

# LARGE-CAP COMMENTARY LETTER FIRST QUARTER 2007

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## Economic Overview

The beginning of 2007's first quarter continued the upward climb from last year's fourth quarter; however, investors saw a significant market sell off at the end of February. Then in March, the market began to rally again. This volatility stemmed from a continued slowing within the residential housing market, sub-prime mortgage concerns, and the short-term unwinding of the Japanese carry trade, catalyzed from rumors of tightening by Chinese authorities. When the dust settled, the market had recovered by quarter end.

The return of high volatility to the market after many months absence served as a "shot across the bow" to investor complacency, which was the product of a steadily climbing stock market without much in the way of corrections. The risk level to stocks has ratcheted up this year due to a confluence of factors. Front and center is the overriding question of just how much the economy will slow. Is it poised to be bad enough to engender a recession and a full blown bear market? If so, could it be avoided, and will the Federal Reserve be the market's savior (by easing interest rates) or nemesis (by raising them still higher)?

In the last three quarters of 2006, the U.S. economy grew at only about a 2.25% to 2.50% real rate, slightly below what is considered its long-run potential. The outlook for 2007 is likely a bit lower than those rates. The Federal Reserve is forecasting a weak first quarter, followed by an uptick, so that the year's growth would come in slightly below the long-term potential. Most market participants seem to expect the Fed to ease interest rates sometime this year, based on an expectation that the primary risk to the economy is a stall. However, the most recently released minutes of the Fed's Open Market Committee show they were concerned that inflation would fail to moderate as expected and that inflation risks remained the Committee's predominant concern. The risk, as ICM sees it, is that the Fed may overshoot the target on inflation protection, and in turn, choke the economy into a recession with a tight money policy. Normally, a weakening economy reduces the need to raise interest rates, assuming an increase in inflation does not coincide with slowing GDP (what was termed "stagflation" in the 1970's).

Another reason interest rates may stay elevated is because our federal debt is dependent on demand from foreign countries to buy our bonds. This could force the U.S. to maintain higher rates in order to entice foreigners to continue supporting our deficit spending—this issue is exacerbated by a weak U.S. dollar. The dollar has been trending down in value versus foreign currencies since its last peak in late 2005. The exchange value of the dollar versus the Euro is particularly noteworthy with the dollar at an all time low when compared to that currency. There has also been talk out of Europe about the possibility of further rate increases in Europe's key bank rate before year end, further complicating the prospects for lower U.S. rates.

We remain in the camp of believers that the economy won't slip into a recession and that a big, bad, bear market isn't lurking just around the corner. After all, monetary policy is not (yet) restrictive,

valuations seem reasonable, and a healthy wake-up call alerted investors by the market's dip at the end of February. We remain constructive about being able to make money in the market this year yet, a review of some additional risks is worthwhile to discuss.

Consensus estimates for earnings growth of the major stock indices have been reduced steadily for 2007, to the point where the growth rate is now forecasted to be in the mid-single digit range. This estimation compares poorly to the past few years where we were spoiled by double-digit profit growth; therefore, the average stock won't necessarily benefit from a "rising tide."

The housing market continues to be a headwind for the economy. We expect home prices to trend flat to down over the medium term. The key question is the slope of the decline in prices. No matter how steep this decline, it constitutes a reduction of the housing benefit to consumer spending, since spending in recent years was materially driven by home equity appreciation and borrowing.

Last quarter we wrote about federal regulators beginning to show signs of demanding tighter lending standards and how this might be a drag on the residential real estate market. This quarter, the chickens came home to roost, as sub-prime mortgage default rates accelerated and unfortunate stories about lax lending practices became regular news. Sub-prime mortgages were a material portion of the total of new mortgages issued during the last few years. Note that only a minority of all sub-prime mortgages will default, but it appears the entire category is being painted with the same broad brush, which potentially will result in a contraction of mortgage credit and thus housing demand. If the "marginal demand" of sub-prime borrowers is removed from the market, a major crimp will be put in the demand side of the housing market. Forced selling by some of those buyers will also temporarily increase the supply overhang.

Offsetting this scenario, we continue to experience historically low unemployment rates in this country. As long as consumers have jobs, we are confident they will spend (and spend and spend). As we've stated before, the consumer side of the ledger represents about 70% of GDP. Job and wage growth then become key factors in maintaining the economy's momentum. How much push we'll get from both of these factors is a big unknown. However, we are encouraged that exports have been growing at a fast rate in recent months, no doubt partly due to the cheaper U.S. dollar.

A final risk to keep an eye on is the state of the credit markets. Debt has become exceptionally cheap, especially for the corporate version of sub-prime homeowners (namely high-yield or "junk" bonds). The extra interest rate these entities must borrow, above what the government pays, is called the spread, and high-yield spreads have become rather small, which indicates lenders see the possibility for default from these borrowers as low when compared to historical norms. History shows these occurrences tend to run in cycles. We can envision a time when spreads widen and the availability of corporate credit worsens. This situation would represent the same kind of dampening effect on the corporate world that the sub-prime mess is having on the residential real estate market.

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## **Portfolio Position and Performance**

During the first quarter, the market maintained its winning streak in spite of a few significant setbacks. Dropping 3.5% on February 27<sup>th</sup> (a day that saw the Dow Jones Industrial Index fall

more than 412 points), both the S&P 500 and the Russell 1000® Indices managed to fight their way into positive territory for the quarter, gaining 0.64% including dividends, and 1.21%, respectively. ICM's Large-Cap strategies returned mostly flat performance, and also slightly trailed performance of the indices (actual performance varied due to account size, individual client mandates, and client restrictions).

In the U.S., Treasury rates were fairly flat during the quarter, where the U.S. 10-year bond fell in yield from 4.68% early in January to 4.65% at quarter end. Similarly, global oil prices were fairly mild, beginning the year at approximately \$60 per barrel of West Texas Intermediate crude and ending March at \$65 per barrel (in spite of this rise, oil spent the first month of the quarter in the low \$50s per barrel and continues to be impacted by global geopolitical events in the Middle East). The dollar continued its slide against the major currencies, modestly falling in value relative to the British pound sterling and the Swiss franc, and somewhat more significantly to the Japanese yen and the Canadian dollar. Most of these values appeared to be within the confines of "market-expectations" and little seemed to roil the markets this quarter with one exception: the rapidly increasing delinquency rates among the sub-prime borrowers in the U.S. housing market.

As we have written before, coincident with the rising home values enjoyed by many during this decade, we have seen a loosening of credit standards in the home mortgage sector. In addition, as Mortgage Backed Securities (MBS) and Collateralized Debt Obligations (CDOs) have become more in demand, especially since investors have sought increasing yields with less regard for credit risk, mortgage originators have been pressed to find ever more creative ways to extend credit to the less creditworthy. Interest-only, negative amortization, and the so called "liar-loans," where borrowers are asked only to state their income and assets rather than provide proof, all became not only acceptable, but common practices. During the first quarter, consequences of these actions became apparent, and as one may witness through any diligent review of history, lackadaisical lending standards always produce the same results. As of this writing, it is still unclear how this activity will impact the broader mortgage business (only approximately 14% of loans in the U.S. are considered "sub-prime") or the spending patterns of the consumer.

We continue to believe that the best value in the large-cap marketplace today is found in the major blue chip companies within the S&P 100 Index (a subset of the S&P 500 comprised of 100 companies across diverse industry groups). It appears investors can forget why these companies have developed the strength they enjoy today: strong brand names, scaled production and development efforts, high free cash flow generation, growth in revenue and earnings, and solid balance sheets with ample cash reserves. Historically, it has been wise to acquire companies with these attributes, particularly if they can be bought at bargain prices. ICM's Large-Cap portfolios continue to be heavily weighted with these opportunities.

During 2006, we consistently wrote about four key themes that were prevalent throughout the Large-Cap portfolios: overweighted positions in technology companies, strong weightings in pharmaceutical businesses, overweighted positions in consumer staples companies, and an underweighting in energy-related businesses. During the first quarter, we remained committed to these themes. The first quarter, however, was unique in that these four significant elements were not the primary drivers of our investment performance. Last year we enjoyed particularly strong gains from two of our larger positions, as well as initiating or holding two other large positions in

the technology and financial services sectors. These positions all performed poorly during the first three months of this year. However, we remain convinced that each will prove to be sound investments as time progresses, and consider their impact on our first quarter's performance somewhat inconsistent, although we feel positive about tracking the indices in spite of these holdings. We also want to highlight that these themes have developed in the portfolios through individual stock selection, and each company was researched individually to determine if the prospects for growth and their market price offered compelling opportunities. Given this disciplined process, our interest is in observing how the fundamental development of these individual businesses progress over time, according to the plan that we implemented when we first purchased the shares. Our four lackluster holdings have been disappointing in share price only and the business fundamentals are following our expectations when we made the purchases. We remain confident that if this continues, the share prices will follow suit.

In spite of the disturbance observed in the sub-prime section of the mortgage market, the consumer economy continues to do fairly well, and credit availability remains reasonably high. We will continue to monitor this situation with attention focused on any spillover effects the sub-prime market may have on the broader mortgage market, and the likely weakness in consumer spending or even recessionary pressure such a spillover would have. It is our hope that this discussion has been of interest. As always, we continue to look for compelling opportunities for your portfolios and invest wisely.

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