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THE VIEWPOINT

Summer 2007

The second quarter of the year was one for the record books, both positive and negative. This gave the financial press countless headlines.

The quarter started with the Dow Jones Industrial Average (INDU) continuing its recovery from a 4% drop in late February and early March. By April 18th the INDU was once again above its record close in January of 2000 and was up 2.7% for the year. The INDU closed at record highs for twelve of the next thirteen trading days. Financial headlines everywhere discussed the record high ad nauseam.

Then in late May it was the S&P500's turn. For most of the month the S&P500 would come close to its old high set seven years ago only to pull back. For days financial reporters talked at length about whether it would set new highs and speculated on what would happen next. Finally on May 30th the S&P500 set a new high and continued to rise over the next 4 days.

June has not been as positive for the markets. I heard a teaser on television stating that the third week of the month had been the worst week since March. He forgot to mention the market was still up almost 6% for the year. It is amazing how the financial reporters can make the day to day volatility in the markets sound so exciting.

The movement in indexes is news, but as a portfolio manager the real question is whether the companies we own or are looking to buy are fairly valued and if their earnings are projected to continue their growth. The average company in our portfolios is projected to grow its earnings 16% this year and 14% next year, over twice the average stock in the S&P500.

It is encouraging to note that these earnings projections have been increasing as the year has gone along. Another encouraging sign that the economy will continue its slow pace of growth is the recent development in the bond market. In early 2006 the yield curve (the relation between the interest rate and the time to maturity of the debt) became inverted (see insert). Usually long-term bonds yield more than short-term bonds. There are two reasons

for this configuration. First, the longer a borrower owes money the greater the risk that something will happen to the borrower's ability to repay the debt. The second reason is the time value of money. A dollar received 5 years from now will not be able to purchase as much as a dollar received today. To compensate the lender/investor for this risk, the borrower must pay a higher interest rate.

An inverted yield curve means short-term bonds yield more than long-term bonds. This is an unusual situation. An inverted yield curve typically indicates a worsening economy and often signals a recession. This is what occurred in 2000. First the yield curve inverted and then a few months later our economy entered into recession. Many expected a recession in 2007 because of the yield curve inversion over the last year and a half. Instead of entering a recession the economy has continued to expand and earnings are growing faster than expected. The yield curve has returned to a more normal shape to reflect more positive expectations going forward and the chances of a recession have diminished.

This is good for the stock market and we expect the market to be higher at the end of the year than it is today. This will not happen in a straight line; if it did, the financial press would have nothing to report.

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