April, 2007

2007 First Quarter Update

Review: Stocks barely rose in the quarter, up 0.8%. Bonds fared better, increasing by 1.6%.

	1Q07	***4Q06***	***3Q06***	***2Q06***	***1Q06***
S&P 500 Index	***0.8%***	6.6%	5.7%	-1.4%	4.2%
Merrill Lynch Intermediate Bond Index	***1.6%***	1.0%	3.2%	0.2%	-0.3%

The Economy: At the end of the first quarter, economic trends continue to point toward moderate growth, but with signs of slowing. Unemployment is low at 4.4% and retail sales have been good. On the negative side, the housing market continues to weaken, energy prices remain high, and business activity has slowed.

We believe the key determinant of US economic performance is consumer confidence, since consumers account for two-thirds of all economic activity. The most significant factors supporting consumer confidence are the availability of jobs and the so-called "wealth effect."

One warning sign is the downward trend in job creation. A troubling development is the apparent pullback in capital spending by businesses, indicating a lower level of confidence in the economic outlook. This may foreshadow a reduction of new hires.

For most consumers, the value of their home is the largest part of their net worth. Until last year, home prices had been rising rapidly, making consumers feel more "wealthy" and providing home equity that could be tapped at low interest rates to support consumer spending. Events in the housing market have undermined both of these factors.

The unwinding of the sub-prime mortgage market threatens to spill over into the prime mortgage market. According to Lehman Brothers, there is an estimated $1.2 trillion in sub-prime mortgages. Another $1.2 trillion of mortgages in the next tier are higher rated, but not of prime quality. For perspective, the total of mortgages outstanding is approximately $8.5 trillion. Therefore, about 28% of the outstanding mortgages- a significant portion- are of lower quality. The delinquency rate for sub-prime mortgages is approaching 10% and has doubled in the past year for the other $1.2 trillion of mortgages in the next tier. The net result is that lenders are tightening credit standards for all borrowers, putting pressure on prices, which means there is less equity value to extract.

In an earlier Investment Update, we estimated that the net drag on consumption due to reduced ability to extract equity value from homes would be about $50 billion in 2007. Now it appears that the drag will be significantly higher.

Taking all of these factors into account, we expect consumer spending to grow at 2.0-2.5%, this year, down from the 3.1% for 2006. With slower consumer growth and sluggish capital spending growth, real GDP will also likely slow, from 3.4% in 2006 to 2.5% this year. While these numbers do not indicate that the economy is headed into a recession, there is not much cushion to absorb additional shocks.

Stock Market: After a strong start, stocks fell back, ending the quarter virtually unchanged. Weighing on the market were concerns about a slowing economy and the collapse of the sub-prime mortgage market.

Bond market: The Federal Reserve Board indicated that it is still concerned about the risk of inflation and, as a result, kept short-term interest rates unchanged at 5.25%. Bond prices rose toward the end of the quarter as estimates of economic growth were lowered. We still do not find current bond yields attractive. Therefore we plan to keep the average maturity of our bond portfolios short.

Strategy: With the decline in the housing market, the current US economic cycle faces its most serious challenge since the days following the terrorist attacks in 2001. Offsetting the US outlook is continued strong global growth, especially in Asia. For companies with a high percentage of international business, profits from abroad may be strong enough to offset softness at home. Also, the valuation of the market is reasonable with the S&P 500 trading at 15.5x 2007 earnings, which should be a mitigating factor. We still believe that stocks should continue to outperform bonds.

We have increased our exposure to stocks that can grow earnings in a slower economic environment. Examples are consumer staples and healthcare. In the more economically sensitive sectors, such as industrials and information technology, we are focusing on companies with a high percentage of exposure to international markets where the growth prospects are still strong.