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Fed In The Box

The Federal Reserve has always maintained that its primary responsibility is to ensure that the broad economy avoids the potential traps that could lead to a long-term collapse. The most recent focus of the Fed has been the residential real estate market that became the target of the interest rate hikes that were intended to slow the expanding bubble in home prices. The increase in rates had the desired effect as the new concern for the Fed has become negotiating a soft landing as real estate prices have fallen sharply, especially on the East and West coast.

Since the Fed is no longer raising rates at this time, it has been anticipated that the next move would be to lower interest rates to support the real estate market and to stimulate a slowing economy. However, the Federal Reserve is now between a rock and a hard place as we are seeing signs of higher inflation, primarily due to rising wages as unemployment has fallen to 4.4%. Cutting rates could fuel even higher inflation, while raising rates could do further damage to residential real estate and accelerate an already slowing economy.

At this juncture, we believe that the policy makers at the Federal Reserve will be forced to take a wait and see attitude until the real estate market begins to rebound. If inflation becomes a real threat and the prices spike upward, an increase in rates would not be out of the question. The concern is that when prices continue to go up as the economy slows, it can lead to what is known as "stagflation". The financial markets will be watching closely and reacting to the nuances of the signals that the Fed sends in the language of the minutes of their meetings.

The U.S. Consumer...Shouldering The Load...Or Loaded With Debt?

The consumer is seen by most U.S. economists as being the glue that holds together our economy since 70% of our output is spending related. Not only does the appetite for more things impact our economy, but in the past the global economy has been dependent on exporting goods to the U.S. as well. This trend is beginning to change as emerging economies mature. However, while there remains this great responsibility to keep on spending, economists are always concerned with things that can cause consumers to put their cash...or plastic...away.

We believe that when numbers are used in the financial headlines that it is important to look at the statistics in the proper context. Recently, the financial press has been dominated by the topic of "sub-prime mortgages" and the bankruptcy of a major lender. As mortgage rates reached historic lows and more people entered the home buying market, marginal buyers were able to qualify with exotic financing programs. The slowdown in real estate and the drop in home prices has made those mortgages most vulnerable to default. It is a problem for the mortgage industry, but any inference that it will have a devastating impact on our economy should be tempered with the fact that "sub-prime mortgages" constitute less than 12% of all outstanding mortgages.

Another concern of some is that the level of consumer debt as a percent of income is at historic highs. However, when measured as a percent of total assets it is well within normal ranges and over 60% of all homeowners have at least 30% equity in their houses. As long as the labor market holds up and income continues to keep pace, current debt levels should be manageable. Recent measures of consumer spending remain higher than expected...indicating that the U.S. consumer is still able to carry the load.

"Sometimes the best decision we can make is to do nothing, especially in advance of any compelling evidence one way or another.."

Warren Buffett

SUMMARY:

The Fed is between a rock and a hard place, due to a slowing economy, yet higher inflation as well.

In February, both domestic & international equity markets experienced a strong correction.

Interest rate spreads on bonds remain flat, but riskier credit yields are rising.

Emerging economies are less dependent on U.S. consumer as global markets continue to show strength.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- Inflation is expected to accelerate on a year over year basis in the second half of 2007.
- Energy prices have been the culprit in the past and still remain a concern, but the primary focus is now on wage inflation.
- The combination of low unemployment and slowing productivity point to higher prices as companies are no longer able to absorb rising wages with more output.
- However, if the economy slows more dramatically than expected, inflationary pressures will subside quickly.
- Interest rates for the 10 Year Treasury should remain within a range of 4.2% to 4.9% until the slowing of the economy becomes more pronounced.

Economic Output and Direction

- The U.S. economy should grow at a below- trend pace as consumers retrench and businesses stay cautious.
- Most estimates for growth this year range between 2.25% to 3.0%.
- However, strong growth overseas could provide some offset to weaker demand in the U.S., strengthening our exports.
- The economy has shown its resilience in the face of various concerns by not registering a negative growth quarter for more than five years.
- Concerns remain over the impact of the declining residential real estate market on the broad economy...but it is hopeful that a bottom will be reached in the near future.

Business and Consumer Indicators

- The consumer surprised once again as spending got off to a stronger start in 2007 than originally expected with an annualized growth rate of 5.5%.
- The measures of both manufacturing and services declined for the second month to levels that indicate the economy may be hitting a soft spot.
- This is confirmed by small business surveys that show expected economic growth at 2.5% for the year and new hiring expectations being lowered.
- Corporations still have significant cash reserves, but there remains a reluctance to invest in capital improvements, choosing acquisitions and stock buy-backs instead.

Inside The Markets

The Stock Markets

- In February and early March, both domestic and international equity markets experienced a strong correction.
- In the U.S. market, the correction appeared more severe as a result of the magnitude of a 400 point single day decline in the Dow Jones Industrials.
- This initial decline was tied to comments by the Chinese government that they wanted to slow the current growth rate of their economy.
- Interestingly, U.S. stocks rallied sharply on comments by the Federal Reserve that were interpreted as being positive with future rate cuts a possibility.
- Within the market segments, Small Company stocks remain strong, but their higher valuations add risk.
- Consequently, we still favor Large and Mid Cap Stocks, especially those with international revenue sources.
- The international markets continue to show signs of growth, with even Europe looking surprisingly positive.

The Bond Market

- The difference between the yields on short-term versus long-term bonds remains very small.
- This is due principally to the disconnect between Fed policy (short-term) keeping rates high and the global demand (long-term) keeping rates lower.
- Interest rates on high credit quality bonds should stay within a tight range for the near term, but yields on riskier credit issues are rising.
- We believe the best course of action is to keep credit quality high and diversify by using foreign bonds and currencies.

Commodities & Alternatives

- There has been a sharp rise in commodity prices as demand has stabilized and the markets had become oversold.
- Even though short-term volatility could persist, we believe that the long-term trend for rising prices is still in place.
- Commercial real estate in the U.S. continues its uptrend with valuations becoming overextended, causing us to look for better value in international markets.



In the past, we have discussed the changing global dynamics that are impacting the financial markets as new economies emerge and competition increases for both goods and services. We have seen the results in our economy in the form of low interest rates, low inflation, and low unemployment ...things that in the past have not coincided. But in the back of our minds, knowing that the U.S. was the largest capital market and the biggest consumer in the world, we have believed that the global economy still depended on us. This sentiment can be found in the saying, "When the U.S. sneezes, the rest of the world catches a cold". We are beginning to see signs that this burden on the U.S. consumer may be in fact easing.

In a somewhat ironic twist, the U.S. stock markets dropped sharply on what was perceived as bad news out of China, so we will use them as our example of changing trends. Approximately 20% of China's exports go to the U.S., its single largest foreign market. Exports represent 33% of China's economic output and it was originally thought that slowing demand from the U.S. would be a crippling blow. However, most economists now believe that a slowdown in exports to the U.S. would only drop the recent Chinese economic growth rate from 10% to 8%, hardly devastating.

Chinese officials have long believed the economic dependence on exports to be a problem. As a result, there are more frequent attempts to control the rate of growth and to develop other areas to expand their economy. Much of the current boom has come from massive building of new housing, highways and factories...the infrastructure that serves local demand. In addition, there is a growing consumer base that is slowly beginning to spend more and save less, a practice that is being encouraged by government policy makers.

One of the results of the continued maturation of these developing countries is that a soft spot in the U.S. economy will not have a contagion effect on the rest of the world. This allows us time to work through the problems in the real estate market and the ripples being felt in the mortgage industry. We can have a correction in our equity markets and not create a downward spiral in foreign stocks as well.

There are headwinds facing our economy that will have an impact on our financial markets, but we do not believe that the risk of recession is great at this time. We believe that the economy is in the midst of a mid-cycle slowdown, and that equity markets are experiencing a normal corrective phase. When it is believed that economic & market cycles have reached a mature stage, based upon the historical averages, then speculation increases about where the "top" is.

Once again, we believe that it is of greatest importance to keep financial data in perspective by looking beyond the averages. When you dig a little deeper you find that conditions that normally choke off an economic expansion...like high real interest rates and a lack of liquidity in the economy...do not exist at present. Market tops in stock prices normally occur when valuations move well above the averages, but at present equities remain reasonably priced.

The original catalysts for the expansion of the economy and the bull market in stocks are no longer there, but the overall environment is still positive and our investment policy will not shift to a defensive posture until warranted. If the Fed "blinks" or the consumer "shrugs", things could change...so we will remain as always ...vigilant.

Best Regards,

Craig Greenway

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