

First Quarter 2007 – Market Review

In the first quarter of 2007 volatility returned to the markets overnight. Beginning in China, a sharp market correction propagated around the world like a small financial tsunami over the course of a few days in February. Many attributed its cause to Alan Greenspan's comments to an audience in Hong Kong about the potential for a recession in the U.S. economy. Even though Greenspan is no longer the chairman of the Federal Reserve, his comments still carry weight. The events clearly show how global financial markets are linked, for better or worse. However, in spite of the volatility, most major indexes were back into positive territory by the end of the quarter.

Closer to home, the rapid deterioration in the sub-prime mortgage market and signs of weakening residential home prices further unsettled investors. Although loan losses from sub-prime mortgages are unlikely to threaten future economic growth, the secondary impact of banks tightening their lending standards is likely to have a larger effect on the economy. Tighter lending standards may restrict some would-be buyers from purchasing a home, potentially causing home prices to fall until supply and demand come into balance. This will likely take a year or two to play out.

Large company stocks, as measured by the S&P 500 Index, were up 0.6% in the first quarter and up 11.8% over the last 12 months. Over longer periods of time, large company stocks have performed well, returning 10.1% per year over the last three years and 8.2% over the last ten years. By the numbers, it's almost as though the 2000-2002 bear market didn't occur. The irony is that, relatively speaking, large company stocks have significantly underperformed their smaller and international brethren over the last five years. In our view the likelihood of such a disparity over the next five years is unlikely, especially now that about one-half of revenues of S&P 500 companies are from foreign sources. Again, global financial markets are forever linked.

Asset Class Returns - Before the Impact of Inflation						
	Investment Type (Index)	1st QTR	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	0.6%	11.8%	10.1%	6.3%	8.2%
	Mid Cap (S&P 400)	5.8%	8.4%	13.4%	10.7%	14.3%
	Small Cap (Russell 2000)	2.0%	5.9%	12.0%	11.0%	10.2%
	International Equities (MCSI EAFE)	4.1%	15.3%	18.2%	14.8%	7.9%
	Commodities (Dow Jones AIG)	4.6%	9.4%	8.2%	14.5%	7.1%
	Real Estate Investment Trusts (NAREIT)	3.5%	31.1%	25.8%	24.1%	15.0%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	1.5%	6.4%	2.9%	6.1%	6.7%
Cash	Cash (T-Bills)	1.3%	5.1%	3.4%	2.5%	3.6%
	Inflation (CPI)	1.2%	2.4%	3.0%	2.7%	2.5%
Asset Class Returns - After Inflation						
	Investment Type (Index)	1st QTR	1 Yr	3 Yr	5 Yr	10 Yr
Equity	Large Cap (S&P 500)	-0.5%	9.4%	7.1%	3.5%	5.8%
	Mid Cap (S&P 400)	4.6%	6.0%	10.4%	7.9%	11.8%
	Small Cap (Russell 2000)	0.8%	3.5%	9.0%	8.2%	7.8%
	International Equities (MCSI EAFE)	2.9%	12.9%	15.2%	12.1%	5.4%
	Commodities (Dow Jones AIG)	3.4%	7.0%	5.2%	11.7%	4.6%
	Real Estate Investment Trusts (NAREIT)	2.3%	28.7%	22.8%	21.4%	12.6%
Bonds	Gov't & Corporate Bonds (Lehman Gov/Credit)	0.3%	4.0%	-0.1%	3.3%	4.2%
Cash	Cash (T-Bills)	0.1%	2.6%	0.4%	-0.2%	1.2%

Thus far in 2007, small and mid-sized companies continue their winning ways. Small caps rose 2.0% in the first quarter and mid-caps rose 5.8%. Over the last five years small caps gained 11.0% per year, while mid-caps rose 10.7%.



200 South Biscayne Blvd, Miami, FL

Despite weakening residential real estate markets, commercial real estate continued to perform well. In February, Equity Office Properties Trust, a company with a portfolio of 543 buildings and 103.1 million square feet of office space (making it the largest office landlord after the U.S. government) sold itself to the private equity firm Blackstone Group for \$39 billion. For a brief period of time it was the largest private buyout in history. Excitement about this deal helped drive Real Estate Investment Trusts (REITs) up 8.4% in the month of January. The Equity Office Properties deal just might mark the peak in commercial real estate prices, as REITs fell in February and March, finishing the first quarter up 3.5%. Over the last five years domestic REITs have produced an average annual return of 24.1%. It is very unlikely that results like this continue over the next five years.

Foreign stocks, as measured by the MSCI EAFE Index, rose 4.1% during the quarter. Stocks in Europe rose 3.9%, while Asian stocks rose 3.6%. Stocks in Finland and Singapore led the way, gaining 10.3% during the quarter, while Ireland was the only developed nation to experience negative returns in the quarter, down 1.0%. Emerging market stocks rose 2.3% in the first quarter, but emerging markets no longer all appear to be heading in the same direction. In China stocks fell 2.3% and stocks in India lost 3.3%. Some emerging markets posted very impressive results: stocks in Peru rose 25.0%, Moroccan stocks rose 24.7%, Malaysian stocks rose 18.3%, and in Pakistan, stocks climbed 15.4% during the quarter. Venezuelan stocks posted the weakest results, falling 11.2%. Of course, many of these stock markets are relatively tiny. Even in China, an emerging economic powerhouse, the value of the entire stock market is only equal to about 3% of the U.S. stock market.



Machu Picchu, Peru

Bond market and cash indices produced positive results in the first quarter. The Lehman Brothers Aggregate Bond index (a mix of government and corporate bonds) rose 1.5%, inflation adjusted bonds rose 2.7% (as measured by the Lehman Brothers U.S. TIPS index), and international bonds gained 1.2% (as measured by the Lehman Brothers Global Credit index). Returns on cash were 1.3% (as measured by the Lehman U.S. Treasury Bills index). That said, inflation during the quarter was close behind, rising an estimated 1.2% in the first three months of 2007 and negating most of the positive returns from bonds.

As you know Madison Wealth Management takes a long-term approach to investing. Periods of volatility present opportunities – to put cash to work at lower prices and/or to rebalance portfolios back to targeted areas. It appears that our clients understand our approach as we did not have one phone call expressing concern about the market during the most volatile days. You are to be congratulated!

“Most people get interested in stocks when everyone else is. The time to get interested is when no one else is.” Warren Buffett