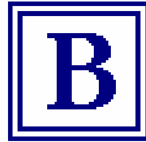

Baldwin Investment Management, LLC

MID–COURSE CORRECTION?

The second quarter of 2007 has seen the U.S. economy rebound more sharply from a rather desultory economic start to the year than many prognosticators had forecast. Because of weakening economic conditions caused by the deteriorating residential real estate market, the fixed income markets had anticipated that the Federal Reserve would begin to cut interest rates by the beginning of 2007's third quarter. However, the bond markets are recently acting like the Fed will not cut rates at all this year. The yield curve (i.e. interest rate levels from two years to thirty years) has gone from being inverted (with short rates higher than long ones, an unusual circumstance) to a more flat repose (with rates generally even across the spectrum). So, what is going on?

Throughout the second quarter of 2007, unemployment rates held quite steady between 4.4% and 4.5%. Historically, this is a very strong employment indicator and with residential construction mired in such doldrums, many seers have been surprised by such low unemployment levels. Some economists have suggested that teenagers have opted to remain in school for longer with the economic case of a better education having been well made over the last several decades. If one is not looking for a job, then one does not get counted in the unemployment roles. Also many who work in the residential construction business (i.e. electricians, plumbers, painters, etc.) seemingly have been able to readily find work outside of new housing developments – so the feared great unemployment rush from this sector has still not occurred. In fact, commercial construction has been very strong so it is quite easy to imagine a migration of talent from the residential arena to where jobs are still relatively plentiful.

With money in their pockets, consumers have continued to spend. Retail sales rose 1.4% in May. This followed a decline in "same-store" sales of 2.3% in April which followed a good March retail sales report. "Woe is me" to the pundit who proclaims the American consumer a "has been". For so long these naysayers have been wrong, wrong, wrong! As long as unemployment rates are low people will spend and as long as people spend, the U.S. economy will perk along.

Happily, it appears that American business of various shapes and forms is beginning to "shoulder some of the load" to keep the economy moving forward. The Index for Supply Management (ISM) rose to 55 in May from 54.7 in April. Any number above 50 signals that the economy is expanding and this particular number would suggest that American manufacturing is expanding. For the service index, the number jumped from 56 in April to May's 59.7, much stronger than expected. U.S. commerce is benefiting from a depreciated

dollar. (As a sidebar, if any of our readers have recently been to England or other parts of Europe, you will have had firsthand experience about how little a dollar can buy as compared to the recent past. A lower dollar is wonderful for exporters of goods and services – but not good for the importers!!) Exports of goods and services have grown strongly and the trade deficit has narrowed. For the first time in years, American companies are enjoying strong international business.

So, employment is strong, the consumer is continuing to spend money and U.S. business is benefiting from a weak dollar generating strong international sales. This, in turn, encourages American companies to spend money, offering further support to the U.S. economy. It all sounds almost too good. What about inflation? In fact, both the wholesale price index (PPI) and the consumer price index (CPI) have been steady to down over the last few months. In March, core (eliminates volatile food and energy prices) wholesale prices were flat (0%) and in May, they were +0.2% vs. an expectation of + 0.3%. The core CPI for March was +0.1% and in May it was also +0.1% - a still surprisingly good performance for some experts who had looked for much more inflation by this time of the economic expansion. Both the PPI and the CPI are very close to the Fed's target range and thus would suggest no reason for worry. There was one recent report that unit labor costs (i.e. costs per hour of labor and an important figure for the Fed) had increased 1.8% and that U.S. productivity had declined. This could be worrisome if it continues. But one data point does not create a statistical pool and it is too early to get concerned over a number which might be an outlier. Overall, inflation continues to be "well in hand".

As a result of the aforementioned, the Federal Reserve has not increased interest rates for some time after having raised them multiple times over a couple of years. The Fed funds rate stands at 5.25% - still a very low rate historically. By way of comparison, in Japan the central rate is 0.5% and in England the rate is at 5.5%. The European Central Bank has set its central rate at 4% - up recently from 3.75%. So what is the Fed going to do? This is the question!!!! The primary responsibility of the U.S. Federal Reserve Bank is price stability – i.e. deminimis inflation. Fed Chairman Ben Bernanke has spoken aloud that inflation measured between 1% and 2% would seem to fit the bill – not too little (deflation) and not too much (rampant inflation). We are close. A secondary concern of the Fed is full employment – at least according to some politicians and unfortunately no matter how independent the Fed seems to be from the political process, politicians appear to be able to influence the Fed's deliberations, if only subtly. Also on that score the American economy seems to be doing quite well, perhaps too well. An argument being floated today is that the Fed has the luxury of not having to cut interest rates because employment is so strong. Until inflation approaches the lower limits of the Fed's range, why should the Fed cut rates to spur the economy? It would be better for the Fed to err on the side of being conservative with regard to inflation and damp that ember a bit more. There is even some talk of increasing interest rates because the economy appears stronger than had earlier been supposed. We do not subscribe to the notion that interest rates are on their way up. We still believe that the next move will be down as what little inflation there is continues to ebb. The risk to our forecast of a second half cut in interest rates is that rates stay put for longer and the cut comes in 2008 and not in 2007. As long as we are right in the direction of the next rate move, we do not think that the markets will mind a little delay in the lowering of interest costs.

OTHER THOUGHTS

The “carry trade” (when investors borrow money in low yielding currencies and buy investments with significant leverage in high yielding markets) has gotten a lot of press and strategists worry about its unraveling. For the foreseeable future we think that “it is good to go” as the Japanese central bank continues to be reluctant to raise interest rates. The central bankers still worry about deflation. Even if the Japanese did increase rates 100%, the level would then be 1% - still very low.

The Middle East, oil and politics are all problematic. The “surge” in Iraq does not obviously seem to be working, but there is still time before the September “report card”. Russia flexes its new-found political muscles almost each and every day. Nigeria is a mess. Venezuela, while fast approaching an economic implosion according to the new head of the World Bank, likes to stir “troubled waters”. The price of oil now ranges between $60 to $70 per barrel and gasoline regularly is above $3 per gallon – all to no seemingly lasting economic effect in the U.S. So, Americans have become accustomed.

Mr. Blair is out in the U.K. Mr. Sarkozy is in, in France. Mrs. Merkel seems to be the leader for Europe at the moment. The political center is holding “fast”. Mr. Putin remains as popular as ever in Russia and loves tweaking the West. Next year Vladimir will be out of office – but the betting is he will not be far away and will continue to wield great power. In China, the politics still align with the “practical” and getting business done while retaining political power for the Party. A real focus for the leadership is the upcoming Olympics. Beijing will shine for this event.

The world is growing and in many parts, faster than the U.S. Investors should maintain their exposure to equities to whatever extent their risk tolerance allows them. Favored companies in any portfolio should be those with a significant percentage of their sales and profits coming from offshore. We believe that these will be the companies which will pleasantly surprise Wall Street and be rewarded with higher stock prices. As the world grows, demand for energy, materials and infrastructure will increase. The “new rich” are popping up all over the world – whether they are in Mumbai or Shanghai or Dubai. Companies with famous brands have already benefited from a surge in business and will continue to do so. Lastly, if private equity firms want to pay an extraordinary price to own a public company – by all means, let them do so. This is another reason why we want to own equity.

PREDICTIONS FOR 2007	COMMENTS
1. The dollar will slowly slide versus the Euro & Yen	Yes vs. the Euro – No vs. the Yen
2. The Fed will reduce interest rates in second half of 2007	Direction is down but timing could stretch into 2008
3. President Bush will become a dealmaker in working with Congress	Some evidence - but not much success
4. Oil prices will settle at “around” $60/BBL	Range of $60 - $70/BBL
5. Japan’s economy will continue to gather steam along with rest of the world	Yes
6. Inflation will not be a worry	Yes
7. The U.S. consumer will continue to spend	Yes
8. Corporations will spend more	Yes
9. Housing will stabilize in 1st half of 2007	Bottom is “Mushy”
10. The U.S. stock market will go up but not at the 2006 pace	Still believe

A FINAL THOUGHT

The opinions expressed in this Commentary are those of Baldwin Investment Management, LLC. These views are subject to change at any time based on market and other conditions, and no forecasts can be guaranteed.

The reported numbers enclosed are derived from sources believed to be reliable. However, we cannot guarantee their accuracy. Past performance does not guarantee future results.

A list of our Proxy voting procedures is available upon request.

A current copy of our ADV Part II is available upon request or at www.baldwinim.com/disclosure.htm 6/30/07