

INVESTMENT OUTLOOK

First Quarter Review and Outlook

by Whitney Brown

- Stock market in correction.
- Economy slowing.
- Interest rates stable.
- Conditions favor further market gains in near term.



After a strong start to the year, the stock market took a spill in late February. The market had gained steadily from last July's low with barely a pullback. An unexpected sell-off in the Chinese stock market provided the catalyst for a stiff round of

profit taking. Much of the damage had been repaired by quarter-end with major U.S. markets ending more or less flat for the quarter. In what has become a regular pattern, foreign stocks again out-gained U.S. shares by a healthy margin.

There is an ongoing debate over whether or not the February decline was the beginning of the end for this four-plus year bull run or simply an overdue correction in a healthy longer term uptrend. A number of sources have cited the potential for serious economic fallout from the problems in the sub-prime mortgage lending sector as well as the broader housing sector as reason for investors to reconsider attitudes about risk. As the stock market has worked its way higher over the past four years and the bond market has behaved well during that time, there is growing evidence that investors have become too complacent about market risks.

That may well be, and periodic market shakeouts are a necessary evil to keep excess speculation in check. With this particular market a check of the 'internals', objective indicators of the supply and demand for stocks in the market as a whole and across all issues traded, does not yet signal that this market is in trouble. Just as there are always leaders,

| <u>Market Measures</u> | <u>1st Quarter 2007</u> | | |
|-----------------------------------|-------------------------|-----------------|----------------|
| S & P 500 | 0.2% | | |
| Dow Jones Industrial Average | -0.9% | | |
| NASDAQ Composite | 0.3% | | |
| Russell 2000 | 1.7% | | |
| Morgan Stanley EAFE | 4.1% | | |
| Lehman Bros. Aggregate Bond Index | 1.5% | | |
| | <u>3/31/07</u> | <u>12/31/06</u> | <u>3/31/06</u> |
| 10-Year Treasury Bond Yield | 4.65% | 4.71% | 4.85% |
| Three-month Treasury Bill Yield | 5.04% | 5.02% | 4.63% |

there also are laggards, but for the typical stock the path of least resistance still appears to be up.

Digging a little deeper on the matter of supply and demand, research has demonstrated that in recent years corporate activities such as stock buybacks, mergers, acquisitions, private equity buyouts, and leveraged buyouts have had a significant limiting effect on the supply of stock on the market. Limiting supply serves to support prices. The downside is that much of this activity has been financed with debt. A sustained rise in interest rates or a severe recession could bring trouble since the amount of corporate debt relative to GDP has ballooned in the past decade.

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A Primer on Bond Ratings

by Watt Dixon



As most people know, any investment carries some down-side risk. Bonds, while generally thought of as a safer investment than stocks, have their own risk of loss as well. There are three main risks investors face when investing in bonds: interest rate risk, purchasing power risk, and credit or default risk. Interest rate risk is the risk that interest rates will rise causing a drop in the price of the bond. Purchasing power risk is the risk that inflation will rise and erode the value of the bond. These two types of risk are more macro in scale and will affect the bond market as a whole. The credit risk of a specific bond is a ranking of an issuer's ability to repay debts and to withstand various types of financial and economic stress compared to other issuers. Bond rating agencies assign ratings to bonds to aid investors in assessing the credit quality of different bond issues.

The main agencies that rate bonds are Moody's Investors Services, Standard and Poors, and Fitch IBCA. Moody's is the oldest rating service. Moody's was founded in 1909 by John Moody to rate railroad bonds. Today, Moody's has ratings on 90% of all public market bonds. All of these services rate bonds from AAA to D, with AAA being the highest and D showing the bond is in default.

Bonds are considered either investment grade or non-investment grade, depending on

how they are rated. In most instances, these different services will have the same bond rated very similarly. The financial health of any bond issuer can change. The bond rating agency will respond with either upgrades or downgrades to a bond's rating. Not surprisingly, a rating change can affect the price of the bond being upgraded or downgraded.

A bond issuer's cash flow has a very high correlation to its rating. Companies or municipalities that are cash rich are very likely to have a high credit ranking. In addition to cash flow and the issuer's overall financial strength, rating agencies examine an issuer's management and assess their ability to cope with competition and other business-specific risks. To a much lesser degree, the rating services also consider the general economic cycle in its ratings.

A bond issuer's rating is very important. The higher the rating an issuer receives, the less interest it must pay on its debt. Investors who buy bonds in a company or municipality with a low rating would need to be compensated with a higher interest rate because they are assuming more risk in dealing with a less stable entity.

In the corporate bond universe some AAA bonds include General Electric, United Parcel Service, Merck, and Johnson & Johnson. One small step down in ratings are the AA corporate bonds, which are very desirable bonds and according to S&P, "differ only slightly from the highest rated

obligations." Some AA issues include AT&T, Proctor & Gamble, Kimberly Clark, Motorola, JP Morgan, Dupont, and Eli Lilly. Single A corporate bonds are more susceptible to changing business and economic conditions. Their ability to repay their debts is only adequate. Consumer cyclical companies such as retailers are often are rated A. Financial companies are often rated single A as well because their profits are related to their loans which are affected by the up and down nature of the business cycle. BBB rated bonds are at the bottom of the "investment grade" category, just one notch above "not investment grade". These bonds are much more susceptible to changing economic conditions. Bonds rated BB and lower are considered speculative. The table on the following page summarizes the credit quality ratings of the three major rating agencies.

Municipal Bonds are rated by the rating services as well. Bonds issued by the state of Virginia carry the AAA rating. In addition to bonds issued by the state of Virginia, individual counties or municipalities will often issue bonds. These bonds will have their own rating. For example, a bond issued by a wealthier county, such as Fairfax, will usually carry a higher rating than that of a bond issued in one of the less affluent counties in the southwestern part of the state.

U.S. Treasury bonds are not rated. Assuming they are held to

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A Primer on Bond Ratings (continued)

| Bond Credit Quality Ratings | | | |
|---|------------------------|------------------------------|--------------|
| <u>Credit Risk</u> | <u>Rating Agencies</u> | | |
| | <u>Moody's</u> | <u>Standard & Poor's</u> | <u>Fitch</u> |
| <i>Investment grade</i> | | | |
| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| <i>Not investment grade</i> | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

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maturity, they are considered very safe investments. These bonds are backed by the federal government. Government-sponsored enterprise (GSE) bonds are bonds created by congress to provide credit to key sectors of the economy such as housing, agriculture and small business. The biggest issuers are The Federal National Mortgage Association (Fannie Mae), The Federal Home Loan Mortgage Corporation (Freddie Mac) , and The Federal Home Loan Bank System. These bonds have an “implied” AAA rating, but are not backed by the federal government. The yield on the GSE bonds will closely track the trend of treasury yields, but the GSE bonds will have a slightly higher yield due to the lack of guaranteed U.S. government backing.

Moody's, S&P, and Fitch supply investors with a lot of information as to the credit quality of bonds. There is no doubt that without these services, the bond market would be much more confusing and less efficient. However, as mentioned, credit risk is but one of the three main factors to consider when buying or selling bonds. Movement of interest rates, inflation, and each

individual's overall asset allocation and risk tolerance all should play into the bond selection process.

What's New at DHF&B

We have officially changed our name to Dixon, Hubard, Feinour & Brown, Inc. Whitney Brown became a principal of the firm several years ago, and we wanted our name to more accurately reflect his involvement. We used the name change as an opportunity to update our logo, as seen on the front and back pages of this newsletter. Also, our web address has changed to **www.dhfb.com**. Thus, the format of our e-mail address is now *lastname@dhfb.com*.

Our stationery has undergone a transformation to a brighter white paper. And we have re-designed our quarterly client reports to compliment the new logo and paper, using a crisper font and a more stylized look.

DIXON, HUBARD, FEINOUR & BROWN, INC. *investment counsel*

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First Quarter Review and Outlook (Continued)

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Looking ahead, it is clear that the economy is slowing. Few economic prognosticators are calling for recession as long as the housing and mortgage markets continue to show signs of stabilizing. The housing market correction may not have run its course, but as long as any further declines take place in an orderly fashion, we could see supply and demand come back in balance within several years.

The Federal Reserve is content to let things play out a while longer before adjusting short-term rates any further, up or down. There are justifiable concerns about inflation, but the softness in the economy may well take care of those fears. The combination of an increasingly global economy and productivity growth through ongoing technological innovation presents a very strong case against inflation running away in the longer term.

We expect market based interest rates like the yield on the ten-year Treasury note to remain within the

broad trading range of the past several years. There are few catalysts to drive rates substantially higher, and based on a historical perspective, not much reason to expect a significant decline from current levels.

Stocks can continue to work higher. This cyclical bull market is among the longest on record, but there is no requirement that it end at any particular time. Thanks to very strong corporate earnings and low interest rates over the past few years, P/E ratios are reasonable. Not cheap, but not too rich either. As long as the Fed doesn't see the need to put the screws to inflation with overly restrictive monetary policy, the market should hold up.

A flexible investment management style is especially useful at times like this when the next move is not entirely clear. Except at extremes, the best indicator of what the market is going to do is what it is doing. For now, the primary trend is up, and the collective intelligence of the market has likely accounted for the known hazards. We will remain alert to changing conditions and adjust our approach as necessary.