

1st Quarter 2007 Market Review

Volatility characterized the first quarter of 2007 in which a one-day, 9% decline in Chinese equity markets was felt throughout the world. This decline led market participants to examine risks that were not, as of yet, fully discounted in the stock prices. Contributing to the sense of heightened market risk were the potential unwinding of the yen “carry trade” (in which one borrows at lower Japanese interest rates and invests proceeds into higher yielding investments elsewhere), weakness in the U.S. sub-prime housing market, public comments from past Federal Reserve presidents on the potential for recession, slowdown in the domestic economy, continuing upward pressure on energy prices, and international geo-political conflicts.

The DJIA experienced a turbulent quarter as it experienced both a 325 point (1.4%) rise to start the year and a one-day, 416-point (3.25%) drop (on February 27) that culminated in a fall of 735 points (5.75%) over nine trading sessions. The index eventually closed down 0.87% for the quarter. The S&P 500 and NASDAQ composites however, which experienced similar volatility, finished the quarter up 0.64% and 0.26%, respectively. (Please refer to the performance illustration to the right for comprehensive YTD returns.)

Out-performance by Mid Caps and a modest tilt towards growth highlighted the 1st quarter. Mid Cap Growth (4.07%) and Value (4.03%) styles took the limelight as investors turned their attention away from the often more popular Large Cap and Small Cap cousins. Growth stocks edged out their value counterparts in all three market capitalization categories. Time will tell if this is the beginning of a new trend or just a one-quarter aberration.

Top sectors included familiar winners from last year: Utilities (8.43%), Materials

(8.38%), and Telecom Services (6.36%). Financials trailed other sectors and proved to be the worst performer, reflecting mortgage market weaknesses.

Mixed economic signals and inaction by the Fed in late 2006 continued into the first quarter of 2007. And although the last Federal Reserve meeting did not lead to changes in interest rates, a softening inflationary tone pushed bond yields *down* 0.21 and 0.05 basis points for the quarter (for two and 10-year maturities, respectively), and *up* 0.05 basis points for 30-year maturities – creating a normalized, yet essentially flat, yield curve.

Emerging markets, as a group, responded similarly to the fall in Chinese markets as the MSCI Emerging Markets index fell 10.23% between February 27 and March 5. Other international sectors experienced similar volatility, albeit to a lesser degree. But while domestic sectors and style groups struggled to reclaim their highs for the quarter, most international markets did. International Small and Mid Caps, often overlooked by investors, outperformed *all* other investment categories, rising 6.09% during the quarter – possibly setting the stage for a potentially rewarding 2007.

Tim Hai



Source: U.S. Morningstar, Inc. (Investment category performance)
*Year-to-date as of 03/31/2007