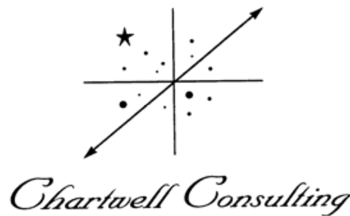

CHARTWELL REVIEW

July 2007 | SECOND QUARTER 2007 | Volume XIV, Issue No.2

Sell in May . . .

. . . . . and go away. That's the old adage. It appears U.S. stock market investors are taking just that idea to heart again this year. Those who "went away" in June risk missing another sharp summer uptrend (as they did last year). But, three weeks into the third quarter and this "good earnings, low inflation" rally is running into some very stiff headwinds. Momentum is extremely negative and daily volatility is high.

That's getting ahead of ourselves. Overall returns in the second quarter weren't exactly chopped liver, as the tables at right attest. The weak June in domestic markets ended the quarter on a down note, but the overall quarter was anything but for stock investors. For those heavily invested in foreign markets, Christmas indeed came early again this year.

The issue is how long this will all last, with yield curves rising around the world (hence the red ink from the bond markets). The clock is ticking toward the next market correction. At this point we are so long overdue in developed country stock markets that each day sets a new record. The only area we've had a correction in was emerging markets last year. And that, as the segment's 45% one-year trailing return suggests, was just a brake tap in the fast lane.

What's our bottom line? 1st, it's still about global earnings growth. As this has surprised to the upside, investors have bid stocks up despite rising interest rates. 2nd, we still prefer shorter-term bonds to longer-term. 3rd, we'll be thrilled if our Global Balanced benchmark (+6.1% YTD) exceeds 8% in 2007.

table 1: Index Benchmarks

Market Index	Q2 2007	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	6.3	20.6	11.7	10.7	7.1
U.S. Large-cap Stocks	6.2	20.3	10.5	9.5	6.2
U.S. Mid-cap Stocks	5.3	20.8	17.2	16.4	11.9
U.S. Small-cap Stocks	4.4	16.4	13.4	13.9	9.1
Foreign Stocks (**devel**)	6.7	27.5	22.7	18.2	8.0
Foreign Stocks (**emerg**)	15.1	45.5	38.7	30.7	9.4
LIBOR (3 month)	1.3	5.6	3.9	2.9	4.1
U.S. Aggregate Bonds	(0.5)	6.1	4.0	4.5	6.0
High Yield Bonds	0.3	11.7	9.0	11.8	6.3
Global Bonds	(1.5)	2.9	3.3	6.3	5.3
CPI, ***annualized***	**5.2**	2.6	3.2	3.0	2.6
Reuters CRB Index	0.9	(4.2)	9.0	11.1	3.3
Chartwell Global 65/35	4.0	17.8	13.3	12.4	8.0

table 2: Average Mutual Fund Returns

Fund Category	Q2 2007	Trailing Returns * 1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	6.5	19.5	11.8	10.6	7.3
U.S. Mid-cap	7.2	20.6	14.8	14.0	10.5
U.S. Small-cap	6.1	17.0	13.6	14.0	10.7
International Lg. Cap	7.3	27.7	22.6	17.5	8.8
International Sm. Cap	8.0	33.5	27.8	24.8	14.0
Emerg. Mkt. Equity	15.2	47.7	38.4	30.5	10.2
Balanced/Hybrid	3.7	14.3	9.4	9.0	7.1
General Bond	(0.5)	6.3	4.4	5.2	5.8
Government Bond	(0.9)	5.3	3.6	3.8	5.5
High Yield Bond	0.3	10.6	8.2	10.3	5.1

* Annualized trailing returns for periods ending 6/30/07.

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Not Quite Prime-time

The Commerce Department's final report on our real economic growth during the *1st* quarter indicated an annualized gain of just 0.7%, well-below early estimates (+1.9%) and the often cited long term non-inflationary target of 3-3.5%. It was the weakest quarter in four years. Nominal GDP increased at an annualized rate of 4.9%, because the inflation deflator jumped a very high 4.2% on sharply rising energy and food costs.

As the following table reflects, three elements were primarily responsible for the 1st quarter's slowdown from the already weak pace of 2006: the import/export growth mix took a highly unfavorable turn, businesses decreased inventories, and private investment continued to fall, driven by another double-digit contraction in residential fixed investment (aka, the housing market).

table 3: Components of GDP Growth

Factor	2Q '06	3Q '06	4Q '06	1Q '07
	% Change from Preceding Period *(seasonally adjusted at annual rates)*			
Personal Consumption	2.6	2.8	4.2	4.2
Private Investment	1.0	(0.8)	(15.2)	(9.6)
Fixed - Businesses	*4.4*	*10.0*	*(3.1)*	*2.6*
Fixed -Residential	*(11.1)*	*(18.7)*	*(19.8)*	*(15.8)*
Chg. In Inventories ($)	*$53.7B*	*$55.4B*	*$22.4B*	*($4.2B)*
Exports	6.2	6.8	10.6	0.7
Imports	1.4	5.6	(2.6)	5.5
Government Spending	0.8	1.7	3.4	1.0
Real GDP Growth	**2.6%**	**2.0%**	**2.5%**	**0.7%**

The Dept. of Commerce preliminarily estimates *2nd* quarter GDP growth was at a 3.4% annualized rate, as businesses rebuilt inventories and the inflation deflator dropped. Nominal growth was about 6%. The Federal Reserve recently set out its projections for all of 2007 and 2008, as follows-

table 4: FED Economic Projections: 2007 and 2008

Indicator (% p.a.)	*Federal Reserve estimates, %Chg. from 4thQ to 4thQ*	
	2007	**2008**
Nominal GDP – *(%)*	4½ - 5%	4¾ -5%
Real GDP – *(%)*	2¼ - 2½	2½ - 2¾
Inflation, ex- food & energy (%)	*2 - 2¼*	*1¾ - 2*
Average Unemployment, 4th Qtr	*4½ - 4¾*	*4 - 4¼*

Some have pointed out the combined expectations of higher growth, lower unemployment, and lower core inflation in 2008 aren't consistent. Current core consumer and producer price trends are already above the Fed's 2007 figures, with headline inflation rates considerably higher. A late June survey of 50 Wall Street and academia economists peg year-end 2007 inflation rates at 3.1%. Indeed, shifting market attitudes about future inflation rates represented one of the biggest changes during the 2nd quarter. In our last *Review*, we noted some acceleration was evident in consumer prices due to increased pressure from rising producer costs, but observed that the market appeared relaxed about it. No longer. This appears to have become a more widespread concern.

The ***labor market*** was fairly strong in the 2nd quarter. *Adjusted for seasonality*, household's employment levels fell by 114k persons in the quarter, while nonfarm payrolls rose by just 444k. But, ignore seasonality adjustments and 2Q employment increased by 1.6mm persons (after falling 800k in Q1). Measuring the labor market in terms of year-over-year change, we see that employment has increased by 2 million persons during the past year.

Adjusted for consumer price inflation, average weekly earnings again fell 0.4% for the quarter. Real earnings rose slightly less than 1.3% in the year ended June. Our national savings rate remained firmly negative.

The index of ***total industrial production*** increased at a rate of 0.8% during the second quarter, versus 1% in the first. Total industrial production has increased by 1.4% the past year, held back by declines in construction and mining activity. Capacity growth has been constrained by modest business investment to just 2.1%, and the overall capacity utilization rate stood at 81.7% at the end of June (about average).

Investor concerns regarding the economic impact of our weak ***housing market*** have quickly expanded into fears regarding the weak housing finance market. You have all been bombarded with statistics regarding how bad selected parts of the mortgage-backed securities market have already become. With over $1 trillion of adjustable rate mortgage loans (prime and non-prime) facing upward interest rate resets in 2007-08, we can't see how the overall housing market gets better before it first gets worse. The stage appears set for a weakening consumer sector on the one hand, or big bond investor losses on the other. Each holds the potential for negative credit market and credit availability implications, which is a considerable concern in a country as leveraged as the U.S.

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Global Bonds

Investors again pushed out expectations for a cut in the current 5.25% Fed Funds rate, this time to 2008. This paralleled the January to mid-February environment. The result was to eliminate the last bit of yield curve inversion. Interest rates rose across the board, leading to losses in most bond sectors.

The bellwether 10-year Treasury bond ended the quarter priced to yield 5.03%, compared to 4.65% at the end of March. Its yield hit a five-year high of 5.32% in June, before prices rallied at quarter's end. Bonds in the 3-5 year maturity bucket saw yields rise nearly 40bps during the quarter, as the short end of the curve was most affected by the negative shift in market sentiment. Yields in the broad corporate bond sector rose 40bps, leading to price declines of 2.5%. After coupons, the sector's total return was (0.76)%. Issuer specific risk was very high due to varying concerns about takeover activity. Lower rated BBB bonds (declining 0.66%), outperformed those A-rated, but underperformed the increasingly rare AAA sector. The high yield bond index gained 0.3%, which gain has been completely reversed (and more) in July.

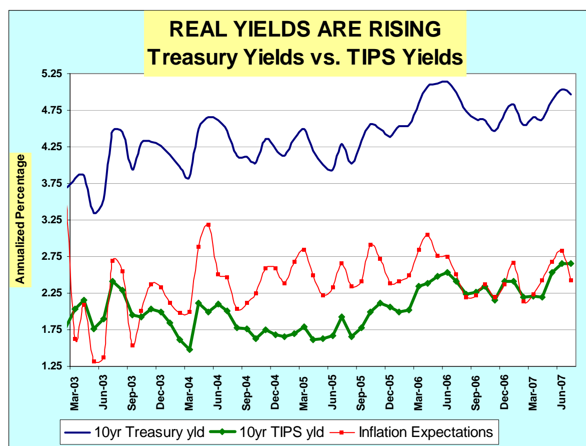
table 5: Bond Market Returns

Periods ended June 30, 2007

Bond Index	2Q '07	Trailing Returns 1 Year	3 Years
Aggregate Bonds	**(0.5)%**	**6.1%**	**4.0%**
Intermediate Bonds	**(0.4)**	**5.9**	**3.8**
US Treasuries, long	(1.9)	6.0	5.1
U.S. TIPS	(0.8)	3.9	3.8
US Agencies	(0.4)	5.7	3.8
Mortgages	(0.7)	6.2	4.3
Inv. Grade Credit	(0.7)	6.8	4.3
3-mo. LIBOR	1.3	5.6	3.9
High Yield Credit	0.3	11.7	9.0
Global Non-$, Unhedged	(1.8)	2.2	3.3
Global Non-$, Hedged	(0.9)	4.0	4.4
Emerging Markets bonds	0.2	14.0	13.6

Government-guaranteed mortgage securities lost just 0.5%, while the broad mortgage bond segment declined 0.7%. Mortgage bond yields jumped more than any other sector. This reflected investor concerns that problems in the subprime market may soon be spilling over to the broader sector (a sentiment we share). The Lehman Aggregate bond index was priced to yield 5.67% at quarter's end, compared to 5.28% at the end of March. The index fell 0.5% in the quarter.

The initial thought was that rising inflation expectations triggered the quarter's yield upshift, but the following graph points elsewhere. Real yields, which are the returns demanded by bond investors <u>in excess of</u> current inflation, jumped nearly 50 bps in the quarter. Inflation expectations among bond investors have been trendless over the past year.



On the global bond front, market yields rose sharply in both Europe and Japan, due to significant price declines. Rising real yield requirements were again the culprit, as core inflation in these regions is low and stable. Currency values did not rise enough in the quarter to offset the price weakness, and developed market non-$ global bonds lost 2% on an unhedged basis and 0.9% on a hedged basis.

Table 5 compares base government bond yields, at the 2-year and 10-year maturity points, in six major countries. U.S. market yields jumped in the quarter, but they are still 20-30bps **lower** than one year ago. Conversely, yields in Germany, Britain, and Australia are much higher now than a year ago. This has greatly shifted capital flows. The US$ has very recently hit a 30-year low versus the Pound and an all-time low versus the Euro.

table 6: Global Bond Benchmark Yields

Source = Dow Jones

	@ June 29, 2007 2-Year	10-Year	One Year Ago 2-Year	10-Year
U.S. Treasuries	4.87	5.02	5.19	5.20
Canada	4.59	4.55	4.39	4.59
Germany	4.45	4.56	3.56	4.07
Japan	1.05	1.87	0.87	1.92
U.K.	5.77	5.46	4.79	4.71
Australia	6.47	6.26	5.88	5.90

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U.S. Equity Markets

The broad US stock market advanced 5.8% for the quarter (cap-weighted basis). April and May were strong months, while June was weak as rising interest rates gave investors a good reason to take some profits (the market's one-year return through May had been 23%!). June's give back was less than 2%.

The large-cap S&P 500 index provided a total return of 6.3% for the quarter. The market's advance in April/May was driven by reports of much better than expected 1st quarter earnings growth, which in the case of the S&P 500 stocks came in at 8% versus a 4% forecast. Market gains were also driven by high levels of M&A, leveraged buyout and share buyback activity. Blackrock places the year-to-date total of such deals at $1.7 trillion, a 90% increase from 2006!

The small-cap segment advanced 4.4% overall, with small growth stocks up 6.7% and small-value up only 2.3%. The same sectors led. The best performing size/style segment was large-cap growth stocks (+6.9%). Russell growth indices beat value across the board during the quarter and for the year-to-date.

table 7: U.S. Equity Market Size/Style Returns

Periods ending June 30, 2007

			Trailing	
	2Q '07	**YTD '07**	**1-Year**	**4-Years**
Growth				
Large Cap	6.9	6.9	18.8	8.9
Mid Cap	6.7	11.0	19.7	17.6
Small Cap	6.7	9.3	16.8	16.4
Micro Cap	4.7	5.4	13.5	14.4
Value				
Large Cap	5.4	5.3	21.8	15.1
Mid Cap	3.7	8.7	22.1	22.1
Small Cap	2.3	3.8	16.1	19.8
Micro Cap	2.0	3.2	14.8	20.2

It is becoming increasingly important to not get overly caught up in the style box game with large cap stocks. Valuation differentials for growth versus value stocks have narrowed dramatically. Excluding the financial services sector, there is much less difference, in P/E, Price/Book, or Price/Sales terms, between "growth" and "value" companies than we've seen for many years. Thus, we see the S&P Value index outperforming S&P Growth in 2007 by 85bps, while Russell 1000 Growth has outperformed R1000Value by 190bps. The largest S&P *growth* stock is Exxon Mobil (7.3% of index). The largest Russell 1000 *value* stock is Exxon Mobil (4.9% of index).

The broad large/mid-cap segment was led higher in the quarter by shares in the pro-cyclical energy (+14.7%), information technology (+10.5%), and industrials (+9.7%) sectors, and held back by the utilities (-0.4%), financials (+1.8%), and consumer staples (+2.5%) sectors. The cyclical sectors benefited from strong growth around the world (and the belief such will continue). Questions surrounding the housing and mortgage fallout, rising interest rates, and a weaker U.S. consumer plagued the lagging sectors.

table 8: U.S. Sector Returns

	Large-cap Returns *(%)*		**Small-cap Returns** *(%)*	
Sector	2nd Qtr	One Year	2nd Qtr	One Year
Utilities	(0.4)	26.2	(5.0)	24.5
Materials	8.1	28.3	10.1	40.3
Telecom Svcs	7.6	38.6	7.5	30.2
Cons. Staples	2.5	14.9	2.4	29.5
Energy	14.7	27.9	11.8	20.6
Industrials	9.8	18.9	10.5	25.5
Health Care	4.6	17.8	2.2	13.3
Cons. Disc.	4.1	20.9	2.4	21.3
Info Tech	10.5	26.2	7.3	21.7
Financials	1.8	14.8	(2.1)	10.1

The small-cap market segment was led by the same pro-cyclical themes in the quarter, but not to the same extent. The global theme made the biggest difference, as smaller energy, tech, and financial services companies were less favored. Global economic growth is being driven by foreign markets, which are more easily accessed by geographically diversified larger U.S. companies than by smaller ones.

From a style perspective, Small Growth has outperformed Small Value this year because it is underweighted to financial services companies and overweight to industrials and information technology shares. As our present bull market matures (ages?), differential sector allocations are having a bigger impact on performance.

We expect the current mini-trend favoring large versus small to continue, with natural fits and starts, until U.S. economic growth returns above its long-term trendline and small-cap stocks are once again cheap versus large-caps on a relative PE basis (as they clearly were at the start of this bull market, but are not now). We suggest reducing all overweight small-cap allocations.

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International Equities Continue to Soar

The pattern of non-U.S. returns for the quarter was similar to that of the US market. Coming off of the Shanghai sell-off in late February, equity markets ended the first quarter weakly. It did not take the markets long to put that behind them, resulting in incredibly strong months in April and May. Markets then began to climb a new wall of worry in June – inflation concerns, rising bond yields and another Chinese market drop after the government imposed higher fees to dampen widespread investor speculation. Non-U.S. markets ended June on a weak note, but quarterly results were still up significantly. In US$ terms, the primary developed market index posted a 7.0% net return and the All Country World ex-US index rose 8.2%. The difference between these two indices is accounted for by the latter's emerging markets exposure.

table 9: International Markets Returns

(index level = net)	**Local Currency Return %**		**U.S. Dollar Return %**	
	2nd Qtr 2007	**One Year**	**2nd Qtr 2007**	**One Year**
Developed Markets	**5.9**	**23.0**	**7.0**	**27.1**
- Int'l Growth	*6.2*	*21.5*	*7.3*	*25.6*
- Int'l Value	*5.7*	*24.5*	*6.7*	*28.6*
- Europe	6.6	24.9	8.3	32.4
- Pacific, ex-Japan	5.9	29.6	9.5	42.6
- Japan	3.9	15.8	(0.6)	7.2
- United Kingdom	5.2	17.5	7.6	27.4
Int'l Small Cap	**4.1**	**22.8**	**5.2**	**26.1**
Emerging Mkts	**12.5**	**39.0**	**15.0**	**45.0**
- EM Asia	*16.5*	*42.8*	*18.4*	*46.3*
- EM Europe	*4.2*	*21.2*	*5.6*	*28.1*
- EM Latin America	*14.8*	*49.4*	*19.8*	*62.3*
- EM BRIC	*13.8*	*43.4*	*17.1*	*51.3*

Growth stocks outpaced value stocks for the second straight quarter. Small-cap stocks underperformed large-caps (but are +1.5% ahead of large-caps in 2007). Among the larger developed markets, the Pacific region (ex-Japan) returned 9.5%, even as the Japanese stock market continued to struggle. Japan had the worst return among developed markets, falling 0.6%. This was due to the weak Yen and concerns about unexciting corporate earnings forecasts for the new fiscal year. Underweighting the Japanese market during the past year has been a key to outperforming the broad indices.

Predictions of Europe's economic demise appear to have been greatly exaggerated. The developed markets Europe index was up 8.3% in the quarter and 32% over the past twelve months. Investment markets have certainly been propelled higher by continued M&A activity, but earnings growth among European firms has also been robust.

Portugal was the top performing European country with a 17.6% quarterly return. Germany (+16.2%, and +24% YTD) extended its strong performance, as their export-led economic recovery continues unabated. In May, new corporate tax reform legislation was approved which will lower nominal tax rates from 39% to 30% and benefit all German companies. This is expected to help prolong strong investment returns.

Nordic countries performed well during the quarter. The strength of Finland's 15.6% return (+28% YTD) came from smaller technology and materials exporters that serve Baltic and Eastern European markets. Norway rose 14.7% as the country's focus on oil and resources stocks propelled results. Switzerland was Europe's weakest performing market (+3.2%), as weak biotech and high tech industries coupled with poor performance from industrials.

Emerging markets regained their leadership role during the quarter. Latin America was the strongest performing region (+19.8% in US$ terms), led by Peru and Brazil. Emerging Asia turned in an 18.4% return. The red hot BRIC (Brazil, Russia, India and China) index was up 17.1%, although held back by Russia (up just 0.3% for the quarter). Emerging European markets advanced just 5.6% for the quarter, which helped explain the broad Emerging Markets index return of "only" 15%!

table 10: Broad International Sector Returns

GICS Sector	***Ending Weight***	***2nd Qtr Return (in $)***	***Contribution***
Cons. Discretionary	10.3%	5.1%	0.6%
Cons. Staples	7.0	4.8	0.4
Energy	10.1	16.5	1.5
Financial Services	27.7	4.8	1.4
Health Care	5.2	0.2	0.0
Industrials	11.2	12.6	1.3
Info Technology	6.7	10.9	0.7
Materials	10.7	15.0	1.5
Telecom Services	6.1	11.4	0.7
Utilities	4.8	6.5	0.3

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As we can see from table 10 on the prior page, all ten sectors of the very broad All Country World ex-US index posted positive returns for the second quarter. It was a pro-cyclical rally, just like in the United States. Health care was the worst performing sector for the quarter (+0.2%), dragged down by the large drug companies, while energy was the strongest (+16.5%). Materials and industrials were up 15% and 12.6%, respectively. Companies in the financial services, utilities, and the consumer sectors lagged.

Table 9 allows us to observe the impact of currency effects on investor returns during the second quarter and the trailing twelve months. These were positive over both timeframes, and in some cases highly so. The only exception has been in Japan, where the Yen declined 4.5% relative to the US$ during the quarter and 8.6% in the past year. The European currencies rose 1.7% versus the US$, before taking off to all-time record highs in July. The best performing "primary" currency was the New Zealand Dollar, up 18%, due to increased Yen/NZ$ carry trade activity.

In closing this section, we can't help but observe that international returns in US$ or local terms have outstripped even what has been great corporate earnings growth. Earlier this month we sent out a separate briefing note that looked at relative country market valuations and fundamentals. The data still supports an aggressive allocation to international, but one must acknowledge these markets have also been driven higher by momentum factors that can turn on a dime. Investor portfolios, including yours, are filled with international equity capital gains, and are overweight their strategic targets. Even though this bull market is not out of hand compared to the three previous ones (see table below), we recommend you rebalance your international allocations back to target (or perhaps a little below, in the case of high targets).

The last four international bull markets ….. (MSCI EAFE)

Start	End	Duration	Cumulative Return (local terms)	Ending P/E
Dec-74	Dec-80	73 mos.	132%	9.6x
Sep-82	Sep-87	60 mos.	315%	29.8x
Oct-92	Mar-00	90 mos.	181%	36.1x
Mar-03	????	52 mos.	163%	16.0x

Beach Reading

A few "*new*" investment ideas have been getting a lot of press and are being sold heavily by management firms and intermediaries. You might want to read up on them while you're on the beach this summer.

One is *130/30 Equity Investing*. Here's how it works -

- This is two equity accounts in one. The first consists of the manager investing each $100 you give them in their basic active equity long-only strategy (whatever that has been).
- The second account consists of the manager borrowing stocks to create a $30 portfolio of short positions, then taking the proceeds from these short sales to buy another $30 of the original base portfolio. You end up with a $130 worth of long positions, and $30 of short positions.
- Prime brokers don't lend securities for free, so the second 30/30 account starts each day in the hole. However, if the $30 of short positions go down by less than the extra $30 in long positions go up (or vice versa), this second portfolio can consistently make a modest to moderate positive return.
- You add the returns from the first $100 invested in the base strategy to the returns achieved by the 30/30 "market neutral" strategy to get your gross performance. Take off fees, which are invariably higher than for the original long-only investment strategy, and you have what managers "expect" will be higher future returns than will be achieved by their basic long-only strategy.
- The future path of 130/30 product returns will track with that of the original 100% actively managed strategy, because the 130/30 product is also 100% "net long". It also has the same beta exposure, because it invests in the same market space. The 130/30 approach does have $160 of "active positions" ($130 long + $30 short). That increased exposure, or leverage, is what underpins the higher return expectation.
- We look for managers with a good base investment approach in the first place, *plus* demonstrated expertise in managing market neutral portfolios. Provided you find this at a reasonable cost, we believe 130/30 strategies can be excellent direct replacements for some of your current actively managed equity allocations.

Two other areas generating some buzz, both of which we also believe should be of some interest to our clients, are "fundamentally-weighted" index portfolios and infrastructure investing. More on these at a later date.

See you next quarter!

Natalka Bukalo ***Richard Shaffer, CFA***

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