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Well, it was an interesting first quarter! Stock price indexes like the Dow and the S&P 500 rose fairly smoothly through January and most of February, then nosedived for a couple of weeks, but recovered starting mid-March. By quarter end, the Dow was down 0.87% year to date while the S&P 500 was up 0.18%. All this volatility was due to concerns over just about everything – recession, inflation, China, Iran, sub prime mortgages – you name it. However, at quarter end things still look pretty good to me.

The economy appears to be solid. Both consumer income and spending rose in January and February. Trade is finally turning with exports up 10.7% over the last 12 months vs. a 2.7% rise in imports. Housing has been a weak area, but that may be stabilizing with housing starts, existing home sales and home prices rising in February. However, new home sales remain shaky. Also, business capital spending has been soft, but I view that as reflecting continued company cost control, not a fundamental problem. The inflation rate that the Federal Reserve (the Fed) monitors (the core price index for personal consumption expenditures), is up 2.4% over the last 12 months, just a bit above their 1-2% "comfort zone". The bond market has been fairly quiet with 10-year Treasury note yields at 4.7% and, despite all the bad press over sub prime mortgages, the high yield (junk bond) index was a top fixed income performer over the first quarter.

One news item that has been gaining attention is a big increase in merger and acquisition (M&A) activity. One driver of this increase is the huge rise in financial assets on company balance sheets. According to the Fed, for total U.S. non-financial companies (leaving aside banks and the like) financial assets exceed liabilities by a whopping $1.2 trillion. This represents record low leverage, since this group of companies usually has net debt of between $500 billion and $1 trillion. So, these companies are carrying roughly $2 trillion less debt than is the norm. To put it in perspective, the total stock market value of this group of companies is about $11.5 trillion. They could put the $2 trillion of debt back on the balance sheet and buy back $2 trillion (17%) of their stock. And they are buying. In 2006, this group of companies did buy back a record $600 billion in stock, but without adding any net debt. Obviously, they could do a lot more stock buybacks and return to the historical capital structure. And this opportunity has attracted the attention of various M&A groups that specialize in restructuring company balance sheets.

I apologize for dragging you through this arcane accounting, but this is important because I think the current low leverage provides a strong foundation for the U.S. equity market going forward. All in all, 2007 is shaping up to be another positive year. As always, please call me with any questions or concerns.

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