

The Oarsman Outlook

Second Quarter 2007

Most categories of financial investments produced substantial gains in the April-June period, although a sharp rise in bond yields resulted in flat returns from fixed-income securities. Broad domestic stock market benchmarks all gained more than 5%, while U.S. small-company stocks lagged only slightly. Most overseas markets notched returns in-line with or better than those in the U.S., with a number of emerging-market bourses rising 15% or more. The most interest-rate sensitive investments, including utility stocks, real estate investment trusts (REITs) and long-maturity bonds were among the quarter's few losers.

Within the U.S. stock market, the best-performing sectors were Energy, Technology, Capital Goods and basic Materials; lagging sectors included Utilities, Consumer Staples, Consumer Cyclical and Financial Services.

Benchmark Performance – Equities

	<u>Second Quarter 2007</u>	<u>Year to Date</u>
S&P 500 Index	+6.3%	+6.9%
Dow Jones Industrial Avg.	+9.1%	+8.8%
NASDAQ Composite	+7.5%	+7.8%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+6.4%	+6.9%
Small-Cap Stocks (Russell 2000)	+4.4%	+6.4%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+7.9%	+12.5%

Benchmark Performance – Fixed Income

	<u>Second Quarter 2007</u>	<u>Year to Date</u>
Lehman Aggregate Bond Index (taxable)	-0.5%	+1.0%
Lehman Municipal Bond Index (tax-exempt)	-0.7%	+0.1%

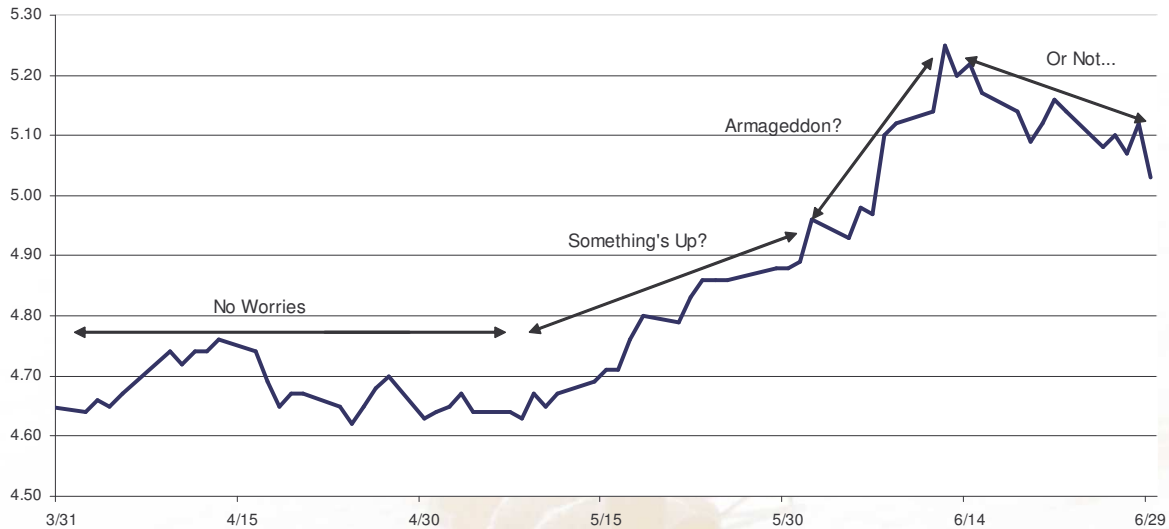
Review

Recovering from a late-winter stumble that saw major benchmarks fall 5%-7%, U.S. stocks sailed smoothly higher for the first nine weeks of the second quarter. Investors were encouraged by first-quarter corporate earnings reports that on average easily surpassed tempered expectations. The period also featured a parade of corporate buy-out announcements, as well as rising hopes that the Federal Reserve might begin cutting short-term interest rates due to lackluster economic growth coupled with tame inflation. Market benchmarks rose to new all-time highs at the outset of June, with the S&P 500 Index finally eclipsing its March 2000 level.

The tone of the markets changed abruptly in early June. Bond yields, having drifted up through May, suddenly spiked higher, with the benchmark 10-year Treasury yield peaking at nearly 5.3%, compared to just 4.6% in late April. Analysts attributed the rise in yields to

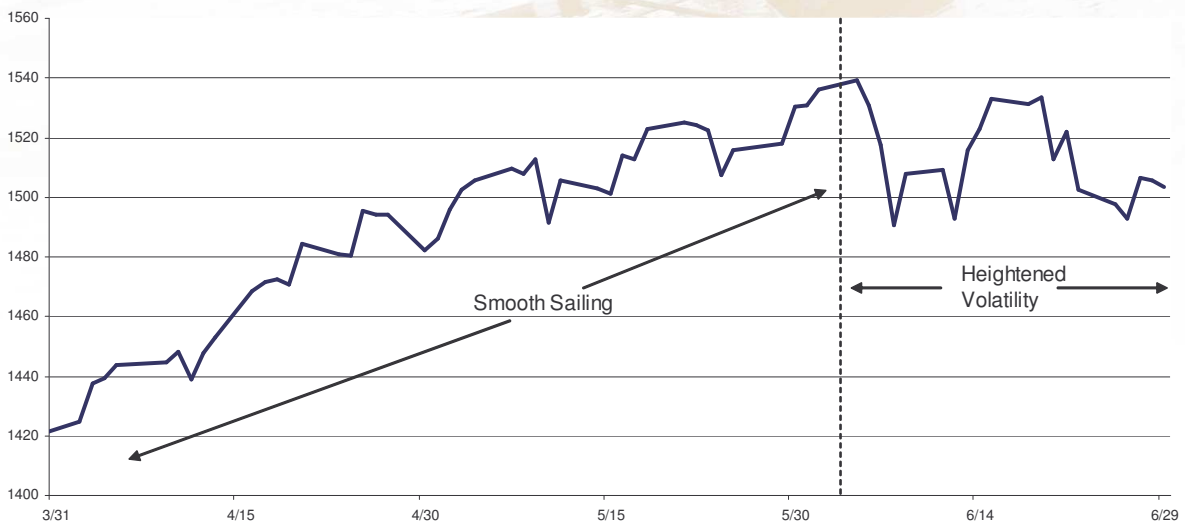
changing perceptions of global economic growth and the likely course of U.S. monetary policy, as well as to worries about the continued willingness of major overseas investors to purchase U.S. fixed-income securities. During this period, the futures market for Treasury securities indicated that investors had largely abandoned hope that the Fed would begin cutting rates this year.

Yield (%) on 10-Year U.S. Treasury Notes – Second Quarter 2007



Though the rise in bond yields seemed to reflect strengthening growth rather than rising inflation, stock investors were sufficiently unnerved to derail the smooth advance underway since mid-March. And while yields retreated somewhat after mid-June, deepening problems in the sub-prime mortgage industry, coupled with indications of a slackening pace of highly-leveraged private-equity transactions, prompted many investors to reevaluate their appetite for risk. The last four weeks of the quarter were characterized by a heightened degree of volatility and major U.S. benchmarks ended June 2%-3% off their early-month highs (though much of this ground has been regained in early July).

S&P 500 Index Daily Closing Price – Second Quarter 2007



Outlook

The recent rise in market volatility may indicate the investment environment is reaching an inflexion point. In the aftermath of terrorist attacks, economic recession and an epochal equity bear market, the past four-plus years have been characterized by low interest rates, improving economic performance, recovering corporate financial health and steadily rising investor confidence. Since the convulsive bear market double-bottom in late 2002 and early 2003, U.S. stock benchmarks have more than doubled in value. Moreover, the advance has been remarkably smooth: the steepest declines have measured no more than 6%-7%, well short of the traditional 10% definition of a market “correction,” and none has endured more than a few weeks. The longevity and low volatility of the advance have induced a gradual increase in investors’ willingness to assume risk and employ financial leverage to amplify returns.

Looking ahead, the landscape looks less benign – not to say treacherous. Robust global growth – paced by the emerging markets of Asia, Latin America and Central Europe – is consuming slack resources and capital, pushing interest rates higher; the housing slump, perhaps soon to be compounded by a nascent credit crunch, is weighing on American consumers, slowing domestic growth; U.S. corporate profit margins are peaking, and rising costs combined with slowing demand – at least in the home market – suggest earnings growth is set to slow; and recent hiccups in the high-flying, high-leverage realm of hedge- and private-equity funds signal a shift in investor attitudes toward risk.

While all of these changes are *per se* unhelpful to stock prices, it is important to acknowledge that each has a redeeming flip-side: strong overseas growth generates demand for highly competitive, U.S.-based multinational companies like Caterpillar, General Electric, Microsoft and IBM; a sluggish U.S. economy helps keep inflation under control and interest rates lower than they otherwise would be; although earnings growth will slow, U.S. companies continue to generate near-record cash flows that must either be reinvested to generate future profits or returned to shareholders via increased dividends and share repurchases; and a renewed appreciation of risk is generally considered a healthy development – much more so than widespread complacency.

Looking ahead, the most important potential catalysts remain developments related to the housing market and inflation. We continue to believe that both history and current circumstances suggest the housing downturn will last years rather than months. Recently published data from Bank of America indicate that more than \$1 trillion of adjustable-rate mortgages are scheduled to reset to higher rates during 2007 and 2008. A large percentage of these loans, issued in 2004 through early 2006, are in the sub-prime and “Alt A” categories, the holders of which may find refinancing options scarce in the current lending environment. Faced with new rates 2-percentage-points or more higher than the “teaser” rates that enabled their purchases, many of these overextended homeowners will seek to sell their homes in an already punk market. (We’ve done the math for you: \$1 trillion is enough to finance more than four *million* average-priced homes.)

The above data suggest to us that house prices will remain under pressure at least through next year. At the margin, rising home values have been an important engine of the consumer spending that accounts for nearly 70% of the U.S. economy. While a healthy job

market and rising stock prices have been helpful offsets, we expect consumers will tighten their belts at least a bit in the period ahead. Any significant deterioration in business confidence – as it impacts plans to hire new workers – could tip the situation decidedly to the downside. To date, businesses have remained cautiously optimistic, with confidence measures healthy, although below previous peaks.

On the inflation front, we believe things look better than the headlines – and central bank pronouncements – would suggest. Recent direct measures of inflation, in both the U.S. and other major economies, indicate that core prices are increasing at rates between 1.5% and 2%, with pressures receding rather than building. While non-core energy and food prices are high, these increases do not yet seem to be inducing a general wage-price spiral that is most damaging to economies and worrisome to central bankers. In this vein, it is encouraging that implied long-term inflation expectations remained almost unchanged during the May-June run-up in bond yields. With economic growth in the U.S likely to remain somewhat anemic over the next several quarters, inflation seems likely to become even less of a threat.

In sum, we anticipate a more challenging investment environment, but not a particularly daunting one. Decelerating earnings growth and uncertainty regarding the outlook for growth and inflation will act as headwinds for stock prices. Stubbornly high energy prices and any lasting up-tick in global terrorist activity would not be helpful, either. However, we do not expect recession or a collapse in profits. Importantly, we believe inflation concerns will wane, permitting the Federal Reserve to ease monetary conditions – aggressively if necessary – should growth fail to revive as the housing slump unfolds. Finally, stock market valuation remains reasonable – especially among the large, high-quality, growth-oriented companies emphasized in Oarsman Capital portfolios – suggesting that any downturn in prices is less likely to be severe.