

2007
THIRD QUARTER
INVESTMENT REVIEW

COMMENTARY



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The Financial Markets

- ◆ The Wall Street Journal compared the most recent quarter in the equity and fixed income markets to “taking an airplane trip through a storm.” Turbulence was accentuated by a peak in the equity markets in July, followed by the sell off in August due to credit market woes, hedge fund problems, weakening housing data, high energy prices, a slumping dollar and fear that the Federal Reserve might not react to the crisis. Finally, financial markets rebounded in reaction to the Federal Reserve’s aggressive interest rate cut in September.
- ◆ Domestic equity markets finished the quarter mixed, with large capitalization indices producing positive total returns, while most small and mid capitalization indices delivered negative results. The S&P 500 Index ended with a total return of 2.0% for the quarter, and 9.1% for the first three quarters of the calendar year. Within the S&P 500, the Energy, Information Technology and Industrial sectors posted strong positive returns, while the Financial and Consumer Discretionary sectors declined for the quarter.
- ◆ The Federal Reserve Bank cut short-term interest rates by .50% at its September meeting in a bold response to the turmoil in credit markets. Further rate cuts are anticipated as the Federal Reserve shifted its emphasis to weaker growth rather than higher inflation. Treasury bond yields moved sharply lower and the yield curve steepened in a classic flight to quality. The yield on the 2-year Treasury Note fell .87% to 3.98% at the end of September while the yield on the 10-year Treasury issue declined .44% to 4.59%.
- ◆ Yield spreads on corporate bonds spiked higher in July and August as investors re-priced credit risk across all sectors in the wake of the meltdown in subprime mortgage securities. Buyers shied away from asset-backed commercial paper, causing yields to soar and issuers to tap back up lines of credit. The high yield sector saw yield spreads jump over 2.00% from early June, though spreads narrowed modestly after the Fed’s September rate cut.
- ◆ The municipal bond market also faltered in August due to the unwinding of leveraged accounts, which pushed valuations to historically cheap levels. In September, demand for tax-exempt bonds firmed and the municipal market enjoyed a significant rally. By the end of the quarter, the greatest yield change was seen in the five-year maturity, with a drop of .38% from the end of June. The slope of the municipal yield curve steepened.
- ◆ International market fluctuations correlated closely with U.S. domestic markets during the mid-quarter declines and subsequent recovery. Exceptions in major overseas markets were Japan and some European markets, which struggled with financial or economic problems and closed lower. Overall, the EAFE Index returned 2.2% for the quarter. Emerging markets, including China, India, Russia, Brazil and Hong Kong all rebounded and closed significantly higher by quarter-end.

The Economy

- ◆ Evidence of a slowing domestic economy is broad-based. The U.S. service sector, representing 90% of domestic economic activity, continued to expand in September, though growth rates were lower than in August. Analysts continued to warn that housing foreclosures and lower housing prices could weigh on consumer spending and flow through to retailers, wholesalers, manufacturers and financial institutions. The manufacturing segment of the economy – the remaining 10% of economic activity - is also experiencing slowing growth, with recent months' manufacturing indices sequentially lower than in the second quarter.
- ◆ Core inflation decelerated to 2.1% on a year-over-year basis, down from a rate of 2.7% at the beginning of 2007. However, market indicators such as gold, oil, and a weaker dollar suggest potential risks of higher inflation.
- ◆ Aided by additional government jobs, recent employment data were stronger than expected, though employment growth still slowed. Private payroll hiring was revised downward and job creation is lackluster. Layoff announcements in August and September, which may not flow through for a few months, were close to 60,000, a new record. On the positive side, average hourly earnings have seen a healthy 4.1% average increase for the last year.
- ◆ The housing industry is the headline concern, as contractions from overbuilt and overpriced regions are seeping into healthy areas. Lending standards have been tightened and mortgage rates are higher than a year ago. August prices for new homes showed a decline of 3.9% year-over-year. Prices have now declined sequentially for 13 months, and are down in 75% of major metropolitan regions. Other housing industry sales and inventory measures are at or below multi-year lows. Sub-prime mortgage delinquencies are 14.5% of the outstanding pool, a five year high, with foreclosures doubling from a year ago.
- ◆ Third quarter corporate operating earnings growth is likely to be the slowest since 2003. Though expectations remain wide, corporations are projected to generate 4.9% growth year-over-year for the quarter versus the 9.3% growth delivered in the second quarter. Historically, mid-single digit growth during an economic slowdown is considered a solid performance, particularly when accompanied by tightening credit. Earnings are expected to be very weak in housing-related and other financial companies, with many companies taking significant write-offs in problem areas. Energy companies should see lower earnings increases as rising costs have contracted profit margins. Technology, healthcare and industrial companies should deliver the strongest earnings growth for the quarter.
- ◆ Global economies have been hit by the effects of the credit and capital markets contraction, as well as the slowing U. S. economy. Some have rebounded strongly, supported by their

underlying domestic growth. Europe is slowing and should see gradual interest rate relief from their central banks by early next year. Japan is finally seeing increases in real estate values, even in the face of a weak economy. Emerging market economies are generally strong, with China again taking steps to avoid overheating. India's current economic growth appears to be more stable.

Future Prospects & Portfolio Strategy

- ◆ Economic growth slowed in the third quarter. Consumer spending held up reasonably well thanks to gains in personal income, but spending is expected to be negatively impacted by the ongoing housing contraction and tighter lending standards. U.S. exports will benefit from the weaker value of the dollar. Risks to the economy remain much the same as denoted last quarter – a further decline in housing and more problems in the sub-prime mortgage sector, the cumulative effect of tighter credit standards, higher energy prices and the risk of a slowdown in global growth. Economic and corporate earnings growth will likely be more subdued into 2008.
- ◆ Analysts' earnings growth forecasts continue to come down, with corporate earnings expected to grow only 4.9% this quarter, though likely a bit stronger in the fourth quarter. Earnings for 2008 are now expected to increase 6.5%. This could set the stage for positive earnings surprises next year, and with them an opportunity for companies with the better rates of earnings growth to be rewarded with higher valuations.
- ◆ Domestic stocks are currently valued at 15X forward 12 month earnings estimates and 16X trailing earnings. Given the current level of interest rates and inflation, stocks still appear to be fairly valued. In this slowing economic environment, we favor exposure to companies with higher rates of earnings growth and exposure to corporate spending and international growth. Current valuation levels also create a basis for further positive returns in equities.
- ◆ The Federal Reserve is still expected to lower short term rates again in the fourth quarter. Longer term rates will likely be affected by expectations for inflation as indicators show continued strength in commodity prices. Under this scenario, fixed income portfolio structures will emphasize intermediate maturities to take advantage of projected additional steepening of the yield curve. Sector strategy will add cautiously to corporate bonds as spreads have widened to reasonable valuation levels.
- ◆ We believe the most likely scenario is for the U.S. economy to achieve a soft landing with a period of below trend growth, but avoiding recession. In this environment, we continue to favor equities over fixed income.

Editor's Note: In a continuing effort to bring our clients relevant ideas to help them in their wealth management efforts, Lowe Brockenbrough & Company is pleased to offer the following article by Penn Rogers, a partner with LeClair Ryan and an expert in tax law. Periodically, we will examine other wealth management and tax strategies in future quarterly Commentary pieces.

YEAR-END TAX PLANNING IDEAS

Tax planning does not always have to be a defensive undertaking. With some forethought and knowledge of tax law provisions likely to have an impact on them, investors can often take the initiative and employ those provisions to minimize the tax bite that would otherwise apply to them. For example, many investors and their advisors make a practice of "harvesting" capital losses by liquidating loss positions yearly and using those losses to offset capital gains recognized on other sales. Here are a few additional tactics that may prove beneficial for you to consider during the fourth quarter of 2007.

- **Use Your IRA to Make Charitable Contributions.** If you are considering making charitable gifts before the end of the year, are age 70 ½ or older and have a traditional IRA or a Roth IRA, the law currently allows you to direct the IRA trustee to make up to \$100,000 in gifts directly from the IRA without the distribution being included in your gross income, as would ordinarily be the case. Such gifts will, however, be counted towards meeting any minimum distribution requirement which may apply to you. While the amount of the gift is not deductible on your return, the exclusion from gross income means that the amount of the gift will not increase the phase-outs of itemized deductions, personal exemptions and other benefits that typically occur with increases in gross income. The gift also will not be subject to the percentage limitations that usually apply to charitable contributions. This special rule is scheduled to expire on December 31, 2007.
- **Make Tax-Free Gifts.** Under current law, any individual may make up to \$12,000 in gifts to an unlimited number of individuals in 2007 without triggering the requirement to file a gift tax return and without adversely affecting the donor's gift and estate tax exemption. A husband and wife can each use the exclusion, meaning that together they may make up to \$24,000 in gifts to an unlimited number of individuals.
- **Get Tax Benefits for "Going Green".** If you are considering home improvements that include energy efficient HVAC systems or building components (including windows, skylights, insulation and exterior doors), consider making those improvements prior to year-end in order to take advantage of energy tax credits that will expire after 2007. Credits typically are available for 10% of the cost of improvements, up to a maximum credit of \$500. In addition, through 2008, expenditures for solar electric or solar water heating systems for your residence are eligible for a credit of 30% of the amount paid, up to a maximum credit of \$2,000.
- **Pay Attention to the Kiddie Tax.** The so-called "Kiddie Tax" rules currently tax children under the age of 18 at their parents' marginal tax rate on investment income in excess of \$1,700. Beginning in 2008, these rules will apply to 18-year olds and to most full-time students through the age of 23. For older children who will become subject to the Kiddie Tax next year, and who hold appreciated investment assets that are likely to be sold, it may be advisable to sell those assets in 2007, rather than in 2008. Gains from such sales in 2007 will often be taxed at 5%, because the child is not currently subject to the parents' marginal rate, while sales in 2008 will likely be taxed at 15%, when the higher marginal rates will apply.
- **Leverage Low Tax Rates.** If you or some other family member are subject to tax in the 15% or lower rate bracket (which might be the case, for example, if you have significant income from tax-exempt securities), you should note that the capital gains tax rate applicable to sales of appreciated stock or other capital assets is scheduled to be reduced from 5% this year to 0% in 2008. Accordingly, it may make sense for those in the lower brackets to defer some sales of assets subject to capital gains tax until 2008. If you are likely to be in the lower brackets next year, you should make sure your financial adviser is aware of that well in advance of year-end, so that he or she can help you properly tailor your year-end trading.

Often the key to maximizing the tax benefits attributable to expiring provisions or changes in law is careful planning and execution well in advance of year-end. A visit with your tax accountant and financial advisor early in the 4th quarter can easily yield enough tax savings to pay for the visit. Furthermore, that visit may be the catalyst for consideration of longer-term planning to take advantage of potential savings from charitable remainder trusts, gifts of conservation easements, use of family limited partnerships and other tax-efficient wealth management strategies.

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