleviate and extinguish any short-term squeeze. Finally, U.S. corporate balance sheets are more liquid and in better health than they have been in perhaps 40 years. A crisis in conjunction with a weak corporate sector is always problematic. But a crisis when corporations are profitable and cash flow rich would be much easier to handle. Simply because most are looking for a crisis, does not make one more likely. However, adopting more conservative business practices and investment portfolio compositions simply because most are "waiting" on a crisis could prove financially costly.

The rise in bond yields has little yet to do with inflation. Rather, the recent jump in bond yields only reflects an increased real growth expectation. Currently, the 10-year treasury yield is struggling with the 5.25 percent Fed funds rate. This psychological level is important since by breaching it, the bond market will suggest the Fed is again behind the curve on fighting inflation. The biggest risk for bond yields, however, is if and when the annual rate of core consumer price inflation rises again. Should economic reports remain fairly strong in the next few weeks (particularly surrounding jobs and housing), the 10-year yield should soon surpass the Fed funds rate. Later this year, if core consumer inflation does rise again, as we expect, the upside risk in the 10-year yield could surprise most and approach 6 percent!

The stock market remains near record-highs despite the recent surge in bond yields. Moreover, bond yields show little evidence of crimping the stock market for long. Not only are stock markets about the globe continuing to outpace bond markets, but leadership within the stock market continues to be concentrated among small cap stocks and economically-sensitive sectors (technology, industrials and basic materials). Non-energy commodity prices also remain near recent cycle highs. If the recently elevated 10-year treasury yield was retarding future economic growth prospects, we would expect the stock market to be reacting much differently. Not only would it be struggling relative to bonds, but defensive sectors and large-cap stocks would be dominating. For this reason, we think a 5 percent treasury yield has only caused a pause, not a peak, in the stock market.

For stock investors, there is still much to like! Valuations remain reasonable, economic momentum is reaccelerating, yields are still relatively low, liquidity is still remarkably ample, core inflation as yet is still well controlled and we gage investor sentiment as still cautious. Our best guess remains is for the S&P 500 index to reach a high between 1600 and 1650 before the year is over. We recommend staying over weighted in the economically-sensitive sectors (technology, industrials, basic materials and retailers), smaller cap stocks and in international markets.

**Van Hoisington, Hoisington Investment
Management Company
(from his newsletter)**

In recent years equity extraction from homes generated a huge pile of consumer cash that was allocated to spending, investments, and a variety of other uses. While the exact allocation of this massive sum is unknown, total home equity cash out (as determined by Freddie Mac) summed to \$1 trillion over the five years ending 2006. That source of cash has largely dried up since home prices are no longer rising, and credit standards have been tightened.

According to Case/Shiller, home prices have fallen at a 5% annual rate over the past six months, now deflating in 3/4 of the country's individual markets. In the past year, home prices decreased 2.7%, the steepest decline in 16 years, and further declines seem certain. At the end of the first quarter, vacant homes for sale, plus unsold new single family homes under construction, surged to 2.454 million, an unprecedented one million above the ten year average from 1994 to 2004. Pending home sales have just recorded the largest three month drop in history, and are now down 12.9% from a year ago. Single family permits for new construction slumped to a ten year low, reflecting the attitude of the National Association of Home Builders, whose index hit a sixteen year low. The great ATM machine (home equity extraction) for consumers has enabled spending beyond income for several years, but it has now been disabled. This strain on consumers, combined with their negative saving rate and over-indebtedness, is already apparent in the current spending pattern and in rising delinquencies and defaults on mortgages.

Our view is that faltering consumer spending and a continuing housing recession will lead to recessionary conditions in the quarters ahead. This will negatively impact global economic conditions and decrease the U.S. inflation rate from its already modest 1.9%, thereby lowering inflationary expectations, and subsequently long bond yields.

Well, Mr. Paulsen is still bullish. Others, like Van Hoisington, are bearish and believe the current economic fundamentals suggest that a major bond rally will ensue in the last half of 2007. We will see.