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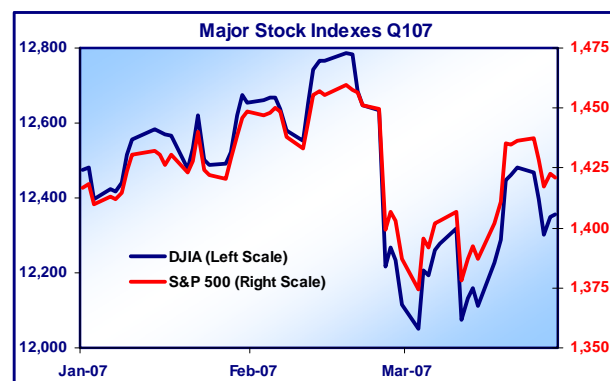
Quarterly Review and Outlook

1st Quarter 2007

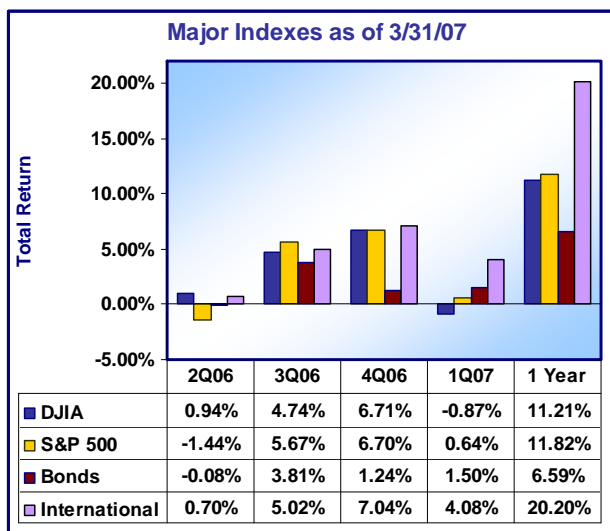
Spring Brake

The stock market carried investors on a ride worthy of a Disney attraction in the first quarter of 2007, first up, then down, and back up again. The Dow Jones Industrial Average finished the quarter down by just 0.87% to date, but provided plenty of thrills on February 27 as it dived 416 points, the biggest one-day loss in four years. Early gains in January and February were fueled by a sharp decline in energy prices and an emerging hope that the Fed would be cutting rates later in the spring, and it looked like the good times were set to continue. Well, before the first blossom appeared on the dogwoods, the price of oil had spiked again, a newly liberated Alan Greenspan mused aloud about the likelihood of a recession, and Asian markets sank by 8% overnight. Investors were suddenly re-introduced to the quondam concept of "risk"; talking heads

and prolix commentators opined about the end of the "carry trade" and the flight away from "risk assets". Stock prices tumbled and assets fled into safer alternatives like bonds and cash.



Ah, but that was so March 15th. By the end of the quarter, the spring thaw was well under way, and the major US equity indices had essentially recouped their February losses. The S&P 500 finished the quarter up 0.64%, while the NASDAQ gained 0.26% since January 1. Investors plowed back into small caps and international issues with even more gusto; the MSCI EAFE index of foreign stocks jumped 4.08%. And the beginning of April has been even better: the Dow turned in a string of eight straight gains, and no one, it seems, wants to be left standing on the side of the road. The beer is cold, the sun is warm; Daytona Beach here we come.



So what could possibly sully our vernal festivities? Most of the reasons posited for the stock market run-up so far this year are

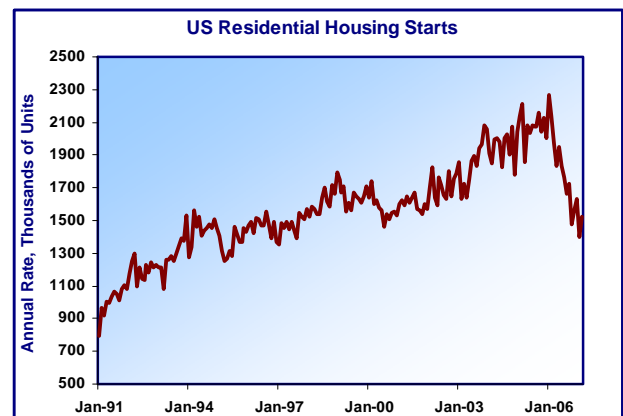
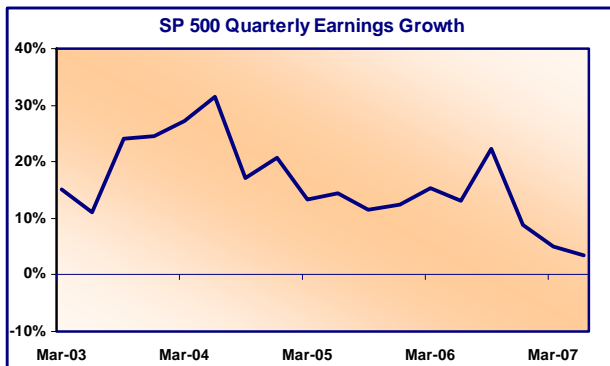
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valid in terms of economic growth and historically moderate valuations; however, it seems likely that investors are not fully discounting the risks that lie ahead as the economy continues to decelerate. Some of the obstacles lying in the road include retarded earnings growth, a slowdown in the growth of GDP, inflationary pressure, the threat of a cutback in business spending, and the potential for increased supply of new stock as private equity firms attempt to cash out. The outlook is not bleak; on the contrary, the long-term prospects for the economy in general remain positive. However, some caution is warranted in the short run, and we would not be surprised to see a moderate pullback in stock prices before the next secular bull run.

Earnings growth is the rocket fuel that powers big market moves, and the current streak has been a standout. For each of fifteen straight quarters ending in September 2006, year-over-year earnings growth has exceeded 10% compared to the same quarter a year earlier; the fourth quarter of 2006 just missed being the sixteenth with a still-respectable 9% expansion rate. Investors have come to expect double-digit profit advances as the norm and have not fully embraced the probability of a sharp decline in the growth rate over the next two quarters. Standard & Poor's has pegged the rate for the first

quarter of 2007 at 5%, while Thomson Financial has lowered their estimate twice from 8.7% to an anemic 3.4% annual rate. Overall earnings growth for all of 2007 is expected to be somewhere around 6%. If anything, the risk is probably to the downside; corporate profit margins are under pressure from slowing productivity growth, rising unit labor costs and higher import prices adjusted for the weakening dollar. If reported profits begin to lag expectations this quarter, stock prices are likely to take their lumps. Experience has shown that once earnings start to decelerate, negative surprises tend to proliferate and can engender disproportionately large stock price declines.

Some of the drop in profit growth is attributable to the overall weakening of the economy and to the softness in the housing sector in particular. Construction-related activity directly or indirectly drives about 35% of the new job creation in the US, and home sales affect a significant amount of retail activity as well. New housing starts fell by 28.5% in February compared to the same period one year ago, the sub-prime mortgage market is experiencing significant defaults, and the National Association of Realtors expects median home prices to decline this year for the first time since the Great Depression. The full impact of the



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housing bust has yet to percolate through to the job market and to the retail sales numbers, but the net effect is a likely to be a reduction in GDP growth down to around 2% for the full year 2007, creating more of a drag on the stock market. Once upon a time 2% real growth was acceptable; nowadays compared to expectations it may prove to be a disappointment.

Another factor that many investors have not considered is the significant decline in the supply of equity in the US public markets. As more and more private equity firms and consortia buy out public companies, the net issuance of stock has declined substantially just in the past two years. Furthermore, companies have been deploying their considerable cash balances to repurchase large amounts of their outstanding equity. In 2006 alone firms bought back \$432 billion of their own stock, or 3.4% of the year-end market cap of the S&P 500. In the aggregate, US public equity contracted at a \$566 billion annualized rate in the third quarter (fourth quarter numbers are not yet available but are likely to be even higher). According to Standard & Poor's this reduction in the supply of outstanding equity is responsible for as much as three to four percentage points of the earnings growth in '06. Clearly there is some limit to the retirement of public equity as the deals get harder to find and

private equity firms look to the IPO market as a way to ring the cash register. A measurable reversal in the trend of equity contraction would add supply and have an adverse impact on stock prices.

Add to the mix one additional cause for concern: business spending, or the potential dearth thereof. This is important since US domestic capital investment by businesses accounts for about 11% of GDP. Analysts had begun the year predicting a projected 5-6% increase in capital spending for the first half of 2007; the consensus now is reduced to around 1.5% growth. Meanwhile, the Commerce Department reported an inflation-adjusted 3.1% decline in fourth quarter business spending and announced that preliminary readings for the New Year are coming in unexpectedly low. A recent survey of economists by the Wall Street Journal found that weakness in capital investment was the number one risk to the economy according to 37% of respondents, twice as many as the number who singled out housing as the chief risk. Softness in capital spending raises concerns because it reflects the outlook of business leaders regarding economic prospects going forward and may also foreshadow a slowdown in hiring that would impact consumer spending.

Most forecasters (including the Fed) still believe that the economy will slow down but will not stall out, and that by 2008 we are likely see GDP expansion re-accelerate. OK, so the tank is half empty and Daytona is out this year; let's watch the speed limit and maybe settle for a long weekend in Gatlinburg.

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