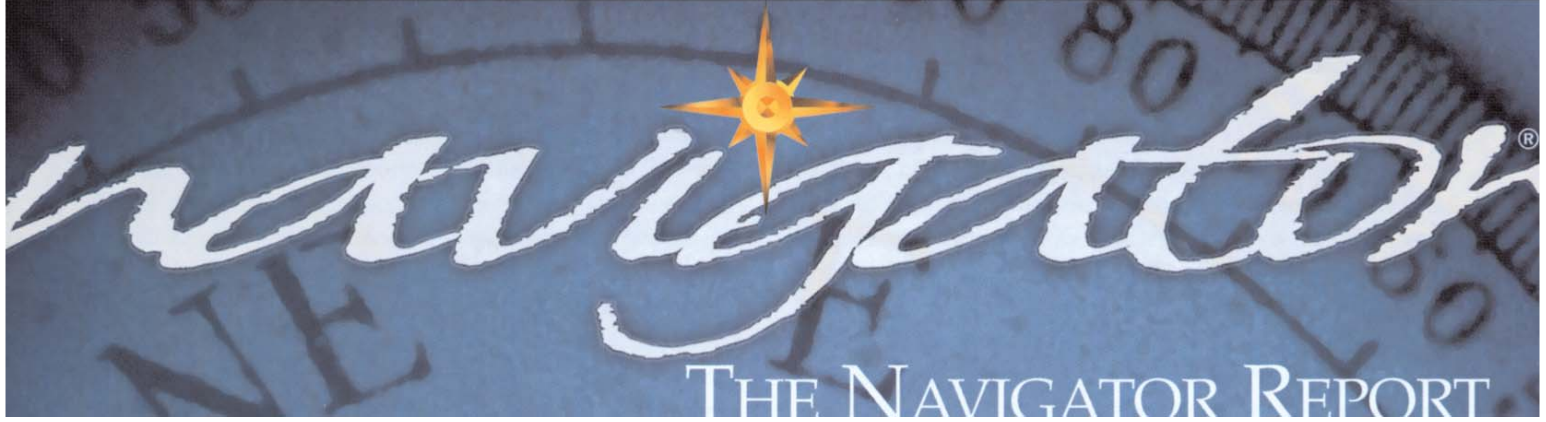
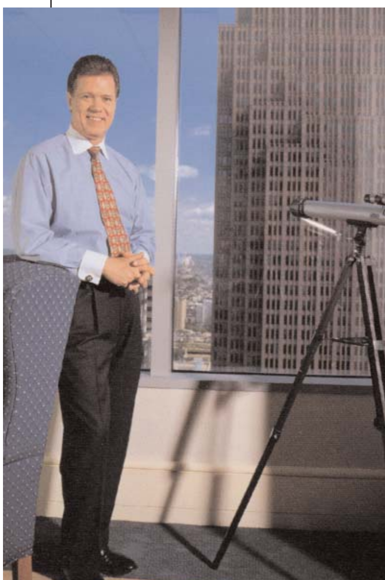


FIRST QUARTER 2007

Fooled Ya !!

Just when most investors were anticipating a good year: wham, three months of gains wiped out in one day and the market is still struggling. What happened? Well the cause officially has been laid at the feet of the Chinese. Their market declined 9% the previous evening, sending economic jitters around the world. A weak Durable Goods report, bad news on real estate loan delinquencies, and a report that Vice President Dick Cheney had been the target of a bomb in Afghanistan all helped rattle investors nerves as the market plunged 419 points. Of course, at the time no one noticed that the Chinese market had been up 31% for the year, but it was a handy excuse for the U.S. decline. In addition, Mr. Greenspan, the former Chairman of the Federal Reserve Board, said that corporate profits had likely peaked (nothing new here) and that the chance of a recession within a year was about 33% (here either). There were a few other minor news items to blame for the **419-point** decline but none of them really mattered one bit. **The fact of the matter is that the U.S. market had simply been stretched too far and needed a pull-back as I had stated two weeks earlier on CNBC.** It was interesting to watch the New York Stock Exchange try to blame the decline on a systems glitch that caused a

"Is the market correction over?" and "Will we be in recession before the year is over?"



HARRY J. CLARK, CFP PRESIDENT / CHIEF EXECUTIVE OFFICER

CCMG In The News

February 8th, 2007
CNBC "Power Lunch"
Harry Clark, CEO of Clark Capital Management Group explains to CNBC audiences that the market is overdue for a correction. A correction of 4 to 6% would be ideal at this time. However, it is possible that there will be a larger one later in the year, which is typical during a pre-election year.

March 9, 2007
CNBC "Squawk Box"
Chief Investment Officer, Sean Clark, reacts to the jobs report announcement on CNBC's "Squawk Box." He estimates 65,000 new jobs will be created. This number will not have a major impact on the market and he believes that inflationary pressures will ease over the next several months, possibly resulting in an interest rate cut by the Fed.

February 14th, 2007
CNNMoney.com
On this record day for the Dow, Harry Clark shares with readers of the online destination for financial news that inflation is pretty much contained. Federal Reserve Chairman Ben Bernanke's comments earlier in the day helped lead a rally for blue-chips.

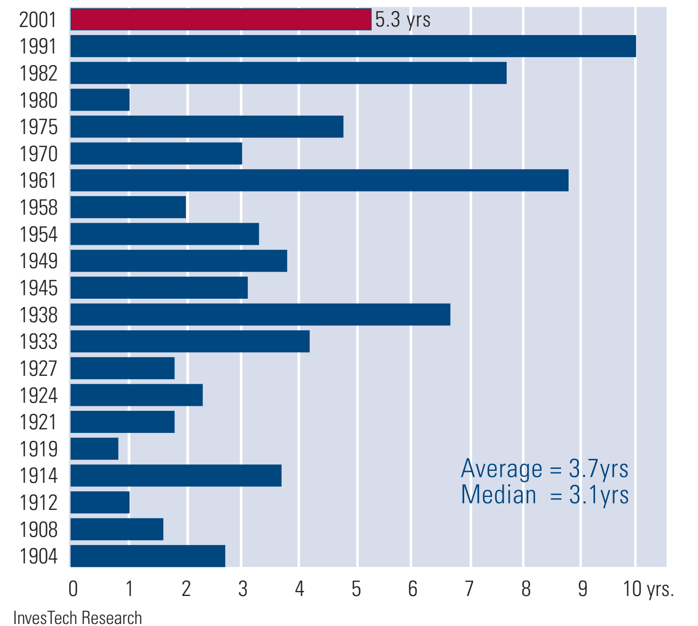
200-point plunge late in the day. If a glitch was a contributing cause on that 4.2 billion share, all-time record volume day, why was downside volume 99% of total volume on the NYSE and 98% on the NASDAQ? There were simply no buyers to be found and that is the one and only reason. The one-day, 419-point loss on the Dow was the eighth largest point loss in history and the 50-point loss on the S&P 500 was the eighth largest percentage loss since January 1, 2000 at 3.47%. **The correction was way overdue. There had not been a one-day 2% correction in the S&P 500 for the past 45 months – a record.** There have been, on average, six 2% one-day corrections per year over the past 25 years and in 2002 there were 30 of them. **This market is still the second longest in history without a 10% correction which means it is still pretty stretched.** Remember, 10% corrections normally happen about once a year. Correctionless markets breed complacency as do very low volatility markets. I believe we are entering a period of relatively high volatility, which will challenge many investors' patience.

The questions that must be answered are: **"Is the market correction over?" and "Will we be in recession before the year is over?"** A war of words, of sorts, has developed between Mr. Greenspan and Mr. Bernanke, the current Chairman of the Federal Reserve. On one hand, Mr. Greenspan says that corporate earnings have peaked for this expansion and the current economic expansion is getting old. Mr. Bernanke says that there is no reason the current expansion can't continue indefinitely. It's an interesting contrast; wonder who is right?

The "R" Word

This chart, from James Stack of InvesTech Research, shows the duration of economic recoveries over the last century.

As Mr. Greenspan has reminded us, "We are in the sixth year of a recovery; imbalances can emerge as a result. Ten-year recoveries have been part of a much broader global phenomenon. The historically normal business cycle is much shorter, and is likely to be this time."



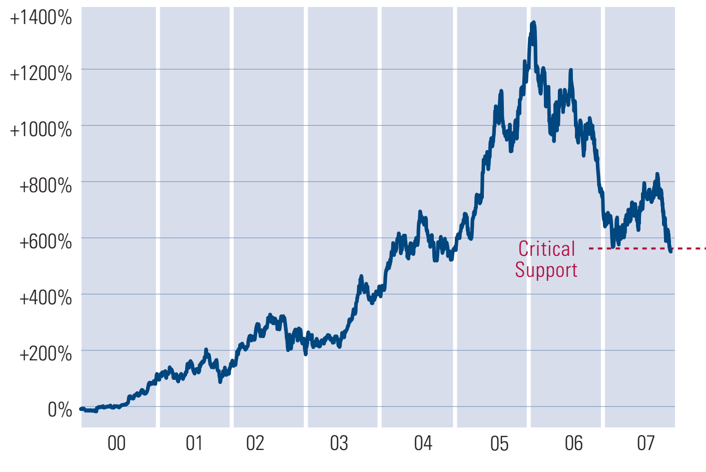
This recovery is already two years longer than the median recovery of the past 100 years. As you can see from the chart, only four recoveries have extended further than today's. Economic expansions are normally put to bed when a recession occurs. A recession is defined as two quarters of negative GDP growth. **I have been saying for several quarters that a slowdown is coming during this year, but I believed that we would escape a traditional recession by the skin of our teeth (see discussion on housing below).**

As you know from previous Navigator Reports, the Federal Reserve has increased interest rates two times or more on 14 occasions in their history and this has resulted in 12 recessions. That means that the Fed has engineered a "soft landing" in the economy following a heavy tightening bias twice before: in 1963-66 and 1994-95. This time last year most economists expected a soft landing once the current expansion was over but now they don't seem so sure. A recent poll found that three out of five people expected a recession within the next 12 months. If we do not have a recession, we will at least have a pullback in GDP. Projections for the first quarter have been revised downward to 1.6% and the full year is now expected to be at 2.2%. That would not by definition qualify as a "recession," but might it be enough of a pullback in the economy to allow this expansion to continue? Time and, I believe the housing situation, will tell! It is estimated that the housing slump has already taken 1.2% away from the GDP numbers.

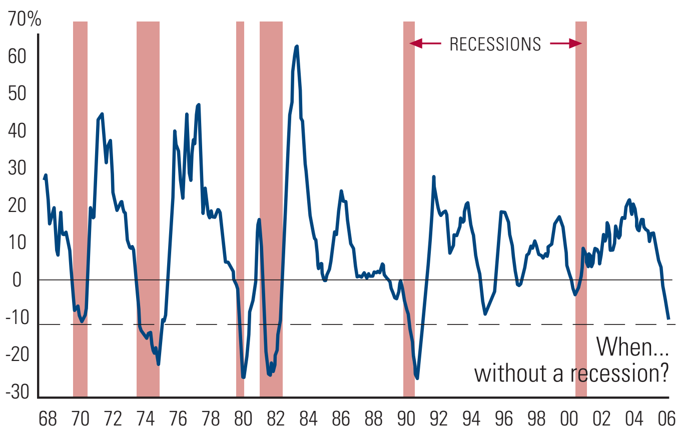
Between a Rock & a Hard Place

This old saying pretty much sums up the position that the Federal Reserve Board finds itself in today. On one hand, I believe that the FED would like to cut interest rates from the present 5.25% Federal Funds rate to stimulate the housing market. But, on the other hand, they also might have to raise it a notch to fight the old nemesis inflation. The charts opposite pretty much sum up the "Rock and a Hard Place."

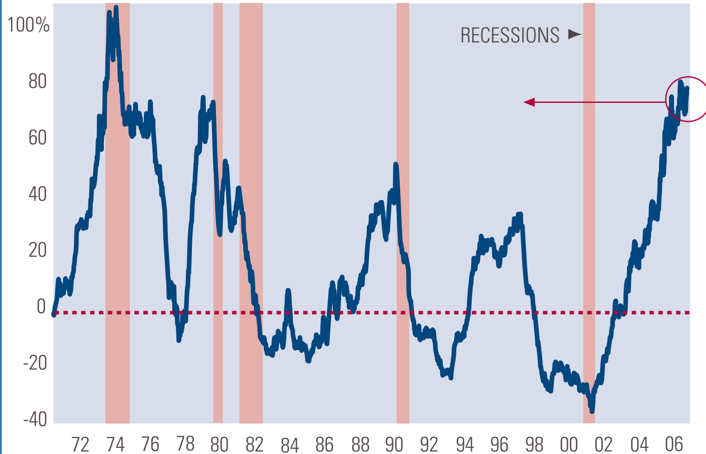
The one chart shows the Housing Bubble Bellwether Index developed by Jim Stack of InvesTech Research. This chart has been shown here before and has quite accurately reflected the plight of the housing market today. D.H Horton, the nation's largest homebuilder, reported a 37% decline in new home orders with a 41% decline in the value of those orders. This is not a good sign for the beginning of the crucial spring home building period and one might think that the Fed would like to lower rates to stem this slide.



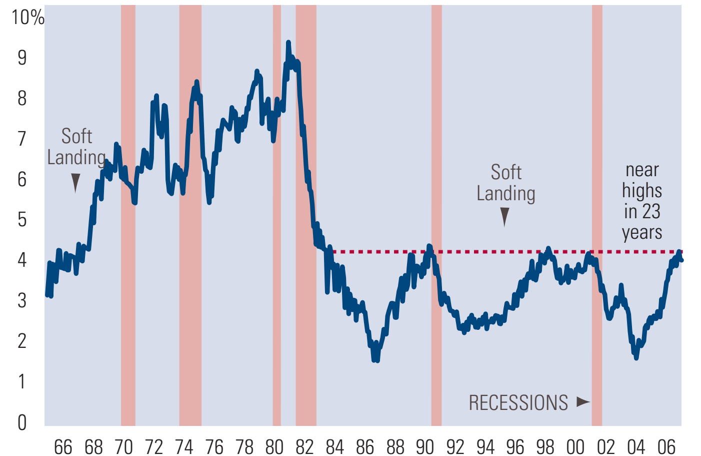
The chart below of Private Residential Construction shows that over the past 40 years there have been six slumps in residential construction, all leading to recession.



The next chart, also from InvesTech Research, shows the CRB Spot Price Index of commodities. Clearly in an inflationary bent.



Combine that with wage pressures, at near 23-year highs, **which have also caused six recessions over the past 40 years.**



The Big Question

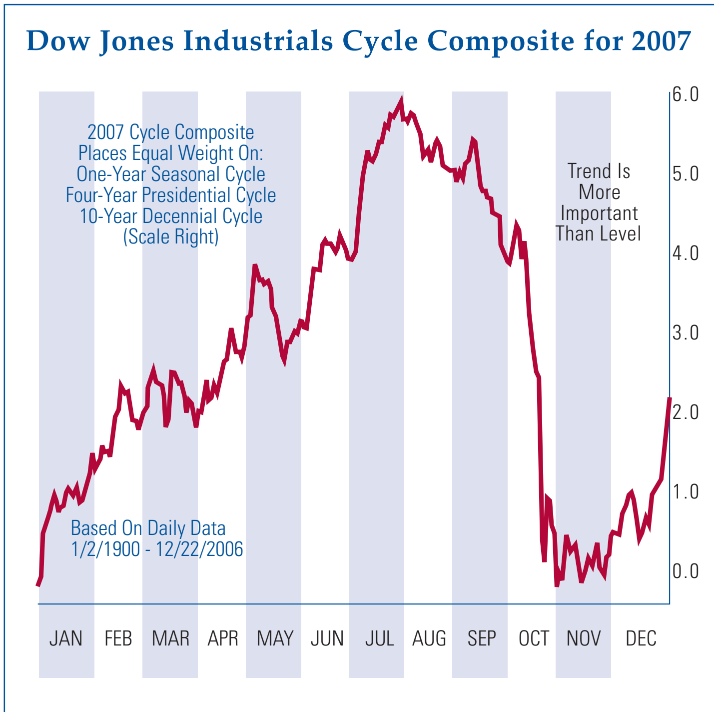
The question on everyone's mind is: **"What will the stock market do for the rest of the year?"**

Interestingly, almost every substantial correction over the past 50 years has occurred in the second year of the Presidential Election Cycle, which was last year. The exception was 1987, which was a pre-election year. We all remember what happened in 1987!!! Ned Davis Research has produced his cycle composite for the year and it was shown in the last newsletter. It is reproduced here because we cannot rule out the possibility of a substantial correction later this year, especially if the economy seems to be slipping into recession.

As stated earlier, the current stock market rally, as feeble as it has been, is now the second longest without a correction of at least 10%. The correction, which began on February 20 and included the 419-point decline, is now seven weeks old and has seen a maximum decline of 5.6% on the Dow. In my opinion, this correction has not been long enough or deep enough to sustain a serious upward movement over the rest of this year and into next year. **I would feel much more comfortable if we finally got that 10% correction to establish a base for advance.**

In addition, after 14 quarters of double-digit growth in corporate earnings, the fourth quarter of last year came in at 8.9% year-over-year and the estimate for the first quarter this year is 4.5% year-over-year.

On the positive side, P/E multiples are hovering near 10-year lows and stock market valuation models show that the stock market is 29% undervalued.



The spread between the S&P 500 Earning Yield and the 10-year Treasury Yield, which compares values for the stock and bond markets, favors stocks by almost 2%. This wide a discrepancy in yields has not been seen since the panic lows of 1979-80.

The job market has also remained healthy with 180,000 new jobs reported for March. The unemployment number is down to 4.4%. By its nature, you cannot have a recession with job growth present. So watch the job growth numbers for a hint of recession.

The one trump card in favor of the market staying healthy and the economy avoiding a recession is the simple fact that this is the pre-election year and next year is election year. It is almost, but not quite, unheard of for the economy to slip into recession during these two years. *These two years of the four-year Election Cycle are by far the strongest in terms of return with 75.5% of all stock market gains occurring during these two years over the past 175 years.* The average return over the four past pre-election years is **26%** and since the end of the Second World War the return has averaged 19%. Not bad!

The bottom line is keep the faith in the stock markets, at least for now. Let's hope that the Fed does indeed lower rates to stop the housing decline; let's trust that the sub-prime mortgage fever does not spread to the prime mortgage market; and let's trust that the U.S. economy is strong enough to avoid recession over the next months.

CCMG In The News

March 27, 2007
CNBC "Power Lunch"
Harry Clark, president and chief executive officer of Clark Capital Management Group joins CNBC's "Power Lunch" as a Market Maven. Mr. Clark shares that the average correction lasts nine to 12 weeks and we are currently in the 5th week of the correction. Harry also thinks that the Fed might make an earlier than expected interest rate cut.

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