

Economic Conditions & Market Outlook

Many investors would gladly trade the recent stock market rollercoaster ride for a good old-fashioned case of the summer doldrums but don't hold your breath. Neither current economic nor geopolitical conditions appear to indicate the daily ups and downs of the stock market are close to being over.

Several varied factors are contributing to this volatility. The most recent catalyst has been increased tension and conflict on several geographic fronts throughout the globe that has driven oil prices to new highs and cast a general pale on most market optimism. The Middle East continues to foment as Israel trades blows with Hezbollah and Hamas terrorists while Iran continues its blustering pursuit of nuclear capability. North Korea's playing with rockets and rebels maliciously promote mayhem and instability in areas ranging from India to Nigeria. In the meantime, the U. S. continues our war effort in Iraq and Afghanistan. A quiet time it is not.

Meanwhile, the relatively newly-minted Fed chief attempts to successfully manage economic growth and control inflation via continued interest rate hikes while learning that his every word will be dissected by market analysts for intent and implication. As we've observed before, the Fed raising interest rates in our current environment is indicative that our economy is generally healthy and, in fact, chugging right along. But similar to a child forced to swallow bitter medicine he/she doesn't like, the demise of 'cheap money' is often met by the market with a bout of kicking and screaming until the dosage is over. In this instance, despite the Fed's interest rate moves generally being recognized to be the proper medication, questions such as, "When will they be done?" and "Will they tighten too far?" contribute to the current market jitters.

That is not to say that all current economic concerns are without merit. Far from it. Evidence indicates that consumer spending has finally started to run out of steam. This is important because the consumer accounts for approximately 65% of total domestic U.S. GDP (gross domestic product), as well as an estimated 20% of total worldwide GDP. However, with rising interest rates, modest wage growth and energy-related pricing pressure, this slowdown should come as no surprise. The U.S. consumer has spent more and continued to spend longer than many had projected during this recent economic expansion.

An obvious beneficiary of this robust consumer spending until recently was the U.S. housing market. Extraordinary residential housing demand was fueled by factors ranging from inexpensive credit and baby-boomer demographics to real estate speculation with a 'get-em-while-their-hot' mentality. But last week's announcement from the nation's largest homebuilder that it was slicing year end 2006 forecast figures in excess of 30% was a clear indication that the residential real estate market has indeed cooled dramatically. Since market boomlets don't last forever, an inevitable hiatus in housing growth should not be a shocker. However, it remains to be seen 'how much' and 'how long' a more reticent consumer will impact other industry market sectors dependent on discretionary consumer spending, such as retail, recreation, and automotive.

Similarly, will reinvigorated corporate spending continue to improve and will it be able to do so until consumer spending retrenches to find a new sustainable middle ground? One industry sector where that question has been apparently answered with a resounding 'no' is technology, a market segment that has been underweighted in our firm's portfolios for the past several years. The beginning of the most recent earnings season included a diverse array of tech companies announcing tepid returns and less-than-optimistic projections for the near-term future. Despite still sporting lofty price-earnings (P/E) ratios akin to "growth" style stocks, most in the technology group seem to be doing little of the sort. The year-to-date result for the Nasdaq Composite index through July 14th is -7.6% and an eye-opening -14.1% decline from 2006's calendar year high in April. For those wondering whether this perhaps creates a 'bargain-buying' opportunity...our answer is clearly, "Not yet."

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Despite higher P/E ratio equities being more vulnerable during times when previously projected profits are being pared, the rest of the market is not certainly immune to some of the factors plaguing technology firms. Record energy prices and rising interest costs will pressure the forecast earnings of even the most staid of stocks. Combine this changing economic environment, and the increased possibility of negative earnings surprise, with the geopolitical turmoil mentioned previously and the result is what the market despises most – uncertainty. And until some of these factors are clarified, the market’s search for direction will result in what has been observed during the past few months – volatility.

However, to keep these market gyrations in perspective, it is important to look past the emotion and instead focus on the numbers. For example, despite three consecutive days of triple digit losses that shaved 396 points from the Dow Jones Industrial Average, closing the week of July 14th at 10,739, that index remained pretty much where it was one month prior (10,816) and is still just slightly above where it began the year (10,717). Similarly, the Standard & Poor’s 500 index closed out that ugly week at 1236, just slightly above its mid-June figure of 1230 and slightly below its 2005 yearend close of 1245. So while the broader market has been recently moving in a spastic fashion, the year-to-date impact has been relatively benign. And while no investor relishes the thought of running in place for the first six months of a year, it sure beats digging out of a -7% hole.

The bottom line is that the daily see-saw movement of a moody market will likely continue until a few of the following occurs: the Fed clearly communicates that it has reached its rate tightening target, fears of increasing inflationary pressure have abated, investor corporate earnings expectations are appropriately adjusted and new geopolitical hotspots are no longer surfacing daily.

So what about the fixed income side of the market? Has it been providing any respite from the equity gyrations of the past few months? Yes...but. The bond market has certainly not had to deal with the same daily ups and downs that have pestered the stock market of late. But, as expected, bond prices remain under downward pressure as interest rates continue their upward path. So while bonds have helped cushion the stock market swings year-to-date, changes in bond pricing have not contributed much positive performance of their own.

While these pricing movements are important when evaluating total return for a specific period, our firm’s fixed income focus is decidedly on the yield side of the equation. As has been the case for much of 2006, the fixed income yield curve remains rather flat, if not inverted, providing very little yield premium for taking additional risk in longer term bonds. As an example, last week a six-month U.S. Treasury was yielding 5.03% versus a 30-year U.S. Treasury yield of 5.11%, a skimpy eight basis point spread that is hardly motivation for lengthening bond maturities.

Similarly, the yield premium typically offered by corporate bonds when compared to the interest paid by an equivalent U.S. Treasury remain at historically low levels. For instance, the last week’s higher paying AAA 10-year corporate bonds were yielding approximately 5.80% versus a 10-year U.S. Treasury rate of 5.06%. And a further move down the bond rating scale currently provides minimal enticement to shoulder extra risk, with the yield spread between AAA and A corporate bonds averaging 20 basis points or less.

While this rate compression will not last forever, it has lingered throughout most of the year and will probably continue until the Fed’s current rate tightening stance has been moderated and a sense of stability returns the markets as a whole. If that occurs soon, the yield premiums typically paid for the risk factors of ‘time’ and ‘quality’ should begin to find their way back into bonds before yearend, although incentives may continue to lag in the very long end of the market. In the meantime, yields on short-term bond investments, including money market funds, provide some of the most attractive fixed income opportunities. For several years, the interest paid on money market funds was abysmal but the rate paradigm has shifted. When compared to the alternatives outlined above, getting nearly 5.00% in an extremely liquid investment subject to minimal principal value fluctuation while rates are still moving up can look sweet indeed.

Our Tactical Investment Stance

Roof Advisory Group's disciplined investment approach emphasizes adding value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's personal investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic context, the firm makes tactical shifts with changing market conditions to optimize client portfolio performance. While every client situation is unique, outlined below are a few of the tactics we are using in the current market:

- For the majority of clientele, we *reduced equity exposure in early June* one level to the targeted *midpoint equity allocations* as defined by each client's individual investment policy. The firm had been at the one-step below equity maximum allocation throughout most of 2005, with the exception of a brief drop to equity range midpoint immediately following the one-two punch of hurricanes Rita and Katrina in the fall of last year.
- Prior to, and as part of, the recent reallocation, we *pared several stock positions* that had *reached price appreciation potential or were deemed to be at risk* from near-term downward market pressure. The firm does continue to *add new stock positions very selectively* when attractive buying opportunities are presented, although we *remain cautious of false market bottoms* during this time of very volatile daily moves. The firm continues its *leaning toward large-cap stocks* with solid management, consistent earnings, low P/E ratios (18 or below), higher dividend yields (2.5%+) and annual growth potential (10%+). Stocks outside these parameters are also used when unique pricing or appreciation opportunities exist.
- *Diversification remains a priority* in both equity and fixed income portfolios. Equity exposure is regularly evaluated for diversification based on style and industry sector while fixed income assets are diversified by issuer, industry and, in the case of municipal bonds, geographic region. While the firm does not make deliberate industry sector bets, above-benchmark concentrations can result from our equity selection process. As a result, currently the industry sectors of *Energy, Utilities & Telecom are over-weighted* versus S&P 500 benchmark averages; while the areas of *Consumer Services, Healthcare & Media are under-weighted*.
- *International equity exposure* is primarily maintained through *multinational firms that operate on a global basis* rather than limiting our focus to strictly foreign-based companies that are entirely removed from the domestic U.S. market.
- Per usual, new account balances and large cash infusions are phased into their targeted investment policy levels. The *deployment of cash for equity and fixed income purchases is currently paced* based on market opportunity.
- Individual bonds are always used for larger fixed income portfolios to control quality, maturity, and yield. We have *notably shortened average bond maturities* over the *past several years* due to the rising interest rate environment. Most portfolios *now have durations of 3 years or less*. Similarly, we continue to *selectively purchase short-maturity, tax-free municipal bonds* in the taxable accounts of our high tax bracket clientele despite a *thin market and limited availability*. A client's tax bracket/account determines whether taxable or tax-free bonds are more advantageous. In all portfolios, overall bond quality is not sacrificed in the pursuit of higher yield.

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