

Quarterly Market Review

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Financial Markets and Economic Analysis, First Quarter 2007

Perspective

At the close of 2006, there was no real consensus in the market concerning the direction of interest rates for 2007. While the futures markets were predicting a rate cut in the first half of the year, cogent arguments could be, and were, made for an increase in rates during that period. While the Fed stayed on the sidelines during the first quarter, as was expected, the economic picture has been clouded even further over the course of the quarter. While GDP for the fourth quarter was revised higher, job growth and manufacturing output was weak. At the same time, PPI and CPI numbers for February (released in March) spiked largely due to energy and food prices. With inflation still the main target of the Fed, this sets back the likelihood of a rate cut in the near future.

Adding to the confusion was the collapse in the sub-prime mortgage market. The housing market was one of the main drivers in the U.S. economy over the last two years, both in terms of jobs (construction, lending) and in terms of the equity tapped by homeowners as prices rose. The unraveling of the sub-prime market however, could have equally disastrous consequences over the next two years. Forty-four lenders across the country have either closed their doors and sold off their assets or declared bankruptcy. It is estimated that more than \$500 billion in adjustable rate mortgages will be subject to rate increases this year and foreclosure rates are already climbing in many parts of the country. Anecdotal evidence of large swaths of neighborhoods and cities being affected is already being heard. Whatever the final shakeout will be, credit will be much tighter in 2007, which is rarely good for an economy as a whole.

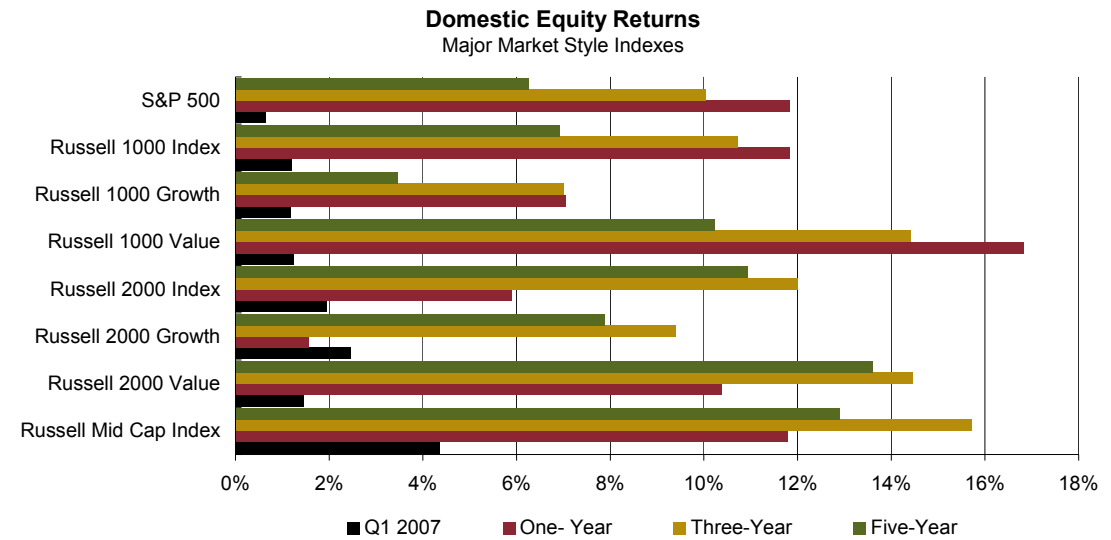
Domestic Equity Markets Overview

Overall, the domestic equity market performed well during the first quarter on the heels of a solid 2006. But the returns for the quarter were, for the most part, garnered in January. Looking at the Russell Indexes for the first quarter, there were three distinct markets. The “blue chip” ranks were largely unchanged for the quarter and growth/value/core designations meant little. Small cap stocks had a relatively average quarter, with the Russell 2000 Index up just shy of 2.0%, but the growth component of that index was up nearly 2.5%. Midcap stocks, as defined by the Russell Midcap Index, were up nearly 4.4%, but the value component of that index that was up nearly 4.9%. When breaking the indexes down, it is fairly easy to see the reason for the dichotomy between the mid and small caps. The Russell Midcap Index was driven by the Energy, Utilities and Materials sectors, which are more heavily represented in the Value portion of the Index. For the Russell 2000 Index, Energy and Financials were major detractors from return. Consumer Staples was the best performing sector by far, but represents only a tiny portion of the overall Index. However, both the Technology and Healthcare sectors, which together make up nearly half of the growth portion of the Index, were up substantially as well.

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International Markets Summary

The international markets had a much stronger first quarter than the U.S. domestic market, and unhedged investors were rewarded with an additional kicker as the dollar continued to weaken. The MSCI EAFE Index was up 3.41% in local currency terms, but 4.15% in dollar terms. Regional and country specific returns were higher across the globe, with very few exceptions. The Pacific regions were generally ahead of Europe, especially outside of Japan. While the MSCI Japan Index was up 3.56% for the quarter, Singapore and Australia led the region with 10.32% and 9.58% returns respectively (all in dollar terms). In Europe, the two top returns were in the Scandic countries, with Finland and Denmark up 10.90% and 8.38% respectively. Only Ireland, of all the MSCI Developed Markets, failed to have a positive, dollar-based return. This is the continuation of a long streak of outperformance by the EAFE Index relative to the S&P 500. The EAFE Index has outperformed the S&P 500 in nine of the last 12 quarters, by a total margin of nearly 40%.

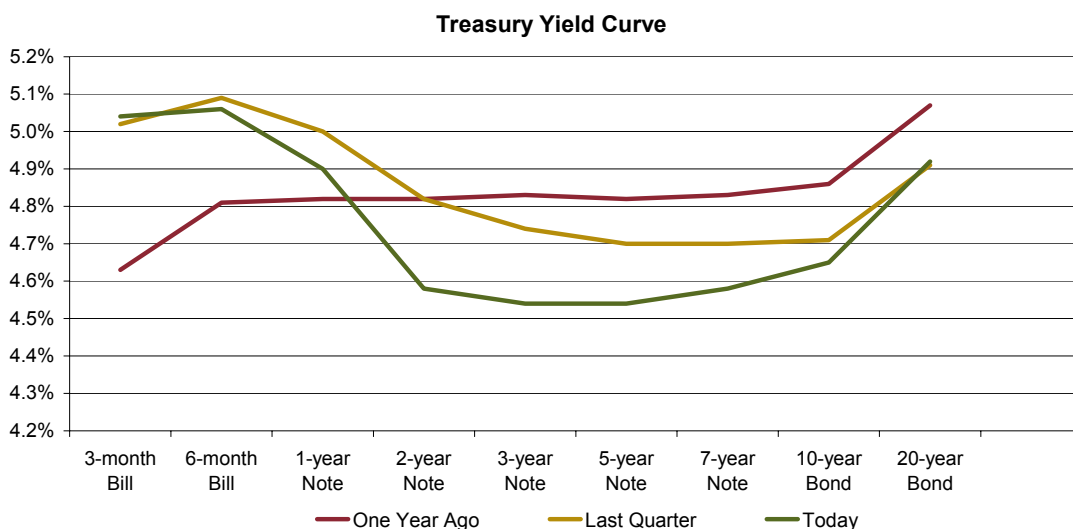
Returns for the quarter across the Emerging Markets were mixed. Coming into the final month of the quarter, all of the MSCI regional indexes were in negative territory, but strong returns in the final month pushed many into positive territory for the quarter. Three of the most popular emerging markets: Russia (-3.01), India (-3.36%) and China (-2.30%) were all down for the quarter. Venezuela (-11.16%) was down sharply after last year’s 80% return. Despite the drop in the Venezuelan market the Latin American region was the quarter’s best performer thanks to Brazil (6.18%), Chile (6.97%) and Peru (25.03%).

Fixed Income Summary

With all the speculation and conflicting data in the market during the first quarter, it is no surprise to look back and see wild gyrations in the yield curve over the last 90 days. The year opened with a “humped” yield curve, with one month bills yielding the same as 30-year bonds, 4.79%. But as the data rolled in during the quarter and Fed comments continued to be pessimistic relative to inflation, yields on the 1-month bill jumped nearly half a percent by the end of February, where they stayed until the last few days of the quarter, before falling to 5.07%. And while the overall change for the quarter in the 30-year bond was just 5 basis points, at the end of January, yields had risen to just below 5%, then fell to 4.62% by the end of February before rising again at the end of the quarter. These movements translated directly into the taxable bond market of course, with the indexes down modestly in January, up sharply in February and mixed in March (shorter maturities had positive returns, while longer maturities fell). Added up, most of the indexes returned a fairly pedestrian 1.25-1.75%.

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The municipal market was a mirror image of the taxable market, with slightly smaller movements and returns between 0.7% (12-17 years) and 0.97% (2-4 years). Credit quality also played a big role in returns for the first quarter. Investors willing to take on the additional risk of “BBB”-rated bonds earned nearly 40 basis points in additional return compared to “AAA” rated issues, while “A”-rated issues added just 3 basis points on average. While the short to intermediate portion of the spectrum produced the best returns for the quarter, the longer maturities have continued to dominate over the last 12 months, as the Lehman 20-Year Muni Index returned 6.06% over that period vs. just 4.29% for the Lehman 5-Year Muni Index.



Outlook

A turbulent first quarter in all three major market sectors should make many investors sit up and take notice. The domestic equity markets continue to hum along starting the fifth year of a bull market, but at least for the first quarter of this year, there are large pockets of weakness across the markets. The domestic fixed income market remains dominated by the Fed, whose intentions remain unclear. They will also have to contend, the rest of the year, with the fallout from the sub-prime lending crisis and the potential impact on the mortgage backed securities market (which makes up more than a third of the Lehman Brothers Aggregate Index). The international developed markets continued their domination of the U.S. market again in the first quarter and appear, on the surface, to be the most likely place for a strong market for 2007. But with many of the large emerging markets showing either signs of weakness (Russia) or being forced to cool the current growth prospects (China), there are deeper implications even for the developed markets. Uncertain times and turbulent markets provide the opportunity for investors with courage to make tremendous gains, but also allow advisors to clearly demonstrate the advantages of a well diversified portfolio for not so courageous investors.

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