

Quarterly Market Review

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Perspective

Inflation has begun to show up in several segments of the market, and among the chief contributors to the current inflation readings is energy, and its corollary affect on various markets.

One of many Wall Street adages, hoary with age, is that the markets must “climb a wall of worry”, or rally in the face of a number of political or economic risks. This is usually true of early stages of bull markets moreso than latter stage markets. The first two quarters of 2007 might well fit this description, save the bull market run that is now halfway through its fifth year. During the first half of the year, the domestic and international equity markets produced robust returns, and the emerging markets even greater returns. Many of the domestic indices have already surpassed the returns forecasted by market strategists before the beginning of the year. There was no action from the Fed during the first half of the year, as a widely anticipated rate cut failed to materialize. GDP growth in the first quarter was the lowest in more than four years. Energy prices rose sharply until the middle of May, before subsiding slightly during the last six weeks. But one of the key foundation stones in the “wall of worry” is inflation, which the equity market largely ignored during the second quarter of the year.

Inflation has begun to show up in several segments of the market, and among the chief contributors to the current inflation readings is energy, and its corollary affect on various markets. Although food and energy are often removed from core inflation, headline inflation over the last 12 months is up 2.3%, pushing the edges of the Fed’s comfort zone. Some energy derivative inflation is beginning to show up in the monthly data as well. One very unusual impact seen in the last six months is the domino effect from the increased production of corn-based ethanol. U.S. ethanol refineries are on pace to produce 7.5 billion gallons¹. As the use of corn for ethanol production has increased, the price of corn has risen. This has filtered down resulting in higher costs (passed through to consumers) in the dairy industry (feed corn), widespread price increases across many food categories (corn based sweeteners), and even price increases in alcoholic beverages such as beer, as corn plantings have reduced barley production. Because the United States accounts for nearly 40% of the world’s corn production, this will continue to have a worldwide impact.

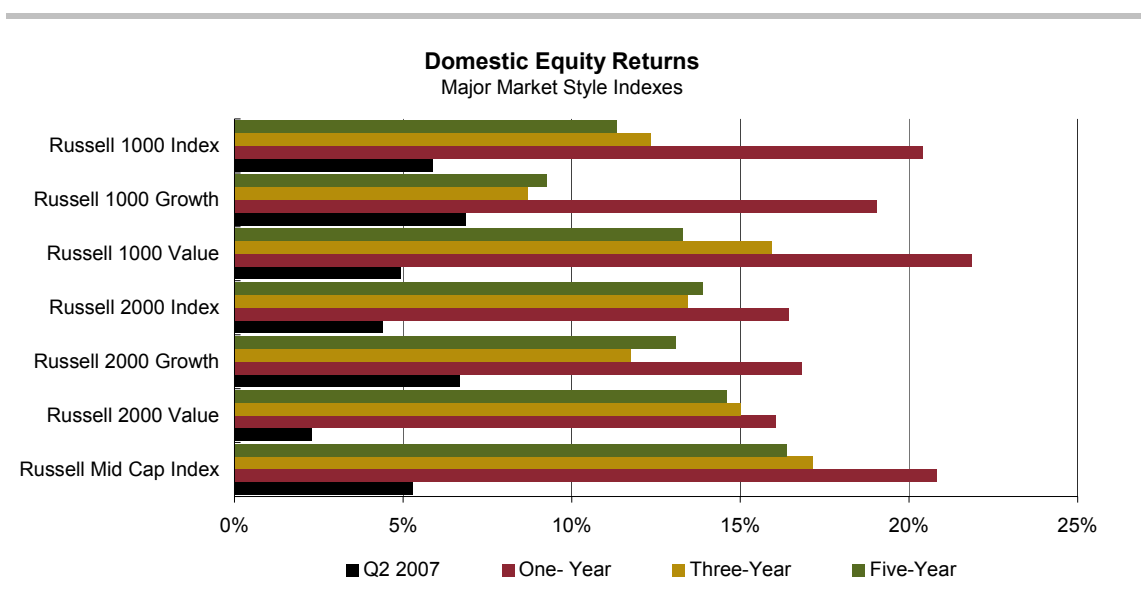
Domestic Equity Markets Overview

This may be the beginning of a typical late rally shift to large caps, for safety, and towards companies showing reasonable long term growth rates that are independent of economic cycles.

The major domestic indices were up 2.5% to 7% during the second quarter, and in a change of market leadership, the large cap indices were up the most. On the heels of a flat first quarter, the second quarter gave the large cap indexes a solid first half. Large caps were up 5 to 7 percent, with growth outperforming value. Growth outperformed value across all market caps, with the effect more pronounced in the small cap indices. There was a spread of nearly 4.4% between the growth and value portions of the Russell 2000 Index, but less than 2% in the Russell 1000 Index. The winner for the quarter took the best of the small and midcap indexes. The 2500 Growth Index was up 6.99 for the quarter and 11.30 for the first half. This may be the beginning of a typical late rally shift to large caps, for safety, and towards companies showing reasonable long term growth rates that are independent of economic cycles. The growth Index had positive returns in all of the economic sectors, and was led by double digit returns in Technology, Energy and Materials. By contrast, in the small caps the Russell 2000 Growth had mixed results in the Energy sector (the integrated oils were down, but “other” energy companies were sharply higher), and managed just a 7.8% return in the Technology sector. The Value indices appear to have been held back largely by the Financial sector, which was barely break even

¹ “Ethanol Production Booming on Demand”, *Washington Post*, Steven Mufson, January 23rd, 2007

among the large caps and down significantly among the small caps. Interest rate pressures and the continuing headlines surrounding the sub-prime market were likely causes, as well as a nearly 10% drop in REITs, a major component in the sector.



International Markets Summary

The international markets were again slightly stronger than the domestic markets during the second quarter in local terms, and with the exception of a few of the Far East markets, substantially stronger in dollar terms. Investors in the Canadian markets saw the biggest currency boost, from a 6.1% local currency return to a more than 15% dollar return. In dollar terms, Europe led the way during the quarter, boosted by the Nordic countries, with the Eurozone Index up nearly 11%. Japan struggled again during the quarter, dragging many of the regional indexes down. These returns were further reduced by a negative currency impact for most of the region. The growth component of the MSCI regional indices broadly outperformed their core counterparts, with significant differences in the Far East and Nordic countries. Similar to the domestic markets, the international small cap indexes were behind the large caps, except in the Far East.

The rally in the emerging markets at the end of the first quarter carried through most of the second quarter as all of the markets outside of Europe and the Middle East showed double digit returns for the quarter, in dollar terms. The leader for the quarter was the MSCI Latin America Index, up just shy of 20% for the quarter and more than 27% for the year. Political unrest in Venezuela has that country's index down nearly 30% in local currency terms, but a tremendous currency impact has the index up 11% in dollar terms. China rallied from its negative performance in the first quarter, to surge ahead 24% in the quarter. Russia remains the weak link within the Brazil-Russia-India-China ("BRIC") market, with a flat (+0.5%) second quarter.

Fixed Income Summary

At the end of 2006, the futures markets were anticipating a cut in interest rates from the Fed during the first half of the year. This anticipation increased when the first quarter GDP came in at just 0.6% (later revised upward to 0.7%), the lowest quarter in more than four years. However, as the remainder of the data came in over the course of the quarter, the spectre of inflation raised its head, and the likelihood of a rate cut fell to zero. Interest rates responded, and by the middle of June the 10-Year Treasury rate jumped to more than 5.25% for the first time since early 2002. The Lehman Brothers Aggregate Index was down -0.52% for the quarter. Only the shortest maturities had a positive return, with long maturities

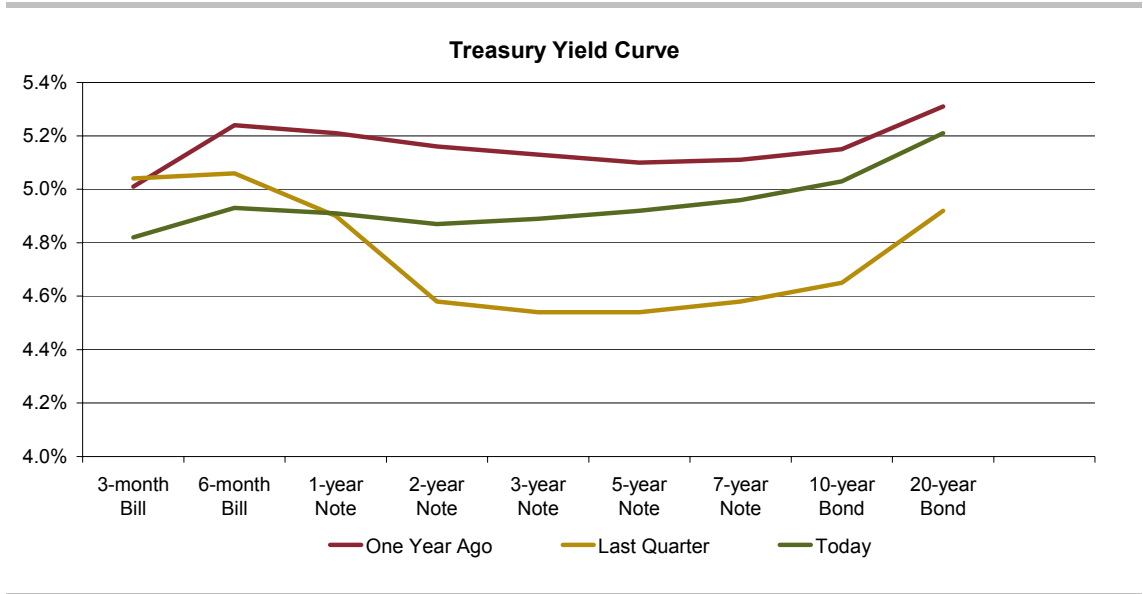
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The Municipal market suffered from many of the same issues as the taxable market. A poor second half of the quarter resulted in the Lehman Brothers Municipal Index returning -0.67% for the quarter, and just 0.14% for the first half of the year. Maturity was the driving factor in returns for the quarter as the longer term issues (six years and longer) had worse returns than the Index as a whole. The slightly higher yields carried by BBB-rated bonds kept that smaller segment of the market (-0.28%) ahead of the higher quality bonds (-0.65% to -0.76%).



Outlook

After a volatile first quarter, the second quarter of 2007 was reasonably straight forward. The major equity indexes, both domestic and international were up sharply during the period, and the fixed income markets were down slightly. There was a change in leadership during the quarter to large cap equities domestically, a change that has historically come when investors are no longer seeking risk, but safety. In the fixed income markets, investors have been actively seeking additional yield for most of the past two years by taking on additional credit risk and additional maturity risk. This strategy has been successful, but with credit spreads tightened to near historic lows (high yield credits trading at an average of 314 basis points over Treasuries as of the end of the quarter), there is very little additional yield to be had. Over the course of this four and a half year bull market run, there have been select quarters when growth has outperformed value, but only once for more than two consecutive quarters. GDP growth, corporate earnings and the threat of inflation will continue to be the key issues for the remainder of 2007.

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