

MONTGOMERY BROTHERS WEALTH MANAGEMENT

Second Quarter, 2007 Investment Outlook Update May 14, 2007

“Money Can’t Buy Happiness”

Recent surveys show that in spite of record net worth for most Americans, we are no happier than we were 30 years ago. Since then economic growth has soared; unemployment, inflation and interest rates have fallen from double digit rates to low single digits, housing values have boomed and stock market averages have risen dramatically, with most at or near record levels. Yet many, if not most, Americans are “down” with a large percentage believing that the U.S. is seriously off track. It’s easy to blame this on George Bush and the War in Iraq but our collective angst goes much deeper. One of the reasons that the U.S. is the U.S. is that most strive, relentlessly, to improve their situation. We believe in hard work and quickly adapt to and then take for granted each success, and then want more. This keeps us hungry but doesn’t necessarily make us happy.

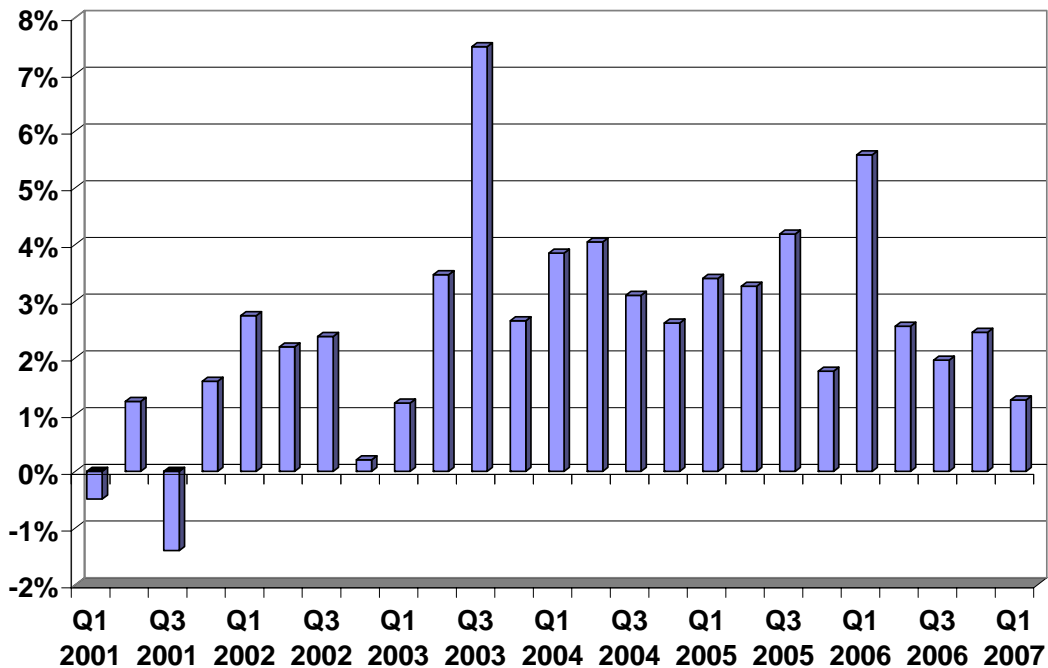
Montgomery Brothers endlessly carps on the negativism of the press (a desire to sell advertising) and of politicians (a desire to get [re]elected) but it goes further than even these factors. The press will continue to dish up the doom and the politicians will continue to promise us the moon. The politicians and press need something to do so even though it’s a long way off, the presidential race is already upon us. Too many candidates to count are telling us how, if we only elect them, things will get ever so much better. You expect that the party out of power is going to tell us how awful things are but both sides are doing it in this cycle. It’s only by (re)electing them that true happiness can be achieved. So the candidates will preen and the press will relentlessly cover the 2008 election, and it’s still eight months until the first primary.

We are keeping a wary eye on the political situation. In spite of record tax revenues, more taxes are wanted. But, not to worry, both sides tell us it will only be the “rich” that will see higher taxes. Unless, of course, you get caught in AMT, or receive dividends, or are fortunate enough to have capital gains. If any of you who fall into any of these categories, you might feel better to learn that while your money may not always buy your happiness it may buy someone else’s happiness. Or, at least, someone’s vote.

Economic Outlook

It's back! Stagflation, that is. Gone are Goldilocks and Rosy Scenario. The slowing economy with still too high inflation has brought back an economic oldie from the past. 1Q'07 economic growth, as measured by GDP, expanded at only a 1.3% annualized rate. This was down from 2.5% growth in 4Q'06 and was the slowest rate of growth since 1Q'03. But, as you can see from the chart below, economic growth picked up fairly sharply after 1Q'03.

Real GDP Growth



We don't have recessions all that often any more as the U.S. has increasingly built in self correcting mechanisms which make recessions less frequent and less severe. Inventories are low, employment is high and incomes are expanding. Importantly, stronger growth in Europe, Japan and China bode well for an increasingly export reliant U.S. economy. Montgomery Brothers continues to feel that the economy will reaccelerate during the second half of 2007 and into 2008, but this is increasingly a minority opinion. Certainly, housing could continue to be a drag on domestic growth. While the subprime scare may curtail consumer spending, no lesser economic light than Warren Buffet thinks it unlikely that subprime will bring the U.S. economy down.

Many believe that if the U.S. economy was to slow further, that the Fed would ride to the rescue by cutting interest rates. While the Greenspan Fed was always quick to pour liquidity into the economy at the slightest sign of economic or financial market duress, we are not so sure that the Bernanke Fed will do the same. All that money that the Fed created did raise the prices of

stocks, bonds, commodities and real estate but, so far, has brought precious little happiness. We'll see if it leads to higher inflation.

Interest Rate Outlook

A recent *Wall Street Journal* article pointed out that the downside of all of the Leveraged Buyouts (LBOs) falls disproportionately on bond holders. When a company is the target of an LBO, its share price usually soars but its bond prices almost always tank. Therefore, the rapid increase in the number of leveraged buyouts has caused bond investors to get the "Heebie-Jeebies," as the *Journal* so eloquently put it, on lower-rated debt. Directly below this article was another saying that mutual fund investors are pouring money into bond funds especially high yield (a.k.a. junk) bond funds. So, it seems that bond investors are getting more nervous about buying bonds, especially lower quality bonds, even as they buy more bond funds, especially high yielding ones. Huh?

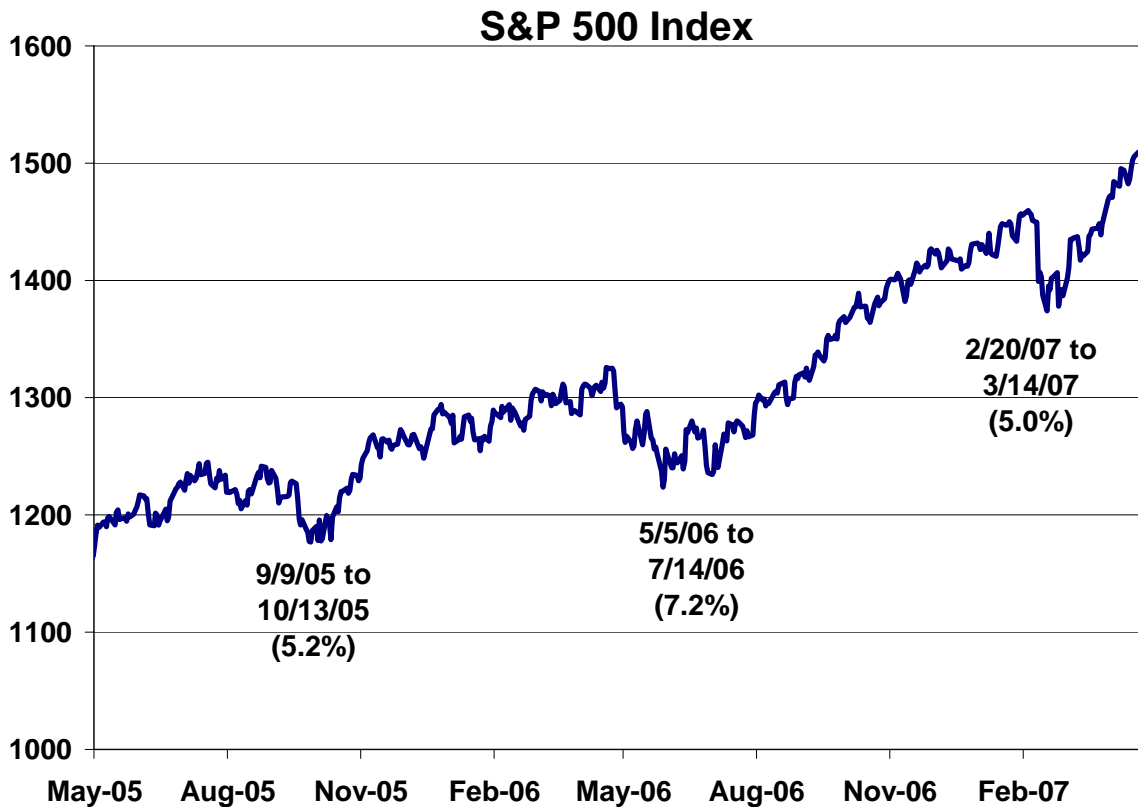
Inflation concerns continue to dominate the Fed's worry list which is usually limited to 1) inflation and 2) economic growth. The Fed seems, as is MBI, fairly sanguine on growth reaccelerating during the second half. If the Fed believes that growth will snap back but is still worried about inflation, why do so many believe that the Fed is so likely to cut rates? The yield curve remains fairly flat while interest rates continue to trace a long-term pattern of higher highs and higher lows. Additionally, quality spreads remain narrow indicating high levels of complacency among supposedly nervous bond investors. Paul McCulley, a top bond expert with PIMCO, recently bemoaned the lack of opportunities currently available in the bond market stating that "it's hard to make money" in his business. He went on to state that "the market is mispricing risk." Stay cautious, stay short, stay quality.

Stock Market Outlook

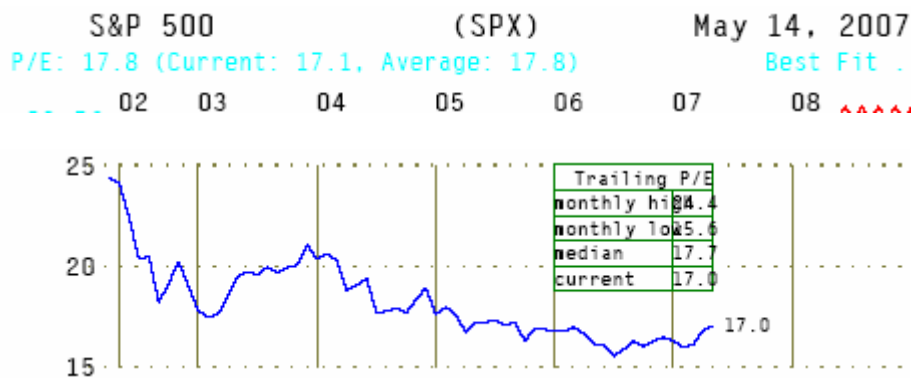
The upside of LBOs is that shareholders receive cash for shares which is generally recycled back into a shrinking supply of shares. And, since the deals are usually for cash this money gets recycled back into the market pretty quickly. There seems to be strong demand from private equity investors to buy whole companies, for corporations to buy other corporations and for corporations to buy their own shares. Lots of demand, shrinking supply.

The markets have recently been on a tear with no significant (10%) corrections since the first quarter of 2003 which was over 5,000 Dow points ago and the Dow recently completed its longest winning streak in 80 years! Usually when the stock market goes straight up, investors become happy. But stock market money is not buying happiness for investors right now. The latest American Association of Individual Investors sentiment index shows almost twice as many bearish as bullish; this after weeks of straight up stock market with most indices hitting multi-year or all time highs. In the past investors would be dancing in the streets but currently there is little joy in Mudville.

This bull market has been amazing. No meaningful corrections; no P/E expansion; precious little enthusiasm. The first chart shown below shows the past two years of the S&P 500's movement with the dates and extent of pullbacks written in.



The second chart shows the Price ÷ Earnings of the S&P 500 over the past 5 years. The current P/E is closer to its low than to its high.



Over this period earnings have grown at double digit annual rates and consistently surprised most by their level and persistence.

Unfortunately, the S&P (and most other averages) have become extended, much as before prior pullbacks but guessing when the next pullback, let alone a full fledged correction might start, has proven counter productive. It's like a reverse Murphy's Law.

MBI is selling its losers, reducing the positions in some of its biggest winners and looking for more reasonably priced, large cap blue chip stocks. We also are incrementally increasing our international exposure and holdings in selected Exchange Traded Funds (ETFs).

If the market continues to rise people may become happier but, even though money can't buy happiness, it can make misery more comfortable.

May 14, 2007

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.