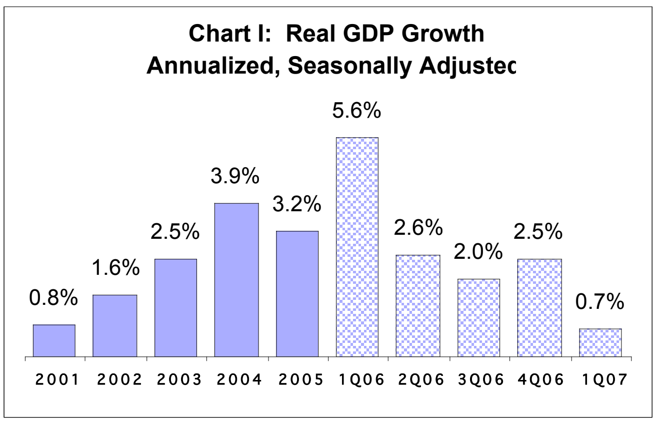
Investment Update
Second Quarter, 2007

The U.S. Economy

After nearly stalling out early in the year, the economy showed better life in the second quarter. Final numbers for Q1 showed real annual GDP gaining only 0.7%, a marked drop from the fourth quarter's 2.5% pace. Residential investment plunged in the first quarter, taking nearly one percent of growth out of GDP. Businesses meanwhile cut inventories, trimming another nearly 1% from GDP. Booming imports outweighed export gains, further hurting GDP growth. Happily, consumers kept spending during the period, with aggregate outlays rising 4.2%, resulting in the net GDP gain.

For the June quarter, GDP rebounded, likely rising upwards of 3%. Business spending picked up, consumers continued to shop (although less exuberantly), and a weaker dollar helped US exports. Monthly data on business expenditures has been mixed—factory orders were up in April, down in May—but broader measures showed a strong rebound in manufacturing during the second quarter. With labor markets relatively tight at 4.5% unemployment and capacity utilization high at greater than 80%, businesses need to make productivity-enhancing investments, picking up the spending slack from a flagging consumer.



Hurt by high gasoline costs, falling home values, and rising interest rates, consumers have pulled back a bit. Real personal consumption expenditures were up 1.9% for the 3 months ended May, down from a near-5% pace for the 3-month period ended January. However, worker productivity is at record highs, powering real year-over-year income gains which are key to spending levels.

One major economic cloud is the ailing housing market. Despite positive signs earlier this year that housing markets were stabilizing, home sales have slumped again while median prices through May fell versus a year ago. Rising inventories of both new and used homes point to further weakness in home prices before we likely see the bottom later this year. That said, the fallout from the housing bust so far has been relatively contained.

The bigger question is will the resulting pressure on the weakest borrowers—the so called sub-prime segment and those now facing rising adjustable rate interest payments—create a broader credit squeeze and ripple through the economy. To date, collateral damage to capital markets has been limited, but the quarter's end may reveal additional losses in speculative mortgage-backed securities. Also, lenders have tightened up standards for mortgages and investors are requiring much higher returns from mortgage-linked securities. The sub-prime crisis has opened investors' eyes a bit to the true extent of leverage within today's financial markets and prompted a more appropriate pricing of risk. Global financial markets appear deep and sophisticated enough to absorb whatever falls out, especially with central banks apt to move to avoid any broader financial contagion.

The Fed's main concern, meanwhile, remains inflation. Steadily increasing food and energy costs are crimping businesses' sales and profits—especially for retailers and restaurants—and could spread more broadly throughout the economy. However, through May, the Fed's preferred indicator of "core" inflation dipped to just 1.9%, falling to within its 1%-2% comfort range. Absent a spreading problem from the sub-prime markets or a spike in inflation expectations, the Fed will likely keep short term interest rates steady for the balance of the year. Meanwhile, we look for the economy to grow 2.5%-3.0% during the second half, paced by lingering effects of the housing slowdown.

The Stock Market

Several concerns weighed on investors' minds during the second quarter—among them the housing slowdown, high energy costs, mounting problems in the sub-prime mortgage markets, and the threat of a pullback from US markets by overseas investors. Yet the stock market climbed a wall of worry and both the Dow Jones Industrial and S&P 500 averages hit all time highs early last month. Stocks benefited from low interest rates, low inflation, and steady (if only moderate) growth. Rising earnings expectations helped power the gains during the quarter, too. First quarter profits handily beat analysts' pessimistic projections, prompting increases in forward estimates. Going into the second quarter, analysts were looking for just 2.5% growth in S&P 500 profits but results likely gained closer to 7%.

Table 1: Equity Market Performance

	6/30/06	3/30/07	6/29/07	12 mth % Chg	2nd Qtr % Chg
Dow Jones	11,150	12,354	13,408	10.8%	8.5%
S&P 500	1,270	1,421	1,503	11.9%	5.8%
NASDAQ	2,172	2,422	2,603	11.5%	7.5%
Russell 2000	725	801	834	10.5%	4.1%
MSCI EAFE	1,760	2,148	2,262	22.0%	5.3%

Equity markets were further buoyed by robust buyout activity as companies were snapped up at a record pace and firms themselves announced large share repurchase programs. During the first half, merger and acquisition activity broke the $1 trillion level for the first time.

Setbacks during the quarter—prompted by sell-offs in bubbling Chinese stock markets and disappointing US retail sales—were generally not long lived. Treasury bonds acted as a safety valve taking nervous money from equity investors until the scare passed. This dynamic played out until yields breached the seminal 5% level. Strong global growth and rising inflation pumped up real yields worldwide, pushing the bellwether 10-year US Treasuries above 5%—a level that historically has spelled trouble for equities.

Rates have risen slightly, bringing some sobriety to risk-taking activity and making the buyout game more expensive, but equities should see continued support from healthy corporate profits. For the full year, S&P 500 earnings will likely moderate to a 7%-8% gain. Also, deals are still coursing through the M&A pipeline—$80 billion worth announced on July 2 alone. Market valuation, meanwhile, remains reasonable at 16 times forward earnings. Major overseas stock markets similarly enjoy earnings support and generally reasonable valuations.

Bond Market

Until early last month, the Fed's efforts to lift interest rates had only pushed up short term yields, resulting in a generally inverted yield curve. But as surging global growth has pushed up real and nominal interest rates, longer term US yields have finally started to go up, with benchmark 10-year Treasuries topping the key 5% level. The good news is higher rates are the result of economic growth and not a flare-up of inflation. Higher yields will exacerbate the US housing slump but on a broader scale help keep the global boom from igniting that inflationary flare-up.

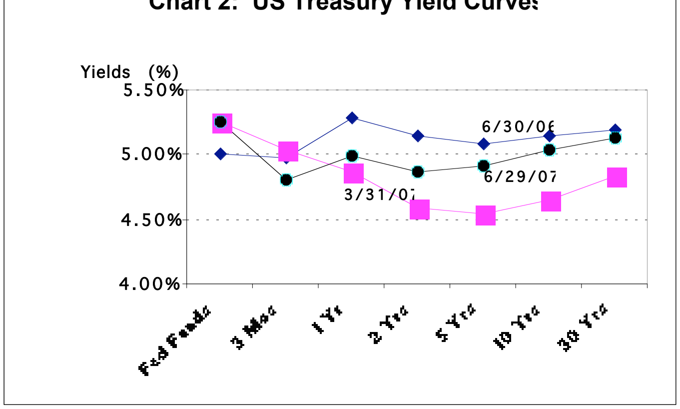


Chart 2: US Treasury Yield Curves

Spreads between "risk-free" government bonds and lower quality junk bonds have been unusually tight. High-yield bonds offered 2.6% more yield than Treasuries in early June, compared to a 20-year average of 5.4%. That spread has widened to 3% more recently and yields up and down the quality spectrum have opened up as investors are again pricing in risk. Treasuries look to be holding around the 5% level, and yields generally should return to a more normal positively sloped curve. With investors still repricing risk into the quality spectrum and the sub-prime debt crisis not fully resolved, corporate spreads might settle out further, leaving us to recommend staying with shorter term Treasuries and agencies for the time being.