Courier Capital Corporation

Market Review & Update

SUMMER 2007

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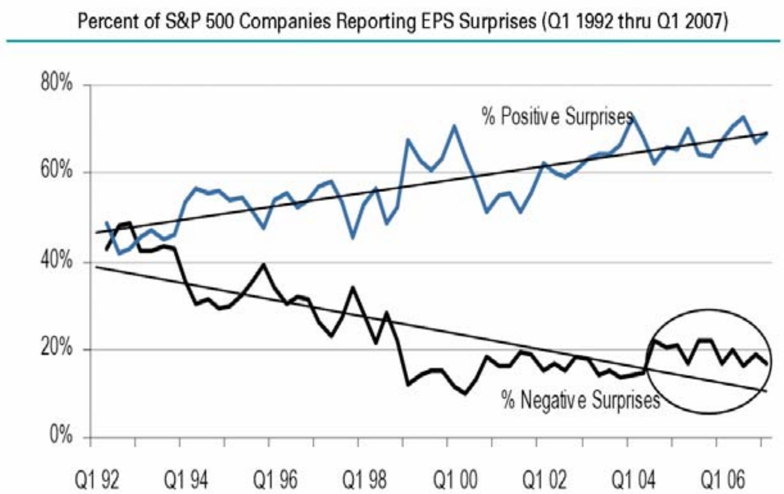
Captivating times in the financial and economic arenas…

Worldwide investment markets continue to bump toward new highs only to be interrupted by the occasional correction. As we have noted previously, the process of the hesitant advance is actually the optimal way for a market to move higher. Hesitance is usually indicative of caution, and caution begets more realistic market valuation than does unbridled enthusiasm. But what's causing all this???

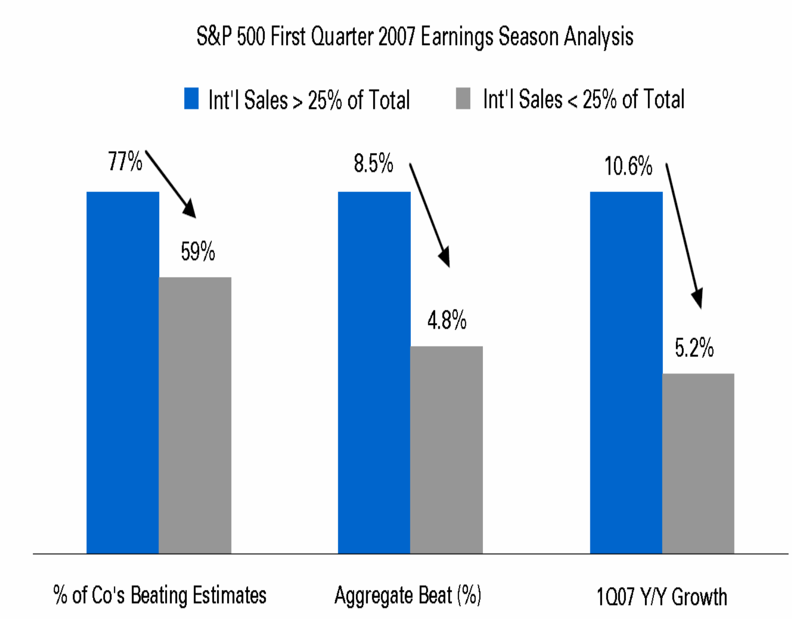
Figure 1. Upside earnings surprises continue



Source: Factset, Thomson Fianancial, Morgan Stanley Research

To begin with, analysts had quite a pessimistic outlook for the economy and corporate earnings in 2007. They were wrong. As anticipated, the economy did trough in 2007; please note the past tense "did". After several years of well above-average cruising, the economy slid to a sub 1% GDP growth rate in the 1st qtr, only to appear to begin its reacceleration more rapidly than forecast. Coincident to this trough is surprising continuance of a corporate earnings growth rate well above expected levels. Thomson Financial calculated that per-share earnings for companies in the S&P 500 Index rose 8.2% in the first quarter from a year earlier, which was significantly better than the 3.2% gain analysts expected in early April (Figure 1). It appears that analysts extrapolated a weaker U.S. economy into weak earnings growth. What wasn't anticipated was the boost to earnings from a weaker dollar and overseas economies thriving despite the U.S. slowdown (Figure 2). Another boost to earnings-per-share has come from stock buybacks. In the first quarter of this year, companies in the S&P 500 bought back $110 billion in stock. This brought the total in the past four quarters to $442 billion which is enough to buy the smallest 100 companies in the S&P 500. Stock buybacks have the effect of increasing per-share earnings as the number of shares outstanding is reduced relative to a company's total earnings.

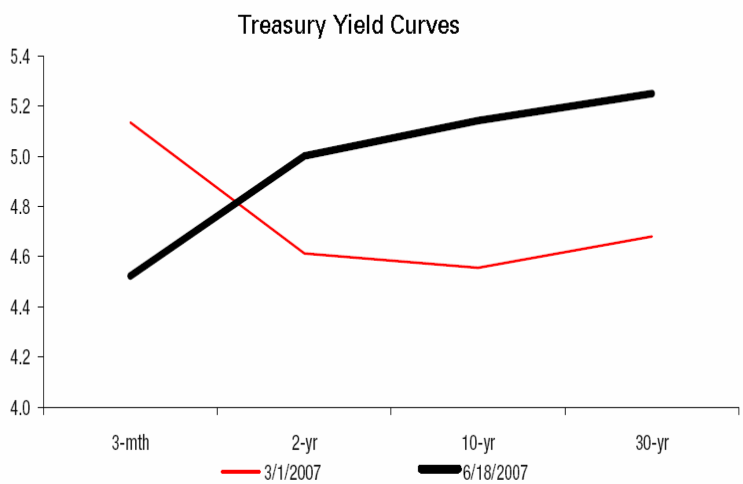
Figure 2. Foreign Growth is Driving Earnings Surprises



Source: Factset, Thomson Financial, Morgan Stanley Research.

The underlying driver to this formidable trend is the persistent power of global growth. We seem to still be in a sweet-spot where the strong global growers continue exporting a measure of deflationary pressure. Quite the opposite effect that one would have assumed. Several noted economists, and

Figure 3. Yield Curve inversion has disappeared

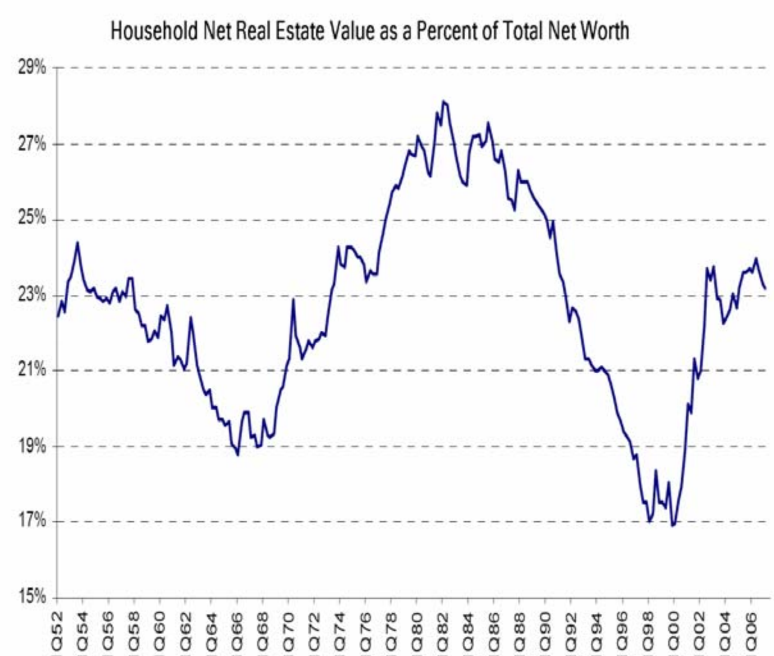


Source: The Yield Book

recently Bill Gross from Pimco Funds, echoed that some key factors have enabled this conundrum. Add a few billion new workers into the freer-trade economic environment, toss in some enabling technologies that make geographic and time obstacles fade into history, and make markets less restricted and more open on a relative basis and you get what has been called an acceleration of returns on capital at the expense of diminishing returns to labor. In short, you have exported lower costs. We have all witnessed an inability to raise wages as the fear of job exportation overrode normal greed impulse. This trend is indeed finite, but could very well continue as long as the growth rate of these net adds are foreseeable. It could last for a few more years. Then what happens??? Well, as the slack you added to the system begins to tighten, the cost constraints produced will begin to fade and increasing inflation assumptions will manifest. So, while inflation will ultimately be the coincident partner on the strong global growth journey, we seem to be enjoying some slack for this interim.

During some of the aforementioned corrections this year, you may have noticed that long term interest rates have likewise been on a bit of a wild ride and perhaps have been the cause, or at least a simultaneous symptom to the change in future outlook we have just discussed. For about two years we have talked about global growth and the strong export/import relationship between the US and places like China. The U.S. and worldwide consumption of these cheap goods created a orrent of global excess liquidity, a.k.a. huge piles of cash. The cash went into bonds, primarily those of the US. Our yield curve may well have been inverted (long-term yields below short-term yields) for that extended period because of the excessive demand created by the cash hoard seeking a stable respite. In just a few short days this year, the interest rate curve adjusted quite violently (at least in the normally tediously slow world of bonds) and now the curve has been "normalized" with short-term yields below those of longer maturities (Figure 3). Why did this happen? Perhaps some of this was about shifts in inflation expectations, but not likely here... Interest rates have been chugging higher around the world. There may be a few regions around the world that are insisting on beating us to the end of slack in their systems and may be portending a nearer term increase in their own cost structure. In that race, we are happy to lose. And yet, given the entangled nature of global exchange rates, as rates go up there the U.S., at some juncture, must follow lest we pine for a punitive "adjustment" in the exchange rate for the dollar. And so we don't forget, a punitive drop in the dollar begets a rather instantaneous tick up in inflation as it suddenly costs more to buy goods from abroad...

Figure 4. Home equity still under 25% of total net worth



Source: Haver Analytics and Citigroup Investment Research - US Equity Strategy

The sub-prime mortgage and housing markets have continued to garner bad press, but one largely ignored aspect of this story is that home equity still represents less than 25% of the average individual's total net worth (Figure 4). The ongoing worry is that reduced mortgage equity withdrawals or slowing home price appreciation will slow consumer spending. But studies have shown that spending tends to be much more closely linked with job growth which has continued to be strong with unemployment still at 4.5%. Also, recent surveys have found that the default rate on fixed rate sub-prime mortgages have remained low. The real area of concern is more exotic mortgage products such as "interest-only" and adjustable rate mortgage loans which are beginning to re-set from extremely low "teaser" rates to interest rates that more accurately reflect not only the credit-worthiness of the borrower but also the current interest rate environment. The fortunes of the housing, equity, and bond markets will depend largely upon the direction of interest rates for the foreseeable future. And so, Ben Bernanke and the Fed, with their continuing focus on inflation casting uncertainty upon the 2007 path for interest rates have clearly, for now, put the captive in captivating...

We'll talk to you soon....