



# CAPITAL MANAGEMENT, LLC

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By Steven M. Sheldon, CFA

## About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



## About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

## Second Half Commentary 2007 Sign, Sign, Everywhere a Sign

Most economists and investment professionals rely heavily on a lengthy list of government-released statistics to evaluate the condition of the economy. One can also learn a lot about the economy, however, by making general observations in everyday life.

For example, if you get bad service everywhere you turn, then you know the job market is pretty tight – generally, full employment is a good thing for the economy. If you notice more “For Sale” and “Price-Reduced” signs on houses in the neighborhood, that means the housing market is softening – a negative for the economy. Lots of pick-up trucks and SUV’s still on the road despite skyrocketing oil and gasoline prices – consumers are not feeling the pinch yet. If you find that you and everyone you know starts and ends their day by “Googling” for up-to-the-minute Paris Hilton news - please let me know because it may be the end of the world as we know it!!

As we begin the second half of 2007, I believe that the economic indicators and everyday signs are all pointing to the same thing: Despite some soft spots, the U.S. economy keeps rolling along. While I expect more volatility in the months to come, the stock market should continue to hold up reasonably well in this environment and may finish the year even higher than where we are today.

## First Half Review

At the beginning of the year, my forecast called for a strong services sector to offset the weakness in housing and manufacturing, keeping the U.S. out of a recession in the near term. While the Q1 GDP came in at a meager 0.6% real growth, down from 2.5% in Q4 of 2006, it was still positive. The weakness in residential housing was largely to blame, but government and personal spending kept the economy expanding. For the most part, corporate profits continue to come in better than expected. In Q1, earnings rose a robust 8.7% over Q1 the prior year, surprising most analysts. In Q2, earnings forecast to grow 5.5% over the same quarter the prior year.

In spite of a mild stock market correction in the first quarter, the DJIA and S&P 500 have logged all time highs this year as investors cheered low interest rates, contained inflation, and solid corporate profits.

At the beginning of the year, my forecast was for the S&P 500 index to advance by about 9% (11% including dividends). As of June 15th, the S&P is already up 8.08% or 9% including dividends (just about at my year-end target).



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### Year-to-Date -2007 (Total Returns - Including Dividends)

Index	Total Return (%)*
S&P 500	9.00%
Nasdaq	10.76%
Russell 2000 (Small Cap)	8.15%
MSCI EAFE (International)	10.43%
Emerging Markets	15.05%
U.S. Bond Aggregate	0.05%

\*Returns through 6/15/2007

Returns in the first half of the year reflect a continuation of the second half of last year. International stocks maintained their leadership over U.S. stocks (aided by a weak U.S. dollar). Large cap stocks (represented in the chart above by the S&P 500) appear to have regained their footing and are besting small cap stocks. If large caps maintain their lead through the end of the year, it will be the first year in the last 8 years that large caps actually out-returned small caps!!

Bonds are struggling again as rising inflation expectations has pushed bond yields higher, hurting the price of bonds (due to the inverse relationship between yield and price). In fact, money market funds (whose NAV's do not fluctuate with interest rate movements) are currently outperforming most bonds funds.

### From Red to Yellow (to Green?)

After a pretty dismal performance in the first quarter, the U.S. economy showed signs of heating up in the second quarter. In fact, the ISM (Institute for Supply Management) surveys (which measure business activity for both the services and non-services economies) recorded the highest readings for May than at any other time in the last 12 months. In addition, the country's market remained strong with unemployment rate holding at a healthy 4.5%.

Despite this up-tick in growth, the slump in the housing markets and higher fuel costs continue to be a drag on consumers, hurting construction and retailing sectors more than others. In addition, the recent spike in bond yields has pushed mortgage rates up to their highest level in almost a year. Undoubtedly, tighter lending standards resulting from the subprime shakeout coupled with higher homeowner borrowing costs will delay the recovery in the housing and home building sector.



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The good news is that against this backdrop, it is hard to see a case where the Fed would raise short term rates. Should they do so, they risk throwing fuel on the fire and really dealing a knockout blow to consumers. Since mortgage rates and borrowing costs have moved higher on their own the need for additional action to keep the economy from overheating is ameliorated. **My guess is that the Fed will be on hold (keeping rates steady) for many months to come.**

### Market Valuation

Midway through the year and the S&P 500 is just a tad below my year-end target of 1550. The value of the S&P 500 is a function of earnings and the multiple at which those earnings are valued by the market. For the S&P 500 to make meaningful gains the second half of the year either earnings growth has to pick or multiples have to expand (or a combination of both). With earnings pressure likely to come from a variety of places including wage inflation, higher borrowing costs, and a decline in consumer spending, it is hard to paint a picture of significantly accelerating earnings growth the back half of the year. Rather, I think earnings growth of 6-9% over last year is more likely.

With regard to market multiples, I see both positive forces and negative forces impacting them in the near term. Stock buybacks, private equity buyouts, consistent earnings, and attractive valuations (especially of larger cap stocks comprising the S&P 500 index) all help drive up market multiples by increasing the demand (or reducing the supply) for stocks.

On the flip side, persistent inflationary pressures, higher interest rates, and slowing earnings growth all work to compress multiples. At present, the S&P 500 is valued at roughly 17x trailing operating earnings, reasonable for the current level of interest rates. **If multiples hold constant and earnings grow as expected, the S&P 500 could trade up to around 1600 (a 5.5% increase from today's levels) between now and the end of the year. With the Fed likely on hold, there is a decent likelihood of that playing out. However, I would expect more volatility to unfold along the way both on the upside and downside.**

### Portfolio Positioning

At the beginning of the year I recommended investors maintain their equity exposure "at or slightly above" targeted levels as I expected the market to continue its bull run. I encouraged investors, however, to take profits from mid and small cap positions and reallocate to the large caps. Large caps continue to



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offer a more appealing risk/return profile, especially at this stage of the business cycle. I would continue with that strategy as large caps, which have underperformed over the last several years, are showing signs of waking up. Furthermore, in a decelerating earnings environment, large caps should have better earnings visibility than smaller companies, making them less risky in a downturn.

I also warned that high yield bonds and REITs “appear overheated.” In fact, after a stellar multiyear run, REITS are finally showing signs of weakness. REITs are well off their highs with many having negative returns so far this year. I would expect this underperformance to continue. Despite the poor performance of bonds, investors should not abandon them as they serve a useful purpose of lowering volatility in a portfolio and smoothing out portfolio returns.

**Overall, I see this stock bull market in stocks extending into 2008. However, at that point, some big issues like the presidential election and the favorable tax treatment on stocks (15% tax rate on long term capital gains and qualified dividends is set to expire in 2010) will take center stage.**

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