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I N V E S T M E N T M A N A G E M E N T

NEWSLETTER

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CONSOLIDATION OR CORRECTION?

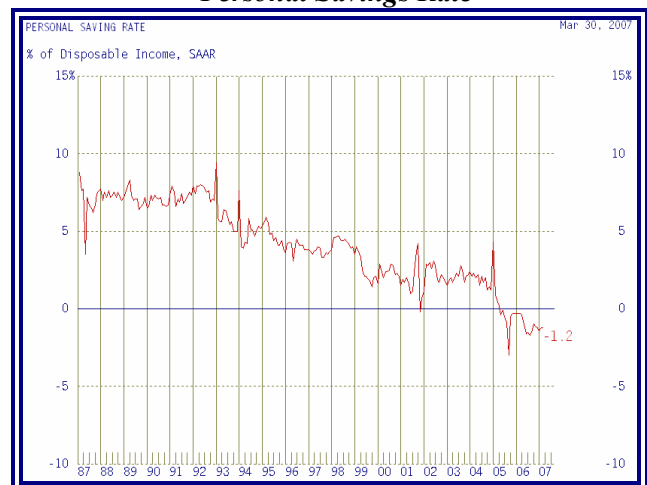
Can stocks decline further?

Did the 416 point drop in the Dow Average on February 27th mark the culmination of the stock market rally? Is this the beginning of a consolidation period in which stocks normally decline up to 10% from their prior peak? Or, could this be the start of a market correction, where stocks decline more than 10%, but less than 20% that would constitute a “bear” market?

Normally, extended “bull” market rallies are interrupted by minor consolidations of 5% - 10%. These shorter-term and less onerous declines often retrace one-third to two-thirds of the prior advance. From last July through February, stocks advanced 18% without a significant retrenchment. From peak to trough, the decline during the first quarter retraced about one-third, or 5.6%, well within the definition of a consolidation. From this perspective, the recent decline should not be cause for alarm, but viewed more as an adjustment from the preceding rally, very similar to the retracing experienced in the spring of last year.

Nevertheless, the adjustment may not be complete. Aside from exogenous factors such as tensions in the Middle East and the potential for further escalation in crude oil prices, several economic trends may put additional pressure on stock prices in the coming months. First, the spiking default rate in the sub-prime mortgage market could have an indirect impact on the more mainstream financial institutions. Additional time will be needed to determine if default rates have peaked, and how the fallout in the housing sector ultimately impacts the balance of the economy.

CHART I
Personal Savings Rate



Second, growth in consumer spending, which comprises over 70% of the economy, is expected to slow in 2007. While much of the increase in personal consumption over the past several years was supported by stronger employment and higher wages, spending has been growing faster than income. Some of this phenomenon was made possible as households tapped into their home equity lines to fund their spending.

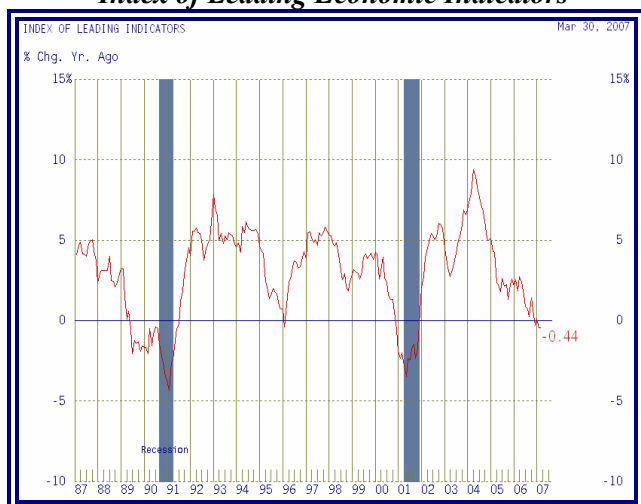
As a result, the personal saving rate dropped into negative territory (Chart I), which cannot persist indefinitely. The adjustment towards a more normal savings rate will dampen future spending plans.

Spending growth in 2007 should also be challenged by a sizeable number of adjustable rate

mortgages that are scheduled to re-adjust this year. Interest payments for mortgages written 3-5 years ago were set when short-term rates were much lower, in the 1% - 2% range. This year, they will have to be re-priced at much higher yields. The resulting increase in monthly payments will undoubtedly curtail spending in other areas.

Third, the Index of Leading Economic Indicators, which gave advance warning of the last two recessions, recently registered a marginally negative year-over-year percent decline (Chart II). That is not significant enough to warn of an economic downturn, but it does suggest that further deceleration is possible to the 1.0% - 2.0% range in the upcoming quarters. For the year as a whole, growth is expected to average 1.5% - 2.5%. This is lower than the 2.0% - 2.5% projected at the start of the year.

CHART II
Index of Leading Economic Indicators



Accordingly, the stock market consolidation experienced since the end of February may not be complete and could possibly develop into a “correction.” If that does occur, however, the extent of the decline should be limited in both time and duration.

Major stock market declines are usually preceded by excessive valuation and/or a major deterioration in the economy. Neither of these conditions is present. Stock price gains over the last several years kept pace with the growth in earnings; and the traditional measure of value, the price-earnings ratio, remains at relatively low levels compared to its range for the last decade. Except for the real estate sector, the economy is expanding with firming conditions in the labor markets, strong growth in business

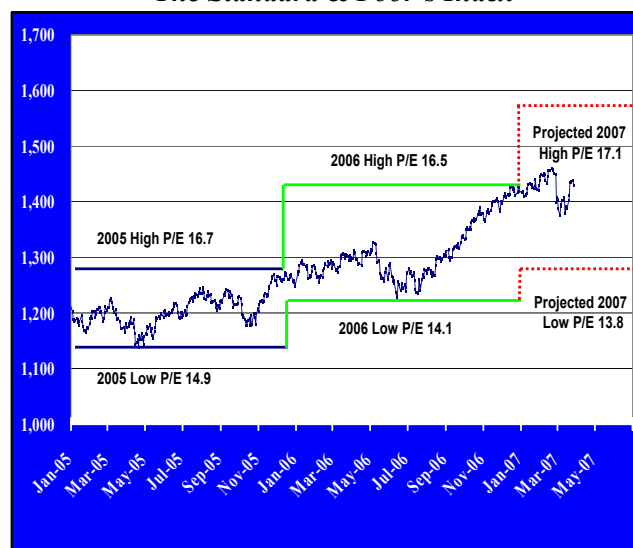
investment, and industrial production growing in the 2%-3% range. These are all consistent with a continuation of the economic expansion.

INVESTMENT STRATEGY

On this basis, the 2007 projected trading range for the Standard & Poor’s Index remains unchanged from that established at the beginning of the year, 1,275 - 1,575 (Chart III). The lower band incorporates a mild correction and is 10% below the March month end close. While there is no assurance that stock prices will not pierce that level, stock prices are low enough to accommodate several quarters of marginal economic growth.

In anticipation that the deceleration in the economy continues, a more defensive posture was adopted on an interim basis. The allocation to stocks was reduced and cash reserves increased to help cushion the portfolio should the current consolidation deepen and/or progress into a correction.

CHART III
The Standard & Poor’s Index



Nonetheless, the outlook for the year as a whole is favorable. Corporate earnings are still expected to increase in 2007; albeit low to mid single digit percent gains. During the second half of the year, investors should begin to focus on stronger profit growth in 2008, and that could elevate prices significantly above closing levels at the end of the first quarter.