

MONTGOMERY BROTHERS

WEALTH MANAGEMENT

Second Quarter, 2007

Investment Outlook

April 1, 2007

“Subprime: All the Time”

As if the 2008 Presidential race, the latest political crisis and global warming weren't enough, the press has found yet another horse to beat to death – Subprime Mortgages. Whether Subprime turns out to be a bona fide problem or another Y2K or Asian bird flu pandemic, only time will tell but the press is covering the topic 24/7.

Similarly, the politicians are “all over this one” (as the clowns on CNBC love to say about their coverage of any and all topics.) Certainly Subprime has all the ingredients of a media-fueled financial scandal. Dim-witted, poor and unsuspecting folks being dunned by unscrupulous lenders aided and abetted by greedy “Wall Streeters” into borrowing money to buy homes which they couldn't afford. Ignoring the fact that millions of poorer people were able to purchase homes which they will keep thanks to Subprime lending, there were certainly some who should not have been lent to. The unfortunate few will be the headlines not the fortunate many. Much like junk bonds, Subprime has become part of the financial landscape and has a valid and valuable role in the global marketplace.

Congress is on the case and has started the investigations. Dragging a bunch of white guys in blue suits and white shirts up to the Hill to testify on why they made these poor people borrow all that money merely to fulfill the American dream of homeownership, the politicians are already plotting the rescue of a whole new group of victims. Expect a Subprime bailout which will cost far more, especially for taxpayers, and last far longer than merely letting events run their course. Politicians have never met an issue that they can't demagogue.

Economic Outlook

In and of itself, the Subprime market is not large enough to bring down the U.S., let alone the global, economy. If, however, the media and politicians create enough of a fire storm, the resultant fear could cause the economy to slow even further than it already has. 4Q'06 GDP was revised down to a 2.5% annual growth rate which was faster than 3Q's 2%. For 2006, U.S. GDP growth rate was 3.3%, less than 2004's 3.9% and about the same as 2005's 3.2%. The good

news, if that's what one chooses to call good, was that most of the downward revision in growth was due to less inventory accumulation and that real final demand remains at a healthy 3.7% per annum growth rate and consumer spending rose at a 4.2% rate. Somewhat short of a disaster.

Economists are rapidly marking down their forecasts for economic growth to reflect the recently glum news. While we have certainly witnessed some disappointments, employment growth remains strong and consumer incomes, especially wages and salaries, are growing. This is borne out by personal taxes continuing to grow faster than both income and nominal economic growth which, in turn, leads to a declining budget deficit which, in turn, leads to slower economic growth. (Sorry folks but that's how economic growth is calculated.)

Foreign economies continue to power ahead. Europe is seeing accelerated growth and is finally creating enough jobs to help stabilize global economic growth even as the U.S. slows. Japan continues to expand, albeit not in a straight line, and even witnessed the first increase in its real estate values in 16 years. Both Japan and, importantly, China recently raised their short-term interest rates in an effort to slow their economic growth. (In the case of China, the government hopes to slow its growth to 8% per annum to tamp down inflationary pressures.)

In what may have been the stupidest opening paragraph of an economic article that we've read recently, *The Washington Post* recently wrote that "The coldest February since 1979 caused U.S. retail sales to grow at the slowest pace in *three* months (italics added for emphasis) as consumers *delayed* (italics added for emphasis) buying spring merchandise." You've gotta watch those consumers, you never know what they're up to.

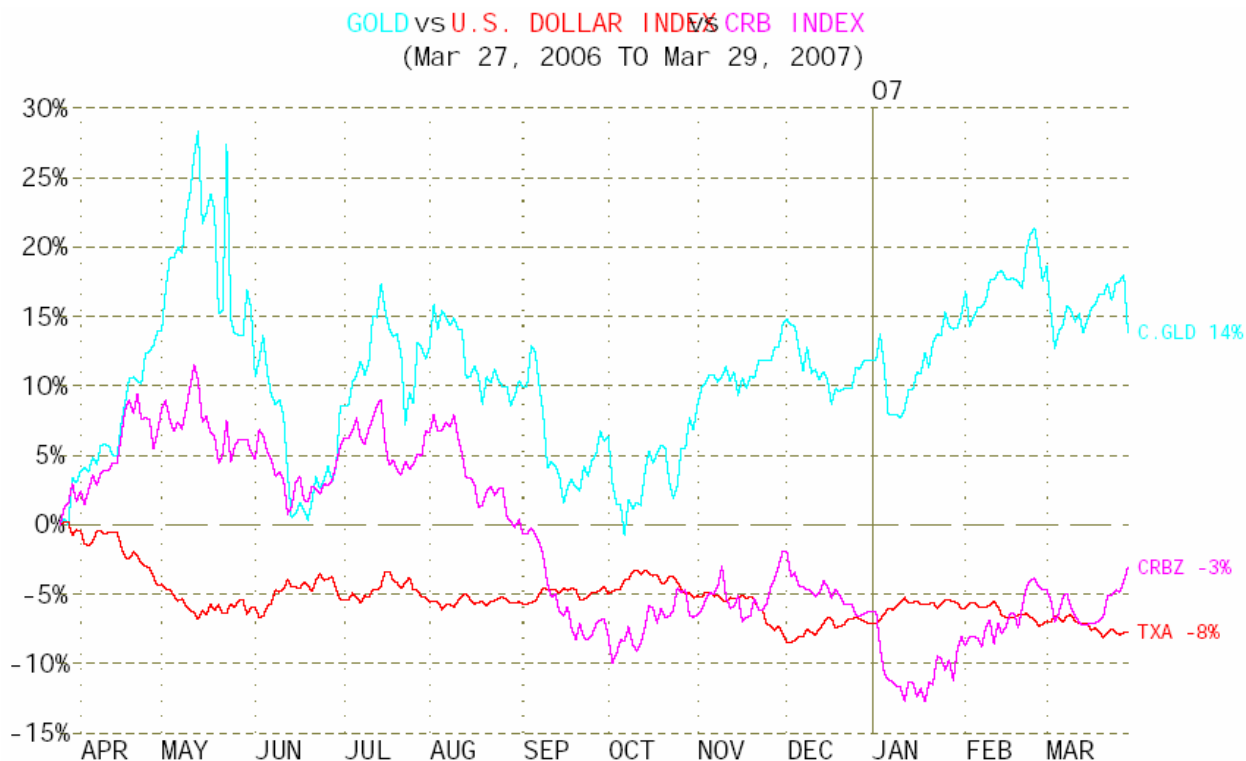
Brian Westbury, one of our favorite economists, recently wrote in *The Wall Street Journal* that "Last year, U.S. exports, industrial production, real hourly compensation, corporate profits, federal tax revenues, retail sales, GDP, productivity, the number of people with jobs, the number of students in college, airline passengers and the Dow Jones Industrial Average all hit record levels." What does everyone hear about? How Subprime mortgages will sink the economy and that Alan Greenspan feels that there is a one in three, that's 33.3%, chance that the U.S. economy will enter into a recession this year. (By the way, watch the Maestro's reputation take a serious beating during this Subprime flap.) Montgomery Brothers feels that there is better than two out of three chances that the U.S. economy will continue to expand in 2007 and probably by more than the "blowing in the wind" economic consensus.

Interest Rate Outlook

What to do? What to do? The Fed let rates stay put once again at its latest FOMC meeting. Faced with slowing growth on one hand and persistent inflationary pressures on the other, the Fed decided, wisely in our opinion, to do nothing. Rather than saying that it has no idea what to do, it couched its decision in the usual Fed-speak gobble-de-gook which was greeted (at least initially) quite positively. On closer examination it looked less certain what would happen next and the markets sank back into uncertainty.

A slowing economy, shrinking budget deficit and growing incomes and corporate profits should reduce borrowing demands but there is still a lot, no an awful lot, of liquidity in the

financial system. Since inflation is a monetary phenomenon caused by too much money chasing too few goods and since little liquidity has yet to be drained from the system, inflationary concerns continue. The chart below shows several indicators of inflationary pressure that Montgomery Brothers monitors and how they have performed over the past twelve months.



During the past year, gold has increased 14%; the dollar, as measured against a trade-weighted basket of currencies, has declined 8%; but the CRB Commodities index has declined 4%. During the first quarter, these indicators rose 2%, declined 1%, and rose 3% respectively. It looks to us that inflationary pressures may be abating. The Fed is likely to continue to do nothing and bond investors are unlikely to earn more than their coupons.

Stock Market Outlook

In spite of virtually everyone expecting one, and many saying that it was necessary and would be healthy, few have liked this correction once it finally came. Unlike the May-July 2006 correction, which saw the S&P 500 decline 8% over a 5 week period, the first quarter 2007 correction has, so far, witnessed a 6% decline in the S&P 500 which lasted all of 9 days. Few liked it when it finally came and the “correction” actually caused some to call for the Fed to ease monetary policy – the old “Greenspan Put,” if you will.

While Montgomery Brothers is relatively sanguine on both the economy and stock market, we are less enthusiastic on the outlook than we were at the beginning of the year. This mini correction initially elicited concerns about risk but as soon as the stock market righted itself,

everyone went right back to ignoring risk in order to chase short-term performance. Never before have people so quickly gotten, then (re) lost religion.

There was the infamous “glitch” on February 27th which helped cause the Dow Jones Industrials to decline 416 points that day. No good explanation has been forthcoming. MBI wonders what hedge fund managers, especially those doing bizarre stuff with the Japanese “carry trade,” are really up to and what effect they had and will have on the market. Our concerns are more related to the structure of and the liquidity in the market than on the fundamentals.

Lost in the midst of what has, to date, been a garden variety correction was the 50th anniversary of the Standard & Poor 500 which occurred on March 5th. During its 50 years in existence, the S&P 500 has produced an annual total return of a little over 10.8% per annum. Its greatest one-year gain was 38.1% in 1958, its worst annual loss was 29.7% in 1974. Its single biggest one-day percentage loss was 20.5% on October 19, 1987, followed two days later by its largest one-day percentage gain of 9.1%. (Now that's volatility!) During its first 50 years, the S&P rose 6,608 days with an average gain of 0.63% while it declined on 5,900 days for an average loss of 0.64% (on 73 days it was unchanged) and yet it produced an annual gain of 10.8% -- almost a third of which came from dividends. The most recent all time high for the S&P 500 was on February 20, 2007.

MBI's bottom line: stay invested in stocks in spite of the volatility and in spite of whatever the “worry du jour” (currently Subprime) might be.

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JOHN E. MONTGOMERY
7475 WISCONSIN AVE, SUITE 810
BETHESDA, MD 20814
301-652-6950 PHONE
301-652-6954 FAX
888-293-6668 TOLL FREE

Some charts courtesy of Baseline.