



# Market Update

Asset Consulting Group, Inc.

## INSIDE THIS ISSUE:

Market commentary

The US Economy

Global Equities

US Equities

International Markets

Global Fixed Income

Monthly Indices Report

(February 28, 2007)

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Monthly Report

February 2007

## THE U.S. ECONOMY

In February, the reemergence of financial market volatility, heightened concerns with credit quality in the housing market, and an ongoing adjustment in business inventories raised concerns about the durability of the current U.S. economic expansion. Despite these mounting concerns, recent economic data demonstrate the economy is still growing at a modest pace, with the consumer sector still weathering the weakness in housing as expanding labor markets continue to augment personal incomes.

### Financial market volatility is back...

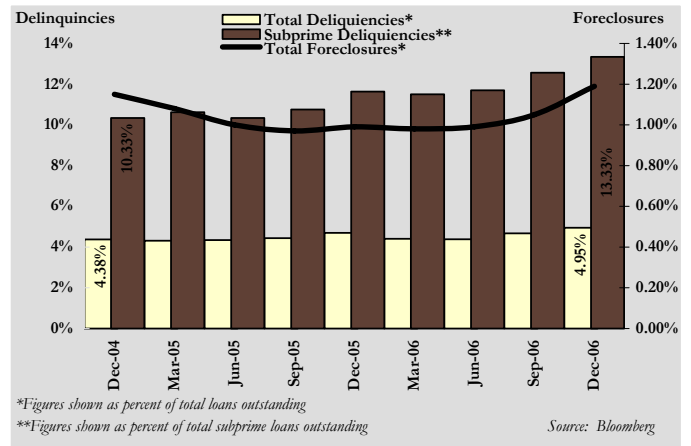
After several years of absence, financial market volatility resurfaced during a broad global sell-off in equities in the closing days of the month. In the U.S., concerns over the possibility of the current economic slowdown in U.S. economic activity leading to a recession triggered a tactical defensive reallocation by investors out of riskier assets, producing a rally in bond markets. Credit spreads on U.S. high-yield corporate bonds widened from record tight levels, while the cost of insurance against bond defaults soared. The impact of these financial developments on real economic activity is not anticipated to disrupt aggregate demand provided financial markets continue to operate properly and liquidity is not impaired.

### U.S. mortgage market faces higher defaults...

In spite of the recent market disruption, financial conditions remain favorable, as historically low bond yields have lowered both business and consumer borrowing costs, positively influencing future spending plans. Declines in the average 30-year fixed mortgage rate to a three-month low and lower home prices have stabilized housing demand. The average rate on a 30-year fixed mortgage fell to 6.04%, a three month low, down from 6.29% at the end of January. Lower financing costs and a decline in existing home prices (median prices of existing homes fell 3.1% in January from a year ago) sent home sales up 3% in January to an annual rate of 6.46 million, a seven month high. Sales bottomed in September 2006 at an annual rate of 6.23 million and have

been consistently above that pace every month since. Although the demand side in housing is recovering, there still remains a glut of unsold homes. The inventory of unsold homes reached a six-year high of 3.86 million in July 2006. The stabilization in sales worked down inventories to 3.55 million by January. However, the oversupply of houses still has builders scaling back plans for new construction, which continues to weigh on economic growth. Residential construction fell at an annual rate of 19.1% in 4Q06, compared to a decline of 18.7% in 3Q06. The decline, the biggest since 1991, subtracted 1.2% from Q406 GDP growth.

Mortgage delinquencies are on the rise, predominantly among subprime borrowers, who generally have weaker credit profiles and accepted loan terms that kept initial rates extremely low for the first few years of the mortgage. These low adjustable rates are now adjusting to higher fixed rates as a result of a 425 bps increase in short-term rates by the Fed. As a result, subprime borrowers are having difficulty making the increased mortgage payments. It is estimated that subprime mortgages total \$1.2 trillion or 14.1% of an \$8.5 trillion mortgage market. Subprime delinquencies were 10.33% of the subprime loan market in December 2004. As of December 2006 they increased to 13.33%,



which still represented less than 2% of the total mortgage market. Delinquencies for the overall mortgage loan market were 4.95% in December 2006, slightly above the 4.38% rate in December 2004, while foreclosures amounted to 1.15%, on par with the December 2004 levels. Going forward, Lehman Brothers predicts that mortgage defaults over the next two years may climb to \$225-300 billion or 2.5-3.5% of the total mortgage market. According to debt strategists at Lehman it will probably be not enough to be a significant drag on the economy.

## Economy at a Glance

Recent growth indicators	Nov-06	Dec-06	Jan-07	Feb-07
ISM manufacturing	49.5	51.4	49.3	52.3
ISM non-manufacturing	58.9	57.1	59	54.3
U. of Michigan Consumer Confidence	92.1	96	96.9	91.3
Change in Payrolls (m-o-m, 000)	132	167	111	97
Personal Income (%m-o-m)	0.3	0.5	1	
Personal Spending (%m-o-m)	0.5	0.7	0.5	

Source: Bureau of Labor Statistics, ISM, Bloomberg

### ***Business inventories weigh on economic growth but consumers hang on...***

Similarly to a negative impact of housing on the GDP, an inventory overhang in manufacturing reduced economic growth. Companies added to inventories at an annual rate of \$17.3 billion in the past quarter of 2006, compared to a \$55 billion increase in Q306. The decrease subtracted 1.35% from Q4 2006 growth.

Overall, the U.S. economy grew at a less than previously estimated annual rate of 2.2% in Q406, compared with the 3.5% reported on January 31<sup>st</sup>. As housing and manufacturing are likely to weigh on growth as they work through the inventory-reduction phase, the bright spot continues to be the consumer sector. Consumer spending rose at an annual rate of 4.2% in Q406, after growing at a 2.8% rate in Q306. This momentum carried over into January as the healthy job market continued to boost wages. Incomes rose 1% leading to a 0.5% increase in spending.

## **GLOBAL EQUITIES**

### **U.S. Equities**

On February 27<sup>th</sup>, U.S. stocks had their worst one-day decline since March 2003 erasing all the year's gains and ending a streak of eight consecutive monthly gains. The plummet in equities began in China spurred by indications the Chinese government might approve legislation that would establish greater controls on investing. The selling quickly spread to both European and U.S. stock markets. Adding fuel to the selling in U.S. stocks were worries about U.S. economic growth as weaker than expected economic data coupled with remarks by former Fed Chairman Alan Greenspan of a possible recession later this year helped send the Dow Jones down 416 points or 3.3% for the day. This was the first daily loss of 2% or more since May 2003, the longest streak in more than a century. The Dow closed February off 2.52% and was down 1.15% YTD. The S&P 500 lost 50 points or 3.5% on February 27<sup>th</sup> and declined 1.96% and 0.48% for the month and YTD, respectively. Market volatility resurfaced this month after months of investor complacency. Stock market risk, as measured by the CBOE's Volatility index, the VIX, had averaged 12.63 over the past year, but surged 64% on February 27<sup>th</sup> reaching 18.31. This was the biggest daily surge ever, signaling volatility was back in play in U.S. equity markets. The small cap index, the Russell 2000, lost 0.79% in February, but was still up 0.87% YTD. Despite the widespread selling, the Russell Midcap index managed to turn out a slight gain of 0.16% for February and was up 3.55% YTD. Value stocks outpaced growth in February as the Russell 1000 Value index lost 1.56% vs. a decline of 1.88% for the Russell 1000 Growth index. However, on a YTD basis the Growth index was up 0.64% vs. Value's decline of 0.30%.

### **International Markets**

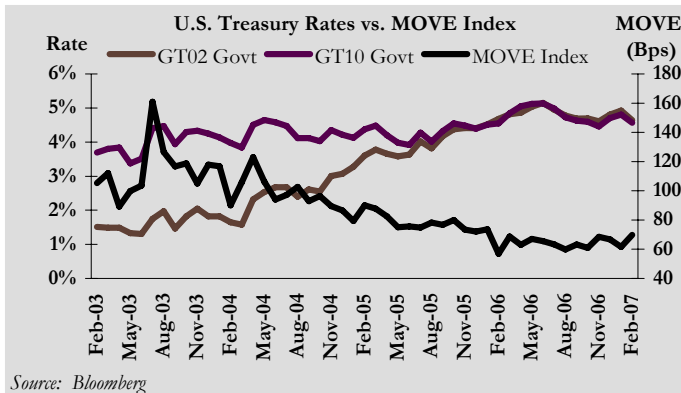
In response to the correction in global equity markets, the yen rose to an 11-week high against the dollar on February 27<sup>th</sup>, rising 2.3%, eventually closing February with a 1.8% gain as investors unwound positions in riskier assets they had purchased by borrowing in yen or other lower yielding currencies (the so called carry trade). For the month, the yen also advanced 1.7% against the euro, while the dollar declined 1.5% against the European currency.

European stocks fell from six-year highs in February, ending a streak of eight consecutive monthly gains. The MSCI Europe index had climbed 33% in USD from June 2006 lows, spurred by takeovers and strong corporate profit growth. The index dropped 2.42% on February 27<sup>th</sup>, sending the monthly return down to 0.35%, but maintained a slight gain of 0.25% YTD. Markets became overheated as much of the good news on economic and corporate profit growth had become reflected in stock prices. In fact, the price-to-earnings (P/E) ratio of the MSCI EAFE index rose 5% to a 9-month high on February 26<sup>th</sup>, selling at 17.09x 12-month trailing earnings, before settling at 16.31x earnings by the end of trading in February. In local currency, the MSCI EAFE lost 0.51% in February but gained 1.34% YTD, while on a USD basis the index gained 0.82% for the month and 1.51% YTD. The Nikkei 225 index rose 1.30% and 2.23% in local currency for the month and YTD, respectively. The strength in the yen further enhanced USD returns, with the index gaining 3.45% and 2.82% for the month and YTD respectively.

Emerging market stocks had enjoyed the largest run up of any other equity class off last year's June lows, with the MSCI Emerging Markets index surging 44% before the plunge in Chinese shares prompted a significant repricing in the sector. The Chinese Shanghai SE Composite shed 8.7% on February 27<sup>th</sup> on a USD basis, but still managed a gain of 3.85% and 8.60%, for the month and YTD, respectively. The MSCI Emerging Markets index gave back 3.07% on that day, leaving it with a loss of 0.58% and 1.61% on a USD basis for the month and YTD, respectively, on a USD basis.

## **GLOBAL FIXED INCOME**<sup>1</sup>

As equities lagged on a global basis, fixed income benefited from the "flight to safety." Investors poured money into U.S. Treasuries sending yields sharply lower. The spread between the two-year and 10-year Treasury yield was 11 basis points (bps) at the beginning of the year. However, the rally in Treasuries pushed the two-year, the coupon issue most sensitive to anticipated changes in Federal Reserve policy, 28 bps lower to yield 4.65% at February month end, narrowing the spread with the 10-year to 8 bps. The shrinking gap reflects growing expectations that the Fed could lower interest rates this year. On February 26<sup>th</sup>, Fed Fund were pricing in a 100% chance of a 25 bps rate cut by January 2008<sup>th</sup>. On February 28<sup>th</sup>, futures were pointing to virtual certainty of a cut by September 2007. The Merrill Lynch Master Treasury index gained 1.65% in February and was up 1.49% YTD. After three years of below average volatility within fixed income markets, volatility resurfaced over the final week of February. Prior to 2006, the Merrill Lynch MOVE<sup>®</sup> index, a measure of option volatilities on Treasuries maturing in two to 30-years, averaged 102 bps since its inception. From the start of 2006 through the end of February, the index averaged 65 bps, reaching 70 bps by the end of the month, the highest reading in 13 months. Investors sent U.S. corporate bond prices higher in February as well, producing lower yields and keeping credit spreads at historically low levels. The Lehman U.S. Corporate Investment Grade index yield declined 27 bps to 5.48%, sending credit spreads relative to Treasuries down to 89.9 bps, the lowest level since July 2005. In addition, the yield on the Lehman High Yield index dropped 17 bps to 7.45%, but spreads to Treasuries widened by 8 bps from January's tightest ever level up to 266 bps.



Source: Bloomberg

The Lehman U.S. Aggregate index gained 1.54% for the month and was up 1.50% YTD. The Lehman High Yield index gained 1.40% in February and rose 2.53% YTD.

Footnotes:

All data from Bloomberg except:  
1- Lehman Brothers

Asset Consulting Group, Inc.

Monthly Indices Report

Periods Ending February 28, 2007

Indices Report

Index Name	Style	Returns							
		Month	Qtr*	YTD	2 Qtrs	1 Year	3 Years	5 Years	10 Years
<b><u>Domestic Equity Indices</u></b>									
S&P 500	Large Cap Core	(1.96)%	0.91%	(0.48)%	8.92%	11.96%	9.09%	6.82%	7.63%
S&P Equal Weighted	Large Cap Core	(0.35)%	2.76%	2.02%	12.04%	13.34%	12.67%	11.84%	11.25%
Russell 1000	Large Cap Core	(1.72)%	1.46%	0.18%	9.68%	12.27%	9.85%	7.57%	8.00%
Russell 1000 Growth	Large Cap Growth	(1.88)%	0.98%	0.64%	9.54%	8.06%	6.16%	4.07%	4.87%
Russell 1000 Value	Large Cap Value	(1.56)%	1.93%	(0.30)%	9.81%	16.58%	13.49%	10.92%	10.28%
Russell Mid Cap	Mid Cap Core	0.16%	3.54%	3.55%	13.51%	13.66%	15.42%	14.05%	12.13%
Russell 2000	Small Cap Core	(0.79)%	1.20%	0.87%	10.76%	9.85%	11.94%	12.43%	9.58%
Russell 2000 Growth	Small Cap Growth	(0.32)%	1.29%	1.53%	11.18%	5.52%	9.24%	9.48%	5.43%
Russell 2000 Value	Small Cap Value	(1.23)%	1.12%	0.25%	10.37%	14.34%	14.53%	14.99%	13.02%
Wilshire 5000	Broad Equities	(1.58)%	1.46%	0.29%	9.89%	12.15%	10.24%	8.40%	8.13%
HFRI Equity Hedge	Long Short Equity	0.60%	3.23%	1.87%	7.46%	9.47%	9.56%	9.41%	13.13%
<b><u>International Equity Indices</u></b>									
MSCI World	Broad Global	(0.48)%	2.79%	0.71%	10.58%	16.42%	14.24%	11.53%	7.88%
MSCI EAFE	Developed Markets Intl	0.82%	4.70%	1.51%	12.27%	21.57%	19.53%	16.88%	8.43%
MSCI EAFE Growth	Developed Markets Intl Growth	0.78%	4.45%	1.60%	10.58%	18.74%	16.66%	13.94%	5.80%
MSCI EAFE Value	Developed Markets Intl Value	0.86%	4.95%	1.42%	13.92%	24.38%	22.36%	19.79%	10.90%
MSCI Emerging Markets Free	Emerging Market	(0.58)%	2.83%	(1.61)%	16.71%	17.39%	26.84%	25.31%	N/A
<b><u>Domestic Fixed Income Indices</u></b>									
Treasury Bills	Cash	0.38%	1.24%	0.79%	2.53%	5.00%	3.29%	2.53%	3.80%
Merrill Lynch 1-3 Yr Treasuries	Treasuries	1.00%	0.99%	1.14%	2.61%	4.91%	2.22%	3.23%	5.03%
Lehman Muni 5 Yr	5 Yr Municipal Bonds	0.90%	0.49%	0.69%	1.87%	3.62%	1.99%	3.62%	4.65%
Merrill Lynch High Yield	High Yield Bonds	1.39%	3.57%	2.45%	8.11%	11.87%	8.67%	10.47%	6.89%
Lehman Aggregate	Core Bonds	1.54%	0.91%	1.50%	3.66%	5.54%	3.56%	5.00%	6.33%
Lehman Government	Government Bonds	1.54%	0.72%	1.42%	3.17%	4.94%	2.99%	4.60%	6.13%
Lehman U.S. Credit Index	Corporate Bonds	2.02%	1.12%	2.00%	4.53%	6.10%	3.72%	5.98%	6.71%
Lehman Muni 10 Yr	10 Yr Municipal Bonds	1.41%	0.48%	0.95%	2.62%	4.73%	3.44%	4.97%	5.66%
HFRI FOF Conservative	Low Volatility	1.12%	3.82%	2.39%	6.24%	8.94%	6.82%	6.89%	N/A
<b><u>Real Estate Indices</u></b>									
NCREIF Property**	Real Estate	N/A	4.51%	0.00%	8.18%	16.59%	17.02%	13.04%	12.50%
NCREIF Classic Property**	Real Estate	N/A	4.02%	0.00%	7.67%	16.05%	16.70%	12.14%	12.35%
NAREIT Equity	Real Estate	(2.24)%	4.34%	5.99%	18.17%	31.04%	25.78%	24.11%	15.04%

\*Rolling 3 months ending January 31, 2007

\*\*For comparison purposes, prior quarter returns are used.

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European government bonds also rose amid the slump in global equities as the safety of the fixed income sector attracted investors. Euro two-year note yield fell 9 bps during the last week to 3.88%, the lowest level of the year. The Lehman Euro Treasury index gained 2.70% in February and was up 0.71% YTD on a USD basis. The JP Morgan Global Govt. Bond index rose 2.34% for the month and gained 1.02% YTD.

\*MOVE Index - Merrill Option Volatility Estimate. This a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the 2 yr, 5 yr, 10 yr and 30 yr Treasury option contract.