WealthHealth
Personal Wealth Management

2007 Mid Year Report

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If the first of half of 2007 has taught investors anything, it is that volatility can be your friend -- so long as you are patient with your portfolio. In both the equity and fixed income markets, we have seen significant volatility in returns on an inter-day, daily, and weekly basis. Much of this volatility is the result of the uncertainty that investors face with regard to the state of the economy. As we wrote earlier in the year in our 2007 Market Outlook, diverse attitudes exist with regard to whether the Federal Reserve will raise or reduce interest rates. This of course depends on the expectation of whether the economy slows and rates are reduced, or whether inflation continues to rise, thereby forcing the Fed to raise rates. At the beginning of 2007, we believed the economy was "not to hot, not too cold" – characterized as a "Goldilocks" environment for the state of the market. In fact, as the chart below indicates, the message that the market clearly provided us in the first half of 2007 is that the economy is doing much better than Wall Street had anticipated earlier this year.

				Annualized Returns	
Index	**Quarter-To-Date**	**Year-To-Date**	**1-Year**	**2-Year**	**3-Year**
S&P 500	6.28%	6.96%	20.59%	14.45%	11.68%
Russell 1000	5.89%	7.18%	20.43%	14.62%	12.34%
Russell 2000	4.42%	6.45%	16.43%	15.49%	13.45%
MSCI EAFE	6.67%	11.09%	27.54%	27.31%	22.75%
Lehman Brothers Aggregate	-0.52%	0.97%	6.11%	2.59%	3.98%
Lehman Brothers Municipals	-0.66%	0.14%	4.70%	2.78%	4.56%
Dow Jones AIG Commodity	-0.13%	4.46%	2.95%	10.26%	9.69%
CSFB/Tremont Hedge Fund	2.02%	5.43%	12.95%	12.90%	11.39%

As the chart indicates, equities extended their gains this year as broad market indexes like the S&P 500 & Russell 1000 hit new all-time highs (and at the time of this writing continue to post new highs with continued volatility) while the fixed income markets got hammered. We saw the 10-year Treasury yield surge during the second quarter, adding volatility to a rather calm market to close at 5.03% -- climbing as high as 5.32%. As rates rose, bond prices fell.

Overall, the equity market shrugged off sharp drops in the Chinese stock market earlier in the year and continued to grow in the face of rising oil and gas prices, a weakening housing market, subprime lending concerns, and fears of inflation. As expected, the Fed stayed neutral and kept the Fed funds rate unchanged at 5.25%, as it tried to find a balance between the softening housing market and increasing inflationary risks from a strong global economy.

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The most recent data shows that the economy appears to be growing moderately and that inflation, while still a concern, seems to be easing. The data indicates that "core prices", which strips out food and energy, fell below 2% and into the Feds comfort zone. As such, the economy appears at a level the Fed hoped it would be, with growth gradually slowing, easing inflationary pressures, and low unemployment.

While globalization is and will likely remain a powerful tailwind for the equity and commodity markets, risk is inherent in the fact that this global growth can turn inflationary. This raises the questions: Will long-term bond rates continue to rise? Will the latter part of 2007 continue to reward equity investors as it has in the first half of 2007?

As we write this piece we see that these questions may have already been answered as the equity markets have experienced a significant retreat from their previous highs. This has resulted from worries over the continued decline in the housing market and the concern over various mortgage obligations and their credit quality.

Despite the recent declines, if consumer spending continues its resilience in the face of a downturn in the housing market and high gasoline prices, while at the same time merger deals continue their pace and the global economy continues its steady expansion, we foresee a very favorable environment for equities and economic growth. We expect the drag on consumer spending from weak housing prices to continue, causing the US consumer to retrench. However, as long as the labor market holds up, consumer spending growth should slow rather than collapse. Although investors may be more cautious, a tremendous force behind this recent bull market has been significant liquidity, as evidenced by share buy-backs, mergers and acquisitions, and private equity deals. The question is, how long can this continue and will the easy access to credit which has funded these deals start to dry up? Will it be tomorrow or five years from now before this phenomenon finds itself over? We shall see.

We expect the Fed to maintain a cautious "wait and see" approach to changing interest rates for the latter part of the year, as the economy seems to be gradually slowing and inflationary pressures seem to be in the Fed's comfort zone of 2%. We expect volatility to persist, as investors try to figure out if this pace can continue or whether inflation will rear its ugly head.

Will volatility continue to be our friend or our foe? Although the lack of a glass ball leaves this question unanswered, we do believe that the best solution for uncertain times is a diversified portfolio designed to meet your specific risk tolerance, income needs, and long-term objectives. Designing a diversified portfolio to meet both your financial and emotional needs is what we do here at Wealth Health.