

Monthly Chartbook

April 2007

Something I had to ask myself recently...

Are we perma-bears?

Macro-economic research

I asked this because we have been concerned about market valuations for some time due to our perspective that risk has been under-priced. But, at the end of the day, you don't want to bet against markets that historically increase roughly 9% per year. There are, however, extended periods of under-performance, and we try to avoid those.

Risk allocation is essentially what we are paid for as portfolio managers, and we have raised a number of questions in recent months about this under-priced risk. So, I thought it might be appropriate to see if this had been a longer-term stance of ours at Cornerstone by reviewing some past Chartbooks.

*Upon review, I believe we would fall more in the **perma-skeptic** category as we are always attempting to find areas of potential weakness in the market and help our clients avoid exposure to those areas (read, sub-prime lending, etc.).*

Capital Markets Expectations (archived 1/1/04)

Index	Current	Forecast		Range	Time Frame
S&P 500	1131.13	Trading range	↔	1050-1200	10-12 Months
Ten Year Treasury	4.13%	Bottomed June 2003	↑	4.00%-4.625%	10-12 Months
Inflation (all Urban)	1.87%	2.25%	↑	1.75%-2.25%	10-12 months
Fed Funds	1.00%	1.00%-1.50%	↑	1.00%-1.75%	6-10 months
S&P 500 Earnings	\$38.17	\$42	↑	\$38-48	1q2004
	Legend:	↑ "Good"	↓ "Bad"	↔ "Indifferent"	

Macro-economic research

In January of 2004, our primary concerns were rising interest rates...

- we thought rates had bottomed during June of the previous year (when the rate on the 10 year US Treasury was as low as 3.33%)
- our accounts were positioned towards equities and away from fixed income, and any fixed income exposure was low in duration
- we weren't sure what the impact of rising rates would be on equities, but we knew it wouldn't be good for fixed

This is an example of skepticism and re-allocation of assets based on that analysis rather than simply being bearish for bearishness sake... we anticipated where assets should not be and avoided that sector. Yet, we couldn't say with certainty what the best asset classes would be going forward (turned out to be international).

However, this asset call took some time to come to fruition – sometimes we tend to be in advance of the investment decisions of the crowd. This introduces another wrinkle of complexity in the asset management equation (that being, remaining in an asset class long enough to reap all the benefit of that exposure).

Macro-economic research

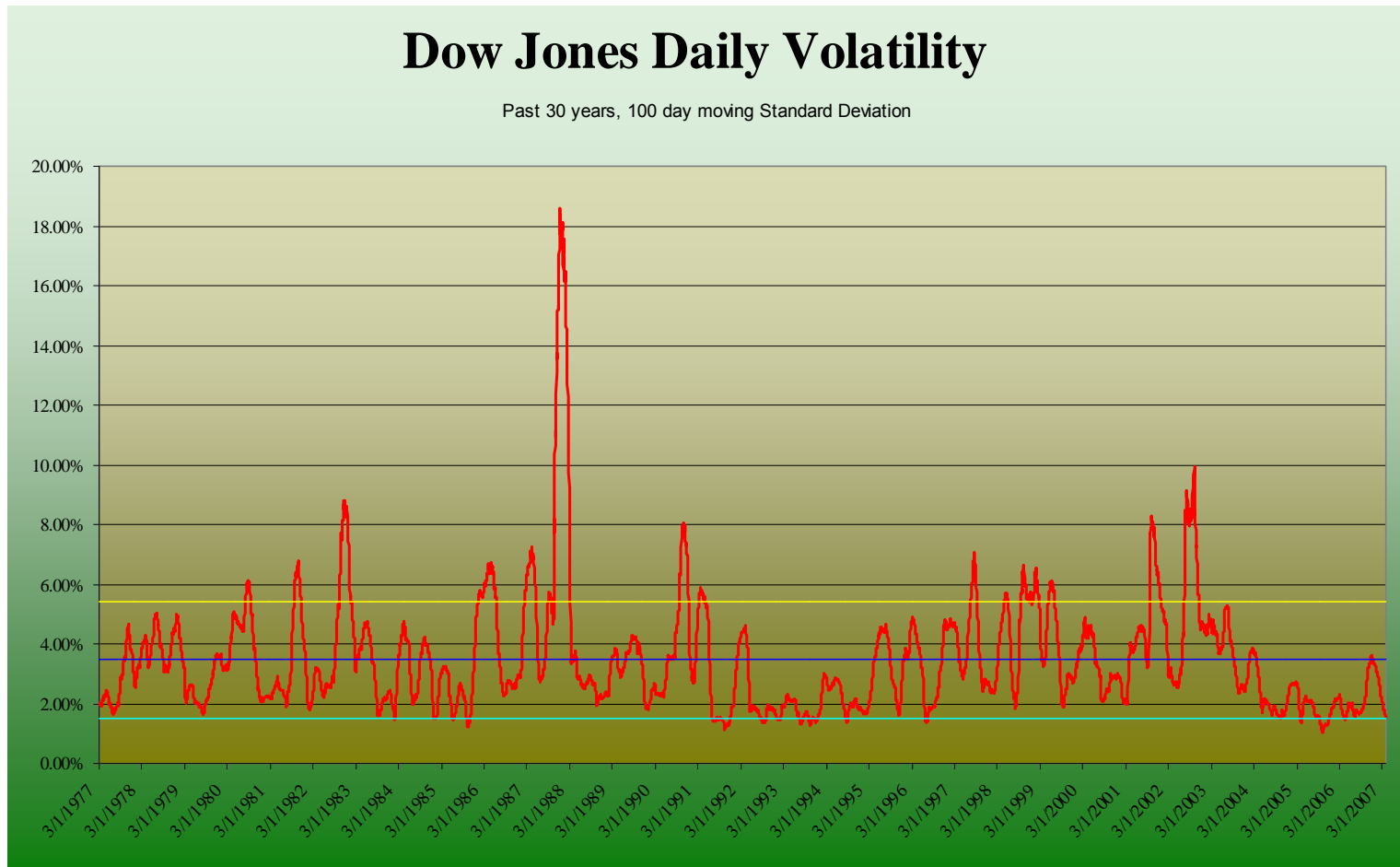
That said, how are our growth accounts oriented right now?

Large Growth
Minimal allocation to Small Cap
International as much as 30%
Cash up to 20%

How would we like them to be in coming six months (given the tea leaves we are reading)?

Large growth – 15%
Large value – 7.5%
Small (both growth & value) – 5% (at most)
International (developed) – 35%
International (developing) – 5%
Other individual securities – 15%
Commodities – 5%
Cash – 10 to 15%

Macro-economic research



Anomalies are always worth considering in the marketplace... sometimes they offer opportunity, and sometimes they raise questions. In this case, lower market volatility, high valuations and less than ideal economic conditions makes us wonder.

Inflation expectations

Within our service-based economy, labor is more expensive than capital.

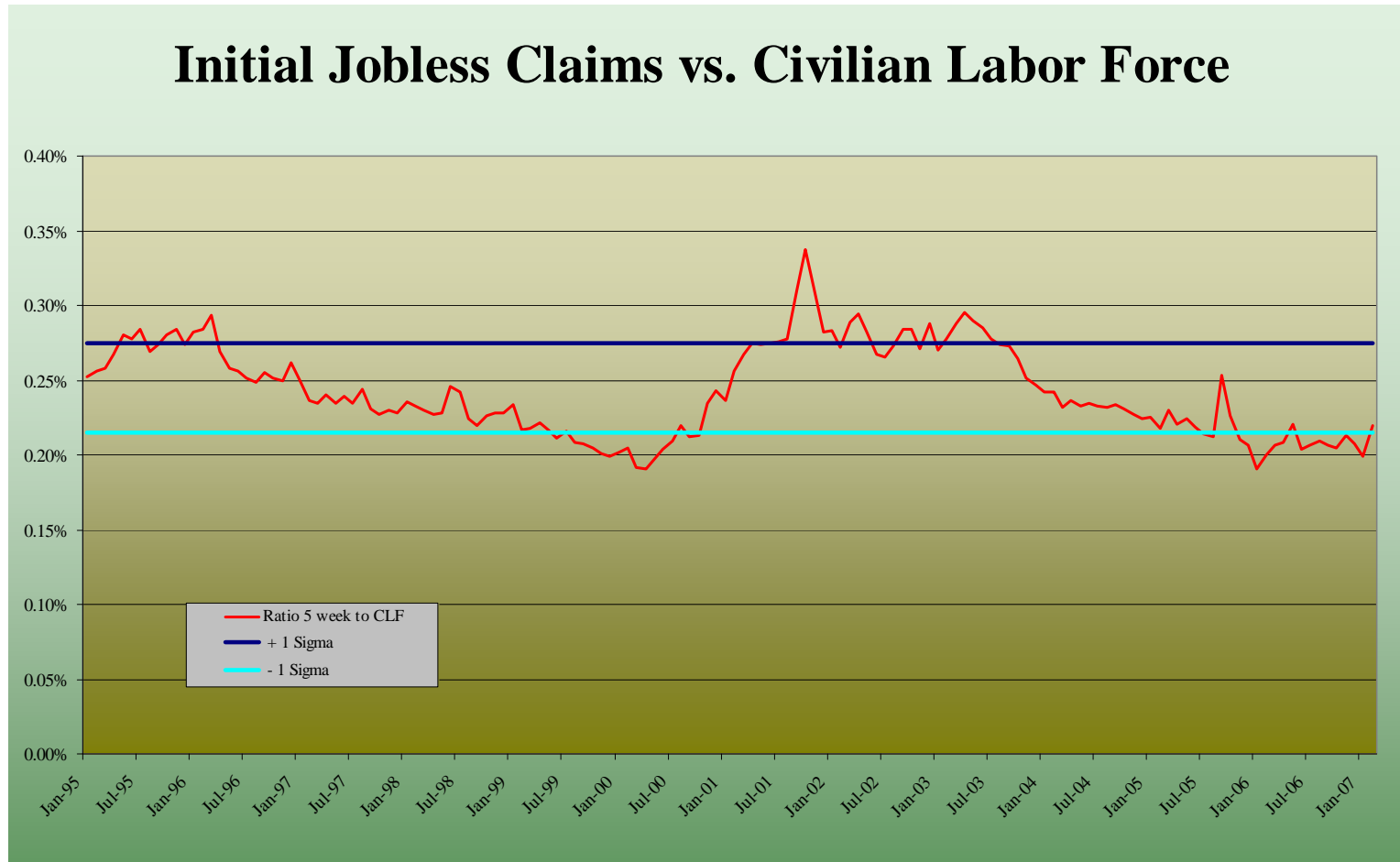
- there remains pressure on labor prices both from the demand for employees and on a historical basis (relative to its share of GDP)

Materials costs are not helping as global demand for commodities continues to rise.

The Price Pressure index indicates that prices should rise, but that predicted rise hasn't yet materialized in widely-used measures of inflation.

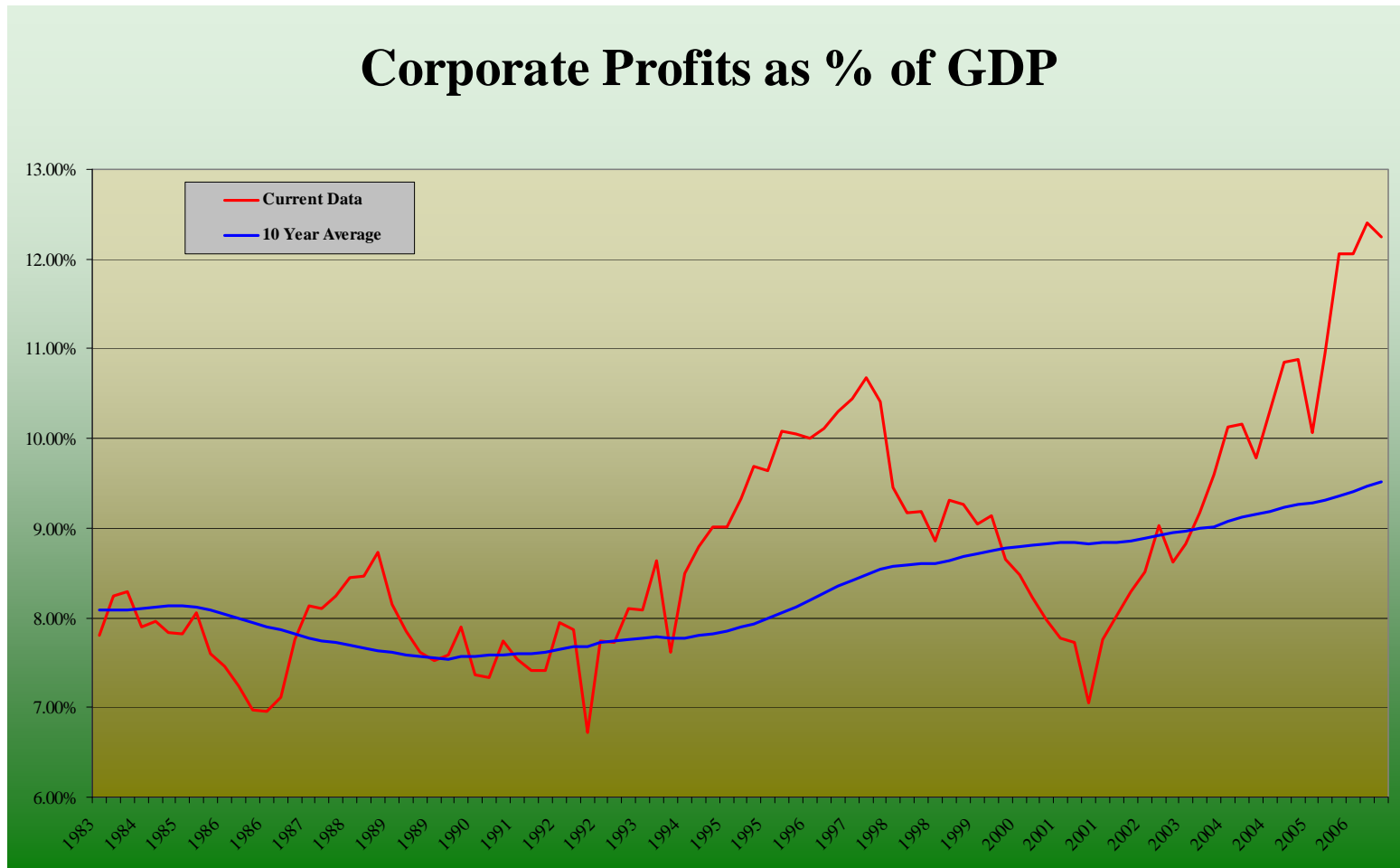
Inflation and inflation expectations are critical factors for the valuation of the S & P 500, and our predictions that inflation may rise and labor costs may diminish corporate earnings could reduce potential returns in coming periods.

Inflation expectations



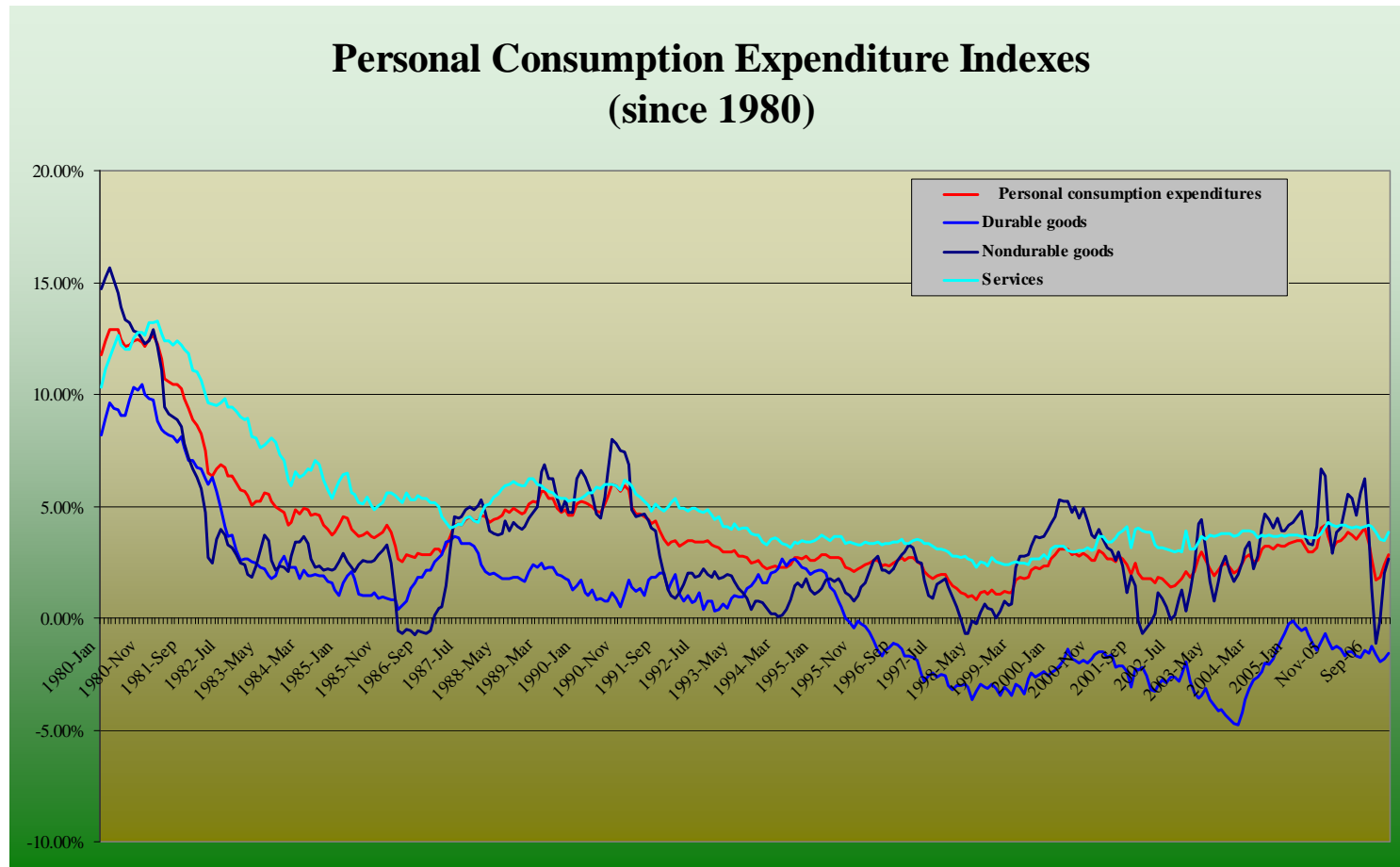
Although jobless claims are slightly higher, they are still low relative to the overall civilian labor force. This, combined with a low unemployment rate and anecdotal evidence, indicates that pricing power may be in the hands of employees rather than employers.

Inflation expectations



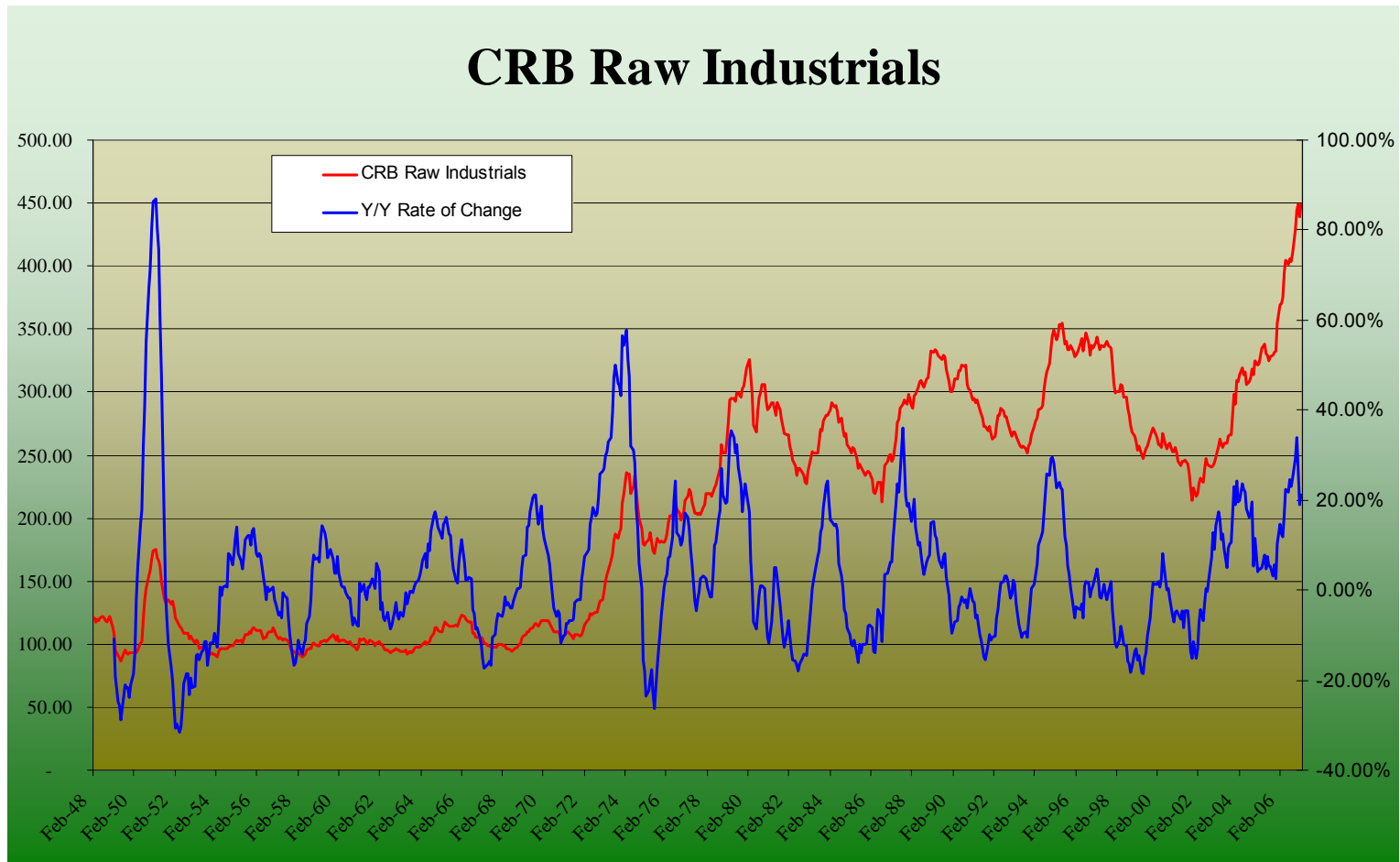
This chart indicates employees are likely due some of the gains from the past decade (that have, thus far, gone to shareholders). Earnings on the S & P 500 were \$38.17 from our January 2004 Chartbook, and they are now \$84.44. These higher wages may cause this earnings growth to stagnate.

Inflation expectations



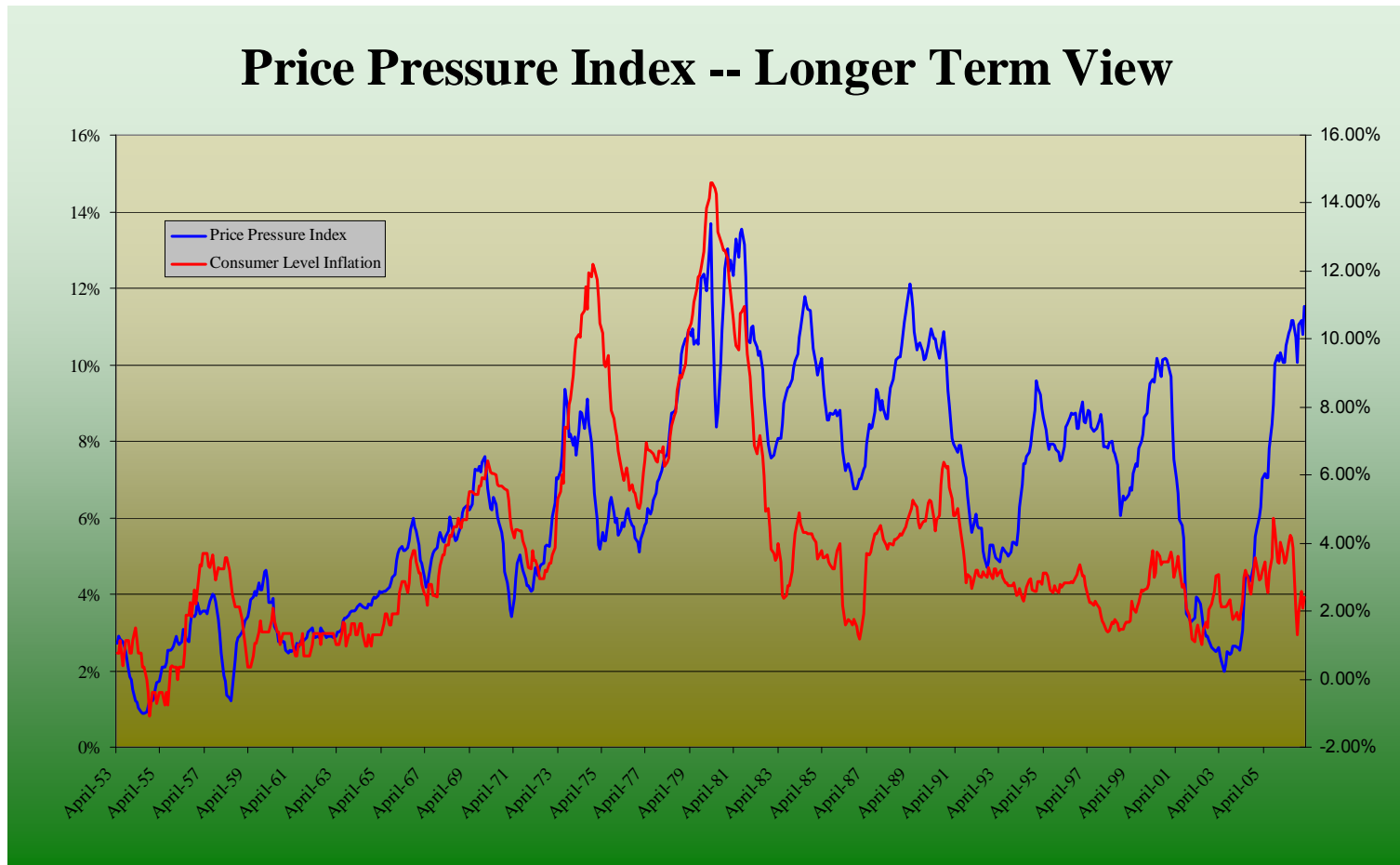
The growth rate in the amount of money spent on goods (both durable and non-durable) has fallen and remained low since the 1980's, while the growth rate in spending on services has actually increased -- further evidence the cost of labor is a critical factor in the cost of goods within our economy. Think about the cost of a good such as a CD player and contrast that with the cost of your haircut... one has fallen while one has risen.

Inflation expectations



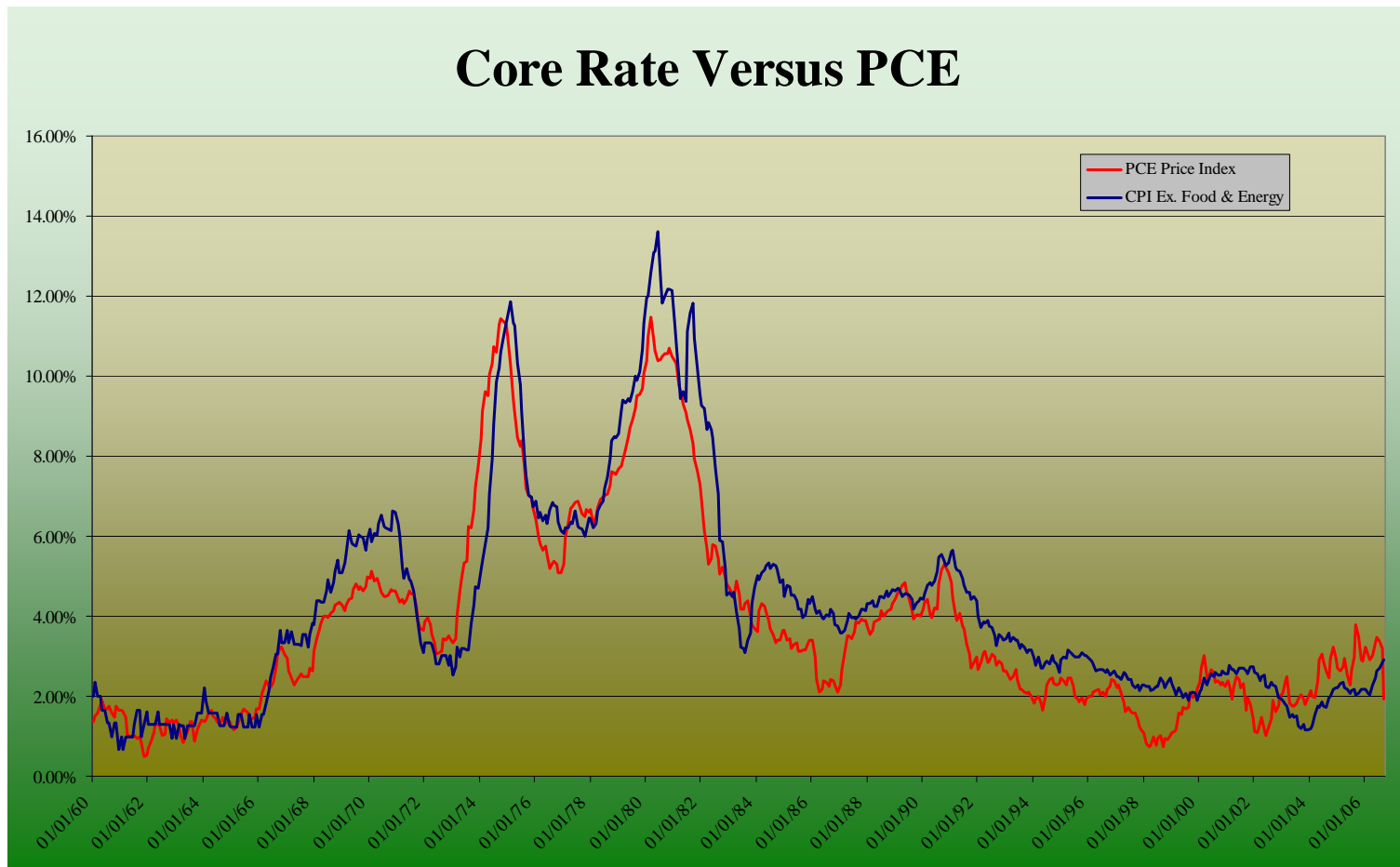
Commodity prices continue to rise as well. This might mean that nothing is especially cheap in coming years (especially if we have to pay with a dollar that is losing value relative to other currencies on world markets).

Inflation expectations



Consumer-level inflation measures don't seem to reflect the potential costs of labor and of more expensive materials as measured by the Price Pressure Index.

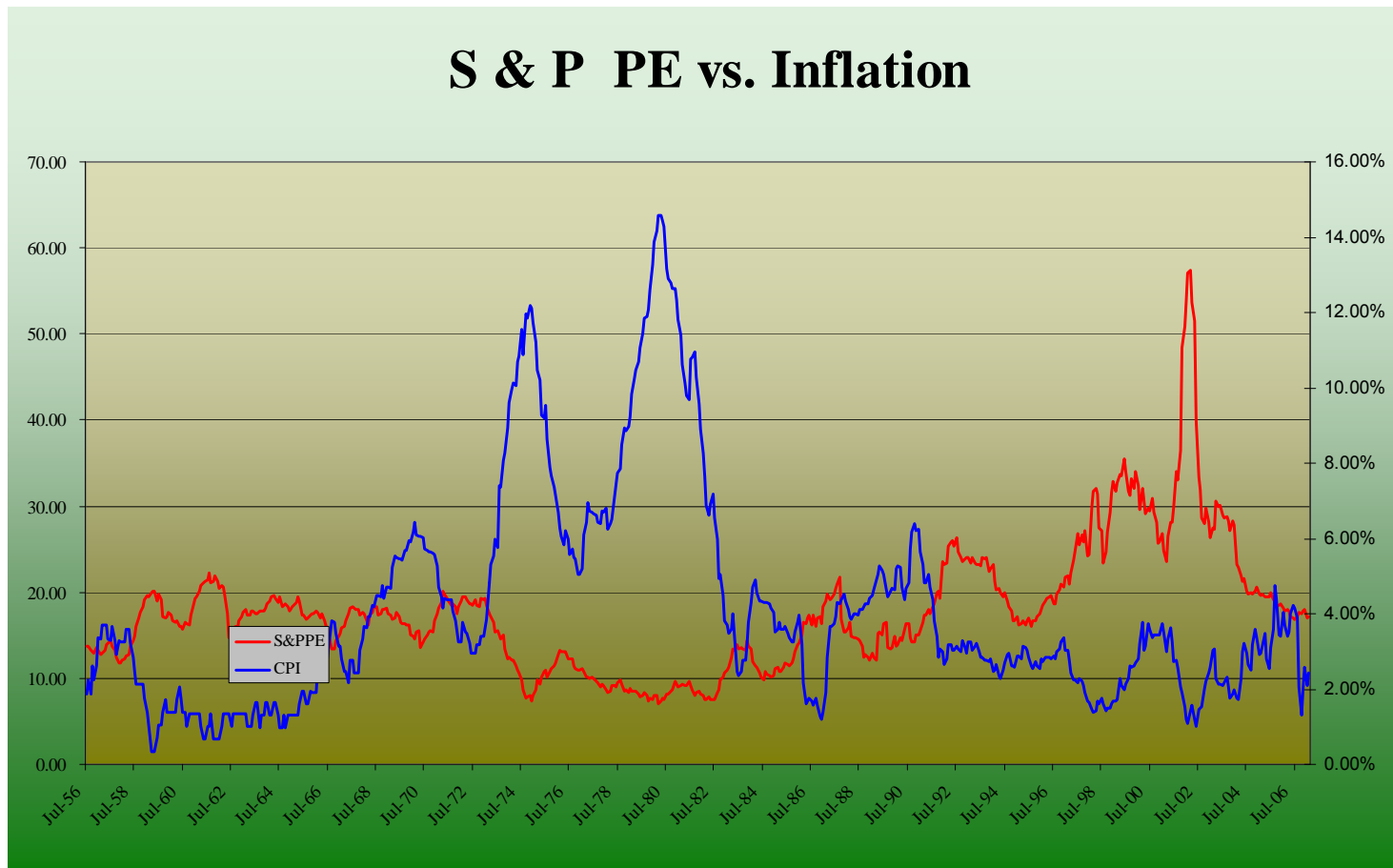
Inflation expectations



But, consumers seem to have been able to substitute goods such that this inflation hasn't impacted their ability to spend (and spend, and spend...). Both CPI and PCE are increasing, but certainly are not out-of-line with historic measures.

Or, could it be that our methods for measuring inflation are not accurately capturing all costs?

Macro-economic research



We have established in previous Chartbooks that the S & P trades at higher valuations when inflation is low, but there may be a number of pressures placed on this relationship. For example, if labor and materials price increases push inflation higher, the PE will likely fall as a result of the inverse relationship. Simultaneously, labor costs may result in stagnating earnings growth, forcing lower prices on the S & P to justify its earnings ratio.

The side of the bet I wouldn't want to be on is the assumption that earnings will continue to increase and inflation will remain low.

Federal Reserve Watch

Monetary conditions remain weak even though money supply growth is not declining. But, there is more to managing the world's reserve currency than occasionally modifying interest rates.

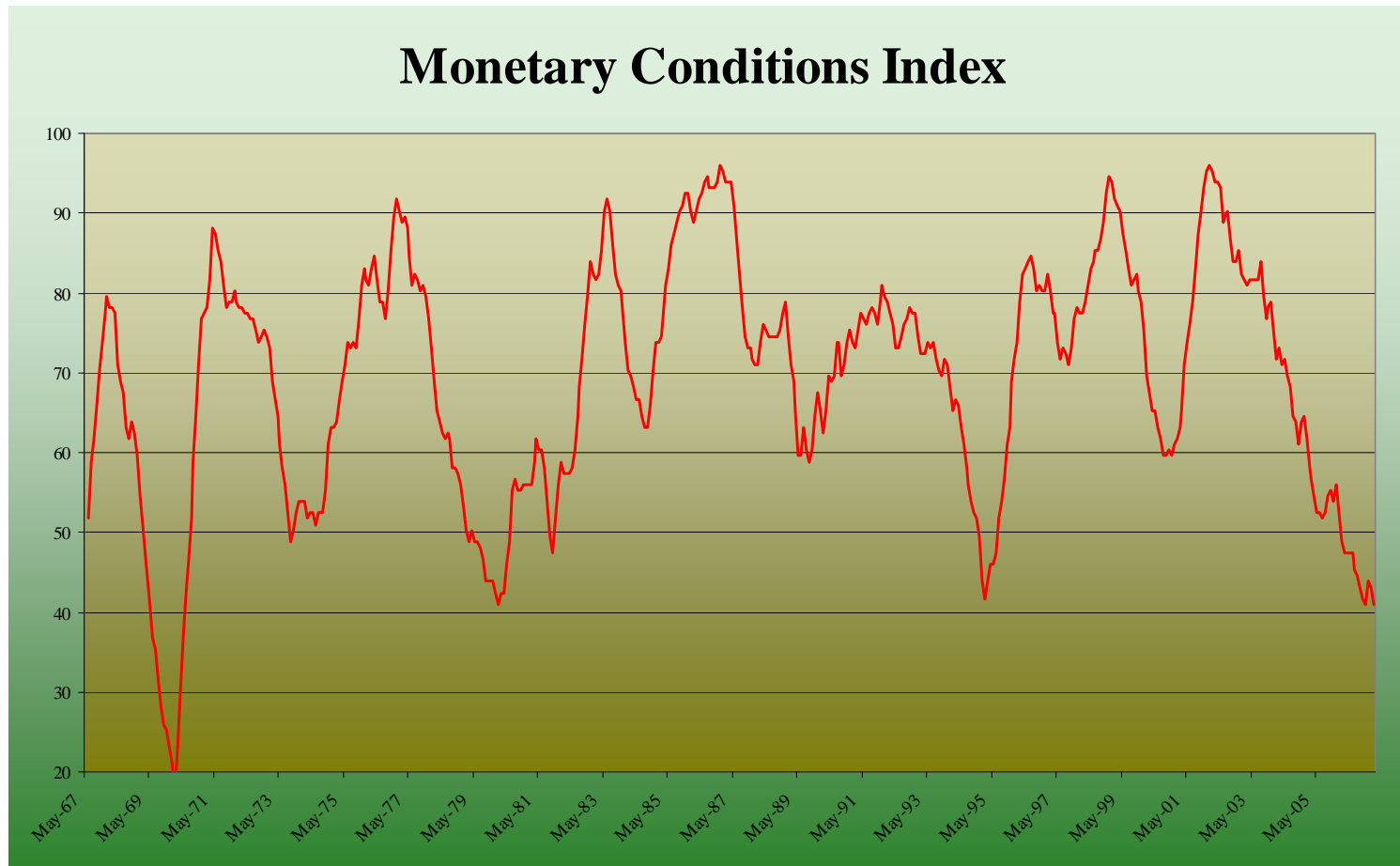
There is a historically significant real spread between the short-term Fed funds rate and inflation as measured on a year-over-year basis.

This helps make the dollar an attractive currency (fundamentals aside) as its value as an asset class is the real interest rate it offers.

We continue to view the Fed as “on hold” and are not willing to bet on a rate cut until signs of broad weakness are detected in the economy (which we view as unlikely).

The Fed is attempting to work through the excess liquidity of past years rather than creating its own excess liquidity.

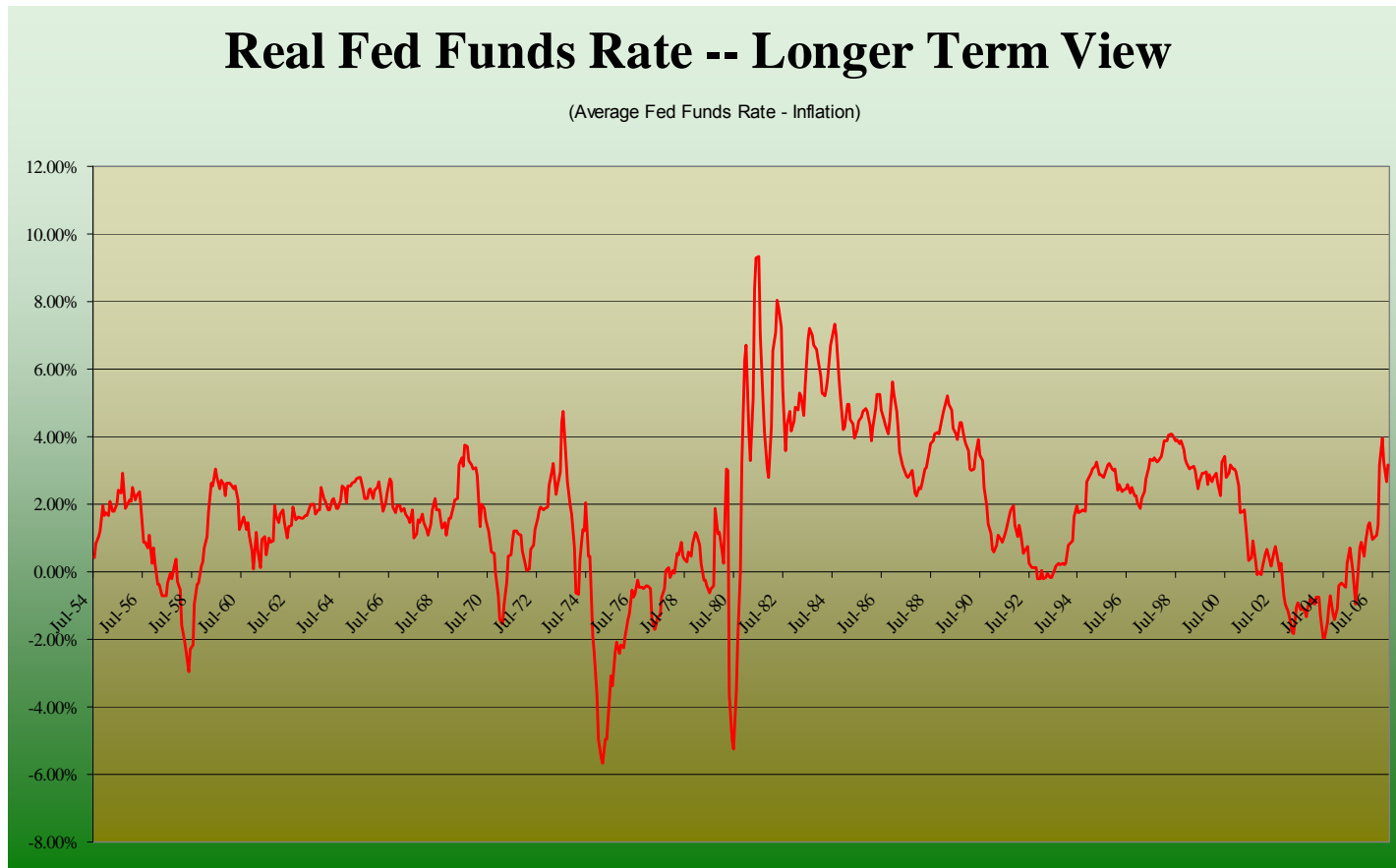
Federal Reserve Watch



Cornerstone's Monetary Conditions Index is an aggregate of a number of monetary policies currently in place. As these conditions have tightened, the index has declined. It is now as low as it has been since around 1970 after a steep decline beginning near the middle of 2002.

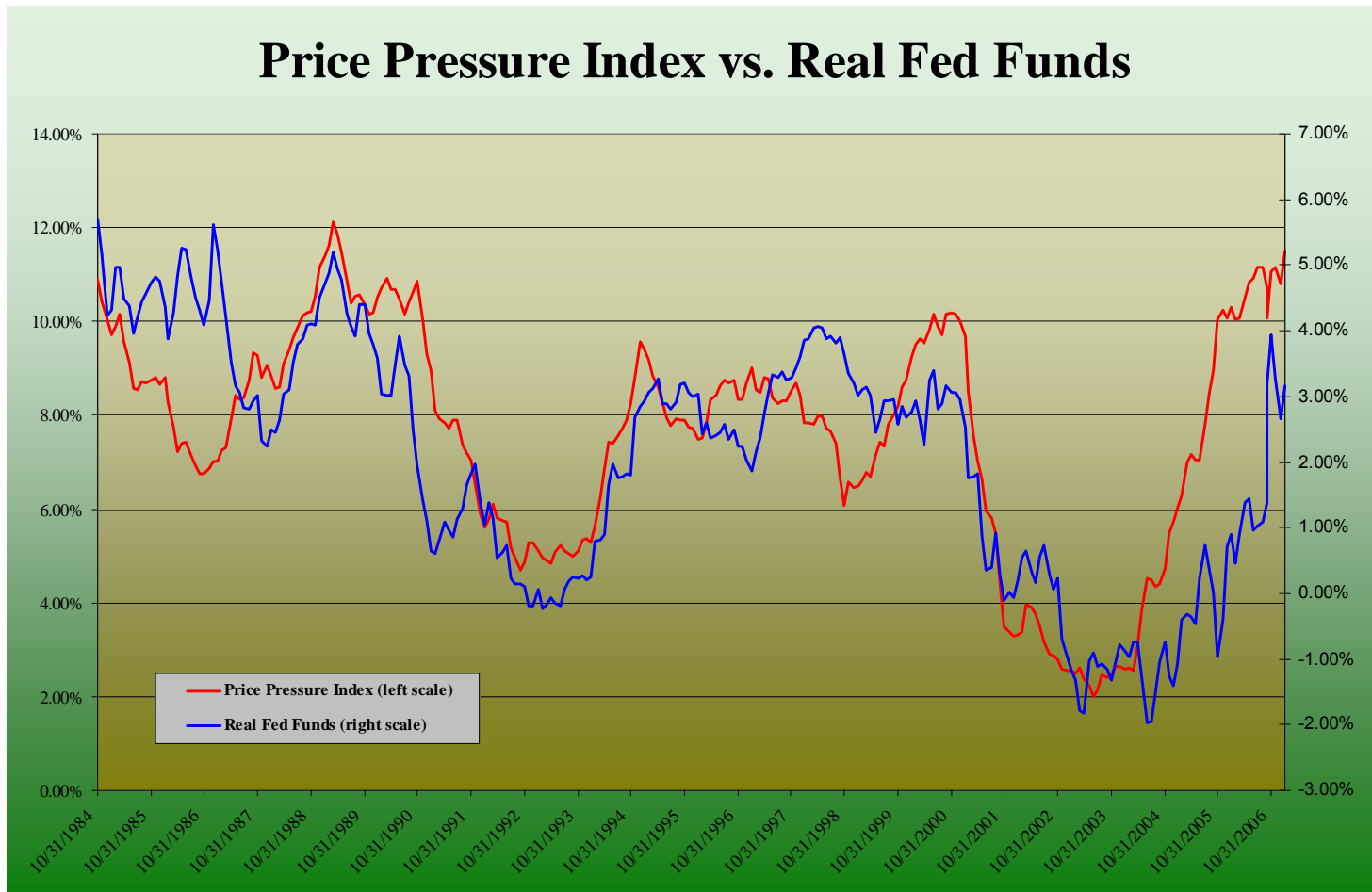
What does this mean for investors? As excess liquidity is removed from the system, it reduces the "fuel" needed for an asset boom.

Federal Reserve Watch



The Fed funds rate after inflation is fairly attractive on a historical basis. Again, though, this could be influenced by the inflation measure being used.

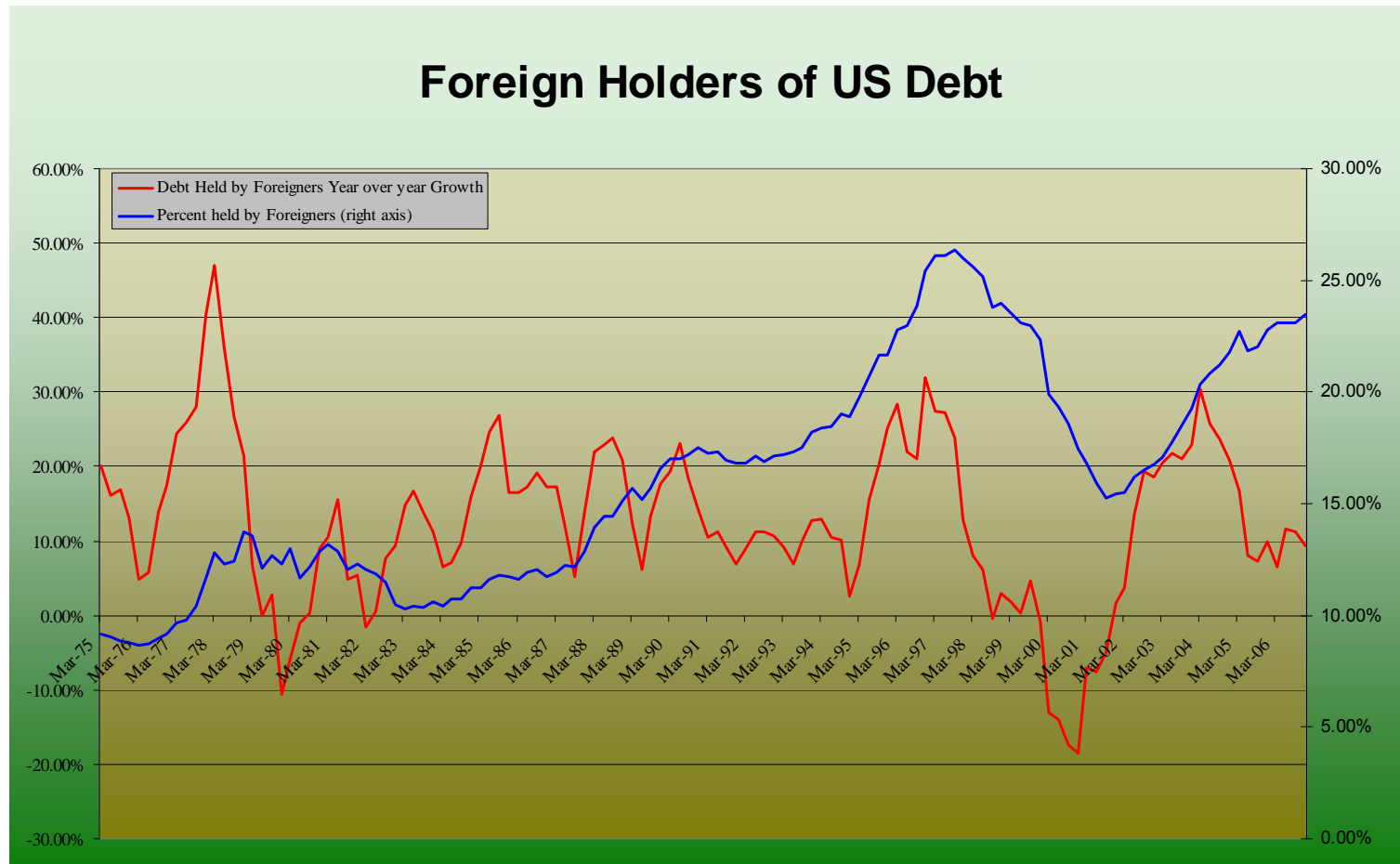
Federal Reserve Watch



Real Fed funds rapidly rose after interest rate hikes; contained inflation has also made this spread attractive (certainly relative to the recent past).

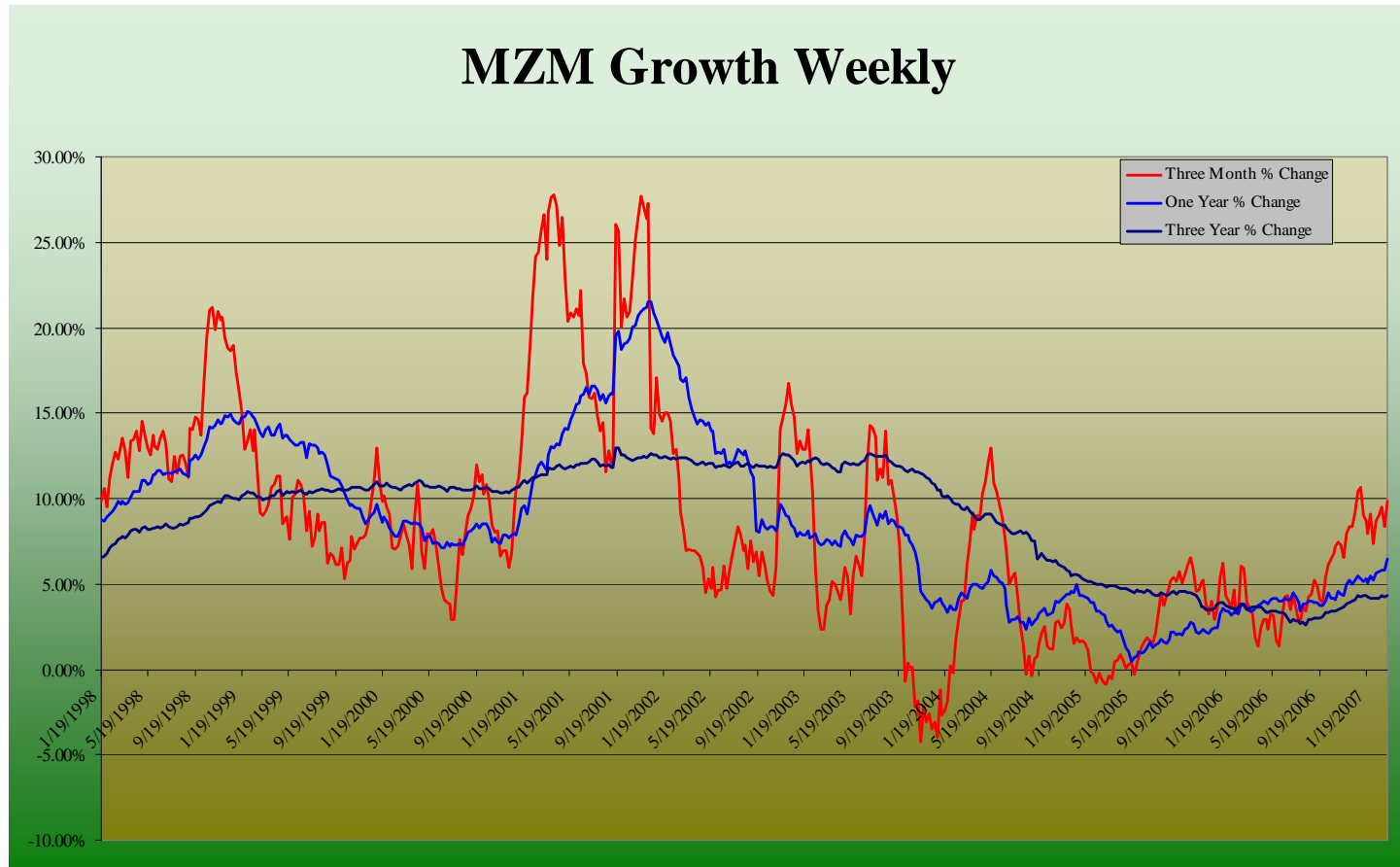
This matters because this real spread makes the dollar an attractive currency (economic fundamentals aside).

Federal Reserve Watch



Foreign governments continue to hold a remarkably high percentage of our national debt. This demand may help explain why there is a disconnect between short-term rate increases and longer term rates.

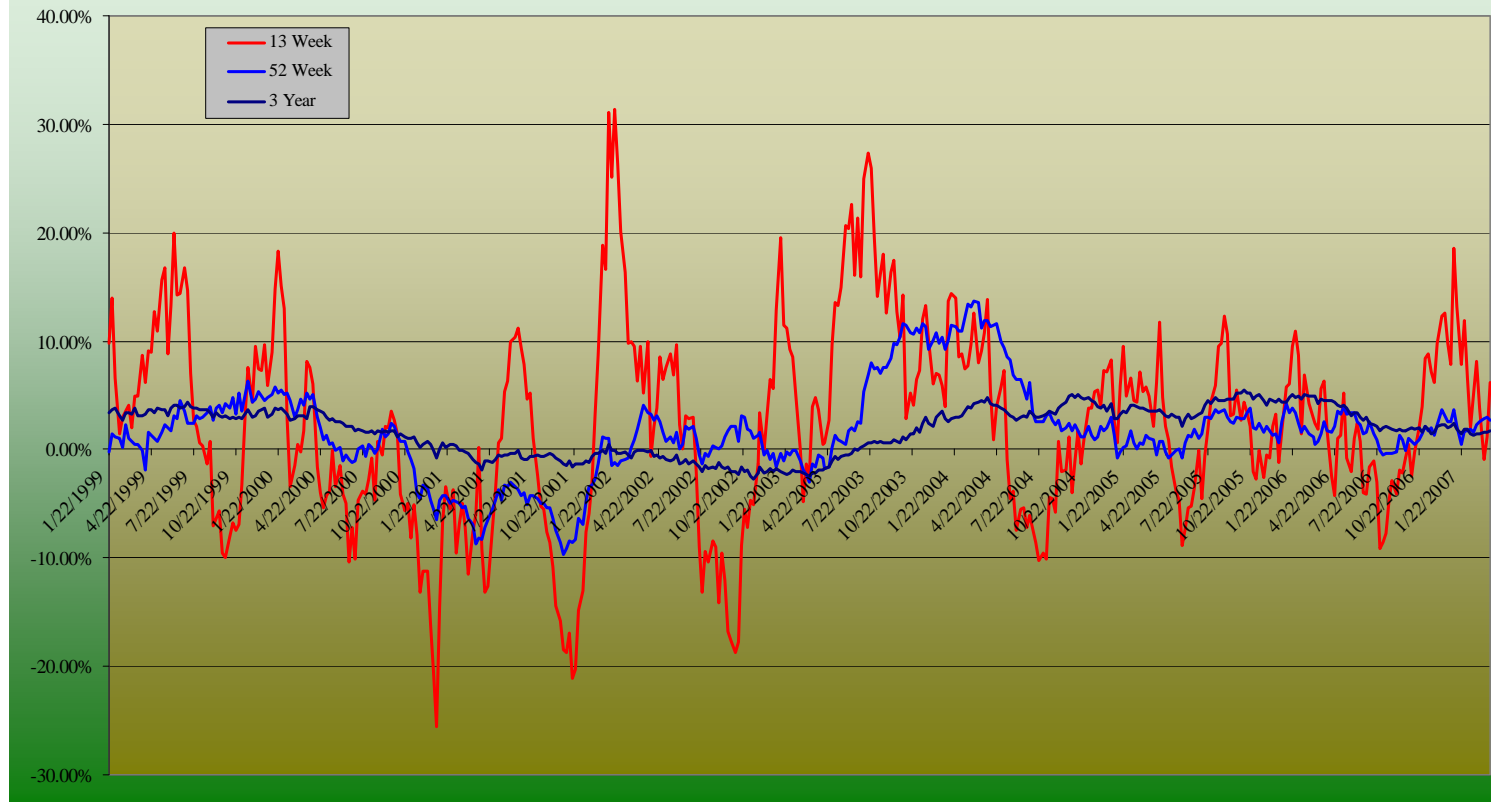
Federal Reserve Watch



All measures of monetary growth are positive, which makes the tightening monetary conditions indicated by the Monetary Conditions index even more interesting.

Outlook & Forecast

Economic Momentum



Economic momentum as measured by the Economic Cycle Research Institute (ECRI) weekly indicators is declining over the 3 year period but fairly stable on a one year basis.

Outlook for our Managed Economy

Index	Current	Forecast	Range	Time Frame	Comments
S&P 500	1420.86	Trading range	1400 -1500	9 Months	Asset prices managed
Ten Year Treasury	4.62%	Trading range	4.6 – 4.85%	10-12 Months	“Disconnect” between short and long-term rates remains
Inflation (all Urban)	2.41%	2.75%	2.35 – 2.95%	10-12 months	Do these numbers reflect what you are having to spend?
Fed Funds	5.25%	No change	5.25%	12 months	Don't look for lower rates
S&P 500 Earnings	\$84.44	\$88	\$84.75 - \$92.50	End of 2007	How fast do wage increases make their way to Income Stmtns?

Mousetype

- This Managed Economy is provided by your Federal Reserve and is “guaranteed” by that body and the PPT until the S & P 500 reaches historical highs (only about 8% away) so that tax revenue can increase as many corporate options are again “in the money”. This “guarantee” will be null and void should there be any exogenous shocks to the economy that cannot be modified by actions on the part of the participating entities.