Second Quarter 2007

April 11, 2007

Brian W. Rahlfs, CFA
April 11, 2007

Recent data on durable goods, capital spending, new orders, housing and building permits confirm that the economy is slowing down. These, along with consumer sentiment, tend to be leading indicators of the economy. Lagging indicators -- such as the unemployment rate, other labor data, and CPI inflation measures -- remain stronger however, and are seen by many as reasons why the Federal Reserve is unlikely to reduce rates in the very near term.

Some of the Wall Street research we read agonizes over this "disconnect" between strong labor markets and weakening business activity, but in fact this situation appears consistent to us with the natural historical lag between these different economic indicators.

We mentioned that the cyclical inflation in energy and industrial commodities would now find companionship with a cyclical inflation this year in food and agriculture sectors as well, and one now sees more mention in the media about concerns with food and fiber inflation. Expect this to continue, and just to mention the obvious, these are elements of inflation which do not necessarily respond to Federal Reserve action. It's worth repeating that many of the factors which impact inflation in this decade are driven by the supply/demand metrics of a particular commodity, or by global growth and policies, and not by the domestic monetary policies of the Fed.

We also projected volatility of the US stock market to increase this year, and for the breadth of the advance to become thinner, with fewer and fewer stocks participating in the uptrends, which typically then leads to an intermediate top in the market. Having already seen signs of this increased volatility and narrowing breadth in the first quarter, we will stick with that perspective on the 2007 stock market. In this scenario, large cap stocks will perform better than small cap stocks and securities providing cashflow and dividend yields would seem to have an advantage.

The weakest sector in the US stock market during the first quarter was Financials. We've discussed that the risk of underperformance in banking and credit/mortgage stocks was growing, and in certain portfolios we've worked hard to reduce our exposure to that group, and maintain the outperformance you've enjoyed in recent quarters.

Looking ahead, historically Consumer-sector stocks tend not to perform as well in the second and third quarters of the year, and it will be interesting to watch consumer sentiment and spending in view of the

mortgage default and home foreclosure trends. The Energy-sector stocks still seem to have wind on the sail, but the growing conclusion in our mind (which we've been slow to speak out loud) is this:

The risks of equity values peaking this year are escalating due to a slowing economy and the now weakening financial position of many households.

-Brian

All rights reserved. User assumes entire risk of any use of this information and is advised against such use. Content represents partial insight into our current thinking relative to management of client holdings, and is subject to immediate and frequent change. The website version of this report is subject to disclaimer and notices found at www.RahlfsCapital.com and may differ from custom versions of this report prepared for specific clients. It is possible this analyst or related entities may hold investments which like these opinions are subject to change without notice, with effort to avoid any conflict of interest. This is not an offer or solicitation to buy or sell. This report is a general update intended for the individual families and entities we work with, is not prepared for use by unknown users of unknown jurisdiction, and could not possibly represent custom or actionable advice on any matter.