

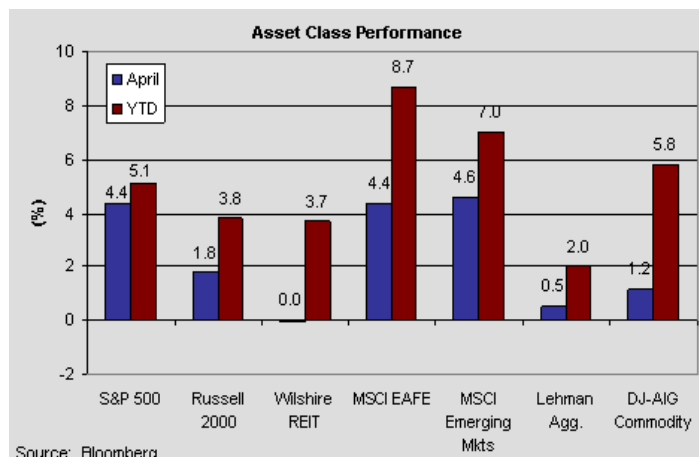
# Running of the Bulls

## Market Summary

April 2007

While the traditional running of the bulls in Spain doesn't take place until July, the bulls were loose on Wall Street and international markets during April. Not only did the Dow close above 13,000 for the first time on April 25<sup>th</sup>, but the Wilshire REIT index (-0.04%) was only benchmark we track that ended the month in negative territory. The major indices were very strong in April with both the S&P 500 and MSCI EAFE returning 4.4%. The S&P 500's return was its best for a month since December 2003. Investors apparently put more weight on strong earnings growth and M&A activity than disappointing economic news.

Domestically, large-cap stocks outperformed mid- and small-cap stocks with the S&P 500 beating the Russell Mid-cap and Russell 2000 indexes by 0.6% and 2.6%, respectively. In addition, growth equities outperformed value investments during April with the Russell 1000 Growth outperforming the S&P 500 by 0.3% and the Russell 1000 value by 1.0%. International equities performed well across the board with international small-cap and emerging market stocks returning 4.5% and 4.6%, respectively. International returns were helped by the US dollar's continued decline, falling to \$2 per British pound and \$1.3 per euro in April.



The Lehman Aggregate Bond and TIPS indexes earned 0.5% and 0.7% in April and are up 2.1%

and 3.2% for the year. Energy turned in the strongest performance of the month with the Goldman Sachs Natural Resources Index up 5.2%.

However, like the annual event in Pamplona, this run with the bulls carries some risks. It's surprising how little attention the market seems to be paying to downside economic risks. First quarter GDP grew only at a 1.3% annualized rate which was the lowest growth for a quarter since 2003 and below the consensus expectation of 2.0%.

	1Q Growth (%)	Contribution to 1Q Growth (%)
Personal Consumption Expenditures	3.8	2.7
Residential Fixed Investment	(17.0)	(1.0)
Non-Residential Fixed Investment	2.0	0.2
Government Consumption	0.9	0.2
Change in Inventories	-	(0.3)
Trade Balance	-	(0.5)
GDP		1.3

Residential real estate investment continued to be the weakest segment of GDP. It declined at a 17% annualized rate for the quarter, subtracting 1% from overall growth. Residential real estate investment still probably has room to fall further. Even after the recent contraction, residential investment still stands at 5.0% of the economy, above the historical average of 4.8%. In previous real estate downturns, residential investment fell below 4% of the economy. This suggests we may be in store for a further decline from the current level.

Earnings growth remains solid. First quarter S&P 500 operating earnings look as if they'll be up nearly 10% year-over-year. However, one just has to look back to 2000/2001 to see how quickly that can change in a weak economic environment. In September 2000, the S&P was showing year-over-year operating earnings growth of 9%. The next quarter it was negative 5%. Three quarters later in June 2001, operating earnings showed a 39% year-over-year decline. Even if there is a recession, it seems very unlikely that earnings will fall to the extent they did in 2000/2001. Nevertheless, investors should

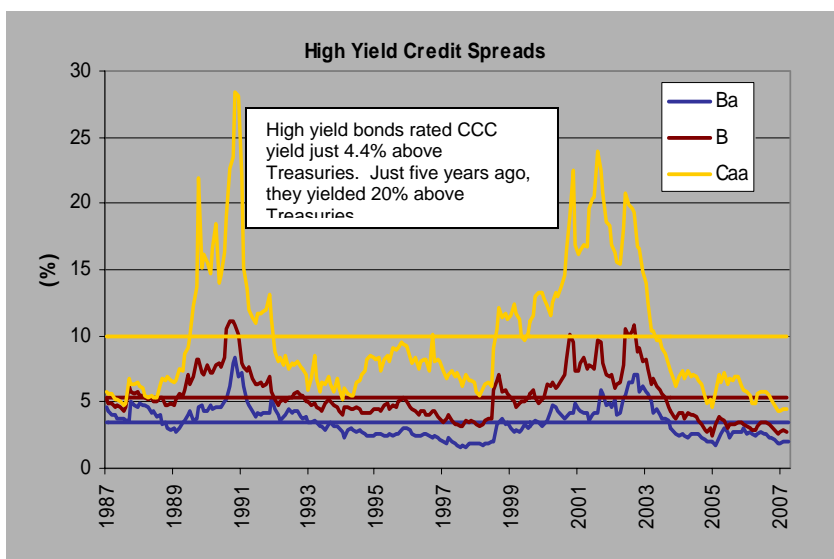
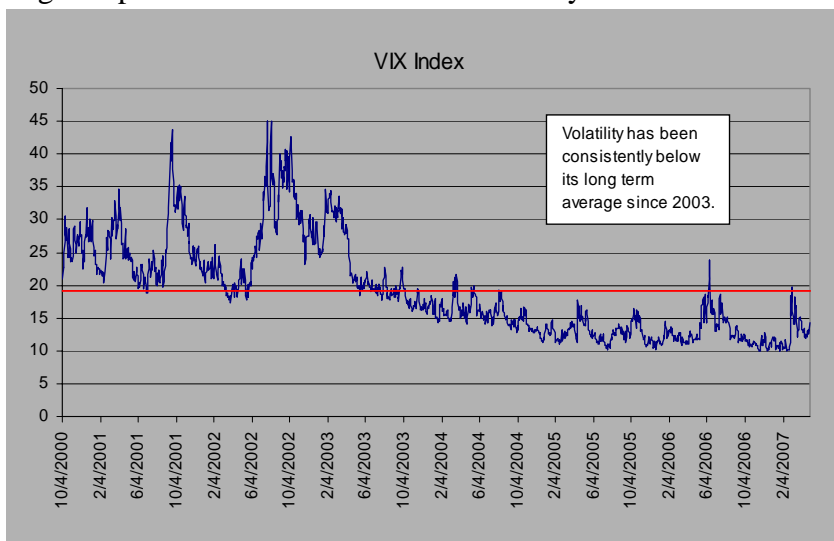
be careful not to underestimate the effects of economic downturns on earnings.

Two important factors that investors need to keep in mind regarding risk in the current environment are that volatility has been below average for the past four years and that other investors continue to take on more risk in the face of ever diminishing risk premiums.

The market's expectation for volatility is measured by the CBOE Volatility Index, often referred to as the VIX Index. The VIX index measures the implied volatility in one-month option prices on the S&P 500 and its average level since 1990 is 19. During April, the VIX traded between 11.5 and 14.3 and has been consistently below average over the past three years. While we would not be surprised to see volatility remain low in the near-term, the low level of volatility has encouraged investors to reach for return. Investors should not be lulled by the low recent volatility since it has generally been mean reverting.

The lengths to which investors will currently go to seek return are evident in the yield spreads of bonds rated below investment grade, or junk bonds.

Yield spreads on junk bonds tightened again in April. As of April 30<sup>th</sup>, BB, B, and CCC bonds yielded 2.0%, 2.7%, and 4.4% over treasuries respectively. These spreads are much tighter than their historical averages of 3.5% for BB, 5.4% for B, and 9.9% for CCC. As you can see from the graph below, as recently as 2002 CCC bonds yielded more than 20% above comparable Treasury bonds.



It is impossible to say when investors' level of risk tolerance will return to more reasonable levels, but history has shown that periods of financial market complacency tend to end badly. An economic slowdown would test high yield bonds, which might finally bring the days of cheap credit to an end. We continue to recommend that investors look to reduce risk since it is currently very expensive relative to historical levels and not expected to yield sufficient return in the future to offset increased portfolio volatility.



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