

# Courier Capital Corporation

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## Market Review & Update

SPRING 2007

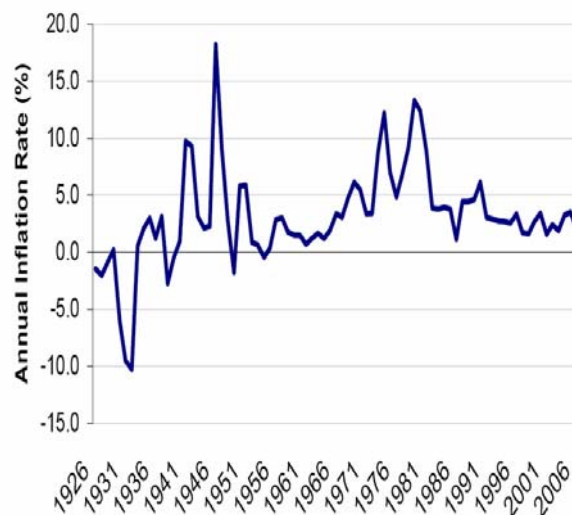
The first quarter of 2007 reminded investors that the equity markets will correct from time to time. In February we saw an end to the longest stretch in 107 years that the Dow Jones Industrial Average had not declined by 2% or more in a single day. The last occurrence was May 19, 2003. It's important to emphasize here that this correction, and basically every other one that has ever occurred, is good news for US markets. Why? As the historical anecdote correctly notes, "good markets climb a wall of worry". Excessive levels of optimism can be just as destructive to investment fundamentals as excessive pessimism. What does a correction accomplish? First and most obvious, it simply makes stocks cheaper. By doing this it causes investors to re-examine their attitudes about risk (always a plus, as the average human will inevitably love stocks more as they become more expensive, and become more timid as they decline), causes weak speculators to go home, and refocuses attention from momentum to fundamentals. As Warren Buffet once quipped, the NY Stock Exchange is the one market that shoppers will avoid when there is a sale...And, as a gentle reminder that corrections are built on a foundation of opportunity, all major market averages worldwide have since risen to 6 ½ year new highs as investors digested the latest economic metrics and corporate earnings releases. As we have previously cited, large US companies remain at the most attractive valuations compared to their smaller and foreign brethren. This discrepancy will continue to evolve into market leadership for the larger US concerns.

Some of the underlying issues relating to this correction that were highlighted by the media (people love to hang a reason on a correction, sometimes they just occur...) include: the sub-prime mortgage lending default reports; Federal Reserve concerns about inflation; geopolitical energy issues and rumors in China relative to future capital gain tax creation. We will deal with the sub-prime mortgage lending later, but with respect to inflation, it appears reasonably well contained as shown not only in the inflation readings themselves (Figure 1), but also in low interest rates found in the bond market which reflects investors' views of future inflation. (Figure 2) This should enable the Fed to begin to lower short term interest rates later this year.

Figure 1. Inflation appears to be contained

Figure 2. Interest rates are still relatively low

### Historical Inflation



Source: Ibbotson

### Near Lows for Historical Interest Rates



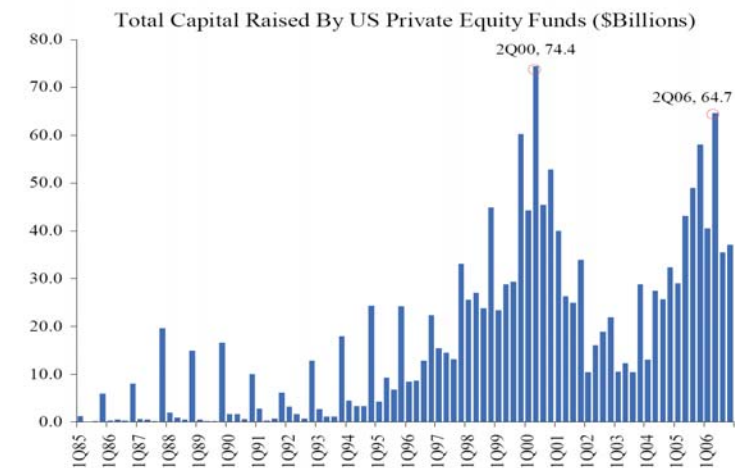
Source: Federal Reserve Board, US 10 year Note at Constant Maturity

Supporting the view that the US markets still represent a good investment opportunity, the first quarter of 2007 also saw the largest leveraged buyout (LBO) in history with the \$45 billion privatization of the utility TXU. This was the second record-setting deal in three months. In fact, eight of the top ten LBO's in history have been announced since June 2006, and in total,

leveraged buyouts amounted to a record \$420 billion in 2006 (Figure 3). On a combined basis, private equity firms control an estimated \$2 trillion in total buying power which would be enough to take 10% of the entire US equity market private.

Figure 3. Private Equity deals supporting market

**Private Equity Levels Moving Toward 2000 Peak Levels**



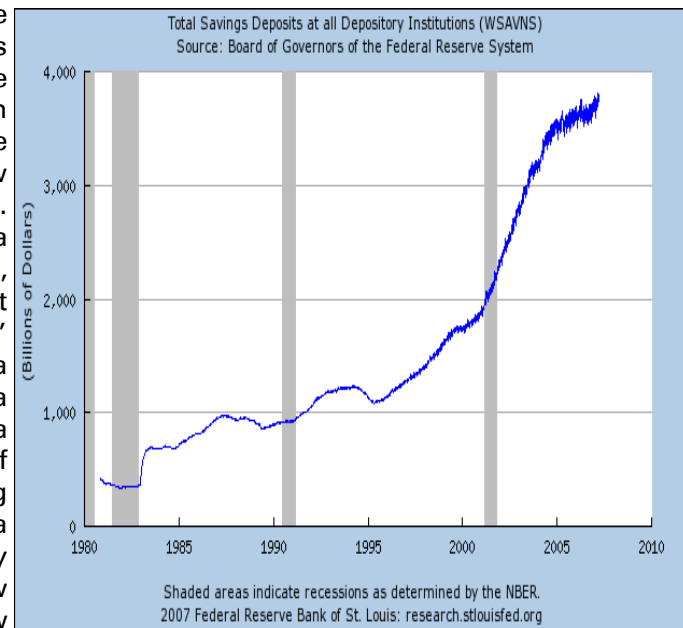
Source: Thomson Financial, Haver, Morgan Stanley Research

Another under-reported point supporting today's market is the fact that individual investors are sitting on a record stockpile of cash in the form of savings and money market funds (Figure 4). We have highlighted in previous letters the record cash position of US corporations, but this is also the case for individuals. This is a curious piece of data, as it coincides with the one major piece of negative data we could find, margin debt. Margin debt is now at fairly high levels. Normally, this would signal that stocks are overbought. We doubt that this time. First, as we have noted, valuations are certainly in the realm that would make us conclude that the equity markets are slightly undervalued. And, more notably, the aforementioned level of cash held by individuals is at a record high. Why would investors have high margin debt when they have cash??? The answer could well be debt substitution. What does that mean? In recent years, Americans have gravitated to more widespread use of home equity lines of credit (HELOC) as substitutes for higher cost credit card debt. After all, interest on the first \$100,000 of HELOC debt is deductible. But you may have seen press over the last year or two describing how many more people are being drawn into alternative

minimum tax status (AMT) each year. The value of HELOC deductions are lost or diminished for AMT taxpayers, but margin or investment debt remains deductible even if an investor falls into the widening AMT trap. So, we could actually be witnessing a flow of HELOC debt into the margin arena. This would certainly begin to explain investors with high cash levels while simultaneously having margin balance. So, we must look at the margin debt level we see today with a cautious eye.

The sub-prime news that garnered so much attention in the press is worth focusing some time on. Concern becomes high when mortgage defaults begin to accelerate, as it historically is reflective of workers being hurt by a bad economy and job market, thereby rendered unable to pay their debts. This time it is indeed different. Product, rather than economy, has driven this cycle. What do we mean? Let's first note that we are in a period of very strong job growth and historically low unemployment, so the normal root causes of default are not present. This time, the default rates seem to be caused by two factors. First, a public that could see only future gains in real estate prices. Second, lender avarice that led to the creation of exotic mortgage products that offered low interest rates, or interest only payments, that will "adjust" a few years down the road and can potentially result in as much as a quadrupling of a homeowner's monthly mortgage payment. In a normal environment, property owners would simply refinance. But, a decline in property values, coupled with lenders that often lent 100% of property values results in investors that are "upside down" (owing more on a loan than the underlying property is worth). Facing a quadrupled mortgage payment and being unable to refinance, many who bought more house than they could originally afford are now faced with the default option as their last resort. These loans are now beginning to reset and the news reports of increasing defaults nationwide are due to the greed cycle and a financial industry much too eager to feed into that. So, the sub-prime problem is not as economically indicative of weakness as in the past, and is therefore less likely to be manifesting current economic trouble.

Figure 4. Investor Cash positions at record high



Those two concerns aside, many of the good things we noted in 2006 still exist today. Global economic strength, particularly in China, India, Brazil and the Soviet states are continuing at historically high rates, and this is stimulating economies around the world. The amount of global commerce is creating a global liquidity glut that is allowing for the import and export imbalances to ameliorate for the time being, keeping destructive inflation at bay. Domestically, the US economy is slowing a bit. We should see an ebbing around mid-year followed by an eventual reacceleration into 2008. Corporate earnings have just exited a period of 16 quarters of double digit growth and will slow in a pattern that coincides with economy, reaccelerating to perhaps the teens by early '08. A Fed easing could well occur later in 2007 which would enable an expansion of price-to-earning ratios, which will guide the markets higher.

We'll talk to you soon.....

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