



FOCUS POINTS

Expansion Revived:

While the economic slowdown in the first quarter exceeded most economists' forecasts, the corollary is that second quarter economic growth now appears better than expected. The resumption of more vibrant growth, including some encouraging signs in the housing market, did panic the super-bulls in the bond market. Interest rates spiked higher in mid-June, causing volatility to increase in the stock market which, in turn, halted the strong upward surge in stock prices that started in early March. For the quarter, the performance of fixed income securities was disappointing, while the return on stocks was strong.

Understanding Mid-cycle Corrections:

In a high or accelerating inflationary environment, business cycles tend to be short; bond and stock markets tend to amplify those cycles. Alternatively, in a low or stable inflationary environment, expansions tend to last a long time before much milder downturns; the markets follow a similar, milder pattern. However, it is not uncommon for the long expansionary phase of the economy or the markets to include a notable slowdown or trend interruption.

In any slowdown, strength in some sectors of the economy is ebbing and it is not clear which sectors will sustain the expansion. In the bond market there is fear that expansion has already been so strong that inflation will increase, monetary policy will become very restrictive and yields will increase. In the stock market, concerns usually center on profit margins peaking and fear of slower growth.

Our Mid-year Outlook:

For this economic expansion to persist business confidence needs to improve worldwide to encourage an increase in capital good orders. Corporate balance sheets are clearly strong enough to support such an increase; there is ample liquidity in the system to finance them; and, profits are likely to grow to pay for them. Our concern is that orders will be restrained by political uncertainties, particularly global trade issues, causing too much corporate "buying power" to be channeled into acquisitions and stock buy-backs. While monitoring this closely, we will also be keeping an eye on government and consumer expenditures which we expect will stay sufficiently strong to prolong the cycle.

We continue to think that the Federal Reserve will talk a lot, but not act for the balance of 2007 because it is unlikely that there will be convincing evidence that inflation has broken out or that the economy is so weak that it needs help. As a consequence, we expect yields to trade along a flat yield curve and in a fairly narrow range, occasionally breached by a preponderance of news swinging in favor of the bulls or bears. We think the Fed's concern about inflation continues to warrant an **above average duration**.

We also continue to maintain a **positive stance** on stocks. Some stocks have run too far and profit taking is justified, but stocks in general remain reasonably valued both in terms of their current and prospective earnings. Our focus is on finding interesting new investments to replace the ones we think are overvalued.