



INVESTMENT COMMENTARY

Market Review

What Happened ... In spite of the pullback in June, the equity markets concluded another strong quarter, continuing a nearly uninterrupted four year “bull” market. Most of the major equity indices gained between +5% and +7% during the second quarter alone. The twelve month gains, as shown below, are even more impressive. Bonds (and cash), however, did not fare as well as equities. Long-term (bond) interest rates rose and short-term (money market) interest rates fell, restoring a slight upward slope to the yield curve, i.e. interest rates as a function of bond term. The yield on the 10-year U.S. Treasury bond rose from 4.7% to 5.3% in mid-June, before falling back to 5.0% at the end of the quarter¹. The rise in long-term interest rates reduced the market value of bond portfolios by more than the coupon return, resulting in the negative fixed income returns for the second quarter, as shown in the table below.

Comparative Performance Indices		Total Return for periods ending June 30, 2007 ²		5-Year Average Annual Return
		Quarter	Year	
U.S. Large Stocks	Standard & Poor’s 500 Index	+6.3%	+20.6%	+10.7%
U.S. Small Stocks	Russell 2000 Index	+4.4%	+16.4%	+13.9%
Foreign Stocks	MSCI EAFE Index	+5.3%	+24.1%	+15.0%
Taxable Bonds	Lehman Brothers Aggregate Bond Index	-0.5%	+6.1%	+4.5%
Municipal Bonds	Lehman Brothers Municipal Bond Index	-0.7%	+4.7%	+4.6%

The indices above are representative of investment asset classes. The Standard & Poor’s 500 Index is composed of 500 large company stocks chosen to represent the broad U.S. equity market. The Russell 2000 Index is composed of U.S. companies ranked from 1001 to 3000 based on total market capitalization, representing smaller company stocks with market capitalizations typically below \$1.5 billion. The Morgan Stanley Capital International (MSCI) Europe, Australia and the Far East (EAFE) Index is comprised of a widely followed group of stocks from 20 countries, excluding the U.S. The Lehman Brothers Aggregate Bond Index is composed of U.S. Treasury, U.S. government agency, corporate bond, and mortgage-backed securities. It is not possible to invest directly in an index.

What were the Concerns ... During the second quarter, market commentators worried about the impacts on the U.S. economy and corporate earnings as a result of the U.S. housing slowdown, rising interest rates here and abroad, high oil prices, an overheated Chinese stock market, and the ever-present geopolitical risks. Increasing delinquency rates on sub-prime mortgages, exacerbated by rising interest rates and falling house prices, threatened to cause a severe financial crisis. None of these threats, so far, appears to have caused serious harm to the U.S. economy, corporate earnings, or the financial system. In our contrarian opinion, these worries represent extremely healthy signs that the markets have resumed pricing risks appropriately (see our January 2007 FMA Investment Commentary), creating the possibility of achieving further gains through savvy security selection on both the equity and the fixed income sides of our portfolios.

¹ Yahoo Finance

² Data from Lipper and WSJ Market Data Group as published in the Wall Street Journal, July 3, 2007.



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Market Outlook

What Do Bonds Tell Us ... Expectations for future inflation among bond market participants can be assessed by comparing the yield of the 10-year U.S. Treasury Inflation Protected Security (TIPS) bond, i.e. the *real* interest rate, with the yield of the regular 10-year U.S. Treasury bond, i.e. the *nominal* interest rate. The difference (a.k.a. TIPS spread) between the real rate and the nominal rate equals the expected inflation rate. On this basis, the expected inflation rate fell from 2.6% to 2.3% during the second quarter³. We believe that this seemingly small decline in inflation expectations is highly significant for two reasons. First, the 0.3% decline indicates an expected rate of inflation moving downward and much closer to the Federal Reserve Board's publicly stated "comfort zone" of 2.0% or less, thereby making further increases in short-term interest rates less likely in the near-term. Secondly, this decline in inflation expectations while nominal interest rates are rising suggests that the increase in long-term nominal rates is entirely due to an increase in the real component of the nominal rate of interest. Increases in real interest rates must be caused by either faster economic growth or less capital liquidity. Since we see no evidence of decreased capital liquidity, we must conclude that higher real interest rates are signaling faster economic growth ahead. The current upward slope of the yield curve reflects these expectations for faster economic growth and lower inflation, signaling lower chances for a near-term recession. In our opinion, these indicators are bullish for stocks and bearish for bonds.

What Do Earnings Tell Us ... As explained in our April 2007 FMA Investment Commentary, corporate earnings are another important indicator of equity valuations. First quarter pre-tax NIPA profits, arguably the most reliable measure of corporate earnings because they are derived from corporate tax returns, grew by +6.5%⁴. Though considerably lower than the profit growth rates experienced during the preceding five years, still a positive rate of increase which exceeded the estimates of most analysts. Standard & Poor's estimates \$99.45 in operating earnings for the S&P 500 Index over the next year. The Standard & Poor's 500 Index closed June 29th at 1503, implying a forward P/E ratio of only 15, still well below the 10 year average multiple. Converting to the reciprocal forward earnings yield of 6.6% gives an expected return for equities that compares favorably to current bond yields and expected returns for most other asset classes⁵.

Our Conclusions ... We expect slowing gains in equities and low returns from fixed income with the likelihood of market corrections along the way.

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³ Wall Street Journal Market Data Center

⁴ Bureau of Economic Analysis

⁵ State Street Global Advisors