

# THE MARKET OBSERVER

MAY 2007

While experiencing more volatility than has been the recent norm (but certainly not by long-term historical standards) the broad US stock market as measured by the S&P 500 finished the first quarter up approximately 1%. The index had advanced 3.5% through mid February before dropping 6% from its peak.

In March, prices began to climb back following a benign fed forecast which hinted at

the possibility of rate cuts in the face of a slowing economy. Fueled by strong corporate earnings, market strength has continued since quarter end, bringing the average up close to the level reached in March, 2000. Through 4/24, the S&P 500 is up just over 5% for the year.

The market scoreboard below from J.P. Morgan provides an objective overview of our current economic and

investment climate as opposed to the daily headlines concerning sub prime mortgages and speculation on the direction of interest rates. International and emerging market stocks continue to lead globally while mid-cap and small-cap stocks continue to lead domestically. As discussed in our last update, momentum continues to favor lower quality companies as reflected in the relative outperformance of passive approaches

## Market Scorecard

Investment Returns		Markets post modest returns in Q1 following a strong run in the latter half of 2006.
Overall Economy		Economic growth moderates due to a weakening of the housing market.
Employment		The economy continues to run at full employment, with the unemployment rate at 4.5%.
Earnings		Corporate profits post 19th quarter of double digit earnings growth (y-o-y). Profit margins at cyclical peak.
Interest Rates		Fed leaves funds rate at 5.25%. Yield curve remains flattish.
Inflation		The Fed continues to be concerned about the inflation outlook even as economic growth slows. Key concerns include tightness in the labor market and high capacity utilization levels.
Key News Items		Subprime mortgage delinquencies create concerns. Merger and buyout activity continues to be robust. Market volatility remains at low levels.
Fund Flows		Flows into International equities overshadow more modest activity in US equity, fixed income and allocation funds.

Source: Standard & Poors, FRB, BLS, BEA, JPMorgan

when compared to managers who focus on high quality growth companies. The table on the right from Segall Bryant and Hamill, shows the current relative expensiveness of lower quality stocks when compared to high quality stocks.

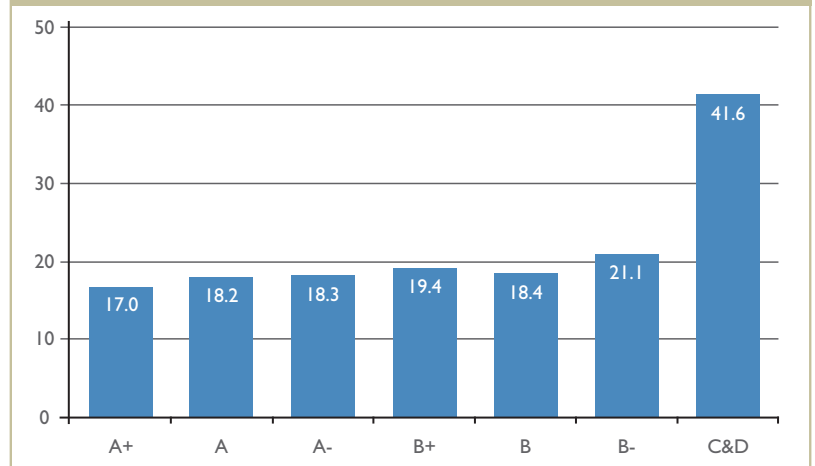
Heading into a possible economic slow down, high quality growth managers hope to step to the front of the line as the market should favor companies with sustainable earnings and pricing power.

Growth stocks have languished since they hit the wall in 2000. The comparison below between growth and value P/E multiples (also from J.P. Morgan) further illustrates the possibility of such a rota-

tion. If you've been holding a growth portfolio over the last six years and are growing impatient, it would be wise to remember the plight of value investors in the late 1990s. Value stocks lagged growth stocks badly until the

tides suddenly turned. Over the entire period, a diversified investor would have been rewarded for their patience by sticking to their asset allocation commitments. It would seem that the same argument could be made today.

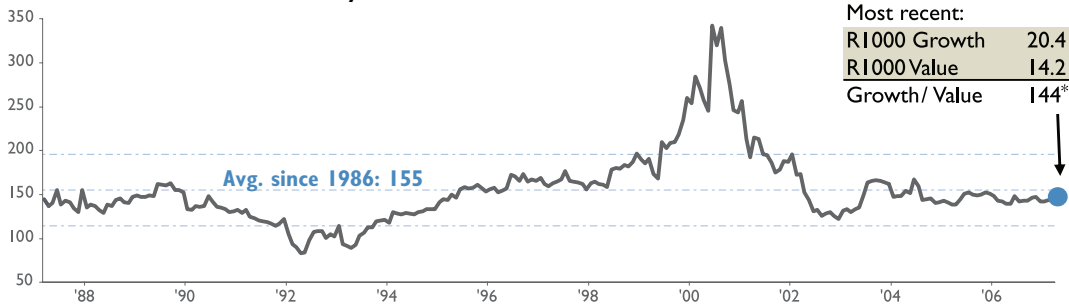
MLQS "Quality Indices Average 2007  
Estimated P/E Ratio as of December 29, 2006



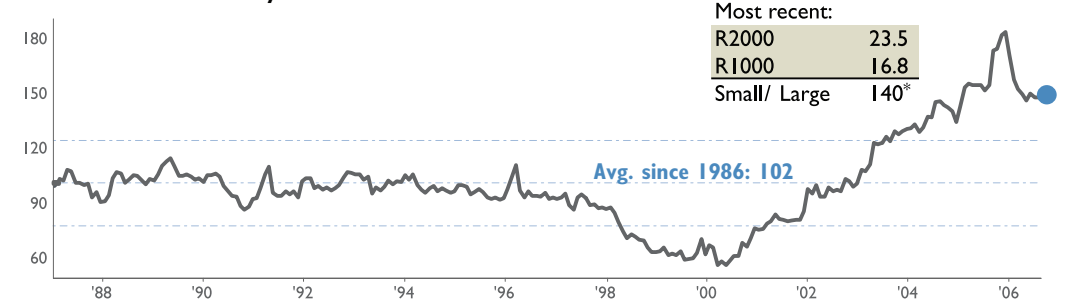
Source: Merrill Lynch Quantitative Strategy, Standard & Poors, Thomson Financial

Relative Valuations: Growth vs. Value, Small vs. Large

Russell 1000 Growth P/E divided by Russell 1000 Value P/E



Russell 2000 P/E divided by Russell 1000 P/E



Source: Russel Investment Group, FactSet, JPMorgan

\*Represents the Russell 1000 Growth Index P/E ratio divided by the Russell 1000 Value Index P/E ratio, multiplied by 100 (top) and Russell 2000 Index P/E ratio divided by the Russell 1000 Index P/E ratio (bottom) Data reflects most recent P/E as of 3.31.07.