

# March 31, 2007 Market Commentary and Outlook

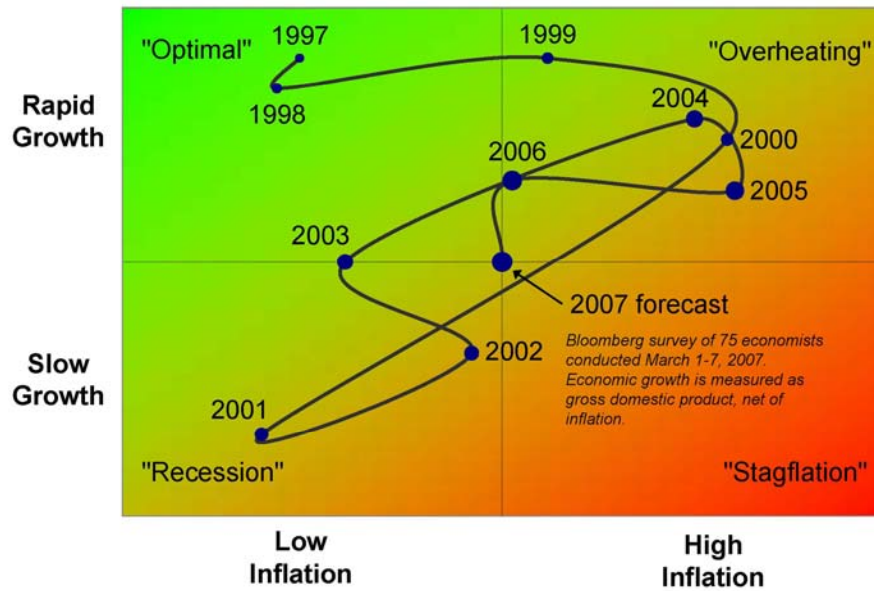
## A Good Time to Call a Time Out?

In competitive sports, the last few minutes of a game can sometimes stretch out to what seems like an eternity. By using time outs and clock-stopping tactics, a team can gain time to strategize, regroup, and sometimes even reverse a game's outcome.

In the "game" of economics, the clock never really stops. However, using a variety of tactics, economic players (such as the Federal Reserve) can often postpone or influence what would otherwise be an inevitable outcome.

For example, during the difficult post-9/11 period, the Federal Reserve cut interest rates to below 2%, and promised to hold them there for a "considerable period". This extended monetary "time out", which lasted for *three years*, was a success – it gave the U.S. economy, which is often compared to a supertanker in terms of maneuverability, ample time to turn around and rebuild momentum.

## Economic Growth and Inflation



The U.S. economy recovered with such vigor that by 2006, the Federal Reserve became concerned that inflationary pressures were building. It responded by lifting the fed funds rate (a rate at which banks lend to each other) to 5.25%, a rate that it believed would quell inflation while permitting moderate growth.

As 2006 drew to a close, forecasters struggled to assess how the U.S. economy would respond to the Fed's actions. Had it raised rates too fast? Had it raised rates enough? Would additional rate hikes be necessary?

In the accompanying chart, we show the historical annual relationship between economic growth and inflation. In recent years, we've seen the U.S. economy move from a near-"Overheating" condition to a more moderate state. According to a recent Bloomberg economic survey, forecasters are calling for some additional economic slowing in 2007, with little change in inflation. Should this forecast materialize, we could experience a soft landing. However, if the economy were to slow more than forecast, a recession or stagflation could result.

In recent weeks, we've seen a number of news items that are consistent with economists' predictions of an economic slowdown:

- Feb 27: U.S. durable-goods orders plunge steeper-than-expected 7.8% in January
- March 2: Stocks close worst week in 4 years
- March 5: Greenspan sees one-third chance of recession in 2007
- March 6: U.S. factory orders suffer biggest monthly decline since 2000
- March 13: Home foreclosures at record high; subprime delinquencies rise to 13.5%
- March 16: S&P 500 earnings are expected to grow just 6.6 percent in 2007, the slowest year for growth since 2002
- March 26: U.S. new-home sales fall to seven-year low in February
- March 28: Iran standoff plagues oil prices
- March 28: Federal Reserve Chairman Ben Bernanke says inflation remains the Fed's main concern
- March 30: Dollar tumbles after U.S. imposes sanctions against China

Does the data indicate the soft landing will be a bit rougher than expected?

## Positives for Stocks

Despite the recent disconcerting headlines and choppy stock results, there are a number of reasons to believe equities can move higher in coming years (although not necessarily in a straight line). Consider the following arguments:

- **Low bond yields.** Low bond yields have been very beneficial to corporate income statements, as corporate borrowings have been refinanced at exceptionally low rates. If interest rates remain low or decline, stocks' earnings and dividends are likely to continue to draw investors away from cash and bond alternatives.
- **The Federal Reserve has more "time outs".** With the fed funds rate at 5.25%, the Federal Reserve has plenty of room to lower interest rates, and it may do so within the next few months. Should the Fed begin to hint at the possibility of a rate cut, a new round of anticipatory stock buying could begin.
- **Reasonable valuations.** At a Price/Earnings Ratio of 17, U.S. stocks are valued near their historical average, and well below previous highs.
- **Stock buybacks.** In 2006, strong S&P 500 corporate profitability fueled a record volume of stock buybacks. Repurchases took \$430 billion of shares (3.4% of outstanding share value) out of public hands, boosting the Earnings per Share (EPS) of the remaining outstanding shares.
- **Mergers, acquisitions, and private equity buyouts.** Global mergers and acquisitions topped the \$1.2 trillion mark in the first three months of this year; the busiest first quarter on record. Powered by a seemingly limitless capacity to raise funds, private equity firms have taken a market leadership role, transforming public companies into private entities. As companies merge or are taken private, new efficiencies and pricing power can emerge, supporting stock prices.

## Portfolio Perspective

By holding a variety of asset classes and focusing on long-term investment results, an investor can minimize his or her susceptibility to the short-term fluctuations in any one market.

The practice of spreading money among different investments to reduce risk is known as diversification. It is based on the notion that different asset classes tend to behave differently over time. By picking the right group of investments, you may be able to limit your losses and reduce the fluctuations of investment returns without sacrificing too much potential gain.

## Setting Your Risk Expectations

After the strong stock market results of 2003-2006, it is easy for investors to become complacent regarding investment risk. While it is impossible to predict precisely what the future will bring, a review of the past 81 years of S&P 500 Index data can provide a useful perspective:

# Years S&P 500 advanced:	58
# Years S&P 500 declined:	23
# Years S&P 500 declined more than 10%:	10
# Years S&P 500 declined more than 20%:	5
# Years S&P 500 declined more than 30%:	2
# Years S&P 500 declined more than 40%:	1

*S&P 500 is an index of predominantly large cap U.S. stocks. Observation period: 1926-2006.*

We encourage investors to remain cognizant of market risks when selecting a portfolio. The recent four-year streak of positive S&P 500 returns is unlikely to continue indefinitely.

Investment Committee  
Northwest Capital Management, Inc.  
April 2, 2007

*Past performance is no guarantee of future results. This article has been distributed for educational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Opinions are subject to change without notice. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Northwest Capital Management, Inc. Northwest Capital Management, Inc. is a firm registered with the Securities and Exchange Commission. ©2007, Northwest Capital Management, Inc.*