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Investment Outlook Third Quarter 2007

Second Quarter Review

After a respectable first quarter, equity investors turned almost giddy as major US stock indexes continued the advance that began almost one year ago. For the quarter, the S&P 500 progressed 5.8%, the Dow Jones Industrial Average 8.5% and the Nasdaq 7.5%. Bonds on the other hand suffered through a difficult period as investors finally came to the recognition that economic growth had probably bottomed in the first quarter, was likely to rebound through the balance of the year and the Federal Reserve Bank was not apt to lower interest rates any time soon. This realization triggered a bond market sell-off where yields on the ten-year US Treasury Notes rose from 4.65% to 5.30% intra-quarter, before settling back to 5.03% by quarter's end.

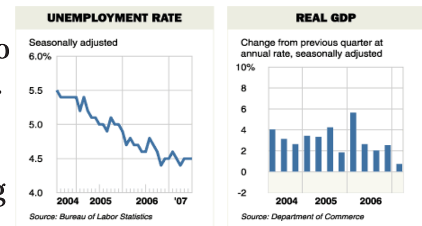
Oil prices also continued to rise throughout the quarter as strong global demand and the start of the summer driving season pushed prices up from $65/bbl to $70/bbl. The elimination of certain refining bottlenecks provided a supply boost allowing gasoline prices to hover near $3/gallon. And the housing slump continued with a number of indicators showing the slowest activity since 1991. Private equity persisted in the spotlight as hardly a day passed without a major deal being announced or rumored and one of the largest private equity firms, Blackstone Group, went public with a $40 billion market value. In Washington, divided government has once again proven to be a plus as Congress has had a difficult time passing any legislation at all, let alone anything that would be perceived negatively for our financial markets.

Economic Outlook

When Fed Chairman Ben Bernanke testified on monetary policy during his semi-annual update to Congress, he implied that monetary policy will remain unchanged for some time to come. While the Fed is likely to retain its subtle bias to hike interest rates, the justification for any near-term rate hike is truly lacking in our opinion. The Fed's primary concern is that the labor market is tight and there is some risk that it may tighten further over the coming quarters. With labor scarce, it follows that labor costs and inflation could accelerate. In addition, economic growth is forecast to have reaccelerated in the second quarter to around 3%. Manufacturing has rebounded from a fairly modest inventory correction, while exports are providing a nice source of incremental demand. Housing, the weakest part of the economy over the past 18 months, seems to be drifting near its bottom, so it is likely to exert far less drag on the economy over the balance of the year. The 40% rise in oil prices this year has also been an impediment to consumption, but prices are expected to peak by the end of the summer driving season and shouldn't be as big an influence on demand in the second half of the year. Consequently, a logical case can be made that the soft stretch in US economic activity has

ended and a faster, more normal rate of growth at around 3% lies ahead.

The Fed has every reason to refrain from hiking interest rates as actual inflation appears to be easing back toward the upper end of their comfort range, especially since the housing market and the mortgage market are still visibly struggling. There is likely to be more dire news emerging in the weeks ahead regarding sub-prime and adjustable rate mortgages. It is hard to justify raising interest rates when mortgage loan problems are still emerging. With rate hikes and rate reduction hard to justify, the Fed is likely to leave policy unchanged until one issue or the other is firmly resolved. We expect interest rates to remain low, perhaps in a range of 4.75%-5.25% in the coming months. With economic growth on the rebound, the yield curve should remain slightly upward sloping, reflecting normal demand/supply conditions within the capital markets. Corporate profit growth has been tracking economic activity with a lag and has slipped into single digits the past two quarters. However, growth has exceeded expectations as corporations continue to run lean operations by remaining slow to add labor and capital and thus allowing profit margins to linger near all-time high levels.



Capital Markets Analysis

After a year-long rally, it is reasonable to expect stocks to correct some of their advance. Since last July's bottom, major US stock averages have risen between 25%-33%. It has been over five years since we've seen a correction of at least 10% as small pullbacks have been viewed as buying opportunities. Yet, as a recent Barron's cover story acknowledges, individual investors have not piled into the US equity markets as in past bull markets. Economic activity is rebounding, interest rates remain low, inflation is under control, valuation levels are still reasonable and corporate profits are growing steadily. These factors, coupled with little signs of speculative trading activity should limit any corrective action in US equity prices. Investors in general and individual investors in particular, have opted to allocate more and more of their assets to foreign markets. And while we also continue to find these markets attractive as long-term investments and desirable from a diversification standpoint, any correction in equity prices is likely to be more severe for foreign stock markets since their prices have risen so much in the past several years without abatement. After the second quarter correction in bond prices, we believe the waters are safe to invest in short to intermediate term bonds without fear that interest rates are likely to rise dramatically in the coming quarters. Commercial real estate as reflected by prices of publicly traded REITs have also corrected in the first half of this year affording investors an opportunity to enter at more favorable prices and yields. With China and India still developing rapidly, most commodity prices are likely to continue to strengthen, with the CRB commodity price index standing near an all-time high.

Risks

Another leg down in housing, additional dislocations related to the sub-prime mortgage market, a sudden surge in oil prices, widespread corporate earnings disappointments or geographical upheavals are the issues most likely to sidetrack our investment forecast over the balance of the year. In addition, credit availability and global liquidity, both of which have been hugely instrumental in driving the private equity boom must remain healthy. Depending on the level of severity, any of these individually, or some combination could inject a greater sense of fear into the capital markets and create an environment where investors flee equities and other speculative asset classes and seek relative safety in high-grade bonds.

Investment Strategy

Following the year long stock market advance, it is only natural for us to be somewhat cautious in the near-term. However, after the usual summer and early fall doldrums, we expect stock prices to prolong their advance into year-end. In this environment, we continue to emphasize broader diversification amongst a greater number of asset classes to reduce overall volatility. We look forward to speaking with each of you individually concerning the appropriate portfolio concerning the appropriate portfolio allocations and risk profile for your objectives.