

MONTGOMERY BROTHERS WEALTH MANAGEMENT

First Quarter, 2007 Investment Outlook Update February 21, 2007

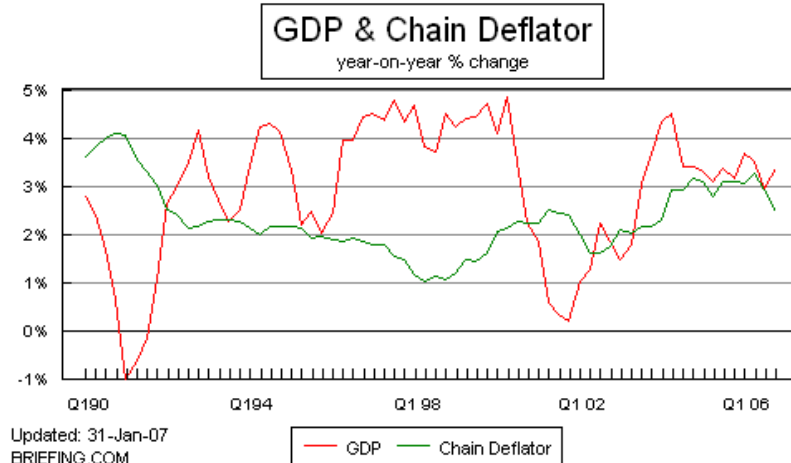
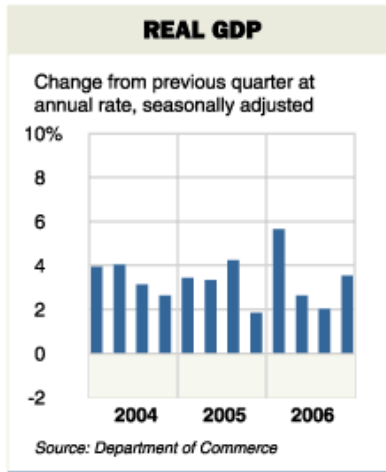
“I have made this letter longer than usual because I lack the time to make it shorter.” (Blaise) Pascal 1657

After reading the MBI 2007 Outlook, one of my favorite clients asked if I couldn't make future Outlooks shorter. Well, I can try.

Not much has happened over the past seven weeks since we wrote our 2007 Outlook. The Democrats took control of Congress and during their “First 100 Hours” blitzkrieg, picked some low hanging political fruit but passed no legislation. Their proposals now go to the Senate where all 100 senators (actually only 8) have announced their intentions to run for President in 2008 which shouldn't make passage of any legislation any easier. (Yes, the presidential race has begun and, yes, I'm already sick of it!) President Bush gave his State of the Union (it's great in his eyes, not so great in the eyes of his detractors) and introduced his 2008 budget (which looked a lot like his 2007, 2006...budgets). A new general took over in Iraq and Bush's “troop surge” proposal proved unpopular. The President's popularity reached near record lows in the polls. It all seems a lot like the movie “Groundhog Day.” If you want a great contrarian bet – go long George Bush. While we fancy ourselves contrarians, we wouldn't/couldn't place that one.

Economic Outlook

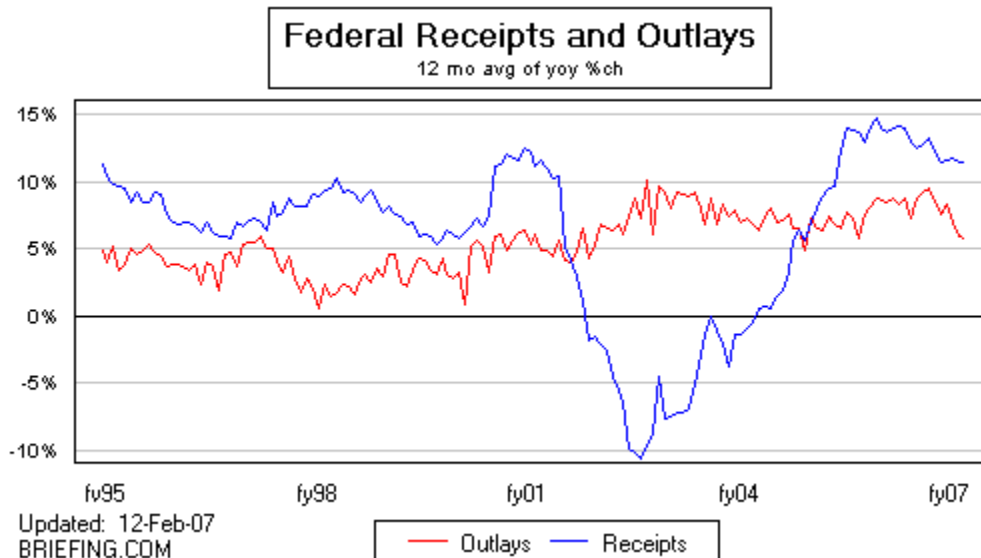
The economy continues to confound the pessimists. 4Q GDP was preliminarily reported at 3.5% annual growth with the core inflation indicator slowing to 2.1% surprising all but the terminally optimistic. As can be seen from the charts below,



growth and inflation seem headed in the correct directions – faster and slower, respectively. Shown below are the Fed’s current economic assumptions as presented by Ben Bernanke in his February 14th testimony on Capitol Hill.

Federal Reserve officials’ forecasts for the economy		
	2007	2008
Economic growth	2.5% to 3%	2.75% to 3%
Inflation, excluding food and energy	2% to 2.25%	1.75% to 2%
Unemployment, 4th-quarter average	4.5% to 4.75%	4.5% to 4.75%

If these forecasts are good enough for the Fed to use to manage U.S. monetary policy, they’re good enough for Montgomery Brothers to use for its baseline economic assumptions. If anything, we feel that 2007 will look more like the Fed’s 2008 forecast, but that’s just us. The consumer is apparently unaware that the housing slump is supposed to cause great spending angst but it hasn’t, as jobs continue to be created, wealth continues to grow, and real incomes continue to rise. But, in our opinion, the surest sign of the economy’s true underlying strength is the rapid decline in the Federal budget deficit caused by taxes increasing faster than government spending and nominal economic growth. This in spite of these dastardly Bush tax cut giveaways to “the rich.”



Additionally, European and Japanese growth rose more rapidly during the second half of 2006 than most expected, especially during the fourth quarter. Developing economies, such as India and China, continue to roar ahead in spite of constant forecasts that their growth has just got to slow. It looks like economic Armageddon has been delayed yet again.

All of this economic growth raised concerns among pundits, the press and politicians that there wouldn't be enough to worry about. But, the worry ship was quickly righted and concerns over higher inflation and higher interest rates seized the fancy of the media while politicians dusted off the old income inequality chestnut. Even if income inequality is a real issue, exactly what should the government do about it? I guess you could ask Hugo Chavez. Nevertheless, look for income inequality to be a big presidential "issue" for 2008, but please don't get me started on income inequality or this Outlook certainly won't be short.

Interest Rate Outlook

In his report to Congress Fed chairman Bernanke stated that, "The Outlook for real economic activity is uncertain" but, in MBI's opinion, certainly not bad. Continuing in his testimony, Bernanke stated that, "At recent meetings, the FOMC indicated that the risk that inflation will fail to moderate as expected is its predominant policy concern." If the Fed was willing to hold the Fed funds rate steady in the face of an apparently slowing economy during the second half of 2006, it will probably continue to hold policy constant in light of economic growth being better than even it expected. Additionally, Bernanke has said several times that housing may be bottoming. Housing shaved an entire 1% point from the 3.5% growth of 4Q'07. With things apparently going well, why would the Fed shift policy?

The chart below shows how the 10-year U.S. Treasury yield and the U.S. Dollar Index have fared over the past twelve months.

TREASURY BOND 10 vs U.S. DOLLAR INDEX
 (Feb 16, 2006 TO Feb 20, 2007) Rate as Yield

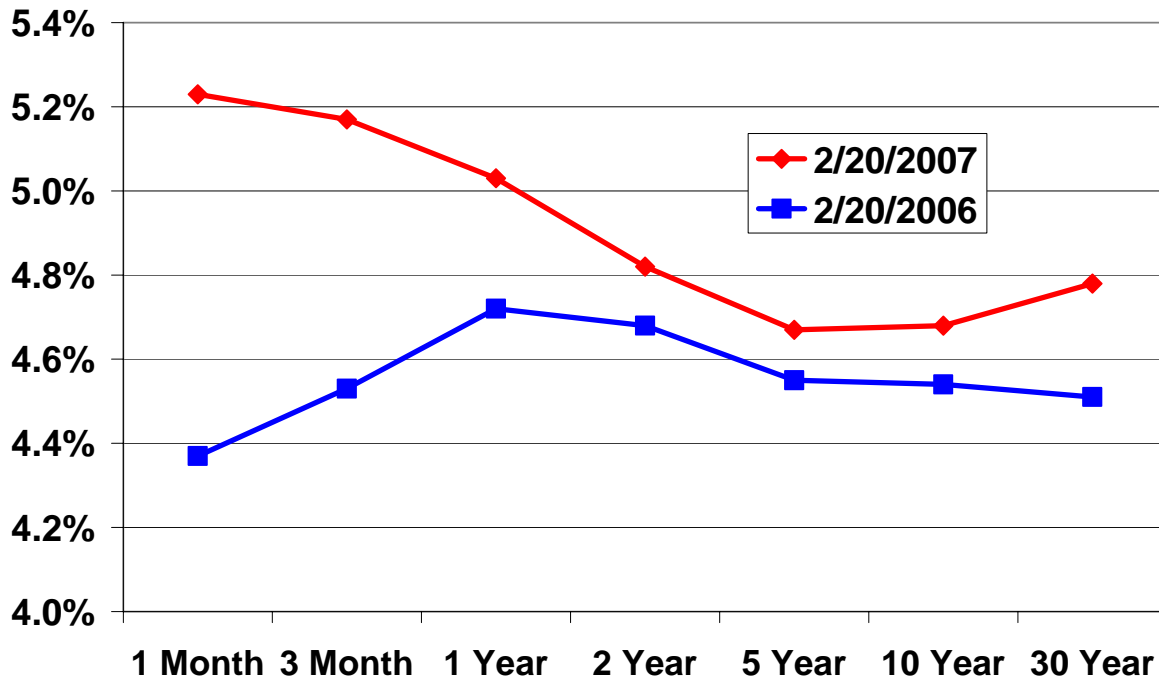


The lion's share of the dollars decline and an upward spike in interest rates, both occurred during May and June when talk of Fed ease was loudest. (Also, that was when the stock market last had a significant correction.) The Fed does not miss nor ignore stuff like this.

Bernanke, who's only been on the job for a little over a year, in spite of it seeming much longer, is earning kudos for his forecasting skills and inflation-fighting resolve. As a result, hopeful talk of immediate interest rate cuts by the Fed has given way to concerns that the Fed might actually raise rates again.

Sitting on one's hands in the bond market has been a relatively good strategy. The chart below shows the yield curve as of 2/20/07 and a year earlier.

Yield Curve for U.S. Treasury Bills, Notes, and Bonds 2/20/07, and One Year Earlier



With longer-term rates low, on both an absolute and relative basis, and with quality spreads historically narrow, investors have increasingly chased yield wherever they could. We don't think it's worth the risk and continue to hold large amounts of our bond allocations in cash equivalents and in very short maturity high-quality debt instruments. We do feel that five years out is the sweet spot on the U.S. Treasury yield curve and would concentrate purchases of high quality debt issues in this maturity.

Stock Market Outlook

There are basically two schools of thought on the stock market currently. The first is that the market is "blue skies and green lights" with the biggest risk being for a "melt up." (Unfortunately, this is equated to 1987 during which the stock market went up 40% before it "crashed" but still ended up for the year.) The second school of thought is that we are overdue for a "correction" but that it will be good for us. (Like Cod Liver Oil, I guess.)

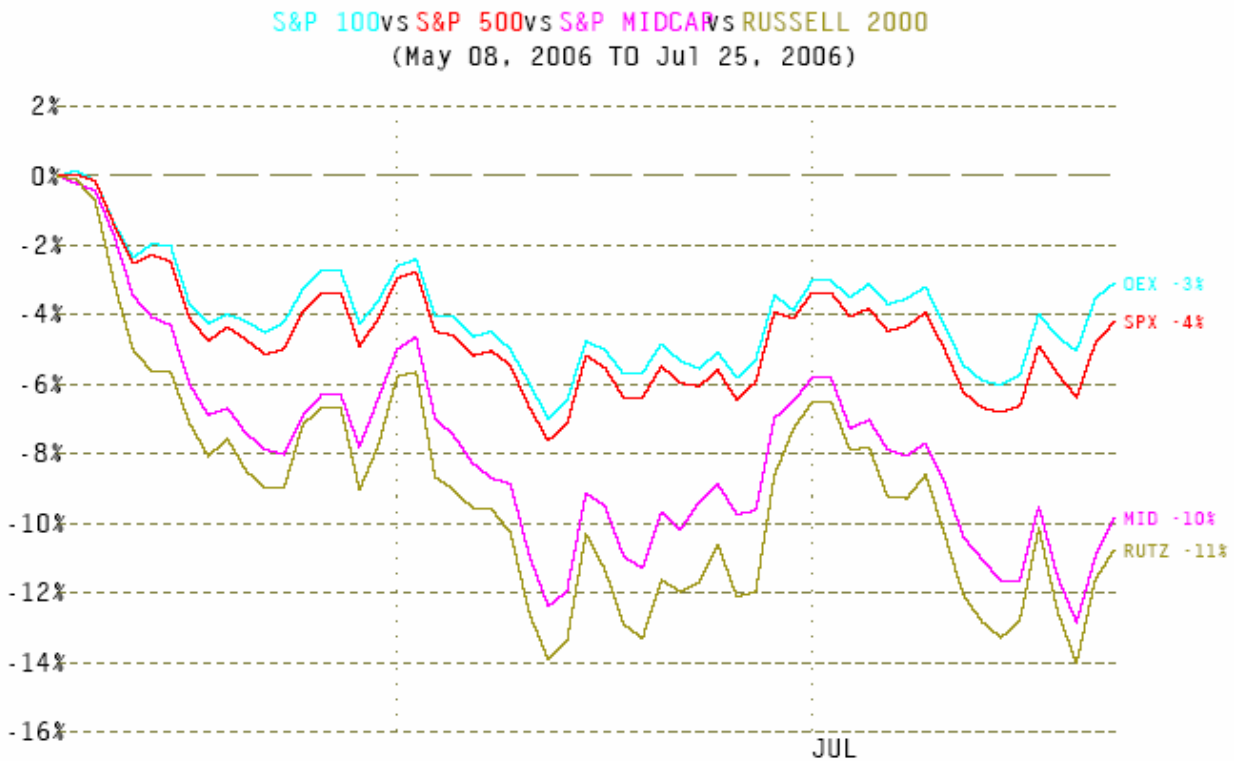
Sachel Page once advised to "never look back, someone may be gaining on you." In spite of the fact that the market discounts the future, virtually everyone dwells on the fact that the Dow and S&P 500 have gone without a 10% correction since the spring of 2003 which is the second longest such period, and only to the 1990s record bull market. Additionally, neither the Dow nor S&P has had even a 2% correction since last summer which is the longest such run since 1954. We confidently predict not only a 2% correction but a 10% correction. Unfortunately, we don't know when or from what levels these corrections will start.

The press loves to intimate that the end is near. While writing this on Friday morning (2/16), we went to Yahoo to see what the stock market was doing. The headline read, “Dow, Nasdaq Tumble in Early Trading.” Right next to this was data showing that the Dow was down 0.07% and the Nasdaq was down 0.43%. The press reserves the right to shout “fire” in a crowded theater.

While investors have not gone totally euphoric, they’re currently a pretty positive lot. The headline from a summary report on the Money Show held in Orlando in early February was, “Not a Bear in the Bunch.” Our colleague and friend, Frank Cappiello, spoke at this conference and reports that the speakers were actually more bullish than the attendees. The latter were more interested in a possible comeback for their high tech disaster of the late ‘90s bubble and in gold and foreign stocks than in the U.S. stock market.

As long as interest rates don’t rise too much, as long as corporate profits continue to be relatively robust, as long as liquidity remains plentiful and as long as alternatives to the stock market are few and far between, stocks should continue to do well. But, as long as we’re at it, how long can all these things continue? (That’s a rhetorical question.)

Montgomery Brothers continues to be impressed by the technical strength of the market and the resiliency on the economy. During the late spring/early summer correction when many started to forecast an economic slowdown, small and mid-cap stocks underperformed the larger cap (and blue chip) stocks. But in anticipation of the economy reaccelerating, the stock market bottomed in July and all capitalizations (large, mid and small) have been performing pretty much in line (see below) since then.

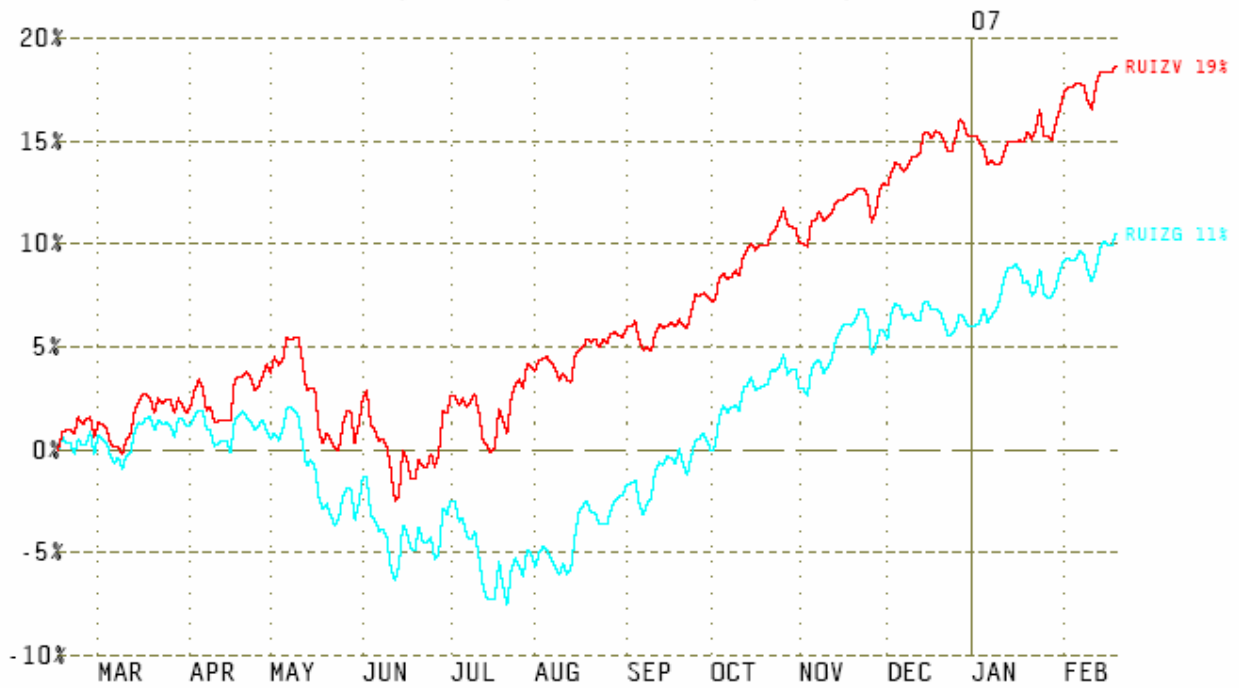


S&P 100vs S&P 500vs S&P MIDCAPvs RUSSELL 2000
 (Feb 15, 2006 TO Feb 20, 2007)



Value has continued to outpace growth.

RUSSELL 1000 GROW vs RUSSELL 1000 VALUE
 (Feb 15, 2006 TO Feb 20, 2007)



Montgomery Brothers has historically followed a GARP (growth-at-a-reasonable-price) investment philosophy and emphasized large-capitalization, blue chip stocks. Our collaborative research efforts with Beaty Haynes & Associates is helping us to expand our exposure to and ownership of smaller and mid-cap stocks when appropriate for our clients' objectives and risk tolerance.

Better, but? When/if you take out the charts and graphs, this is *only* 4 pages long.

February 21, 2007

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Some charts courtesy of Baseline and Briefing.com.

Addendum to Y2K+7. Right on cue! Having written to remind you of the Y2K scare we recently came across "Son of Y2K." Please start worrying NOW that your computer will have problems when we go to daylight savings time on March 11, 2007 since this is not the date originally programmed. Any concerns that we might run out of things to worry about have been allayed.