

# MEMO

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**To:** WFR Clients and Friends  
**Subject:** First Quarter 2007 Economic Trends

*"During the first half of the year the equity and fixed-income markets were buffeted by worries of rising inflation and surging oil prices."* This quote is from our last quarterly letter. Subsequently, the broad equity markets (U.S. and non-U.S. equities) returned between 15.8% and 26.9% for 2006. So what's happening?

Every quarter of every year there will be disturbing news and events that threaten to cause stock prices to drop dramatically. And sometimes that happens, but many times it does not because the U.S. and global economies are far more complex than most market pundits claim. Successful investing for the long haul requires planning, perspective, discipline and patience. This is as true today as it has ever been.

Here's what's been happening the past few months. Prior to February 27<sup>th</sup> the U.S. stock market enjoyed its longest uninterrupted streak of monthly gains in over 10 years. The Fed had raised rates from 1% to 5.25% to combat inflation – and now has paused for the time being. But in late February the Chinese stock market was jolted by fears the Chinese government would take harsh measures to curb excessive speculation in their domestic ("A share") stock market. "A shares" closed down 9% while the "H shares" (available only to non-Chinese investors) were down only 3%. The reaction rippled around the world with the Dow down 3.3% and the S&P 500 down 3.5% in a single day. But the Chinese market began to recover quickly and the U.S. markets showed strength and resilience in a rebound that surprised many investors.

What remains today is perhaps a more realistic level of concern about certain areas in the U.S. economy (energy costs, budget deficits, the impact of problems in the sub-prime lending market, and other economic and political issues); at the same time, many experienced investment managers feel our markets are not overvalued and some feel they may even be slightly undervalued. They cite factors such as the earnings yield advantage the S&P 500 has of 1.88% over Treasuries, which is the highest it's been in 21 years. This ambiguous situation of conflicting data and opinions is normal in all investment markets because when outcomes are certain, there is no opportunity for profit.

<u>% Return as of 3/31/2007</u>			
<u>Equity Indexes</u>	<u>Q1</u>	<u>YTD</u>	<u>3 Yrs</u>
S&P 500	0.6	0.6	9.3
Russell 2500	3.6	3.6	12.4
MSCI EAFE	4.1	4.1	19.5
Emerging Market	2.3	2.3	30.2
NAREIT (equity)	3.5	3.5	22.6
<u>Bond Indexes</u>			
TIPS	2.5	2.5	2.6
Aggregate	1.5	1.5	3.7
Governments	1.4	1.4	3.4
Mortgages	1.6	1.6	4.2
Intermediate Credits	1.7	1.7	3.4
Long-Term Credits	0.9	0.9	3.6
High Yield	2.6	2.6	7.6
Municipals	0.8	0.8	4.1
<u>Cash Equivalents</u>			
3-Month T-Bill	0.8	0.8	3.0

Domestic Equities: This quarter's performance was positive, but relatively flat. The S&P 500, an index of the largest 500 stocks in the U.S., increased only 0.6% for the quarter and smaller stocks represented by the Russell 2500 Index were up more with an increase of 3.6% for the quarter. The S&P result means the index has advanced in seven of the past 8 quarters – a very satisfying result given the disruptions occurring in other markets.

International Equities: International equities continued to outperform U.S. equities with the MSCI EAFE index, which measures developed markets in Europe, Asia and the Far East, rising 4.1% for the quarter. Diversification into non-U.S. equities continues to demonstrate the benefits of holding some international funds in your portfolio. However, the sensitivity of global markets to the general condition of the U.S. economy continues, as demonstrated by their tumble on February 27<sup>th</sup> in response to former Federal Reserve Chairman Greenspan's comments on the possibility of a U.S. recession.

Emerging markets, stocks issued by companies located in smaller, less developed countries, proved again to be quite volatile. Although they ended up slightly for the quarter at 2.3%, during the quarter, drops of 6% and 12% in just a few days also occurred. Although returns can be spectacular and some exposure benefits the diversification of a portfolio, their use requires both patience and perspective.

Real Estate: Concerns continued about real estate investments. Although the NAREIT Index of real estate investment trusts rose 3.5% for the quarter, it finished well below the high it achieved in early February. While real estate values depend a great deal on type and location, slackening demand for housing and serious concerns about the sub-prime lending crisis (with rapidly rising payments on adjustable rate loans issued to poor credit quality buyers) had a definite impact on investor thinking. Our recommended allocations to real estate remain lower than normal, although we don't believe it's prudent to exit the market completely.

Fixed Income: Chairman of the Federal Reserve Ben Bernanke still has to find his voice. His testimony before Congress on March 28<sup>th</sup> was ambivalent – voicing faith in the U.S. economy this year while also voicing concerns about inflation and that the housing correction could be deeper and have more impact than expected. Markets reacted with uncertainty, dropping initially and then recovering.

The Lehman Aggregate, an index consisting of a broad spectrum of bond investments, produced a gain of 1.5% for the quarter versus 1.2% for last quarter. High yield bonds posted gains of 2.6% for the quarter. Government bonds delivered a modest return of 1.4% for the quarter.

### Conclusions

Periodically we need to revisit the lessons past markets try to teach us. There are many, but two stand out. First, in a complex economy predicting the impact of any event is extremely difficult. Second, well structured, globally diversified portfolios will deliver good results to the long-term investor who plans, maintains perspective, is disciplined and has patience.

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