

MONTGOMERY BROTHERS

WEALTH MANAGEMENT

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Investment Outlook
July 1, 2007

“The Media and Other Feral Beasts”

Former British Prime Minister Tony Blair caused quite a stir recently when he equated the media to “feral beasts” who have abandoned impartiality in favor of sensationalism and controversy. The media is “tearing people and reputations to bits,” he said. Well, duh! Now we take a back seat to no one in our disdain for the media, but come on. Feral beasts? That’s insulting to wild animals everywhere, and when it comes to feral beasts, the media has plenty of competition.

Many think that politicians are feral beasts, or worse. Democrats think of Republicans as Goofy Old Pachyderms, while Republicans consider Democrats to be dumb asses. As we trudge further into the 2008 presidential race, the battle lines seem to be hardening with Democrats being pulled further to the left, Republicans further to the right. Fundamentalist politics is fashionable again. Hillary Clinton and John McCain are currently considered to be the moderates. Go figure!

In the meantime, both parties are looking increasingly like jackasses that can’t learn from previous mistakes. It is interesting to watch Congress try to figure out how to tax Steve Schwartzman and other nouveau riche private equity and hedge fund managers in the name of “fairness.” These guys are easy targets but the last time Congress went after a couple rich people who weren’t paying enough taxes, they came up with the Alternative Minimum Tax. They’re now trying to figure out how to undo the damage the AMT has wrought. Similarly, having learned *nothing* from the failed energy policies of the late 1970s and early 1980s, it’s more of the same. Thirty years ago we imported roughly 25% of our energy needs, now it’s more like 70%. Corn ethanol from states which vote early in the presidential primary season is the closest the United States has come to an energy policy in more than three decades. Thankfully, the only thing worse than no Federal energy policy is any Federal energy policy. There will be far more political posturing than legislating over the next year or so. The real mischief will probably start after the next election. Feral Beasts? Not really.

Economic Outlook

The U.S. consumer is wild and crazy, a feral beast(-ette), if you will. The 70% of GDP that consumer spending represents is usually close to a mortal lock to expand, but economists and the press never tire of forecasting the demise of consumer spending. Sub-prime is (once again?) the reason that consumers will stop spending, and there is little doubt that housing is, and will continue to be, a drag on the economy. We expect housing to remain weak since lenders are just now starting to get tough on borrowers and since Congress is looking to lend a helping hand. In spite of the blaring headlines, housing prices are down very little and only after a huge run up. The S&P 500 was up 18.4% year over year as of 6/29/07, offsetting much of whatever decline in home values consumers may have experienced recently. In fact, during the first quarter alone, total (U.S.) household *net* worth increased by 1% (but that's \$587 billion) to \$56.2 trillion. Unemployment is a low 4.5%; jobs and income are expanding; and consumer confidence remains at decent levels in spite of the usual steady diet of bad news. (The *Wall Street Journal* recently ran an article worrying about how bad things could get if consumer spending *doesn't* slow. Really!) The ISM indices (manufacturing and service) are above 50, signifying continued economic expansion, and while orders have been so-so, backlogs are bulging.

It seems like each and every smidgen of economic news leads to a change in the economic outlook, but MBI continues to focus on the *big* picture which looks pretty good. Global economies have been terrific with 120 countries around the world growing at more than a 4% rate in 2006 for the fourth year in a row. Global economies are becoming more important since U.S. GDP isn't as dominant as it used to be. Twenty years ago the U.S. economy was over 40% of the world's output; it is now 25%. Exports are one of the largest and fastest growing parts of the U.S. economy. Xenophobic protectionism, however, is increasingly in fashion.

MBI is less fearful about the economic outlook than we are about the possibility of more inflation. We are greatly relieved to learn that if you don't eat or use energy the core rate of inflation is close to the upper end of the Federal Reserve's comfort level. (And, if you don't have to educate anyone or avail yourself of health care, inflation is even lower.) Why, if these trends continue, the Fed can start worrying about *deflation* again. It was several years ago that the Fed first started worrying about *deflation*, lowered the Fed funds rate to 1%, and left it there for a year. This led to the creation of all the liquidity that helped fuel the housing boom, lifted home prices, and led to the growth of the "sub-prime" lending market. This "liquidity" also fueled the private equity, hedge fund, emerging market, and junk bond crazes. None of these are bad in and of themselves but can cause problems when things get overdone as they almost always do. The global economic expansion is for real, but rising prices could lead to problems.

Interest Rate Outlook

The Fed's reaction to rising prices and the economy is always critical — though not as important or powerful as it used to be — because the Fed is still the 800-pound gorilla of the financial markets. The Fed increasingly has to pay attention to what other central banks are doing. And most of them are still raising rates. The Fed sets the table for the U.S. bond market, or more precisely, sets short-term rates off which the bond market keys. James Carville once said that he

would like to be reincarnated as the bond market so that he could intimidate everybody. Popular economic and investment folklore has the recent rise in interest rates wrecking the economy and investment markets. You'd think that a 5% yield on the 10-year U.S. Treasury is the next bird flu pandemic, and it may well be.

In what will surely be considered one of the worst calls of recent times, *Business Week's* February 19, 2007, cover story was, "It's A Low, Low, Low Low-Rate World." The UST 10-year yield was 4.69% on 2/16/07 and closed at 5.03% on 6/29/07 after hitting 5.29% on 6/12. Only time till tell if this forecast of low interest rates for a long time will match *Business Week's* famous "Death of Equities" issue which happened some 25 years and 12,500 Dow Jones Industrial Average points ago.

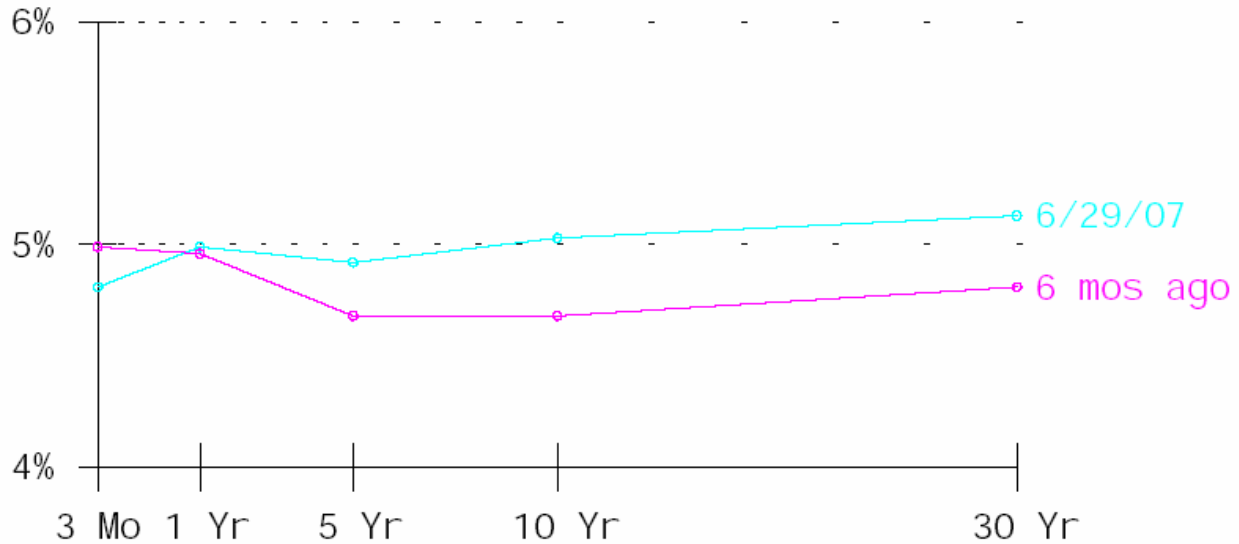
Shown below is a 20-year chart of the yield on the 10-year maturity U.S. Treasury bond. It looks like it may have put in a significant bond bottom and that rates may have started back up.



Many claim that the era of cheap credit may be over with a lot of problems resulting. We'll see.

From a short-term point of view, Montgomery Brothers sees the change in the slope of the yield curve as more significant. Shown below is the yield curve as of the end of June 2007 and as of year-end 2006.

Treasury Yield Curves - 6/29/07



The increase in longer-term rates and steeping of the now positively sloped yield curve indicates to us that economic growth is likely to accelerate and possibly inflation too.

From a fixed-income investor's point of view, the bond market has gone from *Zzzzzzz* to *Eeeeeee*! Longer-term investors have seen a decline in the value of their holdings while short-term investors have seen a decline in their yields. Pretty much the worst of both possible worlds. If longer rates continue north, short rates continue to trend south, and spreads continue to widen, it will remain an unhappy time in bond-land.

Stock Market Outlook

As far as Wall Street is concerned, the Bear is the most feral of beasts. While some are forecasting that the recent rise in interest rates heralds the arrival of the Bear, Montgomery Brothers believes that the stock market outlook is more like a cat — skittish, unpredictable, and all over the place. So far, this year has been better than most expected, and even though the third year of a presidential cycle is historically the best of the four, many would be happy to take the money already earned this year and run.

We do not think it is coincidental that the recent stock market rally peaked on virtually the same day that the *Wall Street Journal* published an article stating that stock prices may not be as high as they appeared at the time. Having the normally bearish WSJ talking nice about the stock market makes us nervous. If Alan Abelson of *Barron's* turns bullish, we'll be headed for the exits — *big time!* The bullish case for stocks rests on the pillars of continued growth,

corporate profits, reasonable valuations, and favorable supply and demand factors. A slowing economy with inflation still too high would further slow the growth of corporate profits. (But corporate profits are at record levels with record profit margins and returns on equity.) Rising interest rates would not only negatively impact valuation but also hurt the demand for stocks. A good part of the bullish argument for stocks has been that private equity investors and corporations have shrunk the supply of shares outstanding and put cash into the hands of equity investors who have to recycle the money back into a reduced supply of shares. Good stuff! Private equity usually leverages their purchase of companies with (hopefully) cheap debt, and corporate share buybacks are often financed by debt. More expensive debt might reduce both sources of demand and reduce the shrinkage in supply. Congress is looking to raise taxes on private equity which further clouds the picture.

Until recently, greed had trumped fear in the stock market, but things seem to be changing a bit. In his 2006 annual report, Warren Buffett wrote, “Be fearful when others are greedy, and be greedy when others are fearful.” Montgomery Brothers thinks that the long-term positives outweigh the negatives, but that a little short-term fear is advisable. We are reviewing our holdings with a particular eye on weeding out those investments which have not worked very well and for those that have worked so well that they may be ahead of themselves.

MBI is not expecting a bear market but we are expecting a “cat market.” Volatility is back and with it a reduction in the complacency many had shown toward the risks always inherent in stock ownership. In fact, Montgomery Brothers views risk as the ultimate feral beast. Meanwhile as far as the media goes, we agree less with Tony Blair and more with Dan Rather, who accused the press of “dumbing it down and tarting it up.”

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