

# The End of a Streak

Will the stock market regain its footing in 2007?

By Paul Woods

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In the first quarter of 2007, the string of positive returns for the S&P 500 Index that started in June 2006 finally came to an end in February 2007. That might not sound like much, but the last string of eight months of positive returns ended in 1995. This streak was brought to an end by shock that borrowers with poor credit who were lent too much money at the top of the housing bubble were having trouble paying it back. As it was possible to get loans for more than 100% of purchase price at the peak and housing prices have subsequently declined, some of the rest of us are surprised the problem isn't bigger.

We also had the usual gibberish about the economy and inflation from various past and present members of the Federal Reserve. Inflation is a problem, or it isn't, or we aren't sure. Economic growth might be slowing, or probably will slow, or might be stable, unless it picks up a bit. It's fascinating to watch a big move in the stock market every time one of these statements are made, which gives the impression most investors are as confused about the economy as everyone else.

Toward the end of the quarter, Iran found that capturing a few British sailors was a good way to get higher prices for their oil. After briefly visiting \$50 per barrel in January, oil prices ended the quarter above \$65 per barrel and appear to be in another uptrend. The combination of rising oil prices and more Democrats in Congress pushed alternative energy to the top of the list for industries, while growth finally outperformed value, and medium sized companies were the place to be. For reference, here's the stock market segment scorecard for the first quarter.

	<u>Symbol</u>	<u>12/29/06</u>	<u>3/30/07</u>	<u>% Change</u>
MidCap Growth	IJK	79.71	84.13	5.55%

MidCap	IJH	80.17	84.60	5.53%
MidCap Value	IJJ	79.24	83.53	5.41%
Small Cap. Growth	IJT	127.96	133.60	4.41%
REITs	VNQ	77.00	79.35	3.05%
Small Cap.	IJR	65.99	67.91	2.91%
Small Cap. Value	IJS	75.34	76.71	1.82%
Large Cap. Value	IVE	76.89	77.60	0.92%
Microcap	IWC	58.45	58.81	0.62%
Large Cap.	IVV	142.00	142.34	0.24%
Large Cap. Growth	IVW	64.92	64.63	-0.45%

Source: Thomson One Financial

In addition, here's the stock market index and industry group scorecard for the same period:

	<u>Symbol</u>	<u>12/29/06</u>	<u>3/30/07</u>	<u>% Change</u>
Dow Industrials	INDU	12,463.15	12,354.35	-0.87%
Nasdaq Composite	COMPQ	2,415.29	2,421.64	0.26%
S&P 500 Index	SPX	1,418.30	1,420.86	0.18%
Clean Energy	ECO	182.06	197.43	8.44%
Utilities	SPUT	186.60	202.34	8.43%
Transportation	TRAN	4,560.20	4,810.70	5.49%
REITs	RMZ	1,090.63	1,118.95	2.60%
Energy	SPENS	455.53	463.37	1.72%
Consumer Staples	SPCNS	268.41	272.68	1.59%
Biotech	BTK	754.25	764.18	1.32%
Capital Goods	IXI	352.16	356.78	1.31%
Health Care	HCX	388.74	391.16	0.62%
Basic Industries	SPIN	322.63	324.52	0.58%
Consumer Services	SPCCS	302.92	299.93	-0.99%
Technology	SPHTI	356.28	352.33	-1.11%
Financials	SPFN	495.31	478.27	-3.44%
Commercial Services	SICSS	200.59	193.65	-3.46%

Source: Thomson One Financial

During the first quarter, yields on 3 Month Bills were slightly higher at the end of the quarter while yields on intermediate bonds dropped. The Fed

kept interest rates unchanged and softened its reference to the need for higher borrowing costs in a statement announcing its decision to keep its target rate unchanged for a sixth straight policy meeting.

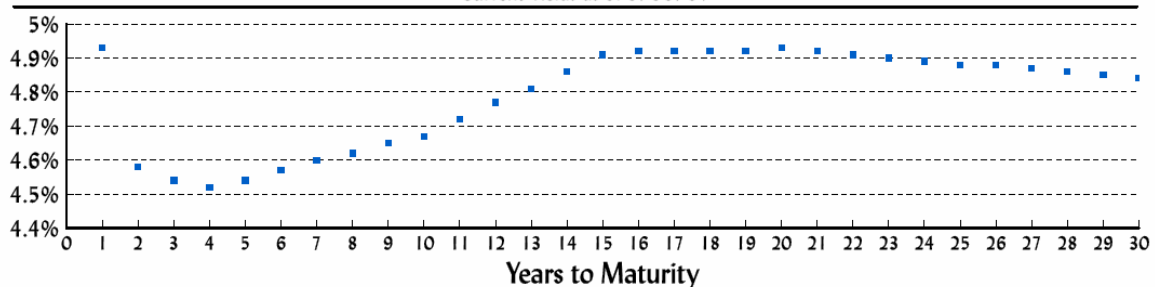
<u>Current Yield</u>	<u>12/29/06</u>	<u>3/30/07</u>	<u>% Change</u>
90 day Treasury Bills	5.02%	5.04%	0.4%
5 Year Treasury Bonds	4.70%	4.54%	-3.4%
10 Year Treasury Bonds	4.71%	4.65%	-1.3%

Source: Bloomberg LP

The yield curve remains a tribute to bureaucratic meddling as yields on the short end are clearly too high. Our opinion is that although there are some risks to the economy, growth will continue and the Federal Reserve will either keep rates where they are or lower them slightly by the end of the year. Our portfolios remain higher in quality and of intermediate maturity to capitalize on improvements in return in that area of the yield curve.

### Treasury Bonds

Current Yields as of 3/30/07



Source: Bloomberg LP

Helped by the modest decline in interest rates, bonds mostly outperformed stocks in the first quarter. While we added to 3 and 4 year U.S. Government Agency bonds during the quarter where spreads were most attractive, we did not add to Treasury holdings. The yield spreads between corporate and Treasury bonds have tightened although the concern about the sub-prime mortgage market may cause spreads to start going the other direction. Municipal bonds in California continue to be under pressure and a huge recent offering produced higher yields. However, the huge demand for California municipals coupled with the lower quality

versus other states still makes them look expensive and unattractive relative to other bonds.

The most recent quarter showed real economic growth chugging along at around 3% with capacity utilization rising a bit. Reported inflation continues to be volatile from month to month, but modest on an annual basis. Earnings growth for the S&P 500 continues to be in double digits, for the fourth year in a row. We expect current problems in the housing market to produce a gradual slowing in economic growth and corporate profit growth for the balance of the year, but don't see a recession on the horizon.

Although the stock market was either up or down in the first quarter, depending upon the index used, the underlying earnings continued to grow. The result was that an undervalued stock market got a bit cheaper. The stock market now appears to be about 18% undervalued relative to the yield on 5 year Treasuries, according to our model. We don't see much competition for stocks from bonds or real estate at present, and expect some recovery in valuations by the end of the year. We still expect the combination of undervalued stocks and rising earnings to produce double-digit returns in most segments of the stock market in 2007.

Our 2007 Form ADV, Part II is now available upon request. In the meantime, please feel free to contact us if you have any questions or if we can be of any service.

Best regards,

Paul

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