

The Oarsman Outlook

First Quarter 2007

Although bumpier than we've been used to, the first quarter of 2007 yielded positive results from most financial investments, as investors grappled with shifting perceptions of the risks facing the economy and markets. Broad U.S. stock benchmarks were essentially flat, but high-quality, growth-oriented stocks fared somewhat better. Small-company and non-U.S. stocks, commercial real-estate and commodity-linked securities gained, as well. Bond yields declined modestly, although widening credit spreads largely offset the benefit; nevertheless, bonds notched positive returns, too.

Within the U.S. stock market, the best-performing sectors were Basic Materials, Utilities, Telecommunications Services and Capital Goods/Industrials; lagging sectors included Financial Services, Technology, Health Care and Consumer Staples.

Benchmark Performance – Equities

| | <u>First Quarter 2007</u> | <u>Last Twelve Months</u> |
|---|---------------------------|---------------------------|
| S&P 500 Index | +0.6% | +11.8% |
| Dow Jones Industrial Avg. | -0.3% | +13.4% |
| NASDAQ Composite | +0.3% | +3.8% |
| Large-Cap. Core Mutual Fund Avg. (Lipper) | +0.5% | +9.9% |
| Small-Cap Stocks (Russell 2000) | +1.9% | +5.9% |
| Non-U.S. Stocks (Dow Jones World ex-U.S.) | +4.3% | +19.2% |

Benchmark Performance – Fixed Income

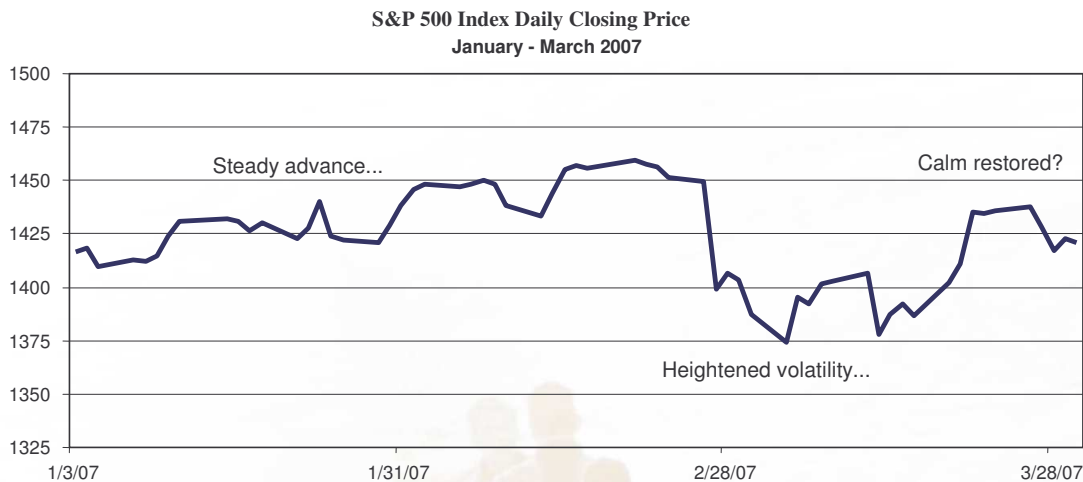
| | <u>First Quarter 2007</u> | <u>Last Twelve Months</u> |
|--|---------------------------|---------------------------|
| Lehman Aggregate Bond Index (taxable) | +1.5% | +6.6% |
| Lehman Municipal Bond Index (tax-exempt) | +0.8% | +5.4% |

Review

The January-March period began much as 2006 ended, with solid fourth-quarter earnings and benign economic data propelling U.S. stocks higher through the first seven weeks of the year. The Dow Jones Industrials and Russell 2000 Small Cap indexes reached new all-time highs during this run, while the S&P 500 and NASDAQ Composite reached post-tech-bubble highs. On the 26th, February appeared poised to go into the books as the ninth consecutive month of stock-market gains.

The tone changed abruptly as February drew to a close, however. A one-day mini-crash in the high-flying Chinese stock market coincided with some of the first disconcerting reports from the similarly frothy U.S. “sub-prime” mortgage industry. Having steadily ratcheted portfolio risk-profiles higher during four years of unusually low-volatility market gains, many investors apparently interpreted these signals as their cue to quit while ahead. After edging lower in the four previous trading sessions, U.S. stocks plunged more than 3%

on February 27th – the first one-day drop of 2% or more since May 2003 (the longest such stretch since 1950). Over the next two weeks, markets gyrated as the paring of risk continued: at the worst point, broad measures of U.S. stock prices had declined around 6% – higher-risk asset categories such as emerging-market equities substantially more – from their February 20th peak.



As March progressed, despite near-daily revelations of more trouble in the mortgage industry, two schools of thought gathered credence, calming the markets. First was the widely held assessment that the sub-prime mortgage debacle was unlikely to have more than a marginal impact on the already-punk U.S. housing market and, accordingly, that the U.S. economy would continue to expand at a subdued pace. Second was the notion (reminiscent of the so-called “Greenspan put” of the late 1990s) that if the mortgage meltdown did threaten broader economic damage, the Federal Reserve would step in and cut interest rates aggressively in order to avert recession. In any case, markets stabilized in late March and early April, with major benchmarks regaining more than half the ground lost in the brief swoon.

Outlook

Recent volatility reflects increasing uncertainty regarding the outlook for the economy and financial markets. The U.S. economy is in the midst of a housing-led slowdown that is either a benign mid-cycle “soft patch” or the transition from expansion to something else. Corporate profit margins appear to be peaking and earnings growth is widely anticipated to begin decelerating after a four-year streak of double-digit gains. At the same time, the Fed is feeling its way, month by month, in search of the correct setting for monetary policy. Tense relations with Iran, yet another spike in energy prices and the imposition of protective tariffs on certain Chinese imports add to the volatile mix.

The ongoing deflation of the U.S. housing bubble remains the key development to watch. Houses are the most important asset of most American consumers, whose spending accounts for nearly 70% of economic output. For much of the decade, steady appreciation, augmented by readily available credit, allowed consumers to use home-equity loans and cash-out refinancing to spend more than their incomes would support. The combination of already-declining home values and soon-to-be-tightening credit conditions clearly represents a

challenge to this important engine of economic growth. So far, the consumer has held up remarkably well – a fact most economists attribute to the relative health of the rest of the economy, which continues to support near-full employment and rising wages (not to mention buoyant financial markets). Recent indications of softening business confidence and capital spending therefore bear close monitoring as potential harbingers of slowing wage gains and/or a downturn in hiring.

Some observers have pointed to recent statistics as indicating a “bottom” in the housing market. History suggests, however, that even if prices don’t have much farther to fall, the correction – which began only in mid-2006 – has yet to run its course. Analysis conducted by the bond-fund manager, PIMCO, suggests that to return residential real estate to a “normal” level of affordability, *real* (i.e., inflation-adjusted) prices may need to fall by 15% or more (to date, they are off less than 5%, on average). Such a decline would likely take the form of several years of stagnant *nominal* prices against a backdrop of 2%-3% inflation in the rest of the economy.

Happily, we know the Fed both recognizes the importance of housing deflation and has already expended considerable resources analyzing possible policy responses. In a study published in late 2005, the Fed examined the interaction of housing prices and monetary policy across 18 countries over the past 35 years. An important conclusion was that persistent housing deflation could be offset by accommodative monetary policy; i.e., lower interest rates. Drawing on this study, PIMCO estimates that if the Fed could engineer a 60- to 90-basis point (0.60% to 0.90%) drop in mortgage rates, the impact on housing affordability would be approximately equivalent to a 15% drop in real prices.

Unfortunately, the Fed’s task is complicated by persistent symptoms of inflation (not to mention astronomical financial leverage employed by certain institutional investors), which could be exacerbated by looser monetary policy. Stubborn inflation fears could also keep longer-term bond yields – and mortgage rates – elevated even in the face of Fed easing. We continue to believe that sub-par economic growth (now in its fourth quarter) will be sufficient to keep inflation contained (the recent rise in oil prices, although not welcome, is the result of seasonal and geopolitical factors, not surging demand). We also believe that despite its public utterances, the Fed is more concerned about *deflationary* phenomena than what still appears to be a cyclical (read: temporary) rise in inflation. We also would argue that a year of below-average growth, the bursting real estate bubble and the imploding sub-prime mortgage industry are all signs that current monetary policy is in fact firmer than most believed nine or ten months ago. Moreover, an ongoing decline in asset values (i.e., house prices), the reduced *availability* of credit as a result of the sub-prime meltdown, and the continuing decline in the foreign-exchange value of the dollar are all acting to make monetary conditions tighter without any action by the Fed. We expect that, barring an unforeseen improvement in the housing market or an acceleration of inflation, the Fed will be cutting interest rates later this year.

Recent volatility and the associated “re-rating” of investment risk were overdue and probably healthy. Similarly, the bursting of the real estate bubble was inevitable, and would only have been worse had it been further delayed. Combined with seemingly permanent geopolitical tensions and concerns about domestic politics (sure to escalate in coming months), such worries have the salutary effect of curbing what otherwise might easily become

“irrational exuberance,” given stocks’ steady and impressive gains over the past four years. With valuation eminently reasonable, interest rates a neutral influence that could shift to a tailwind, and earnings that will likely slow but not collapse, we expect the remainder of 2007 to be rewarding for investors who maintain high-quality, growth-oriented portfolios.

