

August 17, 2007 - Mid Quarter Update!

Over the last couple weeks the market has certainly seen some serious volatility!

According to yahoo finance, after hitting an intraday high of 14,121 on the Dow on July 19th we saw a new intraday low of 12,455 on Thursday the 16th. This would officially make the latest market decline a 10% correction.

To put a 10% correction into perspective, here is some interesting commentary* that Matt Krantz of USA Today authored back on March 12th:

"...The Standard & Poor's 500 stock index has generated 10.4% average annual compound rates of growth since 1927, according to IFA.com. But there have been some brutal swings in the process. Using statistics, we know that about 34% of the time, you can expect the S&P 500 to fall as much as 9% during the year. About 14% of the time, you can expect the S&P 500 to be down more than 9% but less than 29%. And about 2% of the time you can expect the market to be down more than 29%...*"

So using Matt's statistics, what we have just lived through is a fairly common occurrence. The question that many investors are asking is if this is just a small correction or if this is the beginning of a really big correction.

In our opinion, while poor lending practices have and may continue to take a toll on the economy, the big picture still looks pretty good. I really believe almost anyone can figure out if lenders are lending more than the value (125% equity loan) of a rapidly inflating asset (like houses) to people that don't have good credit, eventually the lenders will be in trouble.

To incorporate additional commentary*, On August 2, Ben Stein stated in his column in yahoo finance:

"Subprime is a mess. But it's a small mess. Subprime mortgages account for roughly 20 percent of mortgages even in the most heavily exposed states. About 20 percent of them are delinquent in some way. That's 4 percent of mortgages. Of these, maybe half, or 2 percent, will go into foreclosure. There will be roughly 50 percent recovery on sale of these. This is a loss of 1 percent in the mortgage market -- a sum the lenders have already made many times over because of the hefty fees on those deals. In the context of the size of the U.S. financial sector, it's nothing.*"

When it comes to making major investment decisions for long term investment dollars, at Buttonwood we use logic and do what we can to not be influenced by emotional decisions. After all, planning for long term financial goals is hard to do if assets are sold every time the headlines look scary.

Financial markets have survived a number of other challenges provided by relatively stupid actions (of course, I'm using the term 'stupid' in hindsight). Ironically if you look at what the historical headlines were all about they are very close to the same problems we are facing today – Lending practices, currency exchange rates, and hedge funds!

At Buttonwood we are big believers in cycles – and unfortunately, as very intelligent human beings we are often immune to learning anything from our past and thus we have a tendency to repeat our mistakes.

For example, just look at a few of the “financially challenged” times that were huge headline stories* and have now been forgotten about... Remember the S&L scandals back in the 80’s when there was talk about an entire banking sector collapse? And the Dow was at an average level of 919 during 1980.

The Asian Contagion was in 1997 and there was talk of global economic collapse during this period - and the Dow averaged 7,360 in '97. Then we were faced with the collapse of hedge fund Long Term Capital Management and the wide spread repercussions in the financial industry in 1998.

After living through these “bad times,” I think we all remember what happened to the Dow from the low of about 7,400 in September 1998 to the high on the Dow of over 11,400 in May of 2001.

Selling during the times of fear and crisis has generally had a tendency to reduce the rate of success when looking at long term financial goals.

So, setting the emotion aside and looking at the situation logically, where are we today?

The bullet point summary below ties consecutively to the following pages:

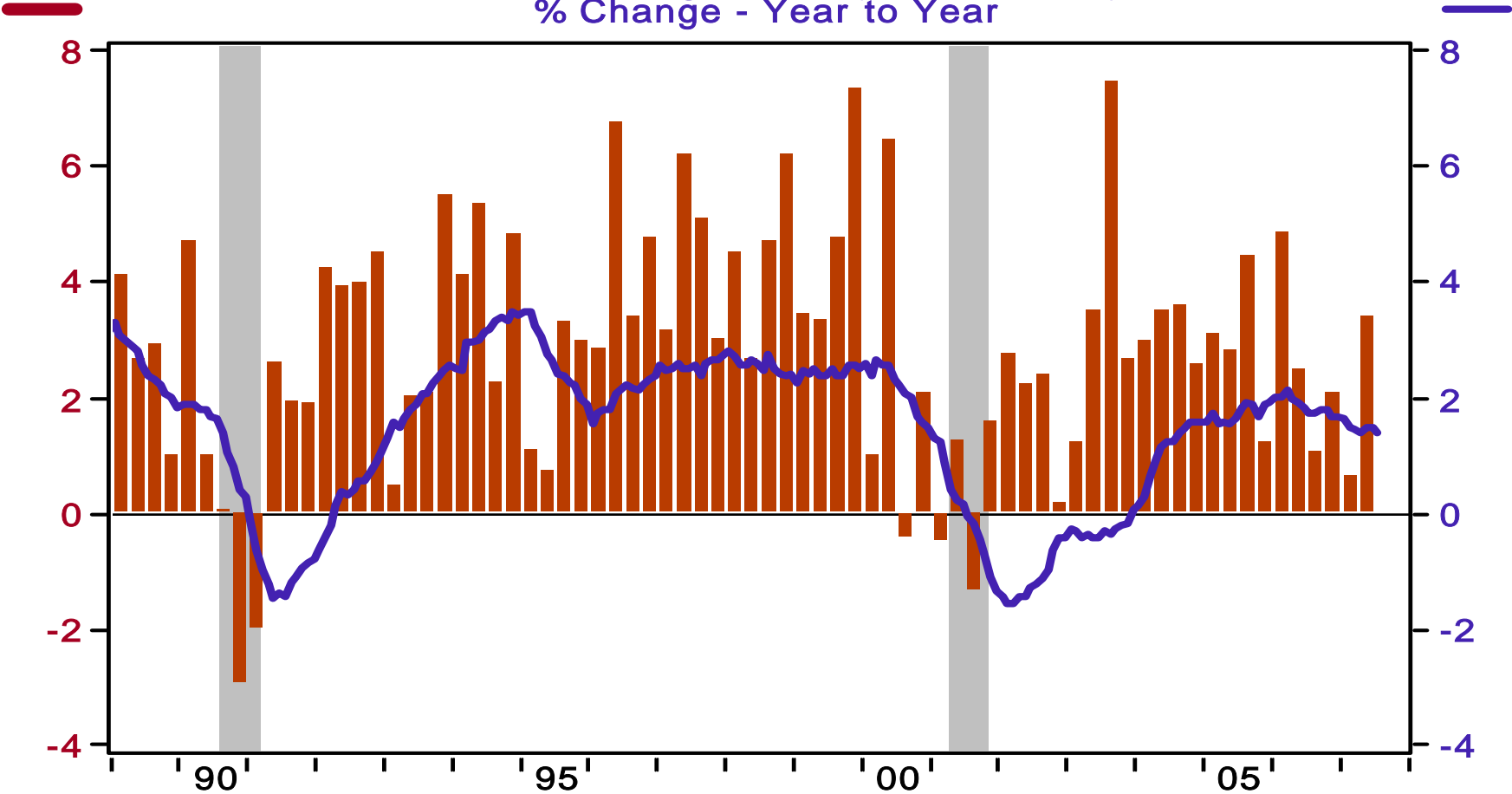
1. GDP Growth continues. While not extremely strong – we are still in growth mode.
2. Forward looking indicators (ECRI and Business) are still trending higher
3. I always find the argument based around the “consumer no longer shopping when (insert reason here)” This chart shows the trend of the shopper at all those chain stores in all those strip malls.
4. Business spending isn't great but it's certainly not doing too badly.
5. The spark for business is in the inventory and backlog levels. The backlog is high and the inventory levels are low.
6. All the headlines would make you think home values have taken a huge plunge. When put in perspective, maybe we should call this a healthy 10% correction?
7. If lenders make good loans they usually don't have a problem. Sure there is a group of lenders that have made some really bad decisions. So far however, when put in perspective, delinquency and charge off rates don't look too bad.
8. And not every job here in the USA has been shipped overseas! People are working... A 4-5% unemployment rate is a very healthy rate of employment.
9. One of the fears of a low unemployment rate is that employers will have to raise salaries and provide more benefits. If they have to do this then we could have 'wage inflation.' But so far that is not the case.
10. & 11. Inflation at both the Producer (manufacturing) and Consumer (people) level looks to be under control – so probably no more interest rate hikes are needed to 'contain inflation.'
11. The Federal Reserve has a tendency to raise rates to fight inflation more than they need to – the thought is that run away inflation is worse than a soft economy. So the next step for the Fed will probably be to drop interest rates rather than raise them.
12. Sure there are risks – the high price of oil is a big drain on the economy. The falling dollar, while benefiting the US today, can lead to problems if it falls precipitously for a long period of time. There are also items like terrorism that are on the table as well.
13. What makes the stock market go up? While this can be a great debate when looking at a short term time frame, over the long run it has to do more with earnings of companies than anything else. And so far earnings are looking pretty darn good.
14. And assuming stock prices rise when earnings rise - with earnings continuing to increase faster than stock prices we are seeing a reduction in the stock Price to company Earnings (P/E ratio). The lower the P/E level, generally the less risk is in the stock market.
15. And how do we know companies believe their stocks are at lower levels than they should be? Think about this from your perspective. If you see something priced lower than you believe it should be you buy it. When you think it something is overpriced generally you sell it. In 2006 Companies bought back \$548 Billion worth of their own stock.
16. And they did that without using their “credit card!” For the first time since the 1950's, companies are lending more money than they are borrowing. They have paid off their 'credit cards' and have extra money so they are buying their stocks with the extra cash they have.

17. Why invest in stocks at all if we have to live through all these ups and downs? The answer is for higher returns. And investors are generally after higher return so they can grow their money faster than the rate of inflation reduces the purchasing power. And as investors assets grow the assets can produce more cash flow for the investor than the investor can produce for herself – and when that position is reached so are many investors' financial goals!
18. So if we are going to use stocks what type of stocks do we want to use? Value stocks have done very well since 2000.
19. In fact, Value stocks have done so well that they their over performance probably can not continue. As such we have begun to overweight growth stocks in relation to value stocks.
20. We also have concerns about small cap stocks for the same reason. Not that there is anything wrong with small companies, they have just gone up for an extended period of time and generally nothing goes straight up for forever (remember cycles tend to come and go).
21. What is something that could stop the current market decline and potentially take the market back to 14,000 and beyond? Might be an interest rate cut by the Federal Reserve...

GDP Growth: Q2 Rebound, Employment Growth Sluggish

Quarterly % Change in Real GDP
% Change - Annual Rate

12-Month % Change in Payroll Employment
% Change - Year to Year

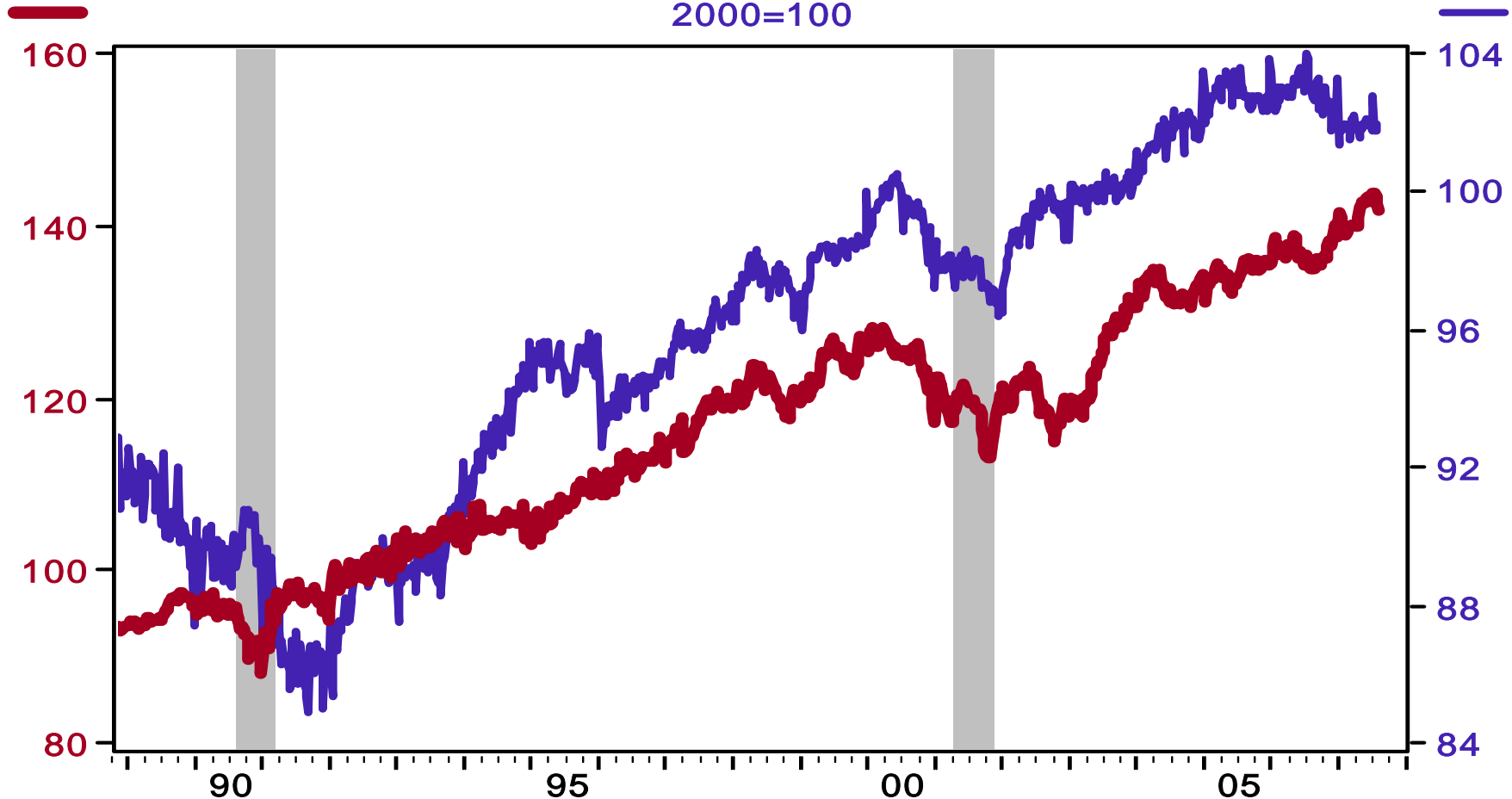


Sources: BEA, BLS /Haver

ECRI Up, Dow Barometer Starting to Recover, Recession Unlikely

← ECRI Weekly Leading Index
1992=100

Dow Jones U.S. Business Barometer Index →
2000=100



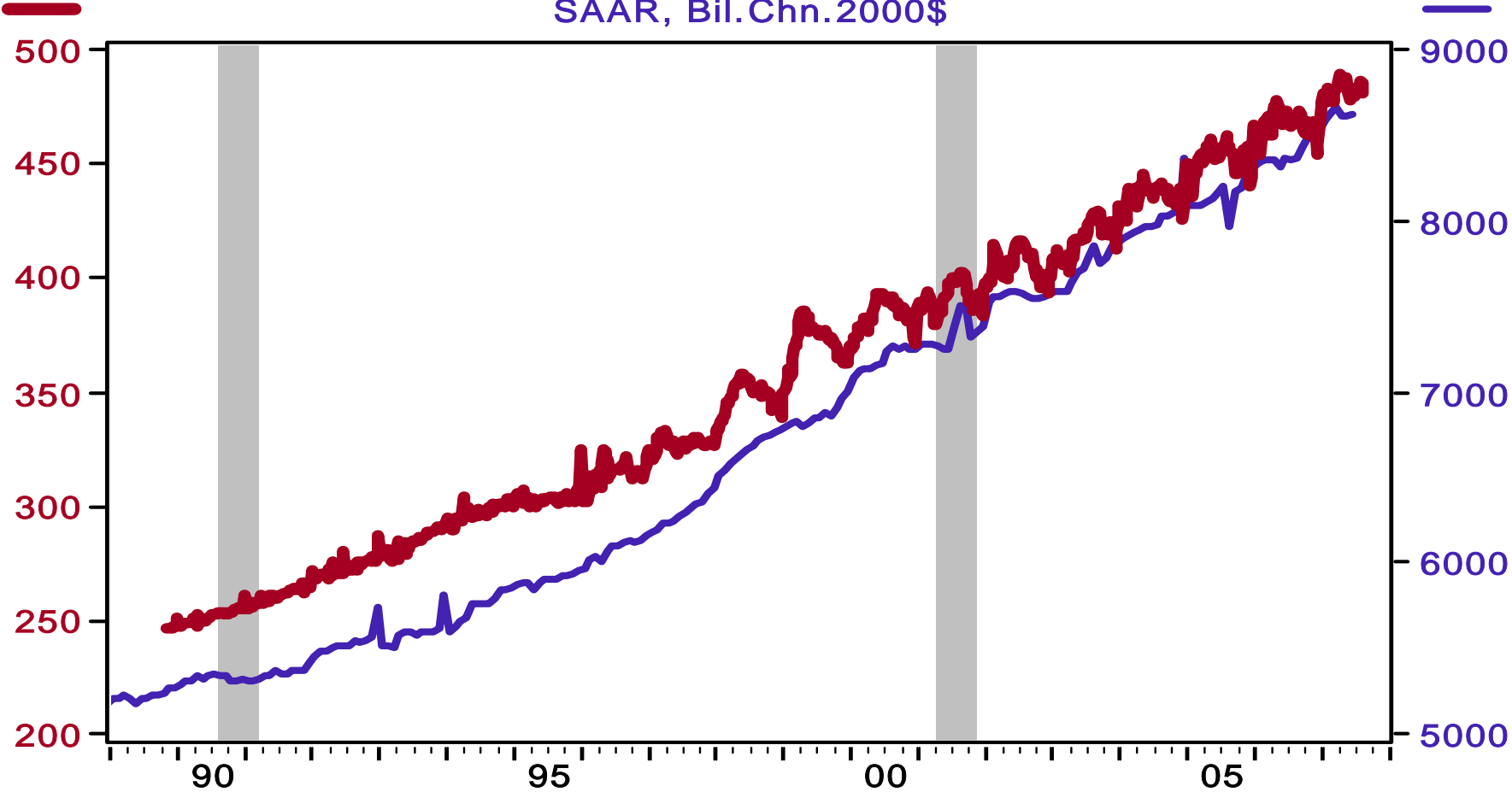
Sources: ECRI, BTMU /Haver

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Real Personal Income Strong, Chain Store Sales Rebound

← ICSC-UBS Weekly Retail Chain Store Sales
SA, 1977=100

Real Disposable Personal Income →
SAAR, Bil. Chn. 2000\$



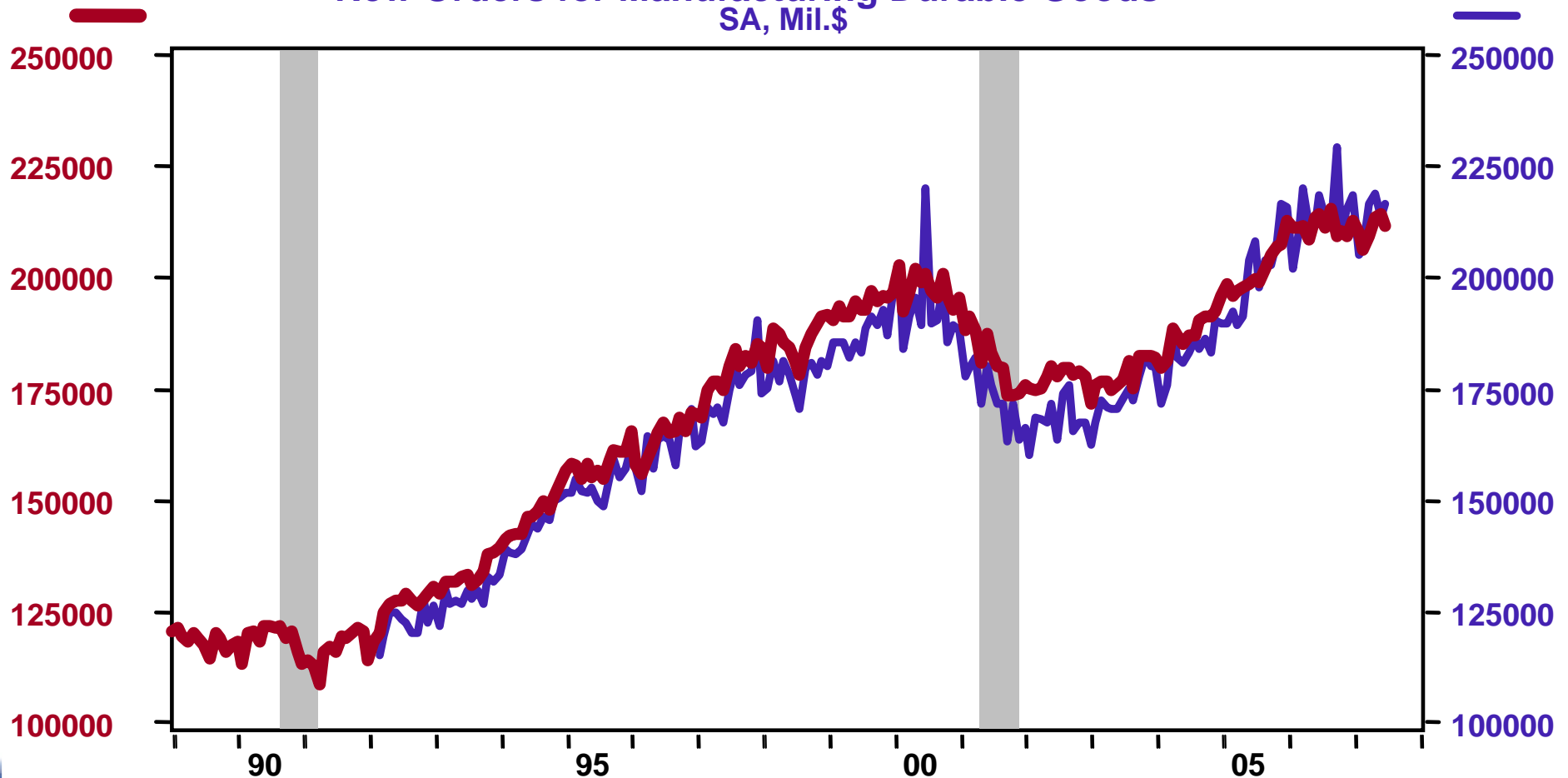
Sources: ICSCUBSW, BEA /Haver

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New Orders & Shipments Recovering – Business Spending Sluggish

Shipments of Manufacturing Durable Goods
SA, Mil.\$

New Orders for Manufacturing Durable Goods
SA, Mil.\$



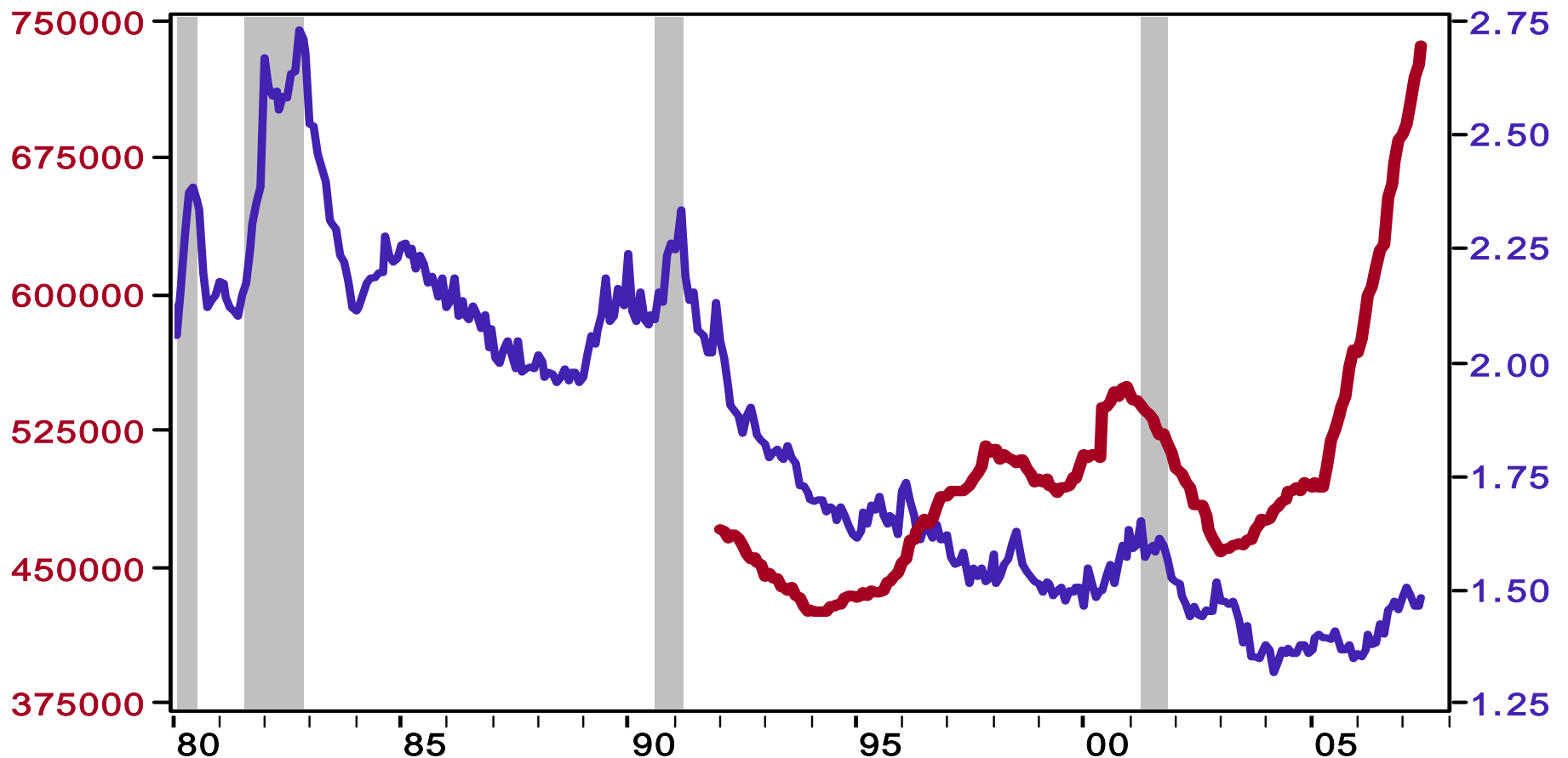
Sources: Census Bureau /Haver Analytics

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BUT, Order Backlog Very High, Inventories Low Relative to Shipments

← Unfilled Orders for Durable Goods: Order Backlog Very High
SA, Mil.\$

Ratio of Inventories to Shipments: Low - No Inventory Backlog →



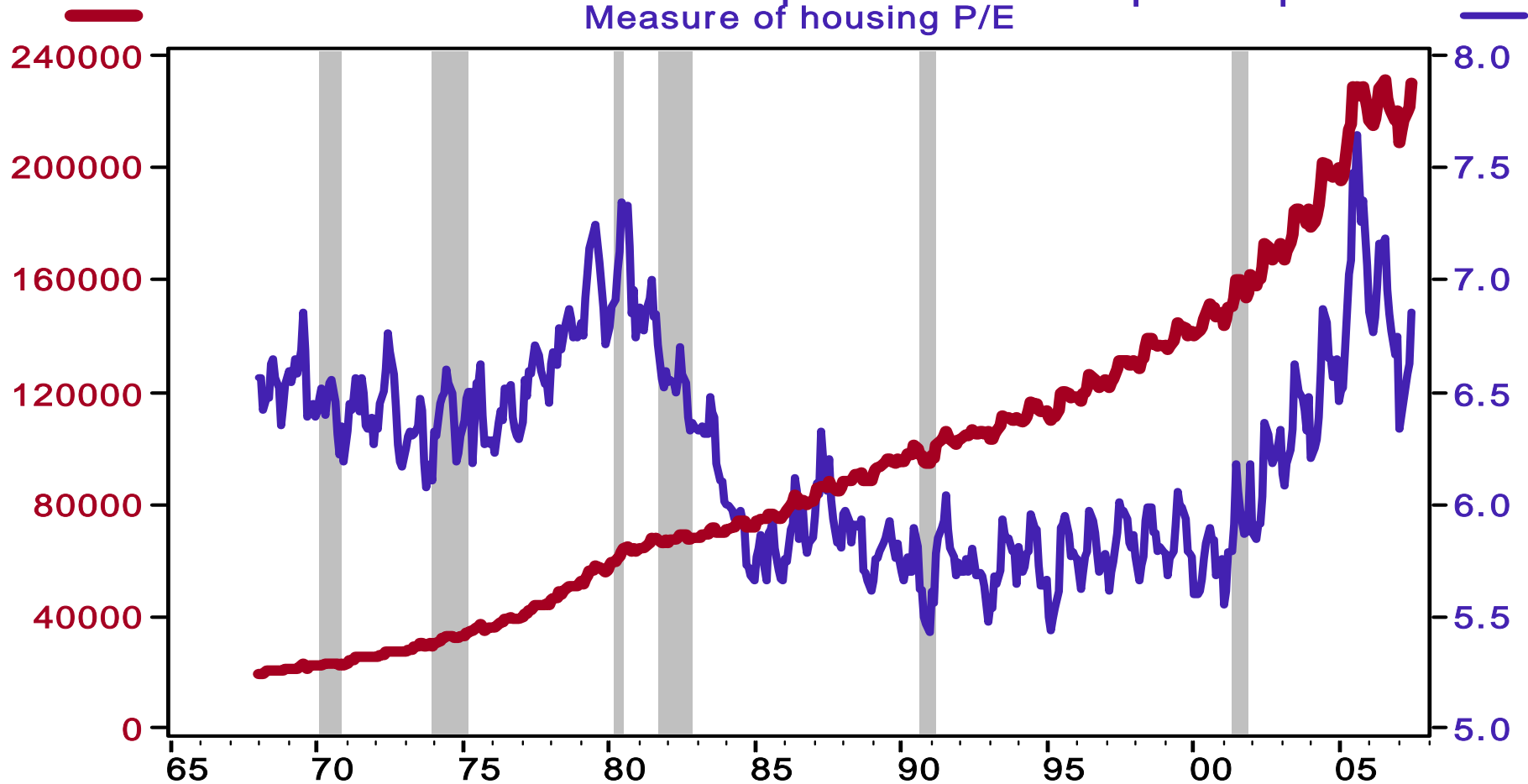
Source: Haver Analytics

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Home Prices Recovering, Income Up, Housing "P / E" at Lower Level

← Median Sales Price: Existing 1-Family Homes
\$

Ratio: Median Price / Disposable Income per Capita →
Measure of housing P/E



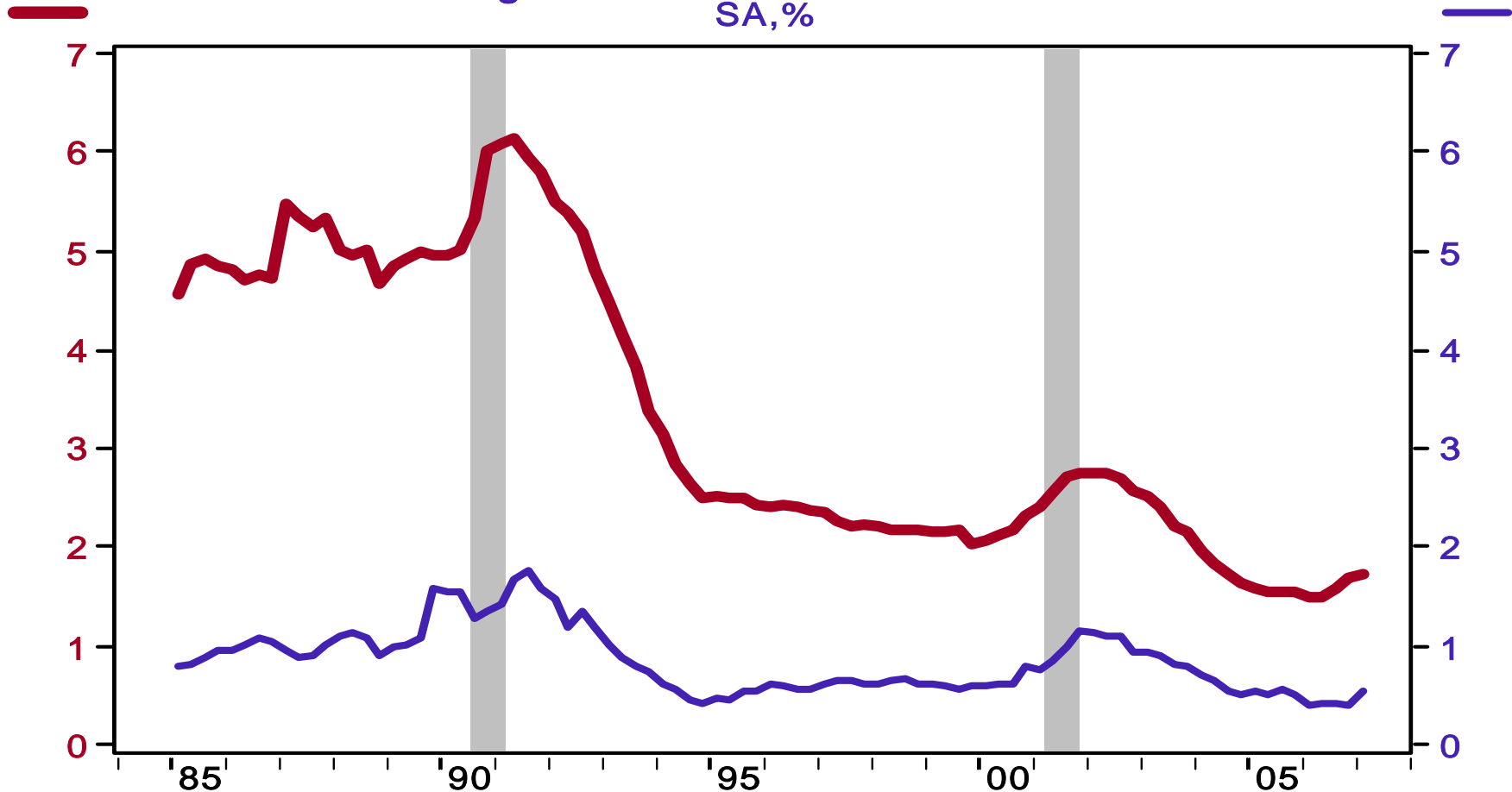
Source: Haver Analytics

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Major Real Credit Threat? No – Bank Problem Loans Remain Low

Loan Delinquency Rate: All Commercial Banks
SA, %

Loan Charge-Off Rate: All Commercial Banks
SA, %



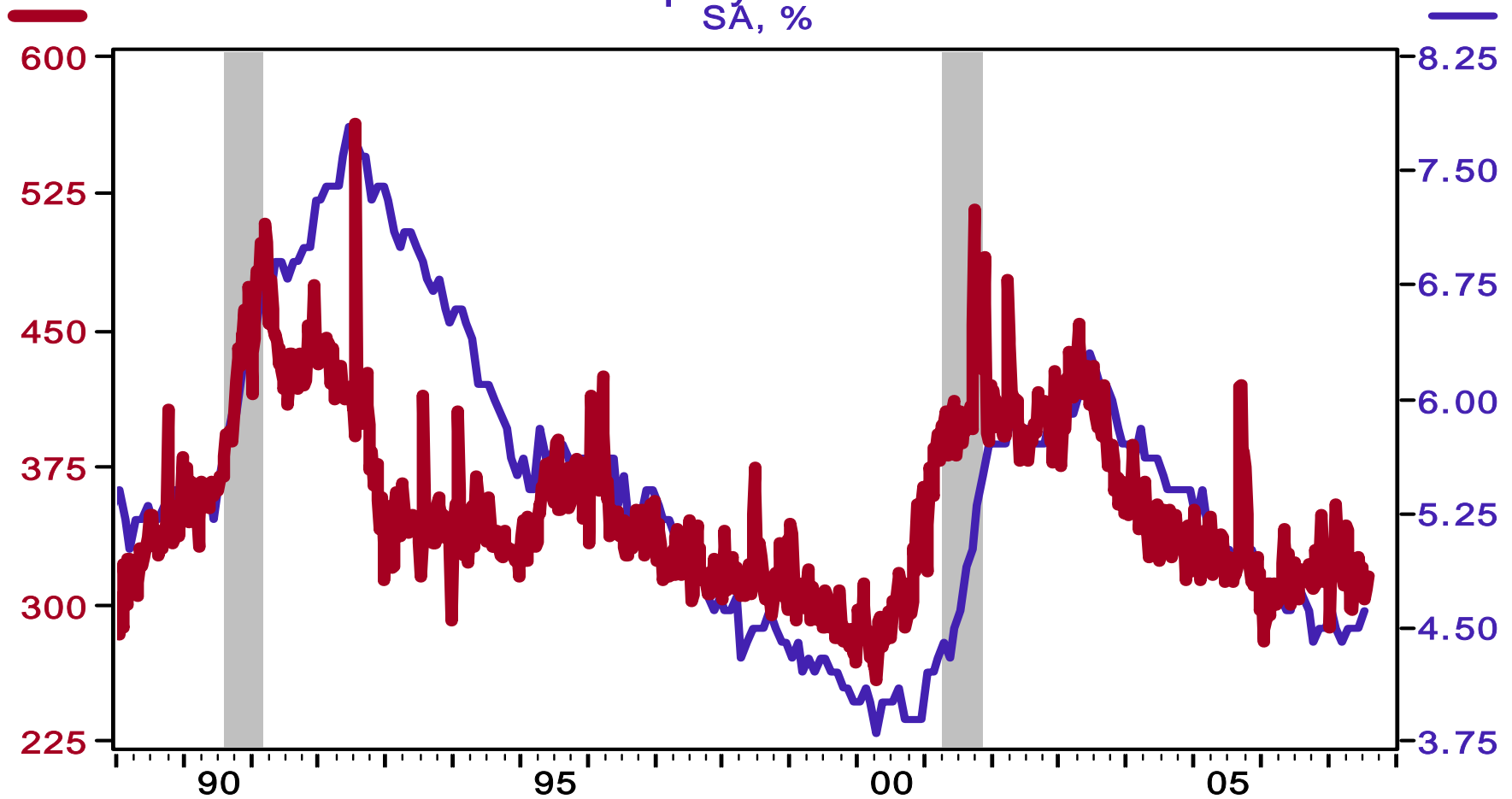
Sources: Federal Reserve Board /Haver Analytics

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Claims Lead Unemployment Rate – at 4.6%, And Wage Inflation Low

← Weekly Initial Claims for Unemployment Insurance
SA, Thous

Unemployment Rate →
SA, %



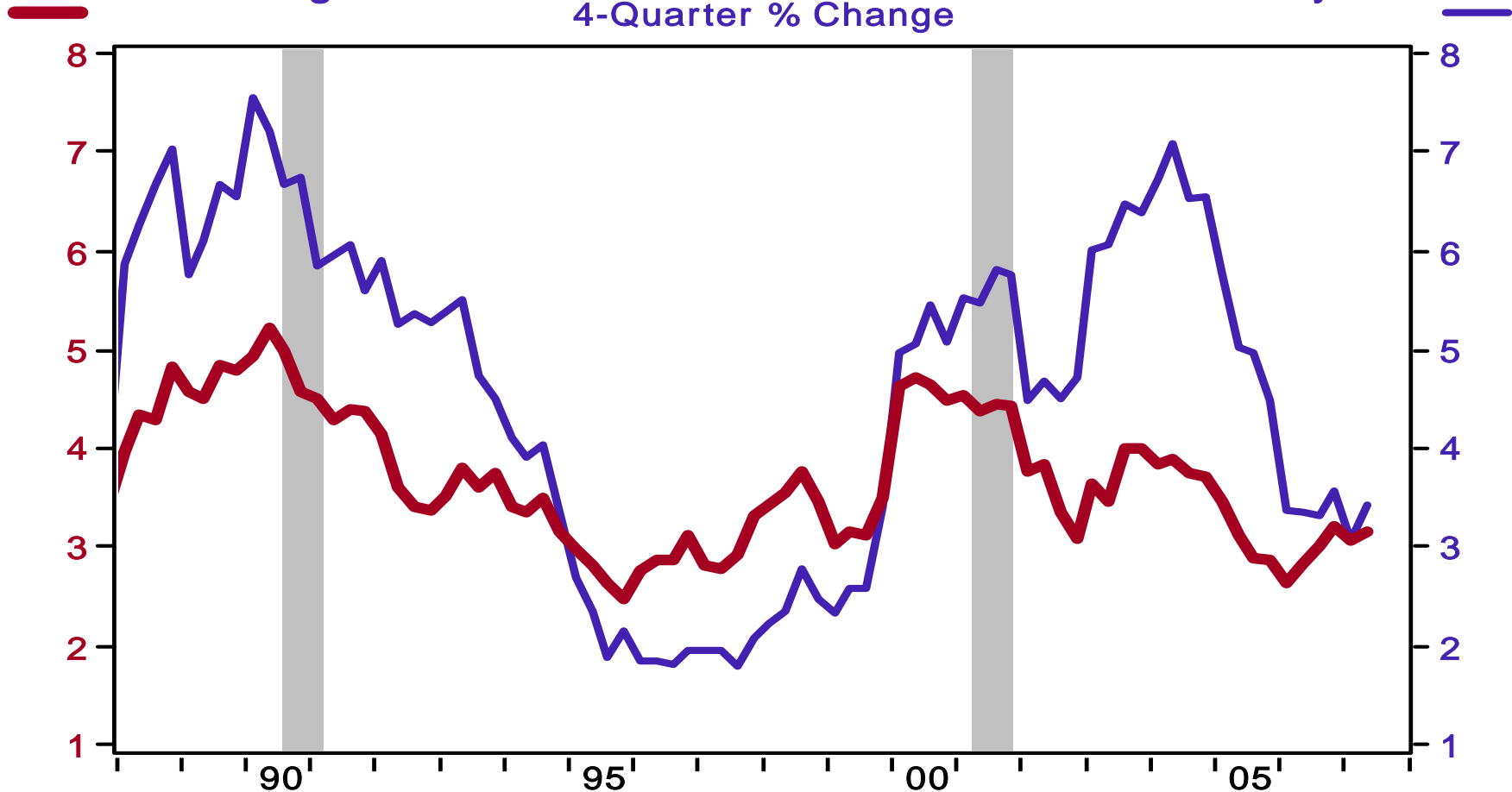
Sources: DOL, BLS /Haver

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Total Employment Cost Inflation at 3% - Benefits Slow Sharply

Change in Total Employment Cost Index (Wages + Benefits)
Private Sector: 4-Quarter % Change

Change in Benefits Cost - Has Slowed Considerably
4-Quarter % Change



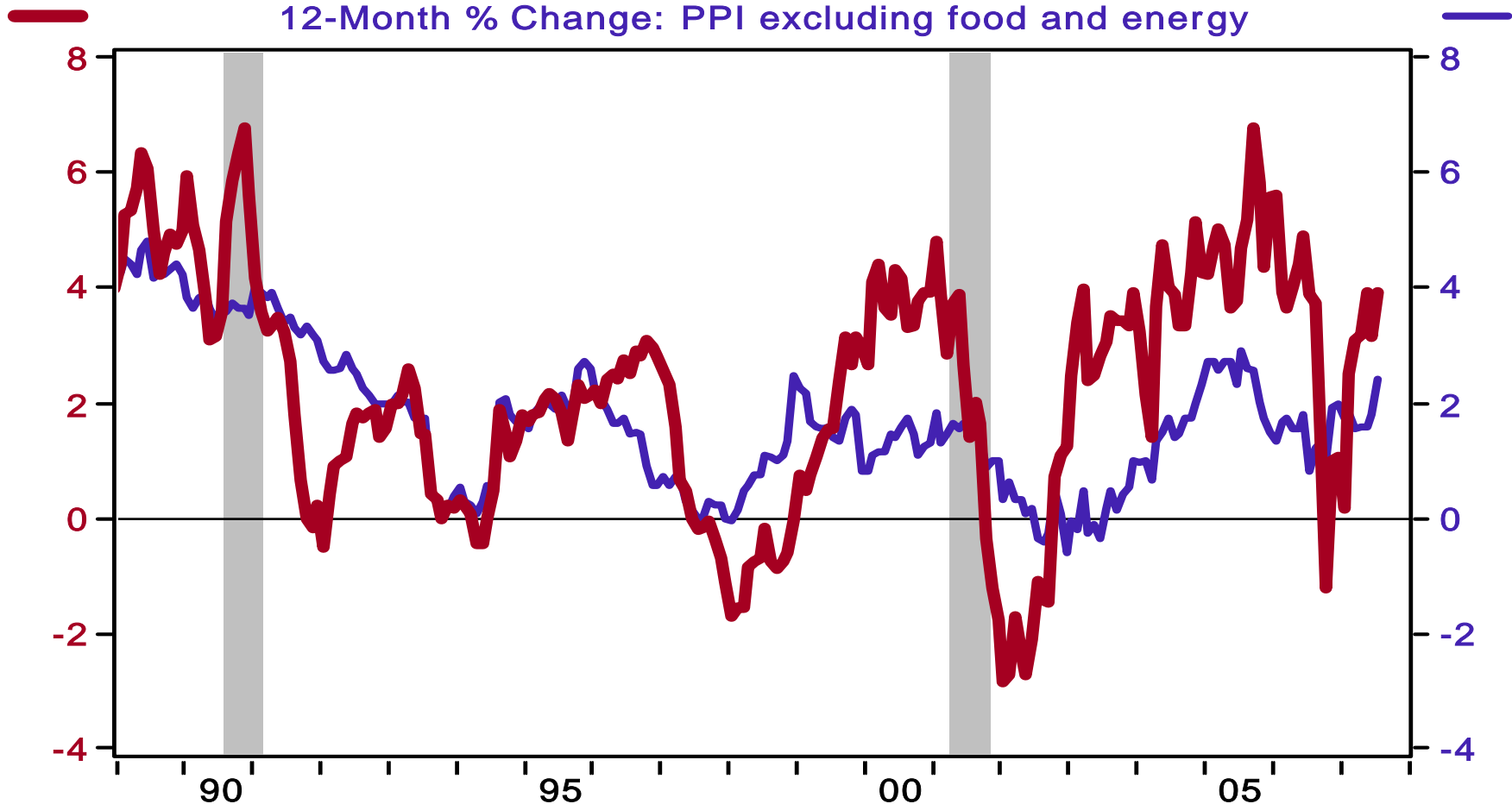
Sources: Bureau of Labor Statistics /Haver Analytics

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Producer Price Index (PPI) Inflation Rise Will Likely Reverse Lower

Total Producer Price Index (PPI) Inflation Rate
12-Month % Change

Core Producer Price Inflation Rate
12-Month % Change: PPI excluding food and energy



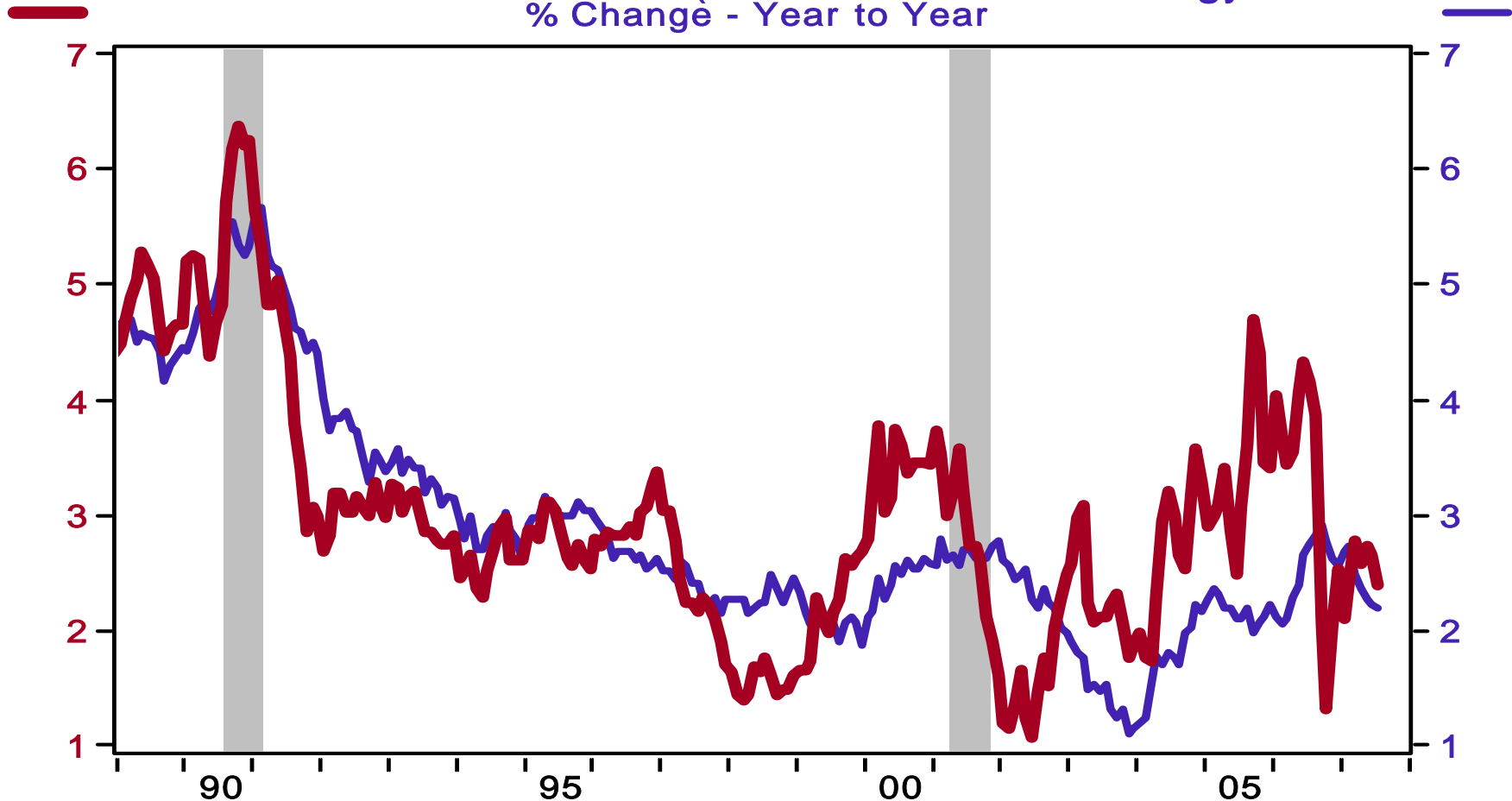
Source: Bureau of Labor Statistics /Haver Analytics

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Total CPI Inflation Heading Down Again, Core Slowly Falling

Total CPI Inflation
% Change - Year to Year

Core CPI Inflation (Excludes Food & Energy)
% Change - Year to Year



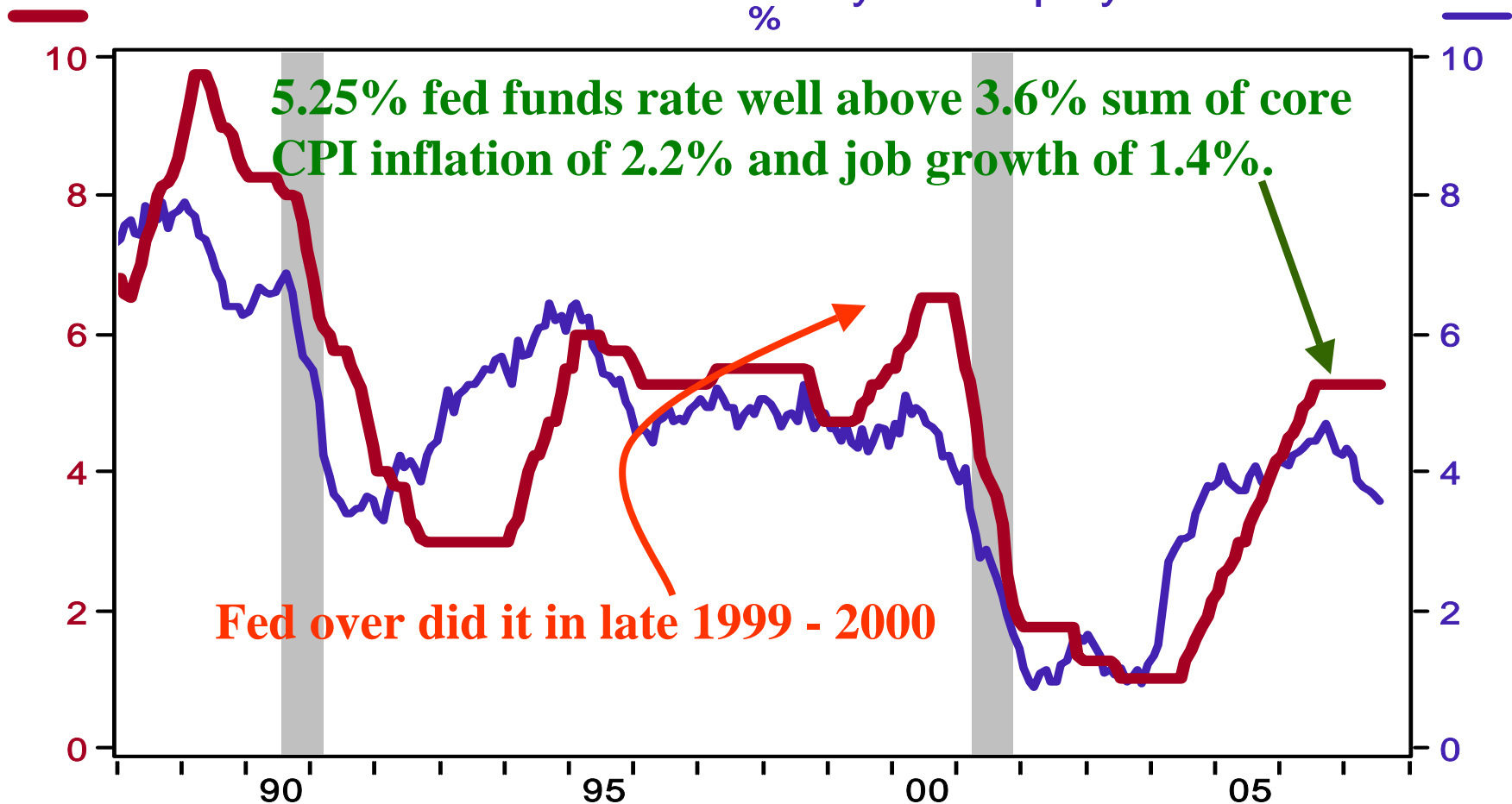
Source: Bureau of Labor Statistics /Haver Analytics

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Fed Should Ease: Target (Roughly) Core Inflation + Employment Growth

Fed Funds Target Interest Rate
%

Sum of Core CPI Inflation and Payroll Employment Growth
%



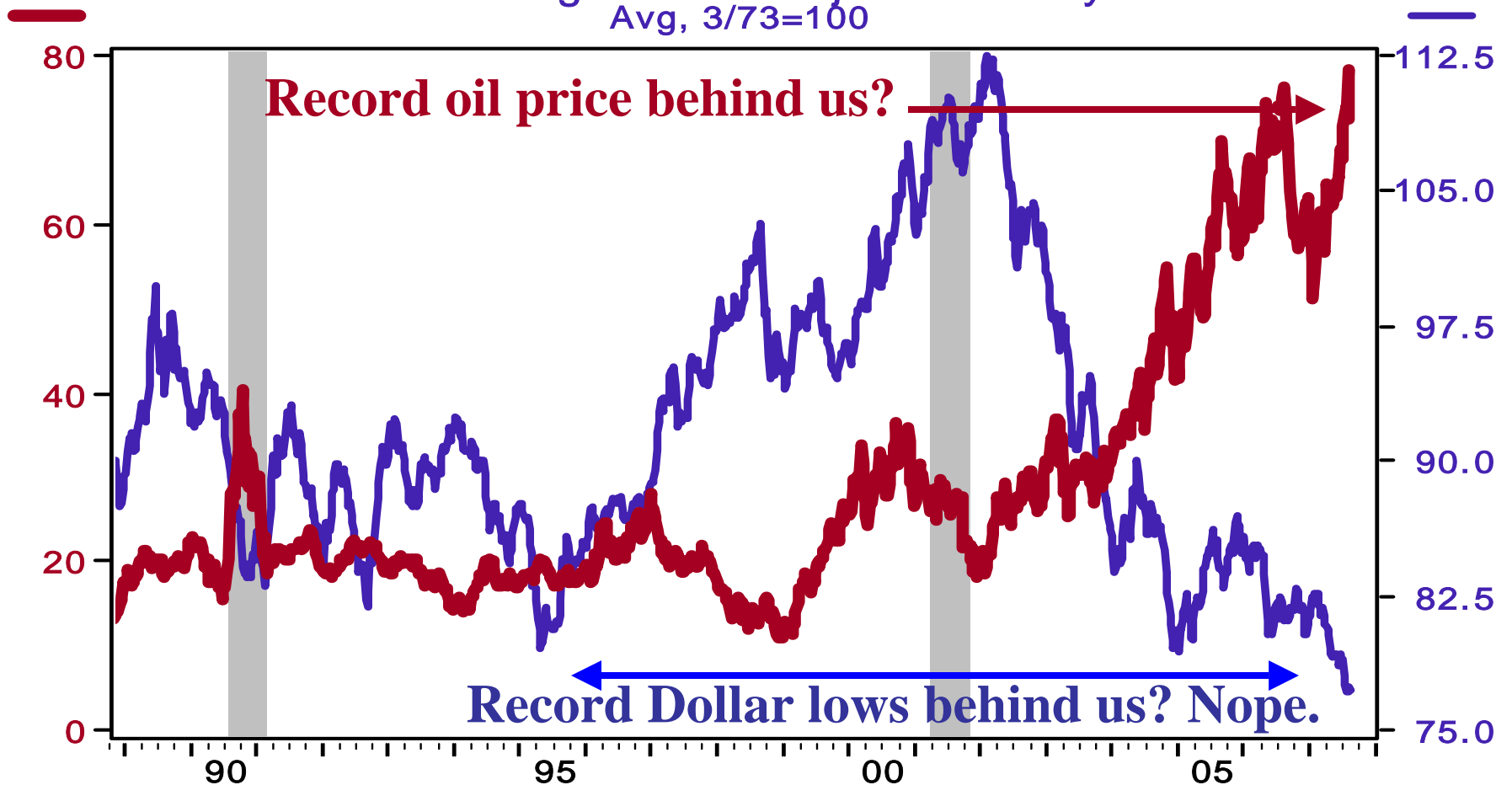
Fed over did it in late 1999 - 2000

5.25% fed funds rate well above 3.6% sum of core CPI inflation of 2.2% and job growth of 1.4%.

Risks? Sure – Sky High Oil Prices & Sustainability of Dollar Rebound

← Crude Oil Price - West Texas
EOP, \$/Barrel

Dollar Exchange Rate - Major Currency Index →
Avg, 3/73=100



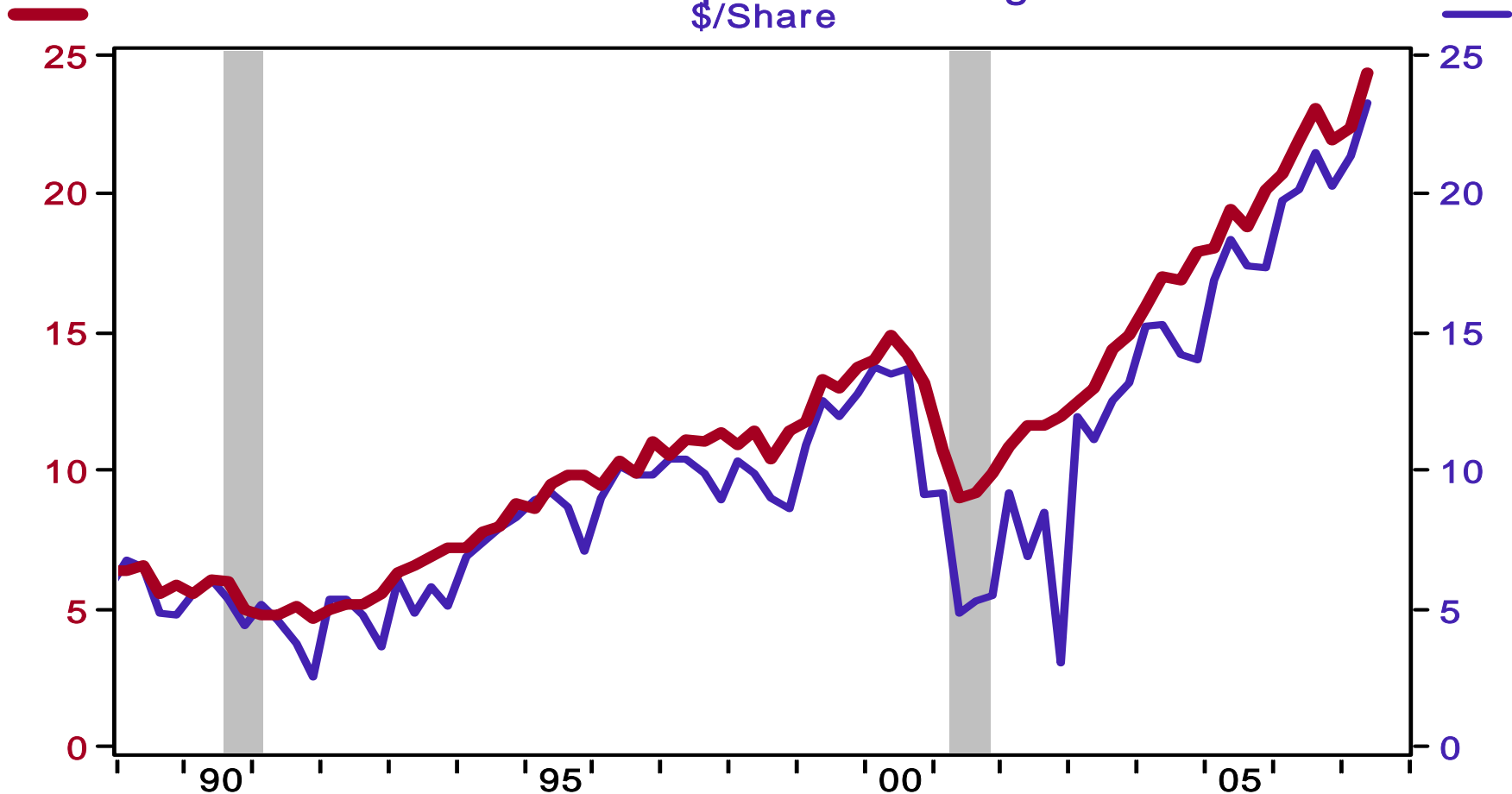
Sources: WSJ, FRB /Haver

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Company Earnings Strong – up 7.9% Q1, Q2 Coming in at 11%

S&P 500 Operating Earnings Per Share
\$/Share

S&P 500 After-tax Reported Earnings Per Share
\$/Share



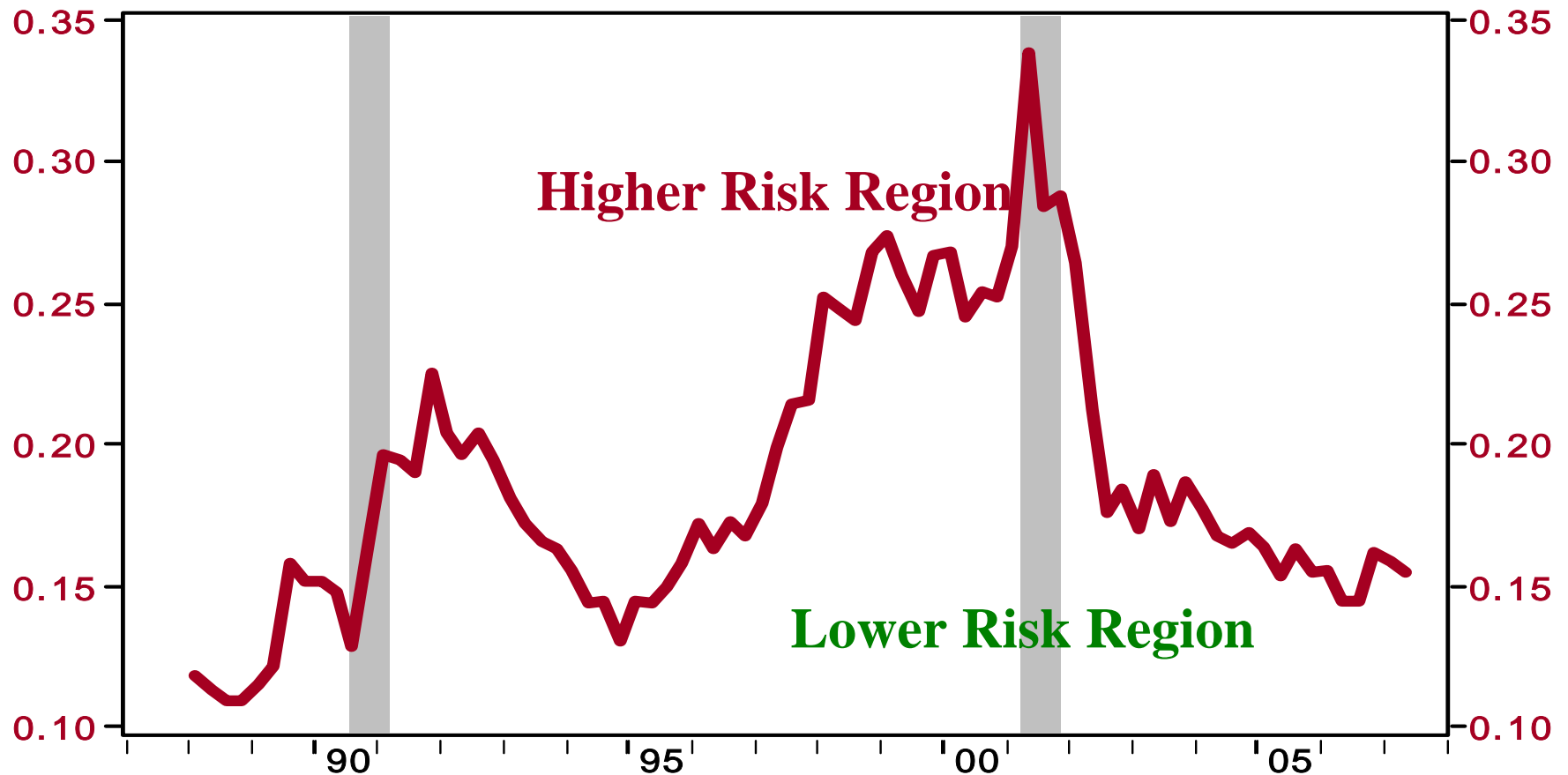
Source: Standard & Poor's /Haver Analytics

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Current Quarter S&P 500 P / E is around 15.4 – Looks Low

P/E Ratio: S&P 500 Stock Price Divided By Same Quarters Earnings

P/E calculated using current quarter operating earnings times 4

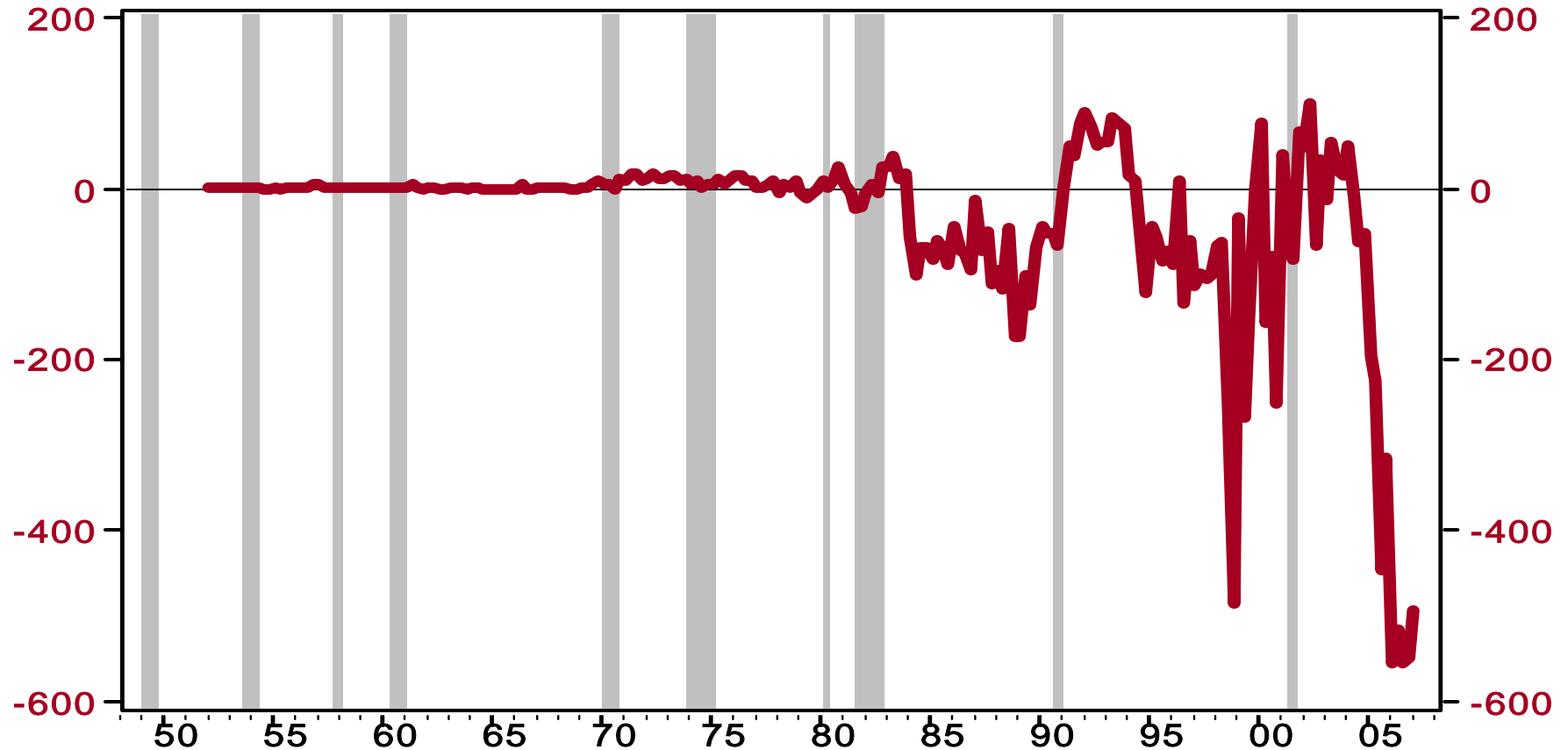


Source: Haver Analytics

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Record U.S. Net Stock Repurchase - \$548 Billion for full year 2006

US Net New Equity Issues: Record High Stock Buybacks!
New Equity Issued less Stock Bought Back in \$Billions at Annual Rates



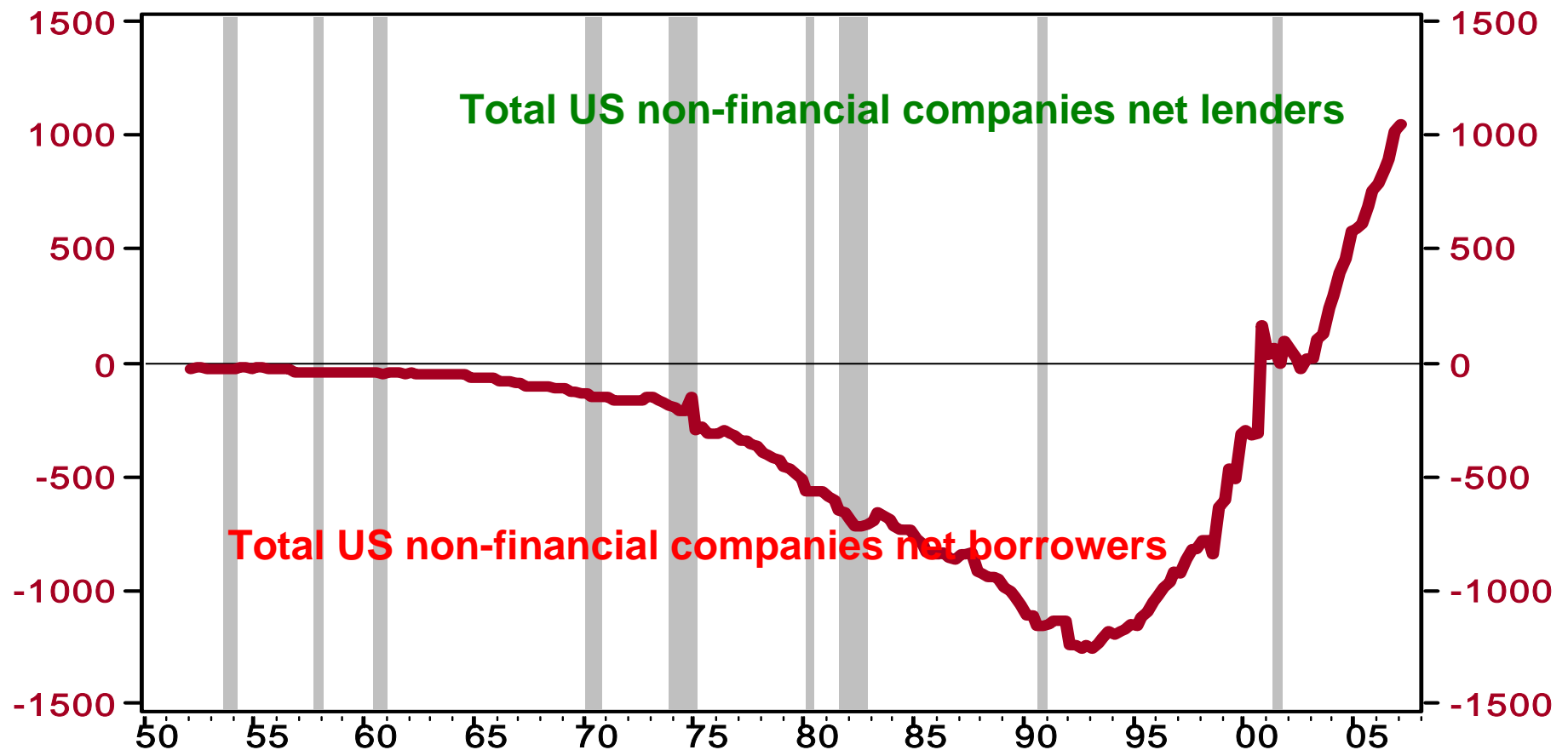
Source: Haver Analytics

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Corp. Balance Sheet – Companies Are Net Lenders of \$1.1 Trillion

Financial Assets Less Liabilities of All US Nonfinancial Corps.

billions - US companies are now net lenders



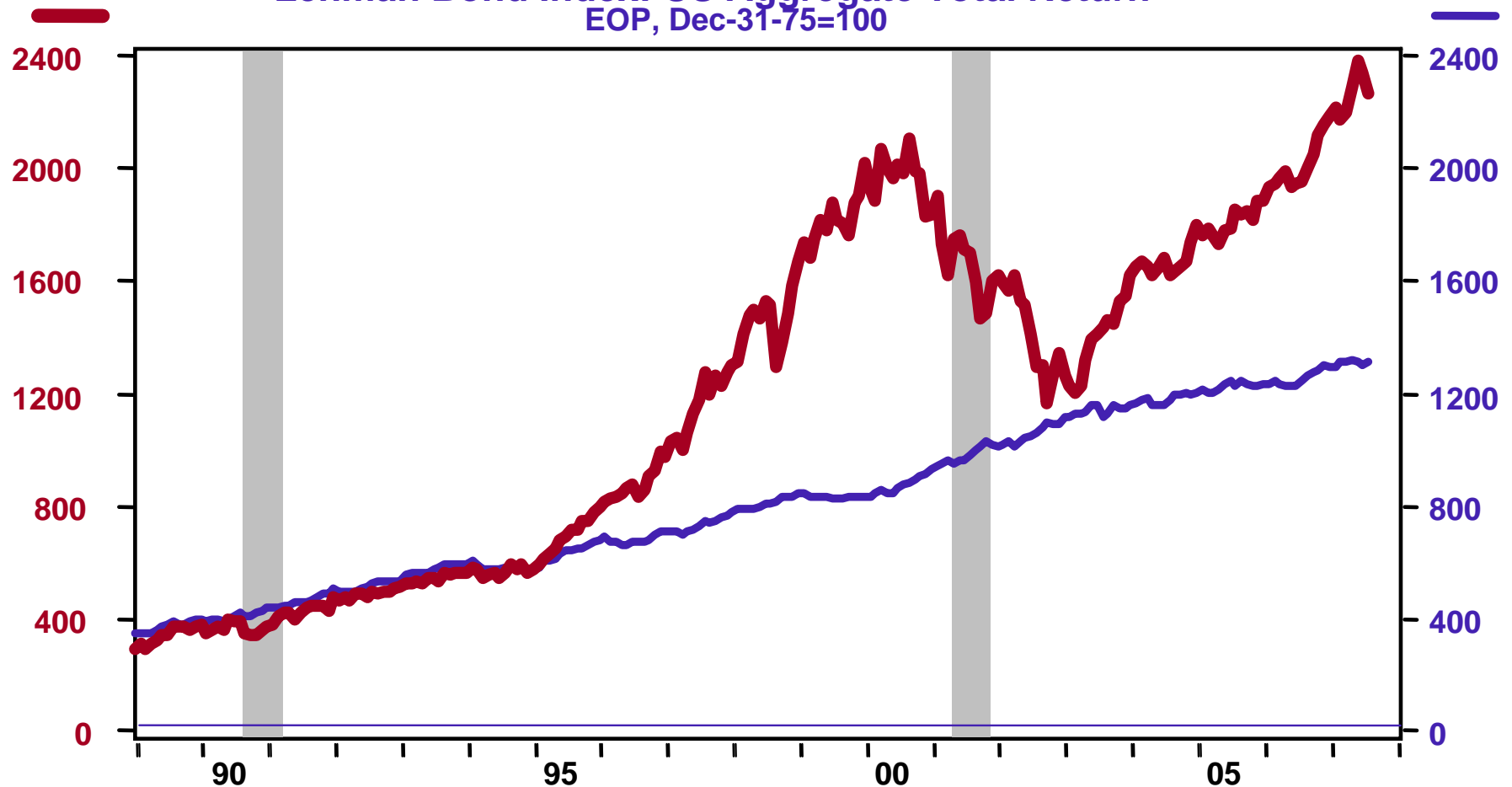
Source: Haver Analytics

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Equity Total Return Beats Fixed Income, But With Volatility

S&P 500 Total Return
EOM

Lehman Bond Index: US Aggregate Total Return
EOP, Dec-31-75=100



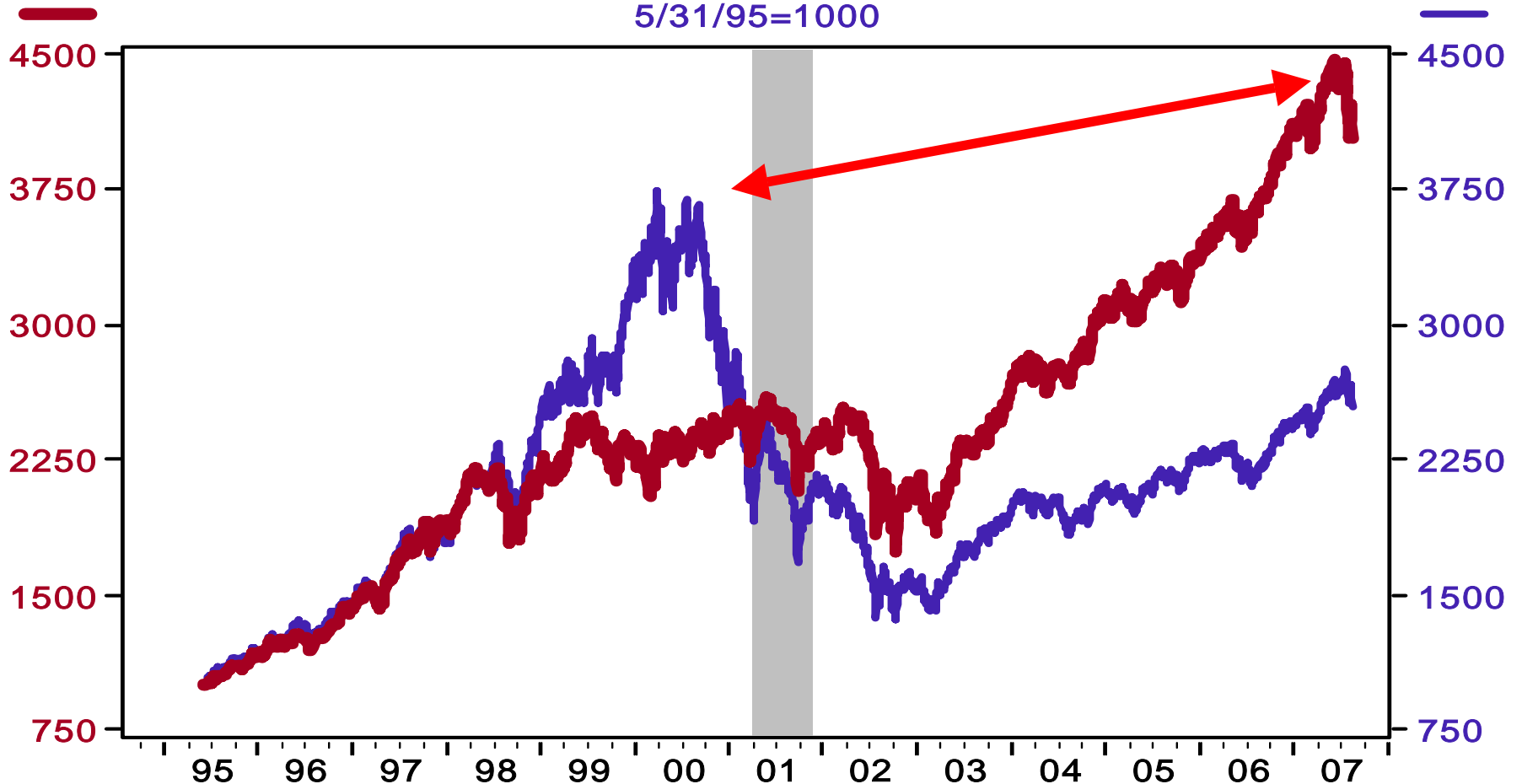
Sources: Standard & Poor's, Lehman Brothers/ Haver Analytics

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Value Has Outperformed Growth Since 2000 – Run Ending?

Total Return: Russell 3000 Value Index
5/31/95=1000

Total Return: Russell 3000 Growth Index
5/31/95=1000



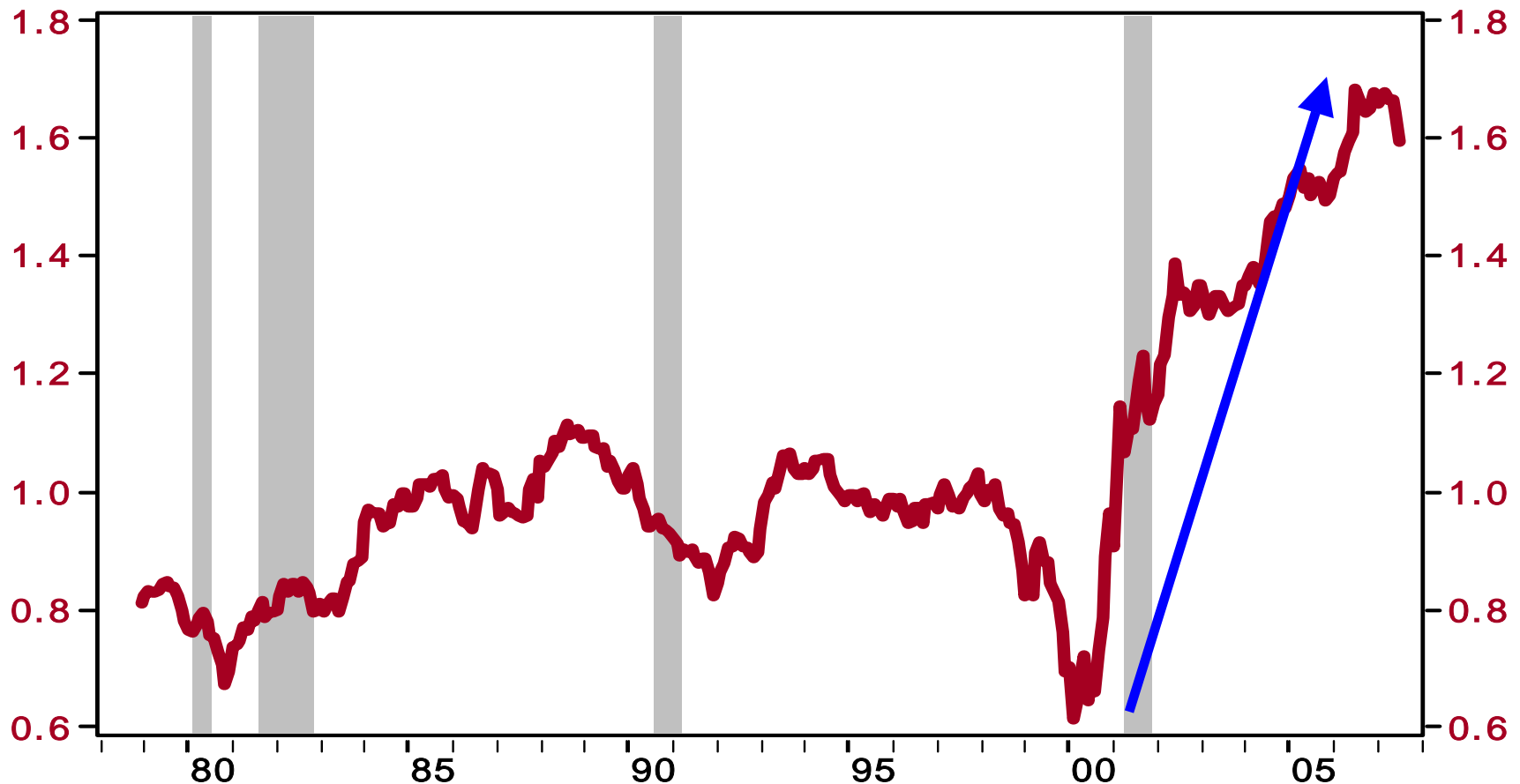
Source: Frank Russell Company /Haver Analytics

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About 110% Outperformance of Value Since 2000. Done?

Cumulative Total Return of Value Relative to Growth

Ratio: Russell 3000 Value / Growth Total Return Indices



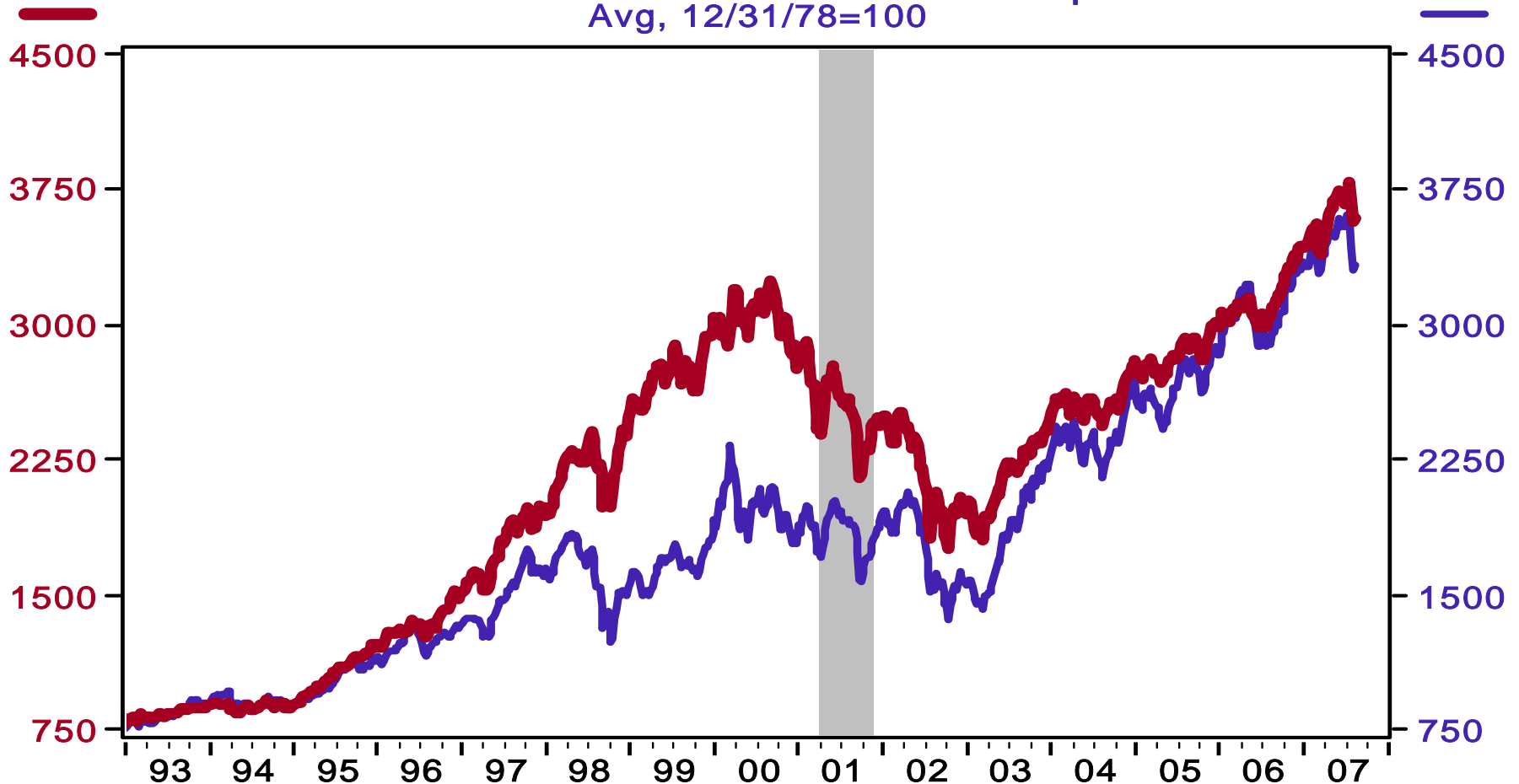
Source: Haver Analytics

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Small Caps Outperformed Large Caps Since 1999 – Now Reversing?

Total Return: Russell 1000 Large Cap Index
Avg, 12/31/78=100

Total Return: Russell 2000 Small Cap Index
Avg, 12/31/78=100



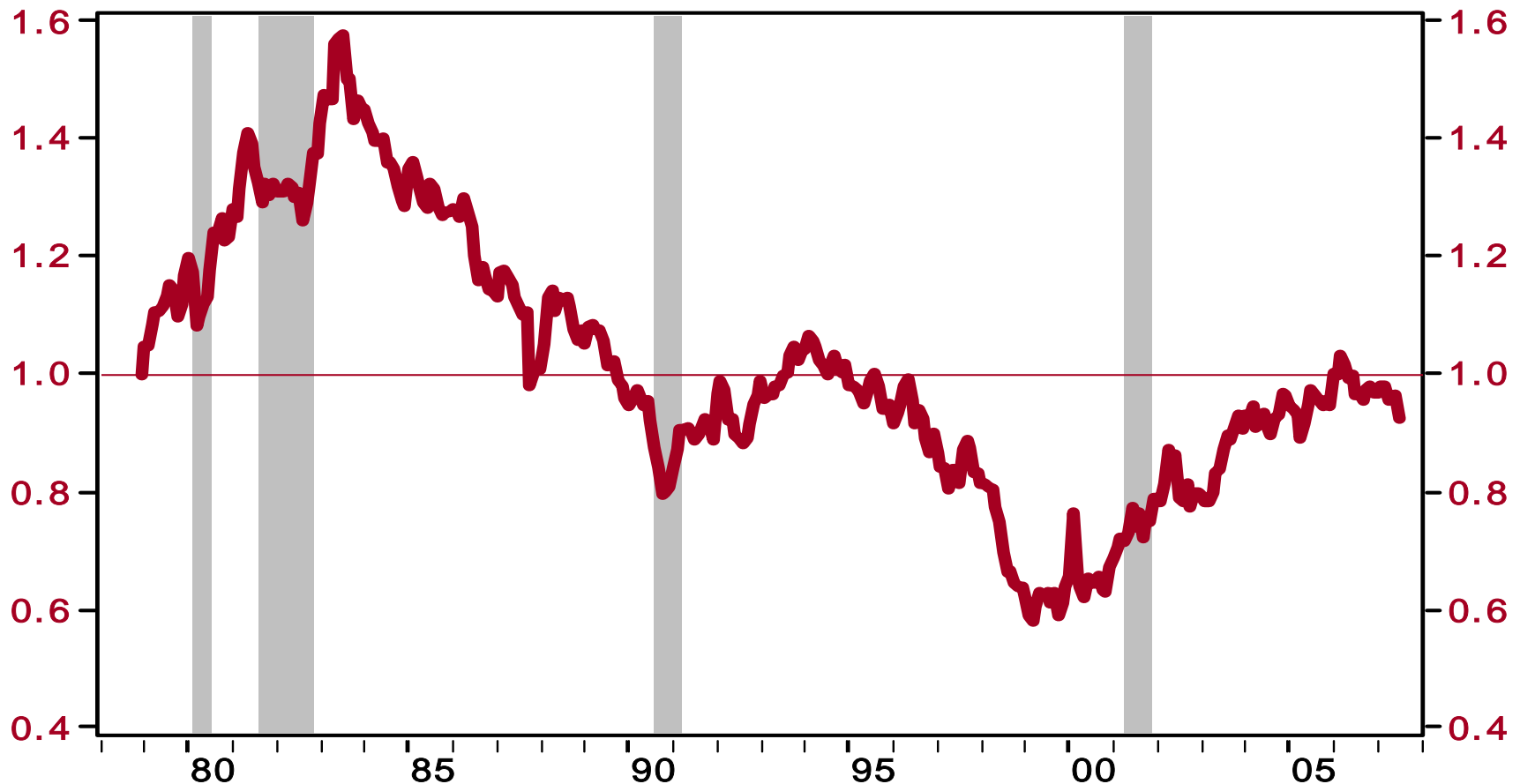
Sources: Frank Russell Company /Haver Analytics

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Last 28 Years Small Caps Have NOT Outperformed Large Caps

Cumulative Total Return of Small Relative to Large Caps

Ratio: Russell 2000 / Russell 1000 Total Return Indices



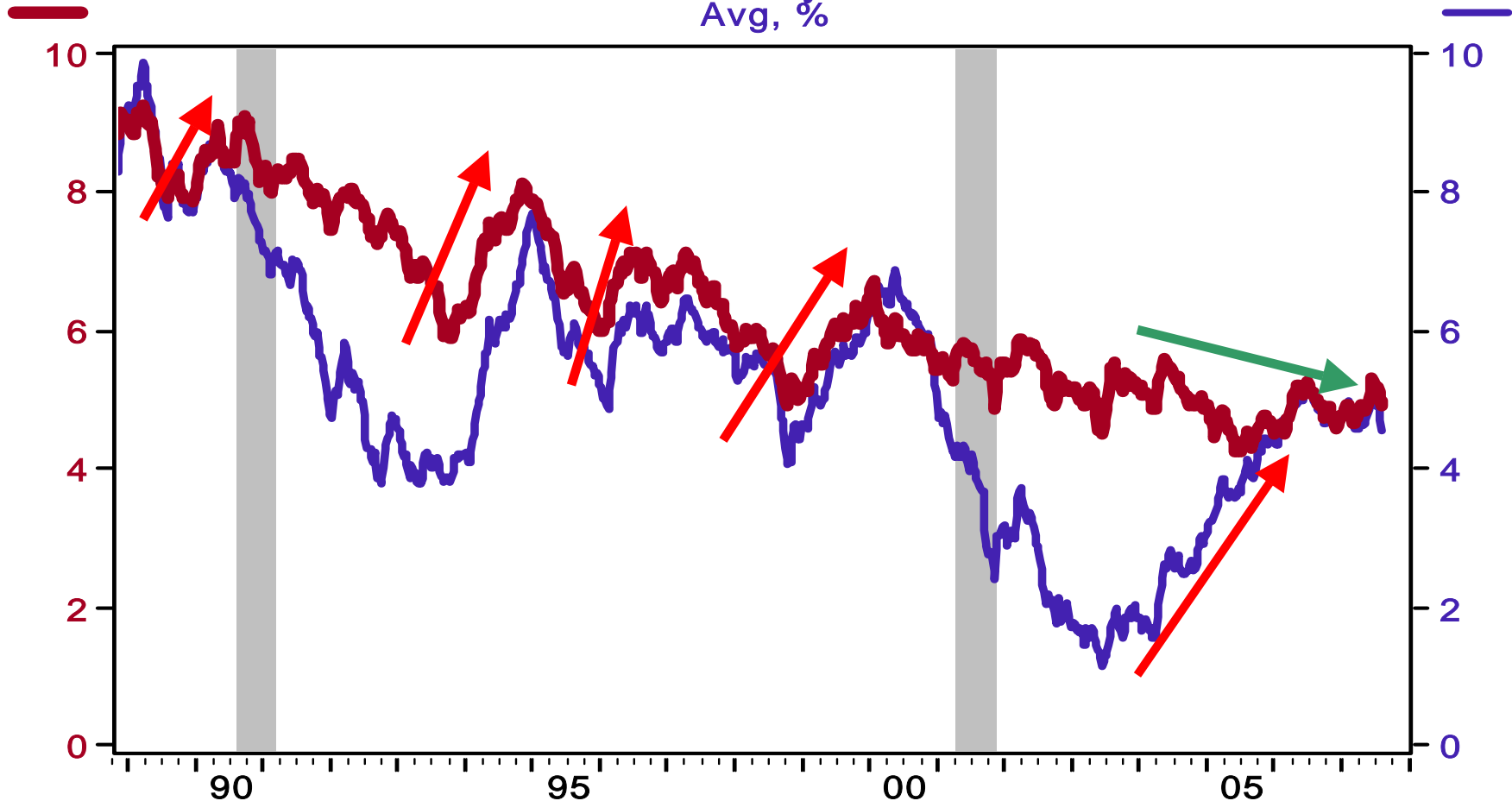
Source: Haver Analytics

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Long and Short-term Rates Now Stabilizing, A Fed Rate Cut Possible

30-Year Treasury Bond Yield
Avg, %

2-Year Treasury Note Yield
Avg, %



Sources: Haver Analytics, U.S. Treasury

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The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual.

Required Disclosures:

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Russell 1000 Index measures performance of 1000 large cap, US companies. The Russell 2000 Index measures performance of 2000 small cap, US companies. The Russell 3000 Growth and Value Indices measure the performance of growth and value stocks respectively.

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries, and widely held by individuals and institutional investors. These 30 stocks represent about a fifth of the \$8 trillion-plus market value of all U.S. stocks and about a fourth of the value of stocks listed on the New York Stock Exchange. It is not possible to invest directly in an index.

The Lehman Brothers Aggregate Bond Index is composed of securities from the Lehman Government/Credit Bond Index, Mortgage Backed Securities Index and Asset Backed Securities Index.

The Merrill Lynch High Yield Index is an unmanaged index consisting of bonds that are issued in U.S. Domestic markets with at least one year remaining maturity. All bonds must have a credit rating below investment grade but not in default.

Government bonds and Treasury Bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small cap market may adversely affect the value of these investments.

P/E Multiple: A tool for comparing the prices of different common stocks by assessing how much the market is willing to pay a share of each corporation's earnings. It is calculated by dividing the current market price of a stock by the earnings per share.

Past performance is no guarantee of future results. Indices such as the S&P 500 may not be invested into directly.

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