Market Review and Outlook—April 16, 2007

The stock market fell, hard, and to some it looked like the weak housing market was finally bringing down the stock market. Like most of these declines, however, the markets began recovering shortly afterwards. Within three weeks the markets resumed the steady upward march that had begun last summer (after a scary April/May). The market fell during the quarter for many reasons (something Greenspan says, something he doesn't say, weak jobs report, strong jobs, weak economic growth report, strong economic growth report, …), but **the main reason that it fell is that falling is what stock markets do** (along with rising and moving sideways).

There is a difference between information and knowledge. The media—newspapers, radio, internet, TV—do a fine job of sharing information. The markets provide a limitless supply of information (the markets jumped/fell today) which the media passes on, filling the airwaves, and newsprint. Information in isolation is merely noise.
What does matter about markets moving up and down? First, it is critical to understand what the market is. A stock market is a collection/aggregate of stocks, and a stock is an ownership slice in a company. The price of a stock is a combination of the company's profits, and how confident/satisfied its owners are. If the company's profits are strong, and the owners are pleased, the stock price will be high/strong. Taken together, a stock market's level reflects the profits of the companies and also the emotional level of its investors.
In this light, a drop in a market could be attributed to sudden weakness in an economy, or sudden worry of investors. In the vast majority of market declines, they are due to investors' worries. This is the reason that long-term investors strive to buy during declines, or **'be greed when others are fearful, and fearful when others are greedy'**. This is the nature of adopting a contrarian approach.

As a contrarian, I regularly look at figures such as I present below. I look for pockets of the markets which appear to be overvalued, and undervalued. At this time, I feel that international stocks could be overpriced, and should be pared back towards 'neutral' levels. US stocks seem fairly valued, especially larger US companies. I continue to hope that sometime, growth stocks will strengthen, however I've been saying that far too long.

Bonds had a good year, not record-breaking, but a solid year. I expect that bonds will continue to produce unexciting returns, neither producing wonderful nor terrible results. When bonds shine is not when they post great returns, but rather when they hold their value while stock markets are dropping.

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Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Money Market—Taxable	+1.15%	+4.57%	+2.81%	+2.02%	+3.38%
Intermediate Term Bond	+1.40%	+6.08%	+2.95%	+4.89%	+5.73%
Intermediate Muni Bond	+0.59%	+4.12%	+2.31%	+3.90%	+4.43%
Large-Cap Core Stock	+0.46%	+9.88%	+8.67%	+5.00%	+6.88%
Mid-Cap Core	+4.49%	+8.99%	+12.34%	+9.73%	+10.95%
Small-Cap Core	+2.78%	+5.45%	+12.08%	+10.82%	+11.26%
International Stock	+3.46%	+17.70%	+18.71%	+14.34%	+8.31%
Real Estate	+3.50%	+21.51%	+21.83%	+22.16%	+14.69%
Natural Resources	+6.05%	+9.94%	+27.24%	+19.56%	+14.29%
Science/Technology	+1.47%	+2.23%	+6.57%	+3.81%	+8.09%
Multi-Cap Growth	+2.20%	+4.95%	+9.19%	+5.88%	+8.14%
Multi-Cap Value	+1.53%	+12.90%	+11.96%	+8.67%	+9.74%
Balanced	+1.49%	+8.79%	+7.53%	+5.92%	+7.00%

The data in this table comes from the Barron's Mutual Fund Quarterly Review.

The US stock markets are intimately tied to the US economy. **The economy currently is a mixed bag**, with strengths and weaknesses. There are strong segments of the economy, and weak ones. Similarly, there are strong sectors of the US stock markets, and weak ones. That has always been the case, and will always be the case.

There are two notable weak sectors at this time, the residential housing and the sub-prime mortgage sectors. The US automotive sector has also been weak. The most pressing question is whether these sectors will bring down the rest of the economy with them. The jury is out, and 'only time will tell'. **I am fairly optimistic**, so let me share the main reasons for my optimism.

The Fed has 'arrows in its quiver'. Should the economy weaken, or appear on the verge of weakening, there are several steps that the Fed can take to smooth the path. The Fed interest rate is high enough that they can cut it substantially to help breathe life into a faltering economy, and this appears to me and others to reduce (or eliminate) the risk of the economy being dragged down by the weak housing market.

While the residential housing market is very weak, this is hurting consumers with minimal equity and rising mortgage rates/payments. While this is reducing jobs in the residential housing sector, many of these workers are able to find jobs building commercial structures, a sector which is not in a slump. Further, when the Fed lowers rates, this will take pressure of homeowners who are having trouble meeting their payments, and can lead to a.rebound in this sector.

The sub-prime sector got hammered, and I think that this is largely good. **'Moral hazard'** is the term when bad behavior has no repercussions. When lenders regularly loan out money to borrowers who have no security and minimal income, the lender should go out of business. It is very unfortunate and painful that so many borrowers were misled by these companies. At least the farce is coming to an end.

While these two sectors get a lot of press, this has been out of proportion to their impact on the economy. The media (paper, radio, TV, internet) are not duty-bound to provide perspective on their stories. In perspective, the current weakness in a few sectors of the US economy is unlikely to directly lead to a shrinking economy (recession). **Overall, the US economy is growing modestly, and while this continues, the direction of US stock markets should also be modestly upward.**

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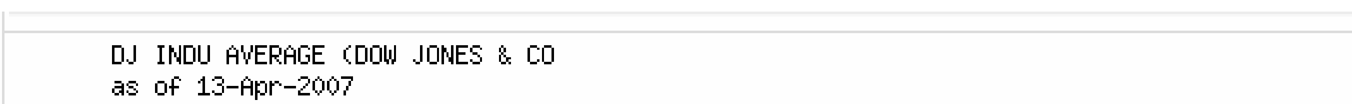

One year chart on Dow Jones Industrial Average from Yahoo.