

## Financial Markets Commentary

### 1<sup>st</sup> Quarter 2007

#### Summary

April 24, 2007

On the whole it was a very average quarter. The first quarter of 2007 got off to a nice start, but concerns about China, sub-prime mortgages, and oil prices knocked prices down at the end of February. Markets steadied in March, enough so that almost all of the indices finished in the black. Despite concerns that falling home prices might take the broader economy into recession, investors never really believed it. Small company stocks and high yield corporate bonds, both very economically sensitive, performed well. That doesn't happen when investors believe recession is a significant possibility. Large company stocks got a lift every time economic data showed weakness, on hopes that the Federal Reserve would have to cut interest rates. In truth, most of the data released did not support that course of action.

The S&P 500 stock index gained 0.64% on the quarter. That index, which measures the performance of the 500 largest companies by market capitalization, was the best performing large company index. The Dow Industrial Average actually lost 0.33%, and the NASDAQ Composite gained 0.26%. Fortunately, that was far from the whole story. The average stock rose close to 2% as smaller companies again beat their large rivals. The S&P 400 Midcap Index gained 5.80% and the S&P 600 Small-Cap Index rose 3.21%.

Worldwide, economies tend to be growing faster than here in America. Now that China is a strong growth engine, foreign markets are less affected by what happens to our economy than has been the case in several decades. Happily, faster growth overseas has been leading to higher returns. The EAFE foreign market index gained 4.08%, led by Latin America and Europe. Pacific Rim stocks did not do as well, weighed down by Japan and South Korea.

Bonds posted a total return of 1.50%, slightly beating stocks. There wasn't much interest rate volatility in the quarter. Consumer prices rose a little more than the Fed would like, but that was offset by the sub-prime mortgage crisis which sparked fears of a general economic downturn. And yet, it still paid to take risks in the bond market. Emerging market debt and high yield corporate bonds each rose almost 3% on average.

## Strategy & Performance

The correct strategy has been to stay the course. In stocks we have maintained a smaller cap bias than the benchmark even though we believe large companies may be better values right now. On the bond side, we have earned a better return by being willing to venture into international bonds. These moves, more than anything else, enabled us to modestly outperform the balanced portfolio benchmark (2.30% net vs. 2.13%). Our aggressive portfolio also beat its benchmark 2.21% to 2.08%. Aggressive portfolios were affected by the late February sell-off in emerging markets. For the most part, however, economic indicators point more to strength than weakness, so riskier securities are likely going to lead.

## Outlook

Investors are hoping that the Federal Reserve is going to cut interest rates as soon as May. That is not going to happen. Part of the reason for the strength in stock market recently has been the hope that the Fed will again ride to the market's rescue. Such an action is not warranted because the economy (outside of the financial sector) is fairly strong. Moreover, the dollar has been fairly weak lately due to greater economic strength and higher yields outside the U.S. and rate cuts will only make it weaker. On the plus side, stocks are not expensive by and large and cash to buy is ample. We believe that investors should expect the market to muddle along over the next several months much the same as it has so far this year.

## Commentary - Grinding It Out

Many of you watched the Masters (a major golf tournament, to you non-sports fans) last weekend. Even under the best circumstances, the Masters is a very tough course. Golfers favor fairly moist conditions, because the green will be soft and they can aim right at the pin (hole) without fear that the ball will roll over the green. Since many shots require deft touches, warm weather is preferred because it is easier on the hands. Unfortunately, for the first time since 2002 (when the course was made more difficult to counteract improvements in club and ball technology and the skill of Tiger Woods), the weather was cold and dry. The course was ridiculously hard. The best golfers in the world were forced to play just about every hole for pars, knowing that winning would depend not so much on great shots as much as fewest mistakes.

That is the way the stock and bond markets are right now. Inflation is running a little higher than the Federal Reserve would like. Corporate profit growth is slowing. The sub-prime mortgage situation is getting worse. Oil prices are back in the mid-\$60s and gasoline is back near \$3 per gallon. Yet, despite all of this, most markets are higher.

**The reason is that there is plenty of money available to invest. In fact, the supply of investable cash easily exceeds the number of places to put it, which is causing upward pressure on securities overall. In other words, despite all of the negatives investors are flush with cash and are feeling pressure to put it to work. This is why the last two market sell-offs (May-June 2006 and February-March 2007) were comparatively shallow, and why the market didn't fall so much as 2% in the 200+ trading days between them. Investors feel compelled to buy any time the market goes on sale, even a little bit.**

**It is important to remember that fear is a stronger emotion than greed, such that markets can fall much faster if investors get scared than it ever does when they are eager. Think of Stuart Appleby at the Masters on Saturday. He grabbed the lead in the tournament by playing 16 nearly flawless holes in 2 under, and then wiped that out by triple bogeying the 17<sup>th</sup>. That is just like the stock market in 2007 – 8 solid weeks producing a gain of more than 3%, completely undone by a 416 point plunge on February 27. We have been rising more or less since mid-March, but we may be one bad housing report or consumer price index number from falling back to even par on the year. Extra care is required right now. Excess liquidity is driving the market (higher) right now, but when investors get nervous liquidity has a way of vanishing faster than a two-stroke lead at the Masters.**

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