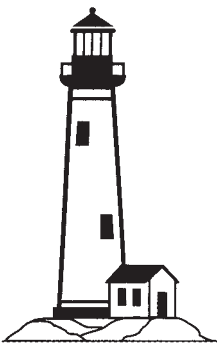

# Lighthouse Beacon

A Guide in the 21st Century

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## Lighthouse Investment Commentary

# Stocks Climb Higher Despite Familiar Worries

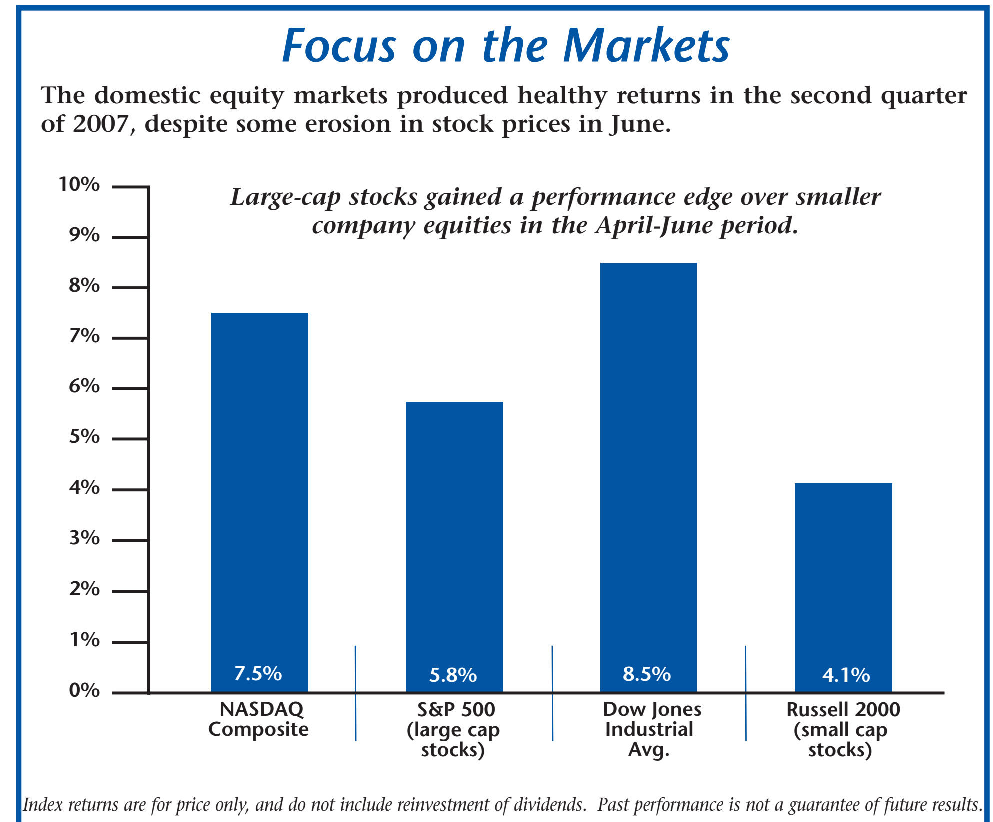
The stock market produced positive returns during 2007's second quarter, notwithstanding some erosion in prices in the final month. On a long road back from the previous peaks early in 2000, market index averages such as the Dow Jones Industrial Average and the Standard & Poor's 500 Composite Index reached all-time highs. It was not quite the same, though, for the more volatile and aggressive NASDAQ Index, which remained far behind its record peak.

While the quarter generated robust results overall, investors continued to climb the proverbial "wall of worry." April and May provided particularly positive backdrops for equities, but prices retreated in June when a variety of old, familiar worries weighed on investors' minds. During the final month of the quarter, interest rates kicked up sharply, resulting in declines in fixed income securities and in those stock sectors –such as the financials, utilities and real estate investment trust groups– considered interest-rate sensitive. Also bothering investors were concerns such as weakness in the housing market, subprime mortgage problems, rising gasoline prices and the potential risks from private equity and merger-and-acquisition activity. At the same time, speculation heightened about what the Federal Reserve Board might –or might not– do to interest rates.

In last quarter's ***"Lighthouse Guides"*** we discussed the issue of subprime mortgages and whether they posed a serious threat to the general economy. We concluded that the threat was limited, although the slump in the housing market would reduce overall growth of the economy. We believed that the greatest risks from subprime mortgages were to hedge funds and some mutual funds that owned debt instruments that had been packaged with subprime mortgages.

## Focus on the Markets

**The domestic equity markets produced healthy returns in the second quarter of 2007, despite some erosion in stock prices in June.**




*Index returns are for price only, and do not include reinvestment of dividends. Past performance is not a guarantee of future results.*

These risks came to fruition during the second quarter as two Bear Stearns hedge funds fell into serious trouble by using leverage to invest in pools of bonds tied to the subprime mortgage market. News of these problems exacerbated fears that interest rates would rise as a consequence or that a mini-bubble might be arising in the private-equity pools that also use leverage to fund equity investments and corporate buyouts. Private-equity buyouts may well persist because their investors see real value in the stocks of many companies. However, the recent poor performance of the well publicized initial public offering of the Blackstone Group, a private equity firm that uses leverage or borrowed funds to help finance deals, may well educate investors about the risks of such transactions. In addition, gyrating gasoline prices in front of the usual summer driving season and the ever-present fear of terrorist acts helped subdue the quarter's stock market rally, masking positive developments for the markets.

*Continued on back*

*The Lighthouse Beacon is a newsletter from Lighthouse Asset Management LLC, a registered investment advisor offering portfolio management services to individuals, trusts, retirement plans and small institutions. The views in the Lighthouse Beacon are those of the professional staff of Lighthouse Asset Management.*

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Economic growth, which had been slowing precipitously, may well have troughed in the first quarter and then begun to accelerate in the April-June period, despite the slump in housing. Consumers' income is rising and the most important inflation index followed by the Federal Reserve –the core Personal Consumption Expenditure (PCE) Index– came in at just 1.9% for May. That could indicate relaxing inflationary pressures. In the meantime, Wall Street has been relatively negative about corporate earnings for the second quarter, despite the presence of good evidence that the economy is re-accelerating and inflation is contained. It could be that second-quarter profits may surprise on the upside. In any case, we believe stock market valuations appear reasonable.

As we begin the second half of the year, we see enough confusion and worry to keep things somewhat volatile. In such an environment, it is important to step back from the day-to-day uncertainties and the mixed economic signals and try to determine the underlying direction of the market. In short, in a complicated environment, try to keep things simple. Too often, investors not only get caught up in short-term events, but they become unnecessarily influenced by labels such as "bulls" and "bears" and discussion about how long the economy and the markets have been in their current cycles.

We need to consider the overall picture. What makes a positive stock market environment? Usually, a favorable backdrop for investing in equities features the following key elements: a growing economy; rising corporate profits and dividends; contained inflation; interest rates that are not stifling growth; stock valuations that are not excessive; and a Federal Reserve Board that is not raising rates to contain inflation and restrict growth.

On the other side of the ledger are those factors that usually are present in a negative stock market environment: excessive growth that pressures supply and demand; accelerating inflation; sharply rising interest rates; stock prices that have risen rapidly in relation to actual business performance; and a Federal Reserve Board that is tightening the reins of the money supply and hiking interest rates to slow things down.

So, what do we have today? We have the ingredients for a positive environment. That does not mean we cannot have a market correction of 5% or even 10%. That is possible at any time. And it does not mean we cannot have some extraordinary event which rattles the confidence of the markets –that risk is always present. What it does mean is that the overall health and direction of the market continues to look positive.

No, we are not in the early stages of a new bull market. However, we certainly don't appear to be in the early stages of a new bear market. Let's forget the labels and look at the market for what it is: reasonably valued, with a good chance for reasonable –not spectacular– returns. Keep focused on our long-term investment goals and invest in quality stocks and fixed-income securities.

# *Lighthouse Guides*

***Q: As the bull market gets longer, are the risks rising that we may fall into a bear market soon?***

**A:** Not necessarily. As we mentioned in our general market commentary, investors often get caught up with labels and focus on the length of time of the most recent market cycle. But there are no set rules for either the duration or the total returns of any particular bear or bull market cycle. Take, for example, the bear market of 2000-2002 that came after the bursting of the dot.com bubble. The market slide was long and it was deep. In fact, prior to that slump, we hadn't had a three-year bear market since the Great Depression. Prior to 2000, we had enjoyed a long and a strong bull market.

Where are we today? Yes, we are in the fifth year of a bull market . . . if your definition of a bull market simply means a rising market. Remember, however, that while the market staged a strong rally in 2003 –the first year out of the bear market– we had only modest results in both 2004 and 2005. And while the markets did well last year, one would hardly call 2006's returns spectacular. Similarly, the major indexes rose by single-digit figures over the first half of this year. This is hardly a speculative bubble.

It has taken more than seven years for the Dow Jones and S&P indexes to break through their old highs from 2000. Don't forget that the NASDAQ Index, which was crushed in 2000-2002, still would have to almost double again to climb back to the level it reached in early 2000. Since 2002, corporate profits have risen sharply, but the major stock indexes have failed to keep pace with earnings growth. As a consequence, we have market valuations that are lower now than they were five years ago.

Our advice is to forget the labels and concentrate on the underlying fundamentals of the market and of the economy. Remember, over the long term, the stock market is up two-thirds of the time. This is why long-term investors usually win and short-term speculators often lose.

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