

Q2 2007 Quarterly Commentary

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The second quarter of 2007 demonstrated the true beauty of asset allocation. While some asset classes were up significantly, such as emerging markets jumping +15.1%, others didn't do so well, such as traded real estate down -9.4%. In the domestic stock market, bigger was better and growth trumped value, with large US growth returning 6.7%, large US value 4.9%, and small cap bringing up the rear at 2.3%. Though small-caps did well in the first quarter and over the past five years, they now lag large-caps over the past year. International stocks had another strong quarter, returning 6.7% and beating the U.S. market again. The effectiveness of asset allocation is demonstrated when returns as diverse as these combine to produce a less volatile, higher returning portfolio.

In every economic cycle there are points where the indicators are particularly confusing. During these times investors who try to read the economic tea leaves can be easily whipsawed. So far, 2007 seems like one of those times.

Early in the year investors worried that the troubles in the housing market might lead to a recession. With weaker economic activity, interest rates dropped and stocks lost about 5% of their value—bottoming in early March. Shortly thereafter, concerns about recession dissipated and optimism improved. The stock market took off, rising 12% from the March bottom into early June.

A renewed fear of inflation and of further interest rate increases came next, almost a complete reversal of the concerns at the beginning of the year. The strength of the global economy (over 5% real growth anticipated for 2007), the need to rebuild inventories, and declining productivity growth rates dashed investor hopes of a Fed interest rate cut later in the year, despite the weakness in the U.S. housing market. The bond market sold off, with the 10-year Treasury yield hitting levels not seen for over five years. Stocks began following suit in early June with a drop of about 3% over three days. Lower core inflation numbers helped the Treasury market to rally, while the stock market dropped back near its low for the month. Mixed signals on the economy and credit market fears led to a fear that the buy-

out boom that has boosted the stock market might slow, leaving investors increasingly cautious. The risk of reacting badly as economic data shifts from week to week or month to month is exacerbated by the intense coverage of the financial media. Though it is difficult to keep a long term focus, we must do exactly that in order to be successful investors.

We believe that the US economy will continue to benefit from global growth. Headline CPI inflation will be higher than in the past few years, but will continue to be moderate due to global economic competition, solid efficiency gains, and a moderating price push from oil. Our expectations are for GDP growth in the 2.5% to 3% range through the end of 2007, and the markets will reward disciplined investors with additional returns above 5%.

91% of the economy has been growing at 3.5% over the last year, while 9% has collapsed at a -12% rate. Autos and housing make up the 9%. Detroit continues to struggle, with major upcoming negotiations with the United Auto Workers arriving just as the sales of the domestic manufacturers have suffered and the Japanese are riding high. The inventory of homes nationwide has risen dramatically, and sub-prime lending problems continue to grow. Lenders are tightening standards for all sorts of mortgages due to the fallout from the sub-prime problems.

The big question is whether this problematic 9% can drag down the rest of the 91% of our economy. More layoffs and diminished spending on retiree health care is coming to the Midwest, but that won't hurt the economy much. It is not in the interest of the unionized workers to drive their employers into bankruptcy.

The securitization of mortgage debt has pushed the costs of defaults off specific lenders and spread it out across the financial markets. Some hedge funds will go under that had taken excessive risk in that particular market segment, while others will make outsized returns taking the opposite tack. Home prices in much of the country might be soft for a while, but most people can afford their payments.



Though we think the strength of the 91% will outlast the weakness of the 9%, we don't want to ignore the potential of the reverse. We are fully weighted in our bond allocations because they will rally if the 9% pulls down the rest. We are emphasizing international stock markets because growth is stronger overseas than in the U.S. We are slightly underweight our long-term allocation to REITs due to their high performance over the last 5 years and their dependence on inexpensive debt to justify their underlying valuations. Once again, diversification helps us lower risk.