

MCM Market Outlook

APRIL 2007

1st Quarter Letter

Equity markets started 2007 strongly as corporations reported 10% fourth quarter earnings growth. These results, while registering a slowdown, exceeded expectations and pushed stocks higher. February and early March brought a meaningful worldwide correction as the Chinese stock market declined, Alan Greenspan predicted the “possibility” of a U.S. recession and default rates and bankruptcies escalated in the sub-prime mortgage market.

As more information became available, the markets rallied in late March. The Chinese stock market was due for a correction as it was trading at a very high valuation. Their economy however, remains in solid shape. China’s central bank is forecasting 10% growth again this year.

Sub prime mortgages represent 10% of all mortgages in the U. S. Approximately 10% are projected to go into default. Thus, only 1% of all mortgages are at risk, a level which we believe should be contained and not push the economy into a recession. Residential construction has been declining for 18 months and a recovery in this sector may still be a year away.

U. S. economic growth is clearly slowing. Modest population growth and reduced productivity gains indicate an overall growth rate of 2-3% is sustainable. Business activity here will continue to be impacted by strong growth in Asia and an improving European economy. Their unemployment rate, while high by our standards, is down to 7.3%, a 25 year low.

Geopolitical risks are dominating the headlines as tensions in Iraq and Iran have escalated. Oil prices and gasoline prices have risen as a result. Additionally, new duties on paper imports from China may signal a movement towards protectionism. While it is unlikely that there will be a trade war with China (resulting in slower growth and higher inflation), it is a risk to carefully watch.

The last Federal Reserve meeting was quite significant. The press release deleted the reference to a bias toward tightening. That sets the stage for future interest rate reductions as the economy slows. When the Federal Reserve lowers interest rates, the current inverted yield curve that we have been experiencing since mid summer 2006 should return to a normal upward sloping curve.

Stocks are broadly undervalued relative to historic norms and growth companies are the most undervalued component of the market. We expect the companies in the S&P 500 to grow earnings in the mid single digits this year while the companies in your portfolio continue to grow at an upper teens rate. That disparity in growth rates could be the catalyst to draw investors back to the growth sector of the market.