

# Sell in May, Go Away?

## Market Summary

May 2007

The old Wall Street adage “Sell in May, go away” arose because domestic equity markets are typically weaker in the May through October period than in the other six months of the year.

However, May 2007 brought robust equity market performance. Strong corporate earnings, rising merger and acquisition activity, and growing overseas economies helped push the S&P 500 index and the Russell 2000 index to all-time highs. For the month, the S&P 500 gained 3.5% and the Russell 2000 rose 4.1%. Also, growth and value stocks as measured by the Russell 1000 Growth and Value indices both returned 3.6%. Our recent overweight to growth stocks is adding value so far in 2007, as the Russell 1000 Growth index returned 9.8% year-to-date while the Russell 1000 Value index rose 8.8%

International equities did well too. In U.S. dollar terms, the MSCI EAFE index and the S&P/Citigroup index of international small caps both increased 1.8%. The MSCI Emerging Markets index rose 5.0% in U.S. dollar terms. Even though domestic large cap equity outperformed international large cap equity in May, international and emerging markets indices lead domestic indices by wide margins over one-year, three-year and five-year year periods. As a result, investors with larger allocations to international markets have benefited.

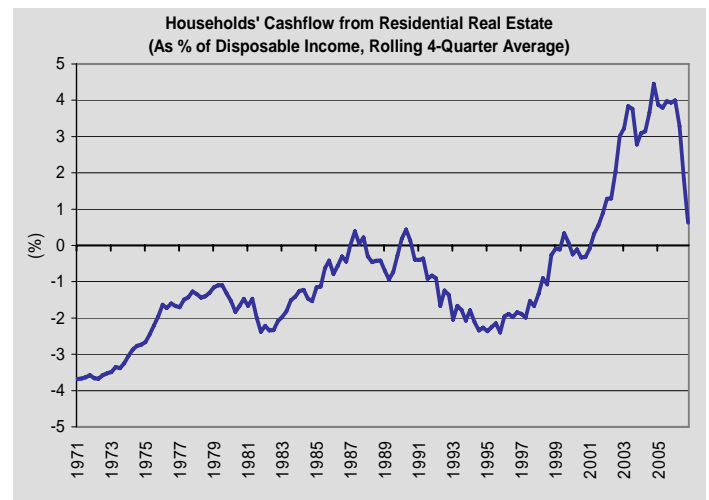
Alternative asset returns were mixed, with the energy-heavy GS Natural Resources index up 8.2% and the more balanced DJ AIG Commodity Index rising 0.1%. The Lehman Aggregate Bond index fell as the yield curve steepened due to inflation jitters.

Despite these generally healthy returns, reasons for caution abound. Here are four we believe noteworthy:

(1) Small/Large Caps: A shift in domestic equity market leadership from small cap stocks to large caps typically signals that the economy is closer to slowing down. We believe a change in leadership from small caps to large caps is underway, as seen in the relative performance of the Russell 2000 and S&P 500 indices. The Russell 2000 leads the S&P 500 in three-year and five-year returns but underperforms in the one-year and year-to-date periods. We recommended underweighting small cap stocks relative to large caps a number of months ago to exploit this trend.

	May	YTD	1 Yr	3 Yrs	5 Yrs
<b>Domestic Equities/Fixed</b>					
S&P 500	3.5	8.8	22.8	13.0	9.4
Russell 2000	4.1	8.0	18.9	15.6	13.1
Russell 1000 Growth	3.6	9.8	20.4	9.7	7.5
Russell 1000 Value	3.6	8.8	25.6	17.7	12.5
Dow Jones Wilshire REIT	0.1	3.8	30.3	27.6	22.3
Lehman Aggregate Bond	(0.8)	1.3	6.7	4.3	4.7
<b>International Equities</b>					
MSCI EAFE	1.8	10.6	26.8	23.1	16.8
S&P/Citigroup EMI-EPAC	1.8	13.4	31.7	29.5	24.0
MSCI Emerging Markets	5.0	12.3	38.2	36.3	27.1
<b>Alternative Assets</b>					
GS Natural Resources	8.2	18.3	22.9	32.0	21.0
DJ AIG Commodity	0.1	5.9	2.8	8.7	15.1

(2) Cash from Home Equity: The National Association of Realtors reported that the median price of a home sold in April was \$220,900, down 0.8% from the \$222,600 price for a typical home a year earlier. This marked the 9<sup>th</sup> straight month that prices declined from the previous year, a condition that has not occurred in 11 years. As a result, households’ cash flow from residential real estate has fallen sharply.



Consumers' reduced ability to monetize home equity has negative implications for consumer spending, which accounts for roughly 70% of U.S. economic activity.

**(3) REITS:** Although different forces drive the commercial property market versus residential property, high-flying REIT returns have declined recently. The Dow Jones Wilshire REIT Index returned 0.1% in May and 3.8% year-to-date. As James Grant reported in an April 23, 2007 article on [Forbes.com](http://Forbes.com), "Starry-eyed [commercial property] buyers think nothing these days of settling for 4% yields, or cap rates. And at the same time, they are borrowing at 6% or more....Not to worry, the bulls insist. Real estate isn't about the cash flow. It's about the price appreciation. An earlier generation of bulls once said the same thing about tech stocks."

**(4) Global High Yield Bond Defaults:** World growth rates above 4% have helped create a relatively hospitable global business environment.

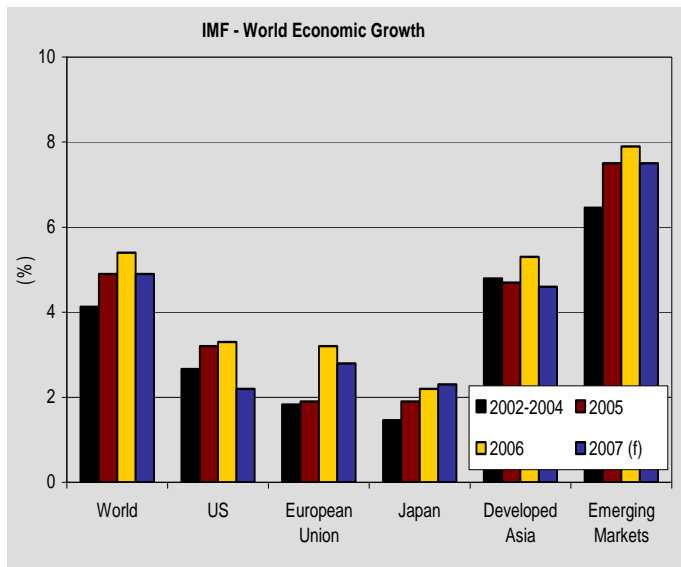
However, high yield default rates are cyclical. A May 30, 2007 [Bloomberg.com](http://Bloomberg.com) article entitled "Looming Crash Prompts Jump in Distressed Debt Hiring" reports how investment banks in Europe are hiring distressed debt bankers at the fastest pace in five years. The banks are positioning themselves for more distressed debt deals owing to their view that high yield bond defaults will rise.

While we don't believe a worldwide recession looms in 2007, we do encourage broad diversification and continue to emphasize reducing risk at the margin. By doing so, investors can avoid the consequences that come from reaching too far for returns.



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The extent of today's business-friendly climate may be seen in the global high yield bond default rate, which stood at 1.5% in April, near the lowest rate in a decade, according to Moody's. The rate was 1.7% at the end of 2006, its lowest year-end level since 1996 and its fifth straight annual decline.