

Financial Markets Commentary

2nd Quarter 2007

Summary

July 11, 2007

Stocks performed very well during the second quarter of 2007. While concerns about rising inflationary pressures and the slowdown in the housing market affected the market at certain times, in the end we had a “not-too-hot, not-too-cold” economic environment that investors generally found to their liking. Even more significantly, corporations and private investment firms found it to their liking. The quarter saw a record number of companies taken private, and an unprecedented level of corporate stock buybacks. In essence, the supply of stocks shrunk while demand for stocks increased. This is a phenomenon that can feed on itself because rising prices tend to create additional demand. So while on one hand it is absolutely true that the higher the price you pay for a given stock increases your potential loss, it is also true that higher prices tend to make people feel that stocks are safer. Right now stocks, having risen in each of the last four years and gained more than 6% this year, seem awfully safe. Later in this commentary we will show why this is not the case.

Until recently, income generating stocks like utilities and real estate investment trusts have been market leaders. Last quarter the real estate sector was by far the worst of all, losing 8%. Utilities gained 3%, but they peaked the third week of May. The leadership is now in more economically sensitive areas like industrial and manufacturing companies. Recently even technology has surged, after having done almost nothing between 2004 and 2006. Energy is volatile from quarter to quarter but the last three months were very strong. That sector gained a market best 14%. There was also somewhat of a shift from small to large capitalization, as large companies outperformed small ones by roughly 6.5% to 5%. Taken together, the sector and size moves may be indicating that the bull market is near maturity.

International stocks gained about 7% as a whole. Emerging markets led the way with a gain of 14.3%. While U.S. and European markets had a 4% hiccup early June, the emerging markets scarcely missed a beat. The availability of credit at very low rates through the Bank of Japan has allowed for an unprecedented level of speculation. High yielding currencies (like the New Zealand dollar) and high beta investment markets (like Latin America and Asia ex-Japan) have been the biggest beneficiaries.

Emerging markets may be red hot, but, these stocks are now roughly triple their 2002 levels. Gains like that are unsustainable in the long run. Those who didn't learn that lesson from tech stocks seven years ago are learning it from real estate right now and we're sure emerging markets will be no different. In the short run, however, credit is plentiful and natural resources prices are strong. As long as those two conditions are in place investors won't care much about valuation. In the long run, however, valuation always matters!

Bonds were the weakest asset class last quarter. Worldwide economic growth was strong and central banks outside the United States did not have to worry about their domestic real estate markets, so they were raising interest rates. The US 10-year bond briefly spiked above 5.25% in June, which is not only bad for bond holders but also sent a shock wave through the stock market. Concerns about losses in the sub-prime mortgage market caused a sell-off in lower quality (high yield) bonds. Later in June rates came down enough to cut the bond market's quarterly loss to about a half of a percent. Still, with bonds having returned just 1% since the beginning of the year, a lot of investor money is flowing out. Stocks are the obvious alternative, but even the money market has done better (2.4%).

Strategy

During the quarter we elected to lighten up on stocks, especially those in highly appreciated areas like real estate, small companies, and emerging markets. We didn't expect to hit the absolute tops in those markets (you never do except by pure luck), but we did feel those areas were fully valued and that in order to be successful over the long term we needed to do some selling. That way our clients are not fully invested at the market top, so they will not have to sell into the falling market that comes next. That said, the real estate sale looks especially well-timed, the small and mid-cap sales look okay and emerging market sales (for those that had emerging market positions) will have turned out to have been early. The best indication of the success of the changes we made in your portfolios were that the quarterly returns for each of the four model portfolios (risk tolerances) we manage all performed at or better than their benchmarks and with less risk.

Outlook

There is an outside chance that before the stock market peaks it has a blow-off phase like September 1999 to March 2000 where already rich areas of the market take off. Most of the time bull markets do not end that way, but there is currently talk of "its different this time" creeping into the market particularly as it relates to world economic growth. We believe statements like that are used to justify paying ever higher prices.

As sure as night follows day strong economic growth brings higher interest rates which eventually choke off borrowing and cause the growth to slow. In other words, the short term outlook is good and might turn out to be quite good, but the intermediate and long term outlook is for below average returns; here is why:

Commentary – Rollin’ Down the River

Think of investing as rafting down a long, wide river. Imagine that on the left side the current is very strong, but on the right side the river is quite lazy. The faster you want to get down that river the more you want to stay left, but you run the risk of being caught in the rapids and flipped over. The greater you fear tipping over, the more you will sacrifice speed for safety and stay right. The more people that zip by you on the left without capsizing, the more you discount the danger, and you begin edging left. Eventually, there are a lot of rafts on the left in rough water, and inevitably some rafters get in over their skill level. Then the river hits a rough patch, some rafts flip, and suddenly everybody is frantically trying to steer to the right and calmer water.

Financial Markets are like that. Risk is always there, but at the beginning of the cycle investors are wary of those risks and only those with skill and experience are willing to take them. As the cycle progresses and the initial investors do well, others want to get in. Some may be aware of the risks, but others just want the returns and they assume that if the market is doing well it must be less risky. Oftentimes, they wind up buying the stock of the savvy investors who got in at much lower prices. Ultimately, the cycle ends with a lot more investors keenly aware of recent performance but fairly ignorant of valuation. As price fall, they sell, setting up the conditions that take stocks from expensive and over-owned to cheap and under-owned.

How does all this relate to the current market? At today’s prices stocks are not cheap. Figure 1 is a graph that shows normalized price-to-earnings ratios for the last hundred and thirty years. You can see that extremes in P/Es tend to be short-lived either way; P/E ratios historically don’t stay below 10 or above 18 very long. It is also interesting to note that P/Es don’t correlate to interest rates as much as many investors believe. In the 30s and 40s we had both low P/Es and low interest rates. Finally and perhaps most importantly, you can see that we are approaching a level that was exceeded only one time previously, and that didn’t end well.

Right now it seems there are a lot of rafts on the left side of the river, as the lessons of past accidents are far from the minds of most rafters. There are very few places we can invest in that offer good reward potential relative to the risks. If you can't buy at reasonable prices, then you just have to be patient. All of the great investors that we have known have been willing to wait it out on the slow side of the river when the other side got too crowded. They know their history. There have been significant lows in 1982, 1987, 1991, and 2002 and relative lows in almost every other year. If you are patient, the stock market always will eventually provide a good opportunity. The river will take you where you want to go, as long as you respect its power.

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