

**AND THAT'S THE QUARTER THAT WAS...****For the Quarter Ended June 30, 2007***Market Matters...*

Market/Index	Year Close (2006)	1 <sup>st</sup> Qtr Close (03/31/07)	2 <sup>nd</sup> Qtr Close (06/30/07)	Qtr Change	YTD Change
Dow Jones Industrial	12,463.15	<b>12,354.35</b>	<b>13,408.62</b>	<b>8.53%</b>	<b>7.59%</b>
NASDAQ	2,415.29	<b>2,421.64</b>	<b>2,603.23</b>	<b>7.50%</b>	<b>7.78%</b>
S&P 500	1,418.30	<b>1,420.86</b>	<b>1,503.35</b>	<b>5.81%</b>	<b>6.00%</b>
Russell 2000	787.66	<b>800.71</b>	<b>833.70</b>	<b>4.12%</b>	<b>5.85%</b>
Fed Funds	5.25%	<b>5.25%</b>	<b>5.25%</b>	<b>0 bps</b>	<b>0 bps</b>
10 yr Treasury (Yield)	4.71%	<b>4.65%</b>	<b>5.03%</b>	<b>38 bps</b>	<b>32 bps</b>

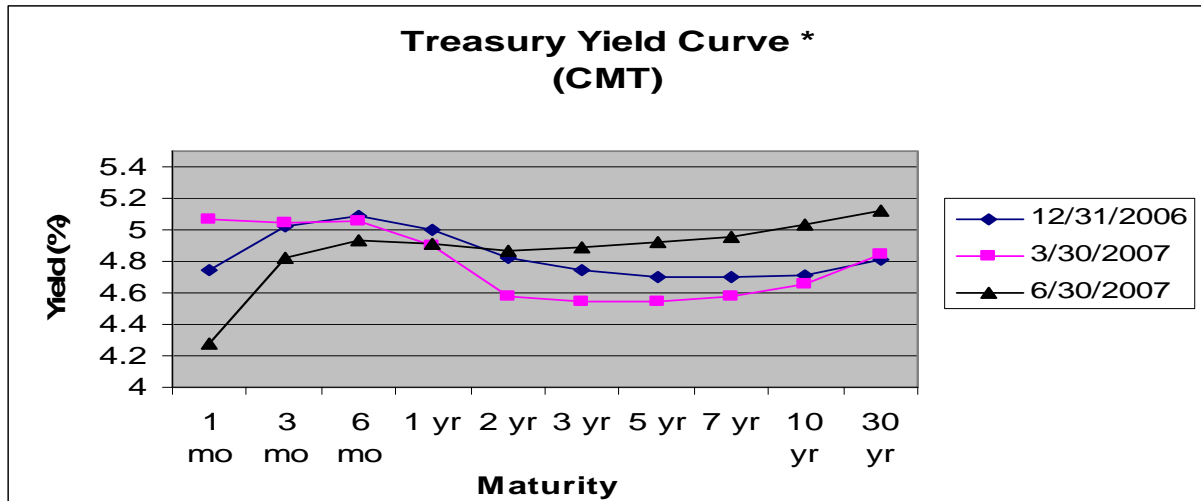
**SUBPRIME (AGAIN):** Last quarter's commentary devoted a section to the mortgage debacle that impacted borrowers, lenders, investors, and the overall housing sector. Well, it's beginning to sound like a broken record. Well, it's beginning to sound like a broken record. While the early stages of the subprime fiasco hindered operations at a few (relatively unknown) specialty lenders like *Accredited* and *New Century*, analysts hoped the damage would be confined there. Three months later, major investment firms were reaping the ill-effects of the controversy. With default rates at record levels, prices of fixed income securities backed by these loans have plummeted. *Bear Stearns* was forced to bail out a hedge fund that owned underwater Collateralized Debt Obligations (CDOs) and investors remained concerned that similar funds may follow suit.

**TRANSACTIONS:** The buyout boom continued as private equity firms and other investors seemed to find perceived value in a great many places (besides the housing sector). Of particular interest, Rupert Murdoch (of tabloid fame) set his sights on **Dow Jones & Co.**, the publisher of that "rag" (kidding for effect) called the *Wall Street Journal*. Major player, **Blackstone Group**, raised some additional capital to fund future deals through the sixth largest IPO in history. As the quarter came to a close, however, analysts began to fear that the takeover "frenzy" may be ending as demand for high yield debt had started to subside as a result of the subprime situation.

**GEOPOLITICAL:** Apparently, it's not only about Iraq anymore. Hugo Chavez is nationalizing the Venezuelan oil fields and Big Oil is uncertain about its future role. Tony Blair announced his resignation (most likely, to spend more time with his family and less with W). A Chinese delegation met with Treasury Secretary Paulson among others to discuss the surging US deficits and currency issues. On a related note, the Chinese index surged to another record (after the February scare), though many analysts (included one Alan Greenspan) warned that Asia is a "ticking time bomb" primed for a "dramatic correction." Oil took its cues from ongoing tensions in Nigeria, Gaza, Iran, and (of course) Iraq and climbed to around \$70/barrel (as vacationers were forced to dig deep to afford gasoline during the summer travel season).

**MARKETS:** Investors seemed to disregard the housing challenges early in the quarter as April was the best month for equities in three years (and May was even better). The Dow moved past 13,000 and set a few more records in the process. The S&P 500 surged beyond 1,500 and into record-setting territory, while the small-cap Russell 2000 and tech-heavy Nasdaq also enjoyed strong quarters. By June, some pessimists re-emerged, touting inflation (oil prices) and fixed income woes (subprime). Though the Fed left interest rates unchanged throughout the quarter, bonds struggled mightily in mid-June as the Bear Stearns bailout loomed fresh on everyone's mind. The yield on the 10-year treasury soared from 4.65% when the quarter began to over 5.25% (until some bottom-fishers swooped in during the last week or so). With half the year now in the rearview mirror, double digit equity returns are not out of the question. And bonds suddenly look a bit more attractive as well (that is, except for anything associated with subprime).

## Economically Speaking...



\* Reflects changes in interest rates over various time frames.

**FED:** While Bernanke and friends repeated their views that inflation remained “public enemy number one,” the Fed continued to leave rates unchanged at 5.25% (with no activity now for an entire year). In fact, the statement accompanying the most recent policy meeting left out the crucial word “elevated” when referencing inflation, a sign that many Fed watchers took to mean no future rate HIKES are on the horizon. (Hopefully, it wasn’t just a typo.) While the Fed stayed pat, other Central Banks (namely European Central Bank) moved to raise their rates with Bank of England expected to follow suit soon. The quarter also brought a Greenspan sighting (or 10) as the former Chairman boldly placed the odds against a year-end recession at two to one.

**INFLATION:** While “public enemy number one” remained high on everyone’s radar screen, the data seemed to indicate that price pressures remain well under control (as long as energy is factored out of the equation). Through May, core (ex-food and energy) CPI has increased by 2.1%, well below the 2.6% level of 2006. Likewise, inflation has largely been contained to the energy sector at the wholesale level as well. In May, gasoline prices skyrocketed by 10.2%, the largest monthly increase since November 2006, and a big concern heading into the summer travel season (and don’t forget Hurricane season is lurking in the background as well). In the meantime, economists seem happy to tout the “core” numbers, which keeping a watchful eye on developments in Nigeria, Iran, Gaza, Iraq, Venezuela, and elsewhere across the world.

**HOUSING:** Those eternal optimists who were calling for a rebound in housing this year have been given a healthy dose of reality as the subprime fallout dampened any chance for recovery. In fact, related numbers seemed to get worse with each passing release. May housing starts suffered its worst showing since the beginning of the year. Existing home sales fell to its lowest level since June 2003 and recent new home sales have not fared much better. The Homebuilder Sentiment index plunged to levels not seen in 16 years. So where are those optimists now?

**OTHER:** GDP rose by a mere 0.7% in the first quarter, its slowest pace in over four years. However, economists found some comfort in the fact that housing was a major contributing factor in the weaker performance. Both *manufacturing* and *services* have exhibited signs of continued strength, while *labor* remained another savings grace with the unemployment rate standing at a the relatively low 4.5% level. While retail sales expanded by a strong 1.4% in May, consumer confidence dropped to its lowest level in almost a year on higher gasoline. (Apparently, not everyone is able to so easily overlook the “elevated” energy prices).

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