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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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THE BULL vs. THE BEAR

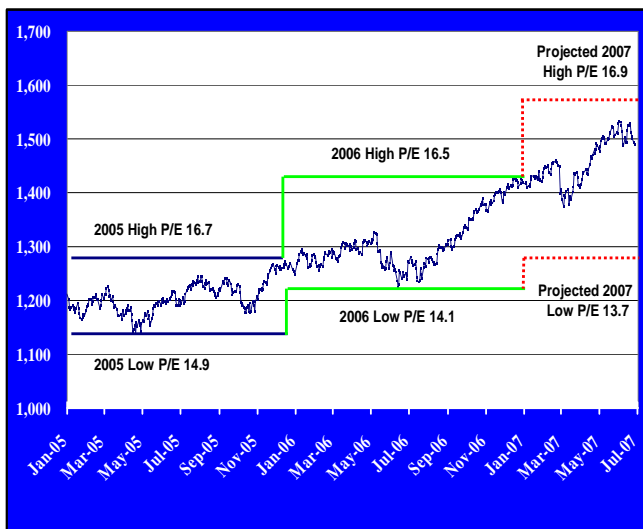
Can stocks continue to rally as interest rates rise?

After more than seven years, the Standard & Poor's Index (S&P) recovered nearly all the ground lost in the 2000-02 bear market. By quarter-end, the Index was within 72 points of the top of our 2007 projected range of 1,275 - 1,575 (Chart I). With the second half of the year ahead of us, is our projected range too conservative, or has most of this year's appreciation already been achieved?

now earn twice as much per dollar sold than 21 years ago. This would suggest some reversion towards previous levels is likely. If that process were to occur, even if partially so, it would restrain earnings growth for a number of years.

CHART I

*The S&P 500 Index Price Range
2005 -2007*

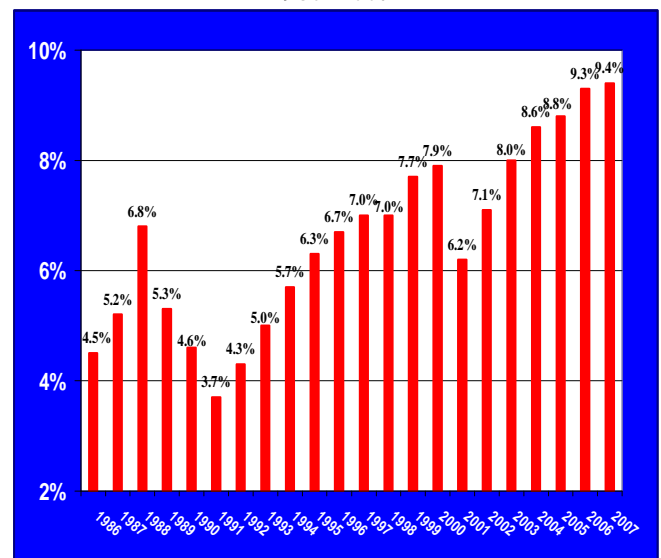


The “bears” argue that rising interest rates will only compound the following “red” flags:

1. Corporate profit margins are at unprecedented and unsustainable high levels. Chart II describes the net profit for the S&P Index since 1986. Profit margins doubled from 4.5% in 1986 to the current peak of 9.4%. Companies

CHART II

*S&P 500 Net Margin
1986 -2007*



2. Earnings growth has already begun to slow, and the ultimate impact of rising interest rates on the consumer and the housing sector is still uncertain.
3. The weak U.S. dollar is causing foreign investors in dollar-denominated securities to suffer currency losses, and this may prompt foreigners to sell U.S. stocks and bonds.

The “bulls”, on the other hand, contend that stocks can continue to rally because the impact of rising interest rates should be more than offset by the following:

1. Strong growth overseas now has a greater impact on our economy than before. Today, as much as 45% of S&P after-tax profits are derived from economic activity outside the United States.
2. The risk of an inventory correction, a contributing factor in many prior recessions, is less today than in the past because information technology has improved inventory control.
3. The risk of escalating inflation is less today than in the past because an increasing portion of manufacturing for our economy is taking place in lower labor cost economies overseas.
4. Lastly, interest rates are still low enough to support further merger activity, leveraged buyouts and share buybacks, which should provide a tailwind to drive stock prices higher.

CHART III
S&P 500 Trailing Price-Earnings Ratio
 1994 - 2007

