Q1 2007 Quarterly Commentary

Author: Mark Duvall, Principal and Chief Investment Officer, CFA®

The investment markets continued to appreciate in 2007, albeit with more volatility than evidenced in the past few years. The S&P 500 fell almost 4% on February 27th, yet has regained not only the 4%, but an additional 1.4% to come close to all time highs. Oil prices have contributed to the volatility; currently, oil is at $63 per barrel, having hit $78 last summer and fallen as low as $53 in January. Considering the stock market's drop in February, the large capitalization market as represented by the S&P 500 was surprisingly positive by 0.6%. Small company stocks rose 1.5% while developed international markets rose 4.2% for the quarter. Commodities (boosted by oil) increased by 4.6%, and commercial real estate as represented by the Wilshire REIT index also did well by increasing 3.7%. The Lehman Brothers Aggregate Bond Index ended up 1.6%.

With 1st Quarter 2007 earnings just coming in, we expect the minor slowing of GDP growth to tick up slightly for the balance of the year. There is much good news: household balance sheets are strong, corporate profits are slowing but still in the upper end of their historical range at 12 times GDP, the unemployment rate has dropped to 4.4%, and consumer spending remains solid. We forecast 2007 GDP to be in a range between 2.5-3.5%. The Federal Reserve remains wary of both inflation and sluggish growth, and we don't expect interest rate cuts or increases any time soon.

On the other hand, not all appears positive. The "subprime" housing fears continue, with considerable speculation as to whether the problem will spread to the overall economy. CPI inflation is higher than desired, driven by commodity prices and low unemployment, although Core CPI appears under control. Home sales are sluggish in many parts of the US with prices falling and unsold inventory. Middle East geo-political issues haunt the daily news and create uncertainty. As always, the stock market reacts in short time horizons to current events, but it is the longer term that really matters. If inflation remains under control and we have no significant economic or political shocks, we expect another year of positive returns, probably in the high single to low double digits.