



Q1 2007 Notes on the Quarter

Overview of the Quarter:

- 1) Most metal and energy prices flattened; Soft commodities (particularly corn) reached new heights, due to ethanol demands – but don't expect the ride to either be smooth or straight up.
- 2) Real estate price weakness became apparent, led by problems in the sub-prime market. Inflation increased, but the Fed has continued to keep interest rates at the same level. We believe this is because they are very worried about a slowing economy.
- 3) The yield curve has started to regain a more normal shape – this is important. It means that investors are starting to demand higher returns for higher risk. It has just started, but this bears watching.
- 4) US markets were flat, China and India were down, but parts of Europe and Asia were strong. Latin America was flat as well.

Portfolio Specifics:

- 1) In the U.S., stock picking was the name of the game. This usually happens when investors do not have a clear picture of what to do. This makes sense because the U.S. economy is starting to show its age. Extreme leverage has kept it going longer than normal; the same can be said for many foreign markets. But as the short-lived correction in March showed, when the market turns, they will turn extremely quickly, and their correlations will be very high. Thus, positioning in anticipation will be essential.
- 2) Madcap stocks performed the best, Large Cap the worst. Investors spent a lot of time flopping around trying to find returns. This shows neither a propensity for investing, as opposed to trading, nor a strong opinion on risk/rewards. We expect this volatility to continue.



Looking Ahead:

- 1) China is expensive. As measured by FXI (iSHARES China 25 Fund), the fund needs to drop by approximately 50% to get back to “normal.” We still believe that energy stocks are expensive as well and continue to hold light positions until prices are more attractive.
- 2) Nine months ago the pundits proclaimed that housing lows had been reached. Three months ago these same pundits said that only sub-prime market was being impacted; no other part of the economy would be impacted at all. Now that GMAC and H&R Block have admitted they have losses from sub-prime lending, as do many Wall Street firms, the pundits are saying that a number of areas of the economy are being impacted, but that the overall economy will not be affected. Except that we are already hearing reports of stricter lending requirements are impacting all levels of borrowers. In addition, we believe the Fed has been keeping rates where they are because they are worried about the economy and the impact raising rates would have. The pinch is that inflation is rising – wages are up, as are food prices, Congress is talking about removing the tax breaks that were implemented in the past few years, and corporate spending is showing signs of slowing. Combine these issues and you have the making of an economic slowdown.
- 3) If we are correct, then a slowdown here will lead to a slowdown in much of the rest of the world. As the U.S. markets are the most liquid, they are likely to fall the least, just as they rose the least in the up cycle over the past several years. While we like the prospects of Asia over time (China, Viet Nam and India specifically) and parts of Latin America (Brazil), we think that they will pull back first.
- 4) Not to worry however, as there are always opportunities, and as the markets weaken, there will be even more opportunities. In the mean time, we want to focus on income generation, diversity by industry, and some good stock picking.